COMMODITY FUTURES TRADING COMMISSION

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SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 230, 240 and 241

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Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping

AGENCIES: Commodity Futures Trading Commission; Securities and Exchange Commission.

ACTION: Joint final rule; interpretations; request for comment on an interpretation.

SUMMARY: In accordance with section 712(a)(8), section 712(d)(1), sections 712(d)(2)(B) and (C), sections 721(b) and (c), and section 761(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") (collectively, "Commissions"), in consultation with the Board of Governors of the Federal Reserve System ("Board"), are jointly adopting new rules and interpretations under the Commodity Exchange Act ("CEA") and the Securities Exchange Act of 1934 ("Exchange Act") to further define the terms "swap," "security-based swap," and "security-based swap agreement" (collectively, "Product Definitions"); regarding "mixed swaps;" and governing books and records with respect to "security-based swap agreements." The CFTC requests comment on its interpretation concerning forwards with embedded volumetric optionality, contained in Section II.B.2.(b)(ii) of this release.

DATES: Effective date: [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. Compliance date: The applicable compliance dates are discussed

in the section of the release titled "IX. Effective Date and Implementation". Comments on the interpretation regarding forwards with embedded volumetric optionality must be received on or before [INSERT DATE 60 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER].

ADDRESSES: You may submit comments, identified by RIN number 3038–AD46, by any of the following methods:

• *CFTC Web Site:* via its Comments Online process: http://comments.cftc.gov. Follow the instructions for submitting comments through the Web site.

• *Mail:* Address to David A. Stawick, Secretary of the Commission, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581.

• *Hand Delivery/Courier:* Same as mail above.

• *Federal eRulemaking Portal:* http://www.regulations.gov. Follow the instructions for submitting comments.

All comments must be submitted in English or, if not, accompanied by an English translation. Comments will be posted as received to http://www.cftc.gov. You should submit only information that you wish to make available publicly. If you wish the CFTC to consider information that is exempt from disclosure under the Freedom of Information Act, a petition for confidential treatment of the exempt information may be submitted according to the procedures established in § 145.9 of the CFTC's Regulations.[1]

The CFTC reserves the right, but shall have no obligation, to review, pre-screen, filter, redact, refuse or remove any or all of your submission from http://www.cftc.gov that it may deem to be inappropriate for publication, such as obscene language. All submissions that have been redacted or removed that contain comments on the merits of the interpretation will be

[1] 17 CFR 145.9.

retained in the public comment file and will be considered as required under the Administrative Procedure Act and other applicable laws, and may be accessible under the Freedom of Information Act.

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I. Background

On July 21, 2010, President Obama signed the Dodd-Frank Act into law.[2] Title VII of the Dodd-Frank Act[3] ("Title VII") established a comprehensive new regulatory framework for swaps and security-based swaps. The legislation was enacted, among other reasons, to reduce risk, increase transparency, and promote market integrity within the financial system, including by: (i) providing for the registration and comprehensive regulation of swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants; (ii) imposing clearing and trade execution requirements on swaps and security-based swaps, subject to certain exceptions; (iii) creating rigorous recordkeeping and real-time reporting regimes; and (iv) enhancing the rulemaking and enforcement authorities of the Commissions with respect to, among others, all registered entities and intermediaries subject to the Commissions' oversight.

Section 712(d)(1) of the Dodd-Frank Act provides that the Commissions, in consultation with the Board, shall jointly further define the terms "swap," "security-based swap," and "security-based swap agreement" ("SBSA").[4] Section 712(a)(8) of the Dodd-Frank Act provides

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[2] See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010). The text of the Dodd-Frank Act is available at http://www.cftc.gov/LawRegulation/OTCDERIVATIVES/index.htm.

[3] Pursuant to section 701 of the Dodd-Frank Act, Title VII may be cited as the "Wall Street Transparency and Accountability Act of 2010."

[4] In addition, section 719(d)(1)(A) of the Dodd-Frank Act requires the Commissions to conduct a joint study, within 15 months of enactment, to determine whether stable value contracts, as defined in section 719(d)(2) of the Dodd-Frank Act, are encompassed by the swap definition. If the Commissions determine that stable value contracts are encompassed by the swap definition, section 719(d)(1)(B) of the Dodd-Frank Act requires the Commissions jointly to determine whether an exemption for those contracts from the swap definition is appropriate and in the public interest. Section 719(d)(1)(B) also requires the Commissions to issue regulations implementing the determinations made under the required study. Until the effective date of such regulations, the requirements under Title VII do not apply to stable value contracts, and stable value contracts in effect prior to the effective date of such regulations are not considered swaps. See section 719(d) of the Dodd-Frank Act. The Commissions currently are conducting the required joint study and will consider whether to propose any implementing regulations

further that the Commissions shall jointly prescribe such regulations regarding "mixed swaps" as may be necessary to carry out the purposes of Title VII. In addition, sections 721(b) and 761(b) of the Dodd-Frank Act provide that the Commissions may adopt rules to further define terms included in subtitles A and B, respectively, of Title VII, and sections 721(c) and 761(b) of the Dodd-Frank Act provide the Commissions with authority to define the terms "swap" and "security-based swap," as well as the terms "swap dealer," "major swap participant," "security-based swap dealer," and "major security-based swap participant," to include transactions and entities that have been structured to evade the requirements of subtitles A and B, respectively, of Title VII.

Section 712(d)(2)(B) of the Dodd-Frank Act requires the Commissions, in consultation with the Board, to jointly adopt rules governing books and records requirements for SBSAs by persons registered as swap data repositories ("SDRs") under the CEA,[5] including uniform rules that specify the data elements that shall be collected and maintained by each SDR.[6] Similarly, section 712(d)(2)(C) of the Dodd-Frank Act requires the Commissions, in consultation with the Board, to jointly adopt rules governing books and records for SBSAs, including daily trading

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(including, if appropriate, regulations determining that stable value contracts: (i) are not encompassed within the swap definition; or (ii) are encompassed within the definition but are exempt from the swap definition) at the conclusion of that study.

5 7 U.S.C. 1 et seq.

6 The CFTC has issued final rules regarding SDRs and, separately, swap data recordkeeping and reporting. See Swap Data Repositories: Registration Standards, Duties and Core Principles, 76 FR 54538 (Sep. 1, 2011); Swap Data Recordkeeping and Reporting Requirements, 77 FR 2136 (Jan. 13, 2012). The SEC has also issued proposed rules regarding security-based swap data repositories ("SBSDRs"), including rules specifying data collection and maintenance standards for SBSDRs, as well as rules regarding security-based swap data recordkeeping and reporting. See Security-Based Swap Data Repository Registration, Duties, and Core Principles, 75 FR 77306 (Dec. 10, 2010); Regulation SBSR – Reporting and Dissemination of Security-Based Swap Information, 75 FR 75208 (Dec. 2, 2010).

records, for swap dealers, major swap participants, security-based swap dealers, and security-based swap participants.[7]

Under the comprehensive framework for regulating swaps and security-based swaps established in Title VII, the CFTC is given regulatory authority over swaps,[8] the SEC is given regulatory authority over security-based swaps,[9] and the Commissions shall jointly prescribe such regulations regarding mixed swaps as may be necessary to carry out the purposes of Title VII.[10] In addition, the SEC is given antifraud authority over, and access to information from,

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[7] The CFTC has issued final rules regarding recordkeeping requirements for swap dealers and major swap participants. See Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants, 77 FR 20128 (Apr. 3, 2012).

[8] Section 721(a) of the Dodd-Frank Act defines the term "swap" by adding section 1a(47) to the CEA, 7 U.S.C. 1a(47). This new swap definition also is cross-referenced in new section 3(a)(69) of the Exchange Act, 15 U.S.C. 78c(a)(69). Citations to provisions of the CEA and the Exchange Act, 15 U.S.C. 78a et seq., in this release refer to the numbering of those provisions after the effective date of Title VII, except as indicated.

[9] Section 761(a) of the Dodd-Frank Act defines the term "security-based swap" by adding new section 3(a)(68) to the Exchange Act, 15 U.S.C. 78c(a)(68). This new security-based swap definition also is cross-referenced in new CEA section 1a(42), 7 U.S.C. 1a(42). The Dodd-Frank Act also explicitly includes security-based swaps in the definition of security under the Exchange Act and the Securities Act of 1933 ("Securities Act"), 15 U.S.C. 77a et seq.

[10] Section 721(a) of the Dodd-Frank Act describes the category of "mixed swap" by adding new section 1a(47)(D) to the CEA, 7 U.S.C. 1a(47)(D). Section 761(a) of the Dodd-Frank Act also includes the category of "mixed swap" by adding new section 3(a)(68)(D) to the Exchange Act, 15 U.S.C. 78c(68)(D). A mixed swap is defined as a subset of security-based swaps that also are based on the value of 1 or more interest or other rates, currencies, commodities, instruments of indebtedness, indices, quantitative measures, other financial or economic interest or property of any kind (other than a single security or a narrow-based security index), or the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence (other than the occurrence, non-occurrence, or extent of the occurrence 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 condition, or financial obligations of the issuer).

certain CFTC-regulated entities regarding SBSAs, which are a type of swap related to securities over which the CFTC is given regulatory authority.[11]

To assist the Commissions in further defining the Product Definitions (as well as certain other definitions) and in prescribing regulations regarding mixed swaps as may be necessary to carry out the purposes of Title VII, the Commissions published an advance notice of proposed rulemaking ("ANPR") in the Federal Register on August 20, 2010.[12] The comment period for the ANPR closed on September 20, 2010.[13] The Commissions received comments addressing

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[11] Section 761(a) of the Dodd-Frank Act defines the term "security-based swap agreement" by adding new section 3(a)(78) to the Exchange Act, 15 U.S.C. 78c(a)(78). The CEA includes the definition of "security-based swap agreement" in subparagraph (A)(v) of the swap definition in CEA section 1a(47), 7 U.S.C. 1a(47). The only difference between these definitions is that the definition of SBSA in the Exchange Act specifically excludes security-based swaps (see section 3(a)(78)(B) of the Exchange Act, 15 U.S.C. 78c(a)(78)(B)), whereas the definition of SBSA in the CEA does not contain a similar exclusion. Instead, under the CEA, the exclusion for security-based swaps is placed in the general exclusions from the swap definition (see CEA section 1a(47)(B)(x), 7 U.S.C. 1a(47)(B)(x)). Although the statutes are slightly different structurally, the Commissions interpret them to have consistent meaning that the category of security-based swap agreements excludes security-based swaps.

[12] See Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 FR 51429 (Aug. 20, 2010). The ANPR also solicited comment regarding the definitions of the terms "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant," and "eligible contract participant." These definitions are the subject of a separate joint rulemaking by the Commissions. See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 FR 30596 (May 23, 2012) ("Entity Definitions Release"). The Commissions also provided the public with the ability to present their views more generally on implementation of the Dodd-Frank Act through their websites, dedicated electronic mailboxes, and meetings with interested parties. See Public Comments on SEC Regulatory Initiatives Under the Dodd-Frank Act/Meetings with SEC Officials, located at http://www.sec.gov/spotlight/regreformcomments.shtml; Public Submissions, located at http://comments.cftc.gov/PublicComments/ReleasesWithComments.aspx; External Meetings, located at http://www.cftc.gov/LawRegulation/DoddFrankAct/ExternalMeetings/index.htm.

[13] Copies of all comments received by the SEC on the ANPR are available on the SEC's Internet website, located at http://www.sec.gov/comments/s7-16-10/s71610.shtml. Comments are also available for website viewing and printing in the SEC's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of all comments received by the CFTC on the ANPR are available on the CFTC's Internet website, located at http://www.cftc.gov/LawRegulation/DoddFrankAct/OTC_2_Definitions.html.

the Product Definitions and/or mixed swaps in response to the ANPR, as well as comments in response to the Commissions' informal solicitations,[14] from a wide range of commenters. Taking into account comments received on the ANPR, the Commissions published a notice of proposed rulemaking in the Federal Register on May 23, 2011.[15] The comment period for the Proposing Release closed on July 22, 2011.[16] Together, the Commissions received approximately 86 written comment letters in response to the Proposing Release.

The Commissions have reviewed and considered the comments received, and the staffs of the Commissions have met with many market participants and other interested parties to discuss the definitions.[17] Moreover, the Commissions' staffs have consulted extensively with each other as required by sections 712(a)(1) and (2) of the Dodd-Frank Act and have consulted with staff of the Board as required by section 712(d) of the Dodd-Frank Act.

Based on this review and consultation, the Commissions are adopting rules and interpretations regarding, among other things: (i) the regulatory treatment of insurance products; (ii) the exclusion of forward contracts from the swap and security-based swap definitions; (iii) the regulatory treatment of certain consumer and commercial contracts; (iv) the regulatory treatment of certain foreign-exchange related and other instruments; (v) swaps and security-based swaps involving interest rates (or other monetary rates) and yields; (vi) total return swaps

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14 See supra note 12.

15 See Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 FR 29818 (May 23, 2011) ("Proposing Release").

16 Id.

17 Information about meetings that CFTC staff have had with outside organizations regarding the implementation of the Dodd-Frank Act is available at http://www.cftc.gov/LawRegulation/DoddFrankAct/ExternalMeetings/index.htm. Information about meetings that SEC staff have had with outside organizations regarding the product definitions is available at http://www.sec.gov/comments/s7-16-10/s71610.shtml#meetings.

("TRS"); (vii) Title VII instruments based on futures contracts; (viii) the application of the definition of "narrow-based security index" in distinguishing between certain swaps and security-based swaps, including credit default swaps ("CDS") and index CDS; and (ix) the specification of certain swaps and security-based swaps that are, and are not, mixed swaps. In addition, the Commissions are adopting rules: (i) to clarify that there will not be additional books and records requirements applicable to SBSAs other than those required for swaps; (ii) providing a mechanism for requesting the Commissions to interpret whether a particular type of agreement, contract, or transaction (or class of agreements, contracts, or transactions) is a swap, security-based swap, or both (i.e., a mixed swap); and (iii) providing a mechanism for evaluating the applicability of certain regulatory requirements to particular mixed swaps. Finally, the CFTC is adopting rules to implement the anti-evasion authority provided in the Dodd-Frank Act.

Overall Economic Considerations

The Commissions are sensitive to the costs and benefits of their rules. In considering the adoption of the Product Definitions, the Commissions have been mindful of the costs and benefits associated with these rules, which provide fundamental building blocks for the Title VII regulatory regime. There are costs, as well as benefits, arising from subjecting certain agreements, contracts, or transactions to the regulatory regime of Title VII.[18] Additionally, there are costs that parties will incur to assess whether certain agreements, contracts, or transactions are indeed subject to the Title VII regulatory regime, and, if so, the costs to assess whether such Title VII instrument is subject to the regulatory regime of the SEC or the CFTC.[19]

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[18] The Commissions refer to these costs and benefits as programmatic costs and benefits.

[19] The Commissions refer to these costs as assessment costs.

Title VII created a jurisdictional division between the CFTC and SEC. The costs and benefits flowing from an agreement, contract, or transaction being subject to the regulatory regime of the CFTC or the SEC may be impacted by similarities and differences in the Commissions' regulatory programs for swaps and security-based swaps. Title VII calls on the SEC and the CFTC to consult and coordinate for the purposes of assuring regulatory consistency and comparability to the extent possible.[20] Title VII also calls on the agencies to treat functionally or economically similar products or entities in a similar manner, but does not require identical rules.[21] Although the Commissions may differ on certain rulemakings, as the relevant products, entities and markets are different, the Commissions believe that, as the CFTC and SEC regulatory regimes share a statutory basis in Title VII, the costs and benefits of their respective regimes should be broadly similar and complementary.

In acknowledging the economic consequences of the final rules, the Commissions recognize that the Product Definitions do not themselves establish the scope or nature of those substantive requirements or their related costs and benefits. In determining the appropriate scope of these rules, the Commissions consider the types of agreement, contract, or transaction that should be regulated as a swap, security-based swap, or mixed swap under Title VII in light of the purposes of the Dodd-Frank Act. The Commissions have sought to further define the terms "swap," "security-based swap," and "mixed swap" to include agreements, contracts, and transactions only to the extent that capturing these agreements, contracts, and transactions is necessary and appropriate given the purposes of Title VII, and to exclude agreements, contracts, and transactions to the extent that the regulation of such agreements, contracts, and transactions

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[20] See sections 712(a)(1) and (a)(2) of the Dodd-Frank Act.

[21] See sections 712(a)(7)(A) and (B) of the Dodd-Frank Act.

does not serve the statutory purposes of Title VII, so as not to impose unnecessary burdens for agreements, contracts, and transactions whose regulation may not be necessary or appropriate to further the purposes of Title VII.

II. Scope of Definitions of Swap and Security-Based Swap

A. Introduction

Title VII of the Dodd-Frank Act applies to a wide variety of agreements, contracts, and transactions classified as swaps or security-based swaps. The statute lists these agreements, contracts, and transactions in the definition of the term "swap."[22] The statutory definition of the term "swap" also has various exclusions,[23] rules of construction, and other provisions for the interpretation of the definition.[24] One of the exclusions to the definition of the term "swap" is for security-based swaps.[25] The term "security-based swap," in turn, is defined as an agreement, contract, or transaction that is a "swap" (without regard to the exclusion from that definition for security-based swaps) and that also has certain characteristics specified in the statute.[26] Thus, the statutory definition of the term "swap" also determines the scope of agreements, contracts, and transactions that could be security-based swaps.

The statutory definitions of the terms "swap" and "security-based swap" are detailed and comprehensive, and the Commissions believe that extensive "further definition" of the terms by rule is not necessary. Nevertheless, the definitions could be read to include certain types of agreements, contracts, and transactions that previously have not been considered swaps or

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22 See CEA section 1a(47)(A), 7 U.S.C. 1a(47)(A). This swap definition is also cross-referenced in new section 3(a)(69) of the Exchange Act, 15 U.S.C. 78c(a)(69).

23 See CEA section 1a(47)(B), 7 U.S.C. 1a(47)(B), clauses (i)-(x).

24 See CEA sections 1a(47)(C)-(F), 7 U.S.C. 1a(47)(C)-(F).

25 See CEA section 1a(47)(B)(x), 7 U.S.C. 1a(47)(B)(x).

26 See section 3(a)(68) of the Exchange Act, 15 U.S.C. 78c(a)(68).

security-based swaps, and nothing in the legislative history of the Dodd-Frank Act appears to suggest that Congress intended such agreements, contracts, or transactions to be regulated as swaps or security-based swaps under Title VII. The Commissions thus believe that it is important to further clarify the treatment under the definitions of certain types of agreements, contracts, and transactions, such as insurance products and certain consumer and commercial contracts.

In addition, commenters also raised questions regarding, and the Commissions believe that it is important to clarify: (i) the exclusion for forward contracts from the definitions of the terms "swap" and "security-based swap;" and (ii) the status of certain commodity-related products (including various foreign exchange products and forward rate agreements) under the definitions of the terms "swap" and "security-based swap." Finally, the Commissions are providing interpretations related to the definitions.[27]

B. Rules and Interpretations Regarding Certain Transactions outside the Scope of the Definitions of the Terms "Swap" and "Security-Based Swap"

1. Insurance Products

The statutory definition of the term "swap" includes, in part, any agreement, contract or transaction "that provides for any purchase, sale, payment or delivery (other than a dividend on

[27] In response to the ANPR, some commenters raised concerns regarding the treatment of inter-affiliate swaps and security-based swaps. See, e.g., Letter from Edward J. Rosen, Cleary Gottlieb Steen & Hamilton LLP, Sep. 21, 2010 ("Cleary ANPR Letter"); Letter from Coalition for Derivatives End Users, Sep. 20, 2010 ("CDEU ANPR Letter"); Letter from Robert Pickel, Executive Vice President, International Swaps and Derivatives Association, Inc. ("ISDA"), Sep. 20, 2010; Letter from Richard A. Miller, Vice President and Corporate Counsel, Prudential Financial Inc., Sep. 17, 2010; Letter from Richard M. Whiting, The Financial Services Roundtable, Sep. 20, 2010. A few commenters suggested that the Commissions should further define the term "swap" or "security-based swap" to exclude inter-affiliate transactions. See Cleary ANPR Letter and CDEU ANPR Letter. The Commissions are considering whether inter-affiliate swaps or security-based swaps should be treated differently from other swaps or security-based swaps in the context of the Commissions' other Title VII rulemakings.

an equity security) that is 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."[28] As stated in the Proposing Release, the Commissions do not interpret this clause to mean that products historically treated as insurance products should be included within the swap or security-based swap definitions.[29] The Commissions are aware of nothing in Title VII to suggest that Congress intended for traditional insurance products to be regulated as swaps or security-based swaps. Moreover, the fact that swaps and insurance products are subject to different regulatory regimes is reflected in section 722(b) of the Dodd-Frank Act which, in new section 12(h) of the CEA, 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."[30] Accordingly, the Commissions believe that state or Federally regulated insurance

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[28] CEA section 1a(47)(A)(ii), 7 U.S.C. 1a(47)(A)(ii).

[29] See Proposing Release at 29821. The Commissions continue to believe that it was not the intent of Congress through the swap and security-based swap definitions to preclude the provision of insurance to individual homeowners and small businesses that purchase property and casualty insurance. See section 2(e) of the CEA, 7 U.S.C. 2(e), and section 6(l) of the Exchange Act, 15 U.S.C. 78f(l) (prohibiting individuals and small businesses that do not meet specified financial thresholds or other conditions from entering into swaps or security-based swaps other than on or subject to the rules of regulated futures and securities exchanges). Historically, insurance has not been regulated as such under the federal securities laws or under the CEA. See infra note 1283.

[30] 7 U.S.C. 16(h). Moreover, other provisions of the Dodd-Frank Act address the status of insurance more directly, and more extensively, than Title VII. For example, Title V of the Dodd-Frank Act requires the newly established Federal Insurance Office to conduct a study and submit a report to Congress, within 18 months of enactment of the Dodd-Frank Act, on the regulation of insurance, including the consideration of federal insurance regulation. Notably, the Federal Insurance Office's authority under Title V extends primarily to monitoring and information gathering; its ability to promulgate federal insurance regulation that preempts state insurance regulation is significantly restricted. See section 502 of the Dodd-Frank Act (codified in various sections of 31 U.S.C.). Title V also addressed non-admitted insurance and reinsurance. Title X of the Dodd-Frank Act also specifically excludes the business of insurance from regulation by the Bureau of Consumer Financial Protection. See section 1027(m) of the Dodd-Frank Act, 12 U.S.C. 5517(m) ("The [Bureau of Consumer Financial Protection] may not define as a financial product or service, by regulation or otherwise, engaging in the business of insurance."); section 1027(f) of the Dodd-Frank Act, 12 U.S.C. 5517(f) (excluding persons regulated by a state insurance regulator, except to the extent they are engaged in the offering or provision of

products that are provided by persons that are subject to state or Federal insurance supervision, that otherwise could fall within the definitions should not be considered swaps or security-based swaps so long as they satisfy the requirements of the Insurance Safe Harbor (as defined below). At the same time, however, the Commissions are concerned that certain agreements, contracts, or transactions that are swaps or security-based swaps might be characterized as insurance products to evade the regulatory regime under Title VII of the Dodd-Frank Act.

Accordingly, the Commissions are adopting final rules that (i) clarify that certain agreements, contracts, or transactions that satisfy the requirements of the Insurance Safe Harbor will not be considered to be swaps or security-based swaps, and (ii) provide an Insurance Grandfather exclusion from the swap and security-based swap definitions for any agreement, contract, or transaction entered into on or before the effective date of the Product Definitions, provided that, when the parties entered into such agreement, contract, or transaction, it was provided in accordance with the Provider Test (as defined below), including a requirement that an agreement, contract or transaction that is provided in accordance with the first prong of the Provider Test must be regulated as insurance under applicable state law or the laws of the United States.

The final rules contain four subparts: the first subpart addresses the agreement, contract, or transaction; the second subpart addresses the person[31] providing that agreement, contract, or

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consumer financial products or services or otherwise subject to certain consumer laws as set forth in Title X of the Dodd-Frank Act).

[31] In response to commenters, the Commissions are changing the word "company" from the proposal to "person." Each of the CEA, the Securities Act, and the Exchange Act contains a definition of a "person." See, e.g., Letter from Carl B. Wilkerson, Vice President & Chief Counsel, American Council of Life Insurers ("ACLI"), dated July 22, 2011 ("ACLI Letter") and Letter from John P. Mulhern, Dewey & LeBoeuf LLP ("D&L"), dated July 22, 2011 ("D&L Letter").

transaction; the third subpart includes a list of traditional insurance products that do not have to meet the requirements set out in the first subpart; and the fourth subpart contains the Insurance Grandfather exclusion (as defined below).

More specifically, with respect to the first subpart, the Commissions are adopting paragraph (i)(A) of rule 1.3(xxx)(4) under the CEA and paragraph (a)(1) of rule 3a69-1 under the Exchange Act (the "Product Test") as proposed, with certain modifications to respond to commenters' concerns. As adopted, the Product Test provides that the terms "swap" and "security-based swap" will not include an agreement, contract, or transaction that, by its terms or by law, as a condition of performance:

- Requires the beneficiary of the agreement, contract, or transaction to have an insurable interest that is the subject of the agreement, contract, or transaction and thereby carry the risk of loss with respect to that interest continuously throughout the duration of the agreement, contract, or transaction;
- Requires that loss to occur and be proved, and that any payment or indemnification therefor be limited to the value of the insurable interest;
- Is not traded, separately from the insured interest, on an organized market or over the counter; and
- With respect to financial guaranty insurance only, in the event of payment default or insolvency of the obligor, any acceleration of payments under the policy is at the sole discretion of the insurer.

The Commissions are also adopting paragraph (i)(B) of rule 1.3(xxx)(4) under the CEA and paragraph (a)(2) of rule 3a69-1 under the Exchange Act (the "Provider Test") as proposed, with certain modifications to respond to commenters' concerns. As adopted, the Provider Test

requires that an agreement, contract, or transaction that satisfies the Product Test must be provided:

- By a person that is subject to supervision by the insurance commissioner (or similar official or agency) of any state[32] or by the United States or an agency or instrumentality[33] thereof, and such agreement, contract, or transaction is regulated as insurance under applicable state law[34] or the laws of the United States (the "first prong");
- (i) Directly or indirectly by the United States, any state or any of their respective agencies or instrumentalities, or (ii) pursuant to a statutorily authorized program thereof ((i) and (ii) together, the "second prong"); or
- In the case of reinsurance only[35] by a person to another person that satisfies the Provider Test, provided that:

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32 The term "State" is defined in section 3(a)(16) of the Exchange Act, 15 U.S.C. 78c(a)(16), to mean "any State of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States." The CFTC is incorporating this definition into rule 1.3(xxx)(4) for purposes of ensuring consistency between the CFTC and SEC rules further defining the terms "swap" and "security-based swap."

33 For purposes of this release, the term "instrumentality" includes publicly supported, state operated or quasi-state operated insurance programs that may not be subject to state regulatory oversight, such as the Illinois Mine Subsidence Insurance Fund and the Florida Hurricane Catastrophe Fund.

34 For purposes of this release, the Commissions anticipate that the parties to an agreement, contract, or transaction will evaluate which state law applies prior to entering into such agreement, contract, or transaction. The Commissions do not anticipate that the parties' analysis of which state law applies will change as a result of the adoption of the Insurance Safe Harbor. In addition, the Commissions will analyze which state law applies (if necessary, in consultation with state insurance regulatory authorities) if and when such issues arise that the Commissions determine to address. The Commissions note that courts routinely determine what is the "applicable state law" when adjudicating disputes involving insurance.

35 For purposes of this release, the term "reinsurance" means the assumption by an insurer of all or part of a risk undertaken originally by another insurer.

(i) such person is not prohibited by applicable state law or the laws of the United States from offering such agreement, contract, or transaction to such person that satisfies the Provider Test;

(ii) the agreement, contract, or transaction to be reinsured satisfies the Product Test or is one of the Enumerated Products (as defined below); and

(iii) except as otherwise permitted under applicable state law, the total amount reimbursable by all reinsurers[36] for such agreement, contract, or transaction may not exceed the claims or losses paid by the cedant[37] ((i), (ii), and (iii), collectively, the "third prong"); or

- In the case of non-admitted insurance[38] by a person who:

(i) 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

(ii) meets the eligibility criteria for non-admitted insurers[39] under applicable state law ((i) and (ii) together, the "fourth prong").

In response to commenters' requests that the Commissions codify the proposed interpretation regarding certain enumerated types of traditional insurance products in the final

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36 For purposes of this release, the term "reinsurer" means any person who provides reinsurance.

37 For purposes of this release, the term "cedant" means the person writing the risk being ceded or transferred to a reinsurer.

38 For purposes of this release, the term "non-admitted insurance" means any property and casualty insurance permitted to be placed directly or through a surplus lines broker with a non-admitted insurer eligible to accept such insurance.

39 For purposes of this release, the term "non-admitted insurer" means, with respect to any State, an insurer not licensed to engage in the business of insurance in such State, but does not include a risk retention group, as that term is defined in section 2(a)(4) of the Liability Risk Retention Act of 1986, 15 U.S.C. 3901(a)(4).

rules,[40] the Commissions are also adopting paragraph (i)(C) of rule 1.3(xxx)(4) under the CEA and paragraph (a)(3) of rule 3a69-1 under the Exchange Act. In addition, in response to comments, the Commissions are expanding and revising the enumerated types of traditional insurance products. As adopted, the rule provides that the terms "swap" and "security-based swap" will not include an agreement, contract, or transaction that is provided in accordance with the Provider Test and is any one of the following (collectively, "Enumerated Products"): surety bonds; fidelity bonds; life insurance; health insurance; long-term care insurance; title insurance; property and casualty insurance; annuities; disability insurance; insurance against default on individual residential mortgages (commonly known as private mortgage insurance, as distinguished from financial guaranty of mortgage pools); and reinsurance (including retrocession) of any of the foregoing. The Commissions note that the inclusion of reinsurance (including retrocession) as an Enumerated Product is meant to apply to traditional reinsurance and retrocession contracts. Specifically, traditional reinsurance and retrocession contracts that reinsure risks ceded under traditional insurance products included in the Enumerated Product list and provided in accordance with the Provider test do not fall within the swap or security-based swap definitions. An agreement, contract, or transaction that is labeled as "reinsurance" or "retrocession", but is executed as a swap or security-based swap or otherwise is structured to evade Title VII of the Dodd-Frank Act, would not satisfy the Insurance Safe Harbor, and would be a swap or security-based swap.[41]

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40 See infra notes 88, 89, and 90 and accompanying text.

41 For example, if a person uses a weather derivative or catastrophe swap to assume all or part of the risks contained in a portfolio of property and casualty insurance policies, that weather derivative or catastrophe swap would be a Title VII instrument that is subject to regulation under Title VII.

In order for an agreement, contract, or transaction to qualify under the final rules as an insurance product that would not be a swap or security-based swap: (i) the agreement, contract, or transaction must satisfy the criteria in the Product Test or be one of the Enumerated Products and (ii) the person providing the agreement, contract or transaction must satisfy one prong of the Provider Test.[42] The fact that an agreement, contract, or transaction satisfies the Product Test or is one of the Enumerated Products does not exclude it from the swap or security-based swap definitions if it is not provided by a person that satisfies the Provider Test; nor does the fact that a product is provided by a person that satisfies the Provider Test exclude the product from the swap or security-based swap definitions if the agreement, contract, or transaction does not satisfy the criteria set forth in the Product Test or is not one of the Enumerated Products.[43]

Further, in response to commenters' concerns,[44] the Commissions are confirming that the Product Test, the Provider Test and the Enumerated Products represent a non-exclusive safe harbor. None of the Product Test, the Provider Test, or the Enumerated Products (collectively, the "Insurance Safe Harbor") implies or presumes that an agreement, contract, or transaction that does not meet any of their respective requirements is a swap or security-based swap. Such an

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[42] As was discussed in the Proposing Release, see Proposing Release at 29822 n. 31, certain variable life insurance products and annuities are securities and therefore are excluded from the swap and security-based swap definitions regardless of whether they meet the requirements under the final rules. See section 1a(47)(B)(v) of the CEA, 7 U.S.C. 1a(47)(B)(v). These securities would not be swaps or security-based swaps whether or not required to be registered under the Securities Act. See SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967) (holding that the accumulation provisions of a "flexible fund" annuity contract were not entitled to exemption under section 3(a)(8) of the Securities Act, 15 U.S.C. 77c(a)(8), for insurance and annuities); SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959) (holding that a variable annuity was not entitled to exemption under section 3(a)(8) of the Securities Act).

[43] For the purpose of determining whether an agreement, contract or transaction falls within the Insurance Safe Harbor, Title VII provides the Commissions with flexibility to address the facts and circumstances of new products that may be marketed or sold as insurance, through joint interpretations pursuant to section 712(d)(4) of the Dodd-Frank Act.

[44] See infra notes 178 and 179 and accompanying text.

agreement, contract, or transaction will require further analysis of the applicable facts and circumstances, including the form and substance of such agreement, contract, or transaction, to determine whether it is insurance, and thus not a swap or security-based swap.

However, future market conditions or other developments may prompt the Commissions to reconsider whether a particular product that satisfies the requirements of the Insurance Safe Harbor should instead fall within the swap or security-based swap definition. Because a determination that such a product is a swap or security-based swap could potentially have an unsettling effect on the domestic insurance or financial markets, the Commissions would only consider making a determination that such a product is a swap or security-based swap through a rulemaking[45] process that would provide market participants with an opportunity to comment.[46]

a) Types of Insurance Products

Final Rules

Product Test

The Commissions are adopting the Product Test as proposed, with certain modifications to respond to commenters' concerns. The Product Test sets forth four criteria for an agreement, contract, or transaction to be considered insurance. First, the final rules require that the beneficiary have an "insurable interest" underlying the agreement, contract, or transaction and thereby carry the risk of loss with respect to that interest continuously throughout the duration of the agreement, contract, or transaction. The requirement that the beneficiary be at risk of loss

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45 The Commissions can engage in rulemakings in a variety of ways including an advanced notice of proposed rulemaking, a notice of proposed rulemaking, or an interim final rule.

46 When determining whether a particular product is a swap or security-based swap instead of insurance, if such product does not meet the requirements set out in the Insurance Safe Harbor, the Commissions will consider prior regulation as an insurance contract as one factor in their respective facts and circumstances analysis.

(which could be an adverse financial, economic, or commercial consequence) with respect to the interest that is the subject of the agreement, contract, or transaction continuously throughout the duration of the agreement, contract, or transaction will ensure that an insurance contract beneficiary has a stake in the interest on which the agreement, contract, or transaction is written.[47] Similarly, the requirement that the beneficiary have the insurable interest continuously throughout the duration of the agreement, contract, or transaction is designed to ensure that payment on the insurance product is inextricably connected to both the beneficiary and the interest on which the insurance product is written. In contrast to insurance, a credit default swap ("CDS") (which may be a swap or a security-based swap) does not require the purchaser of protection to hold any underlying obligation issued by the reference entity on which the CDS is written.[48] One commenter identified the existence of an insurable interest as a material element to the existence of an insurance contract.[49] Because neither swaps nor security-based swaps require the presence of an insurable interest at all (although an insurable interest may sometimes be present coincidentally), the Commissions continue to believe that whether an insurable interest is present continuously throughout the duration of the agreement, contract, or transaction is a meaningful way to distinguish insurance from swaps and security-based swaps.

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47 Requiring that a beneficiary of an insurance policy have a stake in the interest traditionally has been justified on public policy grounds. For example, a beneficiary that does not have a property right in a building might have an incentive to profit from arson.

48 Standard CDS documentation stipulates that the incurrence or demonstration of a loss may not be made a condition to the payment on the CDS or the performance of any obligation pursuant to the CDS. See, e.g., ISDA, 2003 ISDA Credit Derivatives Definitions, art. 9.1(b)(i) (2003) ("2003 Definitions") (stating that "the parties will be obligated to perform . . . irrespective of the existence or amount of the parties' credit exposure to a Reference Entity, and Buyer need not suffer any loss nor provide evidence of any loss as a result of the occurrence of a Credit Event").

49 See D&L Letter.

Second, the requirement that a loss occur and be proved similarly ensures that the beneficiary has a stake in the insurable interest that is the subject of the agreement, contract, or transaction. If the beneficiary can demonstrate loss, that loss would "trigger" performance by the insurer on the agreement, contract, or transaction such that, by making payment, the insurer is indemnifying the beneficiary for such loss. In addition, limiting any payment or indemnification to the value of the insurable interest aids in distinguishing swaps and security-based swaps (where there is no such limit) from insurance.[50]

Third, the final rules require that the insurance product not be traded, separately from the insured interest, on an organized market or over the counter. As the Commissions observed in the Proposing Release, with limited exceptions,[51] insurance products traditionally have not been entered into on or subject to the rules of an organized exchange nor traded in secondary market transactions (i.e., they are not traded on an organized market or over the counter). While swaps and security-based swaps also generally have not been tradable at will in secondary market transactions (i.e., on an organized market or over the counter) without counterparty consent, the Commissions understand that all or part of swaps and security-based swaps are novated or assigned to third parties, usually pursuant to industry standard terms and documents.[52] In

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50 To the extent an insurance product provides for such items as, for example, a rental car for use while the car that is the subject of an automobile insurance policy is being repaired, the Commissions would consider such items as constituting part of the value of the insurable interest.

51 See, e.g., "Life Settlements Task Force, Staff Report to the United States Securities and Exchange Commission" ("In an effort to help make the bidding process more efficient and to facilitate trading of policies after the initial settlement occurs, some intermediaries have considered or instituted a trading platform for life settlements."), available at http://www.sec.gov/news/studies/2010/lifesettlements-report.pdf (July 22, 2010).

52 See, e.g., ISDA, 2005 Novation Protocol, available at http://www.isda.org/2005novationprot/docs/NovationProtocol.pdf (2005); ISDA, ISDA Novation Protocol II, available at http://www.isda.org/isdanovationprotII/docs/NPII.pdf (2005); 2003 Definitions, Exhibits E (Novation Agreement) and F (Novation Confirmation).

response to commenter concerns,[53] the Commissions are clarifying when assignments of insurance contracts and trading on "insurances exchanges" do not constitute trading the contract separately from the related insurable interest, and thus would not violate the Product Test. The Commissions do not interpret the assignment of an insurance contract as described by commenters[54] to be "trading" as that term is used in the Product Test.[55] Nor do the Commissions find that the examples of exchanges offered by commenters[56], such as Federal Patient Protection and Affordable Care Act "exchanges,"[57] are exchanges as that term is used in the Product Test, e.g., a national securities exchange or designated contract market. Mandated insurance exchanges are more like marketplaces for the purchase of insurance, and there is no trading of insurance policies separately from the insured interest on these insurance exchanges. Thus, the assignment of an insurance contract as permitted or required by state law, or the purchase or assignment of an insurance contract on an insurance exchange or otherwise, does not constitute trading an agreement, contract, or transaction separately from the insured interest and would not violate the trading restriction in the Product Test. For the foregoing reasons as clarified, the

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53 See infra notes 74 and 75 and accompanying text.

54 See, e.g., Letter from Kim O'Brien, President & CEO, National Association for Fixed Annuities ("NAFA"), dated July 21, 2011 ("NAFA Letter"); Letter from Robert Pickel, Executive Vice Chairman, ISDA, dated July 22, 2011 ("ISDA Letter"); ACLI Letter; and Letter from Letter from Stephen E. Roth, Frederick R. Bellamy and James M. Cain, Sutherland Asbill & Brennan LLP on behalf of the Committee of Annuity Insurers ("CAI"), dated July 22, 2011 ("CAI Letter").

55 The assignment of the benefits or proceeds of an insurance contract by an owner or beneficiary does not violate the trading restriction in the Product Test. This interpretation does not extend to "stranger originated" products. The transfer of obligations for policyholder benefits between two insurance companies, such as would occur in connection with an insurance company merger or acquisition, also does not violate the trading restriction contained in the Product Test.

56 See Letter from Susan E. Voss, Commissioner Iowa Insurance Division & National Association of Insurance Commissioners ("NAIC") President, and Therese M. Vaughan, NAIC Chief Executive Officer, dated July 22, 2011 ("NAIC Letter").

57 See Patient Protection and Affordable Care Act; Establishment of Exchanges and Qualified Health Plans, 76 FR 41866 (Jul. 15, 2011) (proposed).

Commissions continue to believe that lack of trading separately from the insured interest is a feature of insurance that is useful in distinguishing insurance from swaps and security-based swaps.

Fourth, the final rules provide that in the case of financial guaranty insurance policies, also known as bond insurance or bond wraps, any acceleration of payment under the policy must be at the sole discretion of the provider of the financial guaranty insurance policy in order to satisfy the Product Test.[58] Although such products can be economically similar to products such as CDS, they have certain key characteristics that distinguish them from swaps and security-based swaps.[59] For example, under a financial guaranty policy, the insurer typically is required to make timely payment of any shortfalls in the payment of scheduled interest to the holders of the underlying guaranteed obligation. Also, for particular bonds that are covered by a financial guaranty policy, the indenture, related documentation, and/or the financial guaranty policy will provide that a default in payment of principal or interest on the underlying bond will not result in acceleration of the obligation of the insurer to make payment of the full amount of principal on the underlying guaranteed obligation unless the insurer, in its sole discretion, opts to make payment of principal prior to the final scheduled maturity date of the underlying guaranteed

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58 Financial guarantee policies are used by entities such as municipalities to provide greater assurances to potential purchasers of their bonds and thus reduce their interest costs. See "Report by the United States Securities and Exchange Commission on the Financial Guarantee Market: The Use of the Exemption in section 3(a)(2) of the Securities Act for Securities Guaranteed by Banks and the Use of Insurance Policies to Guarantee Debt Securities" (Aug. 28, 1987).

59 See, e.g., Letter from Sean W. McCarthy, Chairman, Association of Financial Guaranty Insurers on the ANPR, dated Sept. 20, 2010 (explaining the differences between financial guaranty policies and CDS); Letter from James M. Michener, General Counsel, Assured Guaranty on the ANPR, dated Dec. 14, 2010 (noting that the Financial Accounting Standards Board has issued separate guidance on accounting for financial guaranty insurance and CDS); Letter from Ernest C. Goodrich, Jr., Managing Director—Legal Department, Deutsche Bank AG on the ANPR, dated Sept. 20, 2010 (noting that financial guaranty policies require the incurrence of loss for payment, whereas CDS do not).

obligation. Conversely, under a CDS, a protection seller frequently is required to make payment of the relevant settlement amount to the protection buyer upon demand by the protection buyer after any credit event involving the issuer.[60]

As noted in the Proposing Release, the Commissions do not believe that financial guaranty policies, in general, should be regulated as swaps or security-based swaps. However, because of the close economic similarity of financial guaranty insurance policies guaranteeing payment on debt securities to CDS, in addition to the criteria noted above with respect to insurance generally, the final rules require that, in order to satisfy the Product Test, financial guaranty policies also must satisfy the requirement that they not permit the beneficiary of the policy to accelerate the payment of any principal due on the debt securities. This requirement further distinguishes financial guaranty policies from CDS because, as discussed above, the latter generally requires payment of the relevant settlement amount on the CDS after demand by the protection buyer.

Finally, in response to comments,[61] the Commissions are clarifying that reinsurance and retrocession transactions fall within the scope of the Product Test. The Commissions find that these transactions have insurable interests, as the Commissions interpret such interests in this context, if they have issued insurance policies covering the risks that they wish to insure (and reinsure). Moreover, the Commissions find that retrocession transactions are encompassed within the Product Test and the Provider Test because retrocession is reinsurance of reinsurance

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60 While a CDS requires payment in full on the occurrence of a credit event, the Commissions recognize that there are other financial instruments, such as corporate guarantees of commercial loans and letters of credit supporting payments on loans or debt securities, that allow for acceleration of payment obligations without such guarantees or letters of credit being swaps or security-based swaps.

61 See infra note 105 and accompanying text.

(provided the retrocession satisfies the other requirements of both tests). In addition, reinsurance (including retrocession) of certain types of insurance products is included in the list of Enumerated Products.[62]

Requiring all of the criteria in the Product Test will help to limit the application of the final rules to agreements, contracts, and transactions that are appropriately regulated as insurance, and help to assure that agreements, contracts, and transactions appropriately subject to the regulatory regime under Title VII of the Dodd-Frank Act are regulated as swaps or security-based swaps. As a result, the Commissions believe that these requirements will help prevent the final rules from being used to circumvent the applicability of the swap and security-based swap regulatory regimes under Title VII.

Enumerated Products

In the Proposing Release, the Commissions proposed an interpretation that certain enumerated types of insurance products would be outside the scope of the statutory definitions of swap and security-based swap under the Dodd-Frank Act if provided in accordance with the Provider Test and regulated as insurance. Based on comments received,[63] the Commissions are adding three products to the list of products as proposed (fidelity bonds, disability insurance and insurance against default on individual residential mortgages), adding reinsurance (including retrocession) of any of the traditional insurance products included in the list, deleting a requirement applicable to annuities, and codifying the Enumerated Products in the final rules. The revised list of Enumerated Products is: surety bonds, fidelity bonds, life insurance, health insurance, long-term care insurance, title insurance, property and casualty insurance, annuities,

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62 See supra note 41 and accompany text.

63 See infra notes 93 and 94 and accompanying text.

disability insurance, insurance against default on individual residential mortgages (commonly known as private mortgage insurance, as distinguished from financial guaranty of mortgage pools), and reinsurance (including retrocession) of any of the foregoing.[64] The Commissions believe that the Enumerated Products, as traditional insurance products, are not the types of agreements, contracts, or transactions that Congress intended to subject to the regulatory regime for swaps and security-based swaps under the Dodd-Frank Act. Codifying the Enumerated Products in the final rules appropriately places traditional insurance products outside the scope of the swap and security-based swap definition so long as such Enumerated Products are provided in accordance with the Provider Test, including a requirement that an Enumerated Product that is provided in accordance with the first prong of the Provider Test must be regulated as insurance under applicable state law or the laws of the United States.

Comments

Insurable Interest

Six commenters objected to the requirement in the Product Test that the beneficiary have an insurable interest continuously throughout the duration of the contract.[65] These commenters noted that, under state law, an insurable interest may not always be required to be present continuously throughout the duration of the policy. For example, commenters noted that life insurance may only require an insurable interest at the time the policy is executed;[66] and some

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64 See supra note 41 and accompanying text.

65 See ACLI Letter; CAI Letter; ISDA Letter (objecting to the requirement that the risk of loss be held continuously throughout the contact); NAFA Letter; NAIC Letter; and Letter from Kenneth F. Spence III, Executive Vice President & General Counsel, The Travelers Companies, Inc. ("Travelers"), dated Nov. 14, 2011 ("Travelers Letter").

66 See ACLI Letter; CAI Letter; ISDA Letter; NAIC Letter; and Travelers Letter. The Commissions understand that some states may define what constitutes an insurable interest with

property and casualty or liability insurance may only require an insurable interest at the time a loss occurs.[67] Commenters also noted that annuities and health insurance do not require the existence of an insurable interest at all.[68] Another commenter suggested that the Commissions modify the Product Test to indicate that annuities would not need to satisfy the "insurable interest" component, or to use terminology other than insurable interest to make clear that annuities are not swaps.[69]

As discussed above, the Commissions are retaining the insurable interest requirement of the Product Test. The Commissions continue to believe that this requirement is a useful tool to distinguish insurance from swaps and security-based swaps, because swaps and security-based swaps do not require the presence of an insurable interest (or require either counterparty to bear any risk of loss) at any time during the term of the agreement, contract, or transaction. While the Commissions acknowledge commenters who argued that products such as life insurance, property and casualty insurance, and annuities may fail the Product Test because of the insurable interest requirement, the Commissions do not interpret any such failure to mean that life insurance, property and casualty insurance, and annuities are not insurance products. To the contrary, as discussed above, these products are included in the list of Enumerated Products that are excluded from the swap and security-based swap definitions so long as they are provided in

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reference to personal or emotional consequence in addition to the financial, economic, or commercial consequence mentioned in the statutory swap definition.

67 See NAIC Letter and Travelers Letter. However, one commenter noted that the Product and Provider Tests, as proposed, should be an effective means of helping to distinguish between those contracts that qualify for exclusion from the definition of swap and security-based swap from those contracts that will not. See Letter from Michael A. Bell, Senior Counsel, Financial Policy, The Property Casualty Insurers Association of America, dated July 22, 2011.

68 See CAI Letter; ISDA Letter; NAFA Letter; and NAIC Letter.

69 See Letter from Nicholas D. Latrenta, Executive Vice President and General Counsel, Metropolitan Life Insurance Companies and its insurance affiliates ("MetLife"), dated July 22, 2011 ("MetLife Letter").

accordance with the Provider Test. If a life insurance, property and casualty insurance, or annuity is provided in accordance with the Provider Test, such product is not a swap or security-based swap, whether or not an insurable interest is present at all times during the term of the contract.

Indemnification for Loss

Five commenters objected to the requirement in the Product Test that a loss occur and be proven, and that any payment be limited to the value of the insurable interest, because payment under many insurance products may not be directly based upon actual losses incurred.[70] Two commenters argued that annuities do not provide indemnification for loss and that life insurance products are not constrained by the value of the insurable interest.[71] Another argued that many insurance policies pay fixed amounts upon the occurrence of a loss without a requirement that the loss be tied to the value of an insurable interest.[72] Disability insurance and long-term care insurance are other products that commenters indicate would not be able to satisfy this requirement of the Product Test.[73]

As discussed above, the Commissions are retaining the requirement in the Product Test that a loss occur and be proven and that any payment for such loss be limited to the value of the insurable interest. The Commissions continue to believe that this requirement is a useful tool to distinguish insurance from swaps and security-based swaps, because payments under swaps and security-based swaps may be required when neither party incurs a loss, nor is the amount of payment limited by any such loss. While the Commissions acknowledge commenters who

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70 See ACLI Letter; CAI Letter; ISDA Letter; NAFA Letter; and Travelers Letter.

71 See ACLI Letter and Travelers Letter.

72 See Travelers Letter.

73 See, e.g., ACLI Letter and CAI Letter.

identified various products that may fail this part of the Product Test, the Commissions do not interpret any such failure to mean that products such as annuities, disability insurance, and long-term care insurance are not insurance products. To the contrary, as discussed above, these products are included in the list of Enumerated Products that are excluded from the swap and security-based swap definitions so long as they are provided in accordance with the Provider Test. If long-term care insurance, disability insurance, or an annuity is provided in accordance with the Provider Test, such product is not a swap or a security-based swap, whether or not a loss occurs, is proven, or indemnification for loss is limited to the value of the insurable interest.

Not Traded Separately

Six commenters stated that the proposed requirement that the agreement, contract, or transaction not be traded, separately from the insured interest, on an organized market or over the counter, is not an effective criterion in determining whether a product is insurance.[74] According to commenters, this criterion is ineffective and should be deleted from the Product Test because many conventional insurance products, such as annuities, are assignable (and therefore tradable), which may violate the trading restriction.[75] Two commenters observed that the trading of insurance policies has already occurred and is expected to increase.[76] One commenter stated that a number of states have "insurance exchanges" that sell reinsurance and excess or surplus lines, and that the Patient Protection and Affordable Care Act requires states or the federal government

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[74] See ACLI Letter; Letter from Chris Barnard ("Barnard"), dated June 28, 2011 ("Barnard Letter"); CAI Letter; NAFA Letter; NAIC Letter; and ISDA Letter.

[75] Id. ACLI stated that many conventional insurance products, particularly annuities, can be assigned by the owner, and often state insurance law requires such assignability as a condition for approval of the product for sale under applicable insurance law. ACLI also stated that insurance policies are frequently assigned among family members, to third parties as collateral for loans, and in a host of other situations, and does not believe that these common kinds of assignment should cause an insurance product to be characterized as a swap.

[76] See Barnard Letter and NAIC Letter.

to establish health benefit "insurance exchanges" through which insurers will sell health insurance to individuals and small groups.[77] One commenter recommended that the trading restriction apply only to trading by the policyholder or beneficiary of an insurance policy.[78]

The Commissions are retaining the requirement in the Product Test that the agreement, contract, or transaction not be traded separately from the insured interest, on an organized market or over the counter, and as discussed above have provided a clarification regarding assignments and trading on insurance exchanges. The Commissions continue to believe that using this criterion is an effective way to distinguish insurance from swaps and security-based swaps because swaps and security-based swaps are traded on organized markets and over the counter.

As stated above, the Commissions do not interpret the assignment of an insurance contract as described by commenters to be "trading" as that term is used in the Product Test.[79] Nor do the Commissions find that the examples of exchanges offered by commenters, such as Federal Patient Protection and Affordable Care Act "exchanges," are exchanges as that term is used in the Product Test, e.g., a national securities exchange or designated contract market.[80] Mandated insurance exchanges are more like marketplaces for the purchase of insurance, and there is no trading of insurance policies separately from the insured interest on these insurance exchanges. Thus, the assignment of an insurance contract as permitted or required by state law, or the purchase or assignment of an insurance contract on an insurance exchange or otherwise,

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77 See NAIC Letter. The commenter explained that the "insurance exchanges" mandated by the Patient Protection and Affordable Care Act would be marketplaces for insurance policies. The commenter described them as "cooperatives" where people could go to buy insurance policies with standardized terms/actuaries. The commenter noted that the insurable interest would not "trade" separately from the insurance policy in these cooperatives.

78 See Travelers Letter.

79 See supra notes 54 and 55.

80 See supra notes 56 and 57.

does not constitute trading an agreement, contract, or transaction separately from the insured interest and would not violate the trading restriction in the Product Test.

Acceleration

Three commenters believed that the proposed requirement that, in the event of payment default or insolvency of the obligor, any acceleration of payments under a financial guaranty insurance policy be at the sole discretion of the insurer, is not an effective criterion in determining whether financial guaranty insurance falls outside the swap and security-based swap definitions and should be deleted from the Product Test.[81] However, one commenter supported its inclusion, observing that the proposed requirement is "firmly based on substantive business realities."[82] Two commenters believed that the acceleration of payments requirement is not useful in distinguishing between financial guaranty insurance and swaps or security-based swaps because it is designed to protect financial guaranty insurers from insolvency.[83] They noted that the criterion is a regulatory requirement imposed by state insurance commissioners that is subject to change, and that a state could not change this regulatory requirement without converting the financial guaranty policy into a swap or security-based swap.[84] One commenter stated that the acceleration of payments criterion has been the subject of significant analysis and interpretation by state insurance regulators, and including the requirement in the rules could result in

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81 See Letter from Bruce E. Stern, Chairman, Association of Financial Guaranty Insurers ("AFGI"), dated July 20, 2011 ("AFGI Letter"); ISDA Letter; and Letter from Kimberly M. Welsh, Vice President and Assistant General Counsel, Reinsurance Association of America ("RAA"), dated July 22, 2011 ("RAA Letter").

82 See Letter from Dennis M. Kelleher, President & CEO, Better Markets Inc., dated July 22, 2011 ("Better Markets Letter").

83 See ISDA Letter and RAA Letter.

84 Id.

conflicting interpretations and additional legal uncertainty.[85] This commenter also stated that this uncertainty will impose significant burdens on financial guaranty insurers that insure municipal bonds.[86]

The Commissions are retaining the requirement that acceleration be at the sole option of the provider of the financial guaranty insurance policy in the Product Test. In response to commenter concerns, the Commissions are clarifying that they plan to interpret the acceleration limitation in accordance with applicable state law to the extent that it does not contradict the Commissions' rules, interpretations and/or guidance regarding what is a swap or security-based swap.[87] The Commissions continue to believe that, for purposes of further defining swaps and security-based swaps, this criterion is useful to distinguish between financial guaranty insurance on the one hand, and swaps and security-based swaps, such as CDS, on the other because, as discussed above, the latter generally requires payment of the relevant settlement amount on the CDS after demand by the protection buyer.

Enumerated Products

The Commissions proposed an interpretation that certain enumerated types of insurance products would be outside the scope of the statutory definitions of swap and security-based

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85 See AFGI Letter.

86 Id. The commenter argued that these burdens would (a) increase instability in the currently fragile municipal bond market and (b) decrease the availability or attractiveness of bond insurance to municipal issuers that would otherwise save money by employing bond insurance. The Commissions understand that only one member of AFGI is currently active in the municipal bond insurance market.

87 One commenter noted that "financial guarantors, for some time and in full compliance with state insurance laws, have issued insurance policies that contemplate acceleration upon events unrelated to an issuer default, e.g., upon the downgrade of the insurer." See AFGI Letter. In response to this comment, the Commissions note that the acceleration requirement in the Product Test refers only to "payment default or insolvency of the obligor" (emphasis added), without precluding other triggers.

swap. Several commenters stated that the list of enumerated insurance products should be codified in order to enhance legal certainty.[88] In particular, one commenter stated that it is important for the Commissions to codify the interpretation because the traditional insurance products included in the enumerated list may not satisfy the Product Test.[89] The commenter also expressed concern that insurance companies and state insurance regulators would face the possibility that the Commissions could revise or withdraw the interpretation in the future, with or without undergoing a formal rulemaking process.[90] As noted above, in response to commenters' concerns, the Commissions are codifying the Enumerated Products in the final rules.

One commenter further argued that the enumerated types of insurance products included in the list should not have to additionally satisfy the requirements that the person offering such product be a U.S. domiciled insurer and that the product be regulated in the U.S. as insurance.[91] The commenter argued that this additional requirement would result in the Insurance Safe Harbor not applying to traditional insurance products offered by insurers domiciled outside of the U.S. or by insurers that are not organized as insurance companies. The Commissions are retaining the requirement that the Enumerated Products be provided in accordance with the Provider Test. The Commissions also note that, in response to commenters' concerns, the Commissions have revised the first prong of the Provider Test so that it is not limited to insurance companies or to entities that are domiciled in the U.S. A product that need not satisfy the Product Test must be provided in accordance with the Provider Test, including a requirement

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88 See ACLI Letter; NAIC Letter; RAA Letter; AIA Letter; NAFA Letter; and Letter from Mark R. Thresher, Executive Vice President, Nationwide, dated July 19, 2011 ("Nationwide Letter").

89 See Travelers Letter.

90 Id.

91 See D&L Letter.

that products provided in accordance with the first prong of the Provider Test must be regulated as insurance.[92]

Five commenters addressed the treatment of annuities in the proposed interpretive guidance, with all recommending that all annuities be excluded from the swap and security-based definitions regardless of their status under the tax laws.[93] In response to the comments, the Commissions are eliminating the proposed requirement that annuities comply with section 72 of the Internal Revenue Code in order to qualify as an Enumerated Product. The Commissions are persuaded that the proposed reference to the Internal Revenue Code is unnecessarily limiting and does not help to distinguish insurance from swaps and security-based swaps.

Other commenters suggested adding other products to the list of enumerated types of insurance products,[94] with one suggesting that the Commissions' interpretation cover all transactions currently reportable as insurance in the provider's regulatory and financial reports under a state's or a foreign jurisdiction's insurance laws.[95] One commenter noted that the list of enumerated types of insurance products does not include other state-regulated products such as

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92 See infra notes 147 and 148 and accompanying text.

93 See ACLI Letter; CAI Letter; MetLife Letter; Nationwide Letter; and RAA Letter.

94 See ACLI Letter; AIA Letter; CAI Letter; D&L Letter; NAIC Letter; Letter from Michael A. Bell, Senior Counsel, Financial Policy, RAA Letter; and Letter from Robert J. Duke, The Surety & Fidelity Association of America ("SFAA"), dated July 13, 2011, ("SFAA Letter"). ACLI, CAI and RAA requested the addition of other types of annuity and pension plan products, such as group annuity contracts, guaranteed investment contracts, funding agreements, structured settlements, deposit administration contracts, and immediate participation guarantee contracts. D&L requested the addition of reinsurance of any of the enumerated types of traditional insurance products. NAIC requested the addition of mortgage guaranty, accident, and disability insurance. SFAA request the addition of surety and fidelity bonds.

95 See Letter from J. Stephen Zielezienski, Senior Vice President & General Counsel, American Insurance Association ("AIA"), dated July 22, 2011 ("AIA Letter").

service contracts, that may not satisfy the Product Test.[96] In response to requests to expand the list of enumerated products, the Commissions are adding fidelity bonds,[97] disability insurance, and insurance against default on individual residential mortgages (commonly known as private mortgage insurance, as distinguished from financial guaranty of mortgage pools) to the list of Enumerated Products. The Commissions agree that these are traditional insurance products, and thus their inclusion in the list of Enumerated Products is appropriate. The Commissions have also added reinsurance (including retrocession) of any of the traditional insurance products to the list of Enumerated Products.[98] However, the Commissions decline at this time to expand the list of Enumerated Products to include other types of contracts such as, guaranteed investment contracts ("GICs"), synthetic GICs, funding agreements, structured settlements, deposit administration contracts, immediate participation guaranty contracts, industry loss warrants, and catastrophe bonds.[99] These products do not receive the benefit of state insurance guaranty funds;

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96 See NAIC Letter. The Commissions note that service contracts, although regulated as insurance in some states, comprise consumer warranties, extended service plans, and buyer protection plans of the sort purchased with major appliances, electronics, and the like. The Commissions are addressing these contracts in their interpretation regarding consumer/commercial transactions. See infra part II.B.3.

97 SFAA requested that the Commissions issue specific guidance that surety and fidelity bonds are insurance products rather than swaps, noting that all states include surety and fidelity bonds as lines of insurance subject to state oversight. Surety bonds were already included in the list of enumerated insurance products contained in the Proposing Release.

98 See supra note 41 and accompanying text.

99 See, e.g., RAA Letter; CAI Letter; Letter from Ian K. Shepherd, Managing Director, Alice Corp. Pty Ltd ("Alice Corp."), dated July 22, 2011. Alice Corp. stated that industry loss warrants are a contingent instrument with a somewhat illiquid secondary market but "are currently treated as a reinsurance product and require an insurable interest." Alice Corp. also stated that "[c]atastrophe bonds may reference a specific insured portfolio or a set of parameters and may be traded in a secondary market and behave like a coupon bond if there is no triggering event but have a contingent element since some or all of the principal may be lost if the referenced event or loss occurs." Id. The Commissions note that catastrophe bonds are "securities" under the federal securities laws and decline to provide an interpretation regarding industry loss warrants because it is inappropriate to determine whether a complex and novel product is a swap or a security-based swap in a general definitional rulemaking.

their providers are not limited to insurance companies. The Commissions received little detail on sales of these other products, and do not believe it is appropriate to determine whether particular complex, novel or still evolving products are swaps or security-based swaps in the context of a general definitional rulemaking. Rather these products should be considered in a facts and circumstances analysis. With respect to GICs, the Commissions have published a request for comment regarding the study of stable value contracts.[100]

Reliance on State Law Concepts

Two commenters noted that the Product Test relies on concepts derived from state law, such as "insurable interest" and "indemnification for loss," which do not have uniform definitions.[101] This would require the Commissions to analyze state insurance law, as well as to determine which state law should apply.[102] One of these commenters also requested that such concepts be applied consistently with the historical interpretation by the applicable state.[103]

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100 See Acceptance of Public Submissions Regarding the Study of Stable Value Contracts, 76 FR 53162 (Aug. 25, 2011).

101 See ACLI Letter and AFGI Letter. Some states define concepts such as "insurable interest" in statute; in other states definitions have developed through common law. The Commissions recognize that the terms denoting such concepts may vary from state to state; for instance, what one state calls an "insurable interest" may be referred to as a "material interest" in another. See, e.g., New York Insurance Law Section 1101 ("material interest"). The Commissions believe, however, that both the concepts and their labels are well understood by insurance professionals and that any such variations would not impede market participants from interpreting or applying the final rules. Indeed, one commenter acknowledged this and applied the concepts, labeled differently, to particular products. "The terms used in the rule's criteria are different from the terms used with respect to a surety bond. For example, the bond is generally not referred to as a 'policy.' In addition, the beneficiary of a bond typically is known as the 'obligee.' Further, the bond's limit is referred to as the 'penal sum.' Nevertheless, the criteria can be applied to surety bonds and fidelity bonds, and such application would exclude bonds from the statutory definition of swaps." See SFAA Letter.

102 See ACLI Letter and AFGI Letter.

103 See AFGI Letter.

State law differences regarding these concepts should not impede the ability of market participants from interpreting or applying the final rules to distinguishing between insurance and swaps or security-based swaps, and thus the Commissions are retaining these concepts in the Product Test. The Commissions intend to interpret these concepts consistently with the existing and developing laws of the relevant state(s) governing the agreement, contract, or transaction in question. However, the Commissions note their authority to diverge from state law if the Commissions become aware of evasive conduct.[104]

Inclusion of Reinsurance and Retrocession Transactions

Several commenters suggested that the Commissions amend the Product Test to explicitly address reinsurance and retrocession (i.e., reinsurance of reinsurance) transactions.[105]

In response to these comments, the Commissions are clarifying that reinsurance and retrocession transactions may fall within the Insurance Safe Harbor, thus, it is unnecessary for the Product Test to be modified as suggested by these commenters. In addition, the Commissions have modified the final rules to include reinsurance (including retrocession) of certain types of insurance products in the list of Enumerated Products. Reinsurance or

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104 The Commissions may also diverge from interpretations or determinations of state law based on an analysis of applicable facts and circumstances when determining whether a particular product is a swap or security-based swap.

105 See ACLI Letter; CAI Letter; D&L Letter; ISDA Letter; NAFA Letter; Nationwide Letter; and RAA Letter. ACLI noted that the Product Test does not include a reference to reinsurance and that the "insurable interest" requirement under state insurance law generally does not apply to reinsurance products which, therefore, would not satisfy the Product Test. ACLI and CAI state that reinsurance in a chain of reinsurance also should not be considered a swap or security-based swap. In addition to expressly referencing reinsurance and retrocession transactions, ACLI believes that the Product Test should be expanded to include reinsurance and retrocession of insurance risks ceded by non-U.S. insurance companies to domestic insurance companies. RAA recommended adding a new clause to the Product Test to provide that "[a]ny agreement, contract, or transaction which reinsures any agreement, contract, or transaction meeting the criteria of paragraph (xxx)(4)(i)(A) – (C) of this section is also an insurance product."

retrocession of these Enumerated Products will fall within the Insurance Safe Harbor so long as such reinsurance or retrocession is provided in accordance with the Provider Test.[106]

Payment Based on the Price, Rate, or Level of a Financial Instrument

In the Proposing Release, the Commissions requested comment on whether, in order for an agreement, contract, or transaction to be considered insurance under the Product Test, the Commissions should require that payment not be based on the price, rate, or level of a financial instrument, asset, or interest or any commodity. The Commissions also requested comment on whether variable annuity contracts (where the income is subject to tax treatment under section 72 of the Internal Revenue Code) and variable life insurance should be excepted from such a requirement, if adopted.[107]

Eight commenters stated that it is inappropriate to include such a requirement in the final rules because a number of traditional insurance products would not satisfy the requirement and suggested that the Commissions should instead consider whether the agreement, contract, or transaction transfers risk and argued that such a requirement is not a useful marker for distinguishing insurance from swaps and security-based swaps.[108] Several commenters also

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106 See supra note 41 and accompanying text.

107 See Proposing Release at 29824. See also id. at 29825, Request for Comment 7.

108 See ACLI Letter; AIA Letter; AFGI Letter; CAI Letter; ISDA Letter; NAFA Letter; NAIC Letter; and Nationwide Letter (concurring with ACLI's comments).

Commenters cited several examples of products that would fail a requirement that payment not be based on the price, rate, or level of a financial instrument, asset, or interest or any commodity. ACLI, CAI and NAFA cited registered and unregistered variable annuities and variable life insurance, and certain fixed annuities and equity indexed annuities, stating that these could be construed as being based on, or related to, a price, rate or level of a financial asset. ACLI also cited financial guaranty insurance, and replacement value property and casualty insurance, where the insurer's payment obligation may be based on the current price of the insured property or adjusted to reflect inflation. ACLI and ISDA cited crop insurance, because it could call for payment to be based in some way on the market price of the covered crop on the date of loss. ISDA and RAA cited "dual trigger" insurance (such as replacement power insurance); property

believed that the addition to the Product Test of the criterion that payment not be based on the price, rate, or level of a financial instrument, asset, or interest or any commodity would contribute to greater legal uncertainty.[109]

Two commenters agreed that such a requirement should be included in the final rules.[110] One commenter argued that any insurance instrument that provides for payment based on the price, rate, or level of a financial instrument, asset, or interest in any commodity is in substance a swap or security-based, regardless of its label, and should be regulated as such.[111] One of these commenters further recommended that the Commissions exclude annuity and variable universal life insurance from this requirement because these products were investments with some minimal level of life insurance cover or investment guarantee rider on top.[112]

The Commissions are not adopting an additional requirement for the Product Test that payment not be based on the price, rate, or level of a financial instrument, asset, or interest or any commodity because the Commissions find the requirement to be unsuitable for distinguishing insurance from swaps and security-based swaps. While the provision might work for property and casualty insurance, as many commenters noted, it is not an effective distinction for a number of other traditional insurance products.

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and casualty policies purchased by some commodity producers (e.g., oil refineries, copper mines) with deductibles that increase or decrease based on the price of the commodity that the company produces; event cancellation insurance that uses commodity indices to determine claims; and weather insurance and malpractice insurance. NAIC cited guaranteed investment contracts, financial guaranty insurance, and mortgage guaranty insurance

109 See AIA Letter and AFGI Letter.

110 See Barnard Letter and Better Markets Letter.

111 See Better Markets Letter.

112 See Barnard Letter.

Accounting Standards

In the Proposing Release, the Commissions requested comment on whether the proposed rules relating to insurance should include a provision related to whether a product is recognized at fair value on an ongoing basis with changes in fair value reflected in earnings under U.S. generally accepted accounting principles.[113]

Three commenters argued that the proposed rules should not include a provision that an insurance product is recognized at fair value under generally accepted accounting principles.[114] One commenter argued that the determinants of what is an insurance product should be the existence of an insurable interest, transfer of risk, and indemnification of covered loss.[115] Another argued that factoring accounting standards into the analysis of whether a product is a swap or insurance will introduce unnecessary complexity in most cases but that the examination of accounting standards would be useful in cases where the classification of a product as insurance or swap is unclear.[116]

After considering these comments, the Commissions are not including a reference to accounting standards in the Product Test.

b) Providers of Insurance Products

Under the first prong of the Provider Test, the agreement, contract, or transaction must be provided by a person that is subject to supervision by the insurance commissioner (or similar official or agency) of any state[117] or by the United States.[118] In addition, such agreement,

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113 See Proposing Release at 29827, Request for Comment 17.

114 See AFGI Letter; D&L Letter; and ISDA Letter.

115 See D&L Letter.

116 See ISDA Letter.

117 See supra note 32, regarding the definition of "State" contained in the Proposing Release.

contract, or transaction also must be regulated as insurance under applicable state law[119] or the laws of the United States.

The Commissions have revised the first prong of the Provider Test from the proposal. As proposed, the first prong of the Provider Test could only be satisfied by a company that was organized as an insurance company whose primary and predominant business activity was the writing of insurance or the reinsuring of risks underwritten by insurance companies.[120] The Commissions have revised this prong of the Provider Test to address commenters' concerns that the proposed rules would exclude insurers that were not organized as "insurance companies," as well as insurers that were domiciled outside of the United States.[121] As adopted, the first prong of the Provider Test can be satisfied by any person that is subject to state or federal insurance supervision, regardless of that person's corporate structure or domicile. The Commissions understand that, with the exception of non-admitted insurers,[122] foreign insurers are subject to supervision in the states in which they offer insurance products. The treatment of non-admitted insurers is addressed in the fourth prong of the Provider Test.

The Commissions believe that the requirement that the agreement, contract, or transaction be provided by a person that is subject to state or federal insurance supervision should help prevent regulatory gaps that otherwise might exist between insurance regulation and the regulation of swaps and security-based swaps by ensuring that products provided by persons

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118 This requirement in the final rules is substantially similar to the requirement included in section 3(a)(8) of the Securities Act, 15 U.S.C. 77c(a)(8).

119 See supra note 34.

120 See Proposing Release at 29824.

121 See infra notes 139, 140, and 141 and accompanying text.

122 The Commissions understand that the surplus lines brokers who place insurance on behalf of non-admitted insurers are subject to supervision in the states in which they offer non-admitted insurance products.

that are not subject to state or federal insurance supervision are not able to be offered by persons that avoid regulation under Title VII of the Dodd-Frank Act as well.

The first prong of the Provider Test also requires that the agreement, contract, or transaction being provided is "regulated as insurance" under applicable state law or the laws of the United States. As stated in the Proposing Release, the purpose of this requirement is that an agreement, contract, or transaction that satisfies the other conditions of the final rules must be subject to regulatory oversight as an insurance product. The Commissions believe that this condition will help prevent products that are not regulated as insurance in the states in which they are offered, and that are swaps or security-based swaps, from being characterized as insurance products in order to evade the regulatory regime under Title VII of the Dodd-Frank Act. As noted by commenters,[123] the Commissions recognize that the "regulated as insurance" limitation means that it is possible that a particular product that may not be regulated as insurance in a particular state may not qualify for the Insurance Safe Harbor.[124]

As stated in the Proposing Release, the Commissions believe that it is appropriate to exclude, from regulation under Title VII, insurance that is issued by the United States or any of its agencies or instrumentalities, or pursuant to a statutorily authorized program thereof, from regulation as swaps or security-based swaps.[125] Such insurance includes, for example, federal insurance of funds held in banks, savings associations, and credit unions; catastrophic crop insurance; flood insurance; federal insurance of certain pension obligations; and terrorism risk

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[123] See infra notes 145 and 146 and accompanying text.

[124] See infra notes 147 and 148 and accompanying text.

[125] See Proposing Release at 29824.

insurance. At the request of commenters,[126] the Commissions are persuaded that it is also appropriate to provide a similar exclusion to insurance that is issued by a state or any of its agencies or instrumentalities, or pursuant to a statutorily authorized program thereof. Accordingly, the Commissions have revised the second prong of the Provider Test to provide that products meeting the Product Test are excluded from the swap and security-based swap definitions if they are provided (i) directly or indirectly by the federal government or a state or (ii) pursuant to a statutorily authorized program of either[127].

As stated in the Proposing Release, the Commissions believe that where an agreement, contract, or transaction qualifies for the safe harbor and therefore is considered insurance excluded from the swap and security-based swap definitions, the lawful reinsurance of that agreement, contract, or transaction similarly should be excluded.[128] Accordingly, the Commissions are adopting the third prong of the Provider Test as proposed, with certain modifications, to provide that an agreement, contract, or transaction of reinsurance will be excluded from the swap and security-based swap definitions, provided that: (i) the person offering such reinsurance is not prohibited by applicable state law or the laws of the United States from offering such reinsurance to a person that satisfies the Provider Test; (ii) the agreement, contract, or transaction to be reinsured meets the requirements under the Product Test or is one of the Enumerated Products; and (iii) except as otherwise permitted under applicable

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126 See Ex Parte Communication between NAIC and CFTC and SEC Staff on October 5, 2011, at http://sec.gov/comments/s7-16-11/s71611-61.pdf.

127 The Commissions understand that certain types of federal and state insurance programs, including crop insurance, are administered by third parties; as a result, the Commissions have added "directly or indirectly" to the second prong of the Provider Test to clarify that it can be satisfied even if the agreement, contract, or transaction is not provided directly by the federal government or a state. See Id.

128 See Proposing Release at 29825.

state law, the total amount reimbursable by all reinsurers for such insurance product cannot exceed the claims or losses paid by the cedant.

In response to commenters' concerns,[129] the Commissions have revised the third prong of the Provider Test from that contained in the Proposing Release. As adopted, the third prong of the Provider Test encompasses all reinsurers wherever incorporated or organized, and not just those based outside of the United States. The Commissions also have revised the third prong of the Provider Test to clarify that the total amount reimbursable by all reinsurers may not exceed the claims or losses paid by the cedant, unless otherwise permitted by applicable state law. It is not the Commissions' intent to impose requirements that conflict with state law regarding the calculation of amounts reimbursable under reinsurance contracts.

The Commissions have added a fourth prong to the Provider Test to address commenters' concerns that the proposed Provider Test excluded entities issuing insurance products on a non-admitted basis through surplus lines brokers.[130] Non-admitted insurance is typically property and casualty insurance that is permitted to be placed through a surplus lines broker[131] by an insurer that is not licensed to do business in the state where the product is offered.[132] In practice, a provider of non-admitted insurance may not satisfy the first prong of the Provider Test because it may not be subject to state or federal insurance supervision. The Commissions understand that

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129 See infra notes 150, 151, 152, and 153 and accompanying text.

130 See infra note 146 and accompanying text.

131 For the purposes of this release, the term "surplus lines broker" means an individual, firm, or corporation that is licensed in a state to sell, solicit, or negotiate insurance on properties, risks, or exposures located or to be performed in a state with non-admitted insurers.

132 See supra note 39. With respect to domestic reinsurance, state insurance regulators do retain the authority to prevent or allow a non-admitted company from participating in a state market. Some states compile a list of companies that may sell as non-admitteds; other states list non-admitted companies that may not sell.

non-admitted insurance plays a very important role in the insurance marketplace. In addition, Congress has explicitly recognized non-admitted insurance products as insurance and specified that a state cannot prohibit certain types of entities from offering non-admitted insurance products.[133] Because Congress recognized that certain persons qualify as non-admitted insurers, the Commissions find that it is appropriate to add the fourth prong to the Provider Test.

A person will qualify under the fourth prong of the Provider Test if it satisfies any one of the following two requirements:

- it is located outside of the United States and listed on the Quarterly Listing of Alien Insurers that is compiled and maintained by the International Insurers Department of the National Association of Insurance Commissioners;[134] or
- it meets the eligibility criteria for non-admitted insurers under applicable state law.

Comments

General

The Commissions received ten comment letters that addressed the Provider Test.[135] A few commenters recommended that the Commissions retract the Provider Test.[136] These

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133 See Subtitle B of Title V of the Dodd-Frank Act.

134 Section 524 of the Nonadmitted and Reinsurance Reform Act of 2010 (15 U.S.C. 8204) provides that a state cannot prohibit a surplus lines broker from placing non-admitted insurance with a non-admitted insurer that is listed on the Quarterly Listing of Alien Insurers. According to the NAIC the non-admitted alien insurers whose names appear in the Quarterly Listing of Alien Insurers have filed financial statements, copies of auditors' reports, the names of their U.S. attorneys or other representatives, and details of U.S. trust accounts with the NAIC's International Insurers Department and, based upon those documents and other information, appear to fulfill the criteria set forth in the International Insurers Department Plan of Operation for Listing of Alien Nonadmitted Insurers.

135 See ACLI Letter; AIA Letter; CAI Letter; D&L Letter; ISDA Letter; NAIC Letter; NAFA Letter; Nationwide Letter; RAA Letter; and Travelers Letter.

commenters argued that if a product is subject to regulation as insurance in the United States, the regulated status of the insurer is irrelevant.[137] The Commissions are retaining the Provider Test with modifications as discussed above. The Commissions believe that insurance products should fall outside the swap or security-based swap definitions only if they are offered by persons subject to state or federal insurance supervision or by certain reinsurers.[138] The Provider Test will help to prevent products that are swaps or security-based swaps from being characterized as insurance in order to evade the regulatory regime under Title VII of the Dodd-Frank Act. Other commenters suggested various modifications to the Provider Test and those comments are discussed in more detail below.

"Insurance Company" Limitation

Several commenters recommended that the Commissions expand the first prong of the Provider Test so that it is not limited to "insurance companies," but to all insurers because not all insurers are organized as "insurance companies,"[139] to accommodate insurers and reinsurers that are domiciled outside of the United States,[140] and to cover domestic and foreign insurance companies and other entities that issue insurance products on a non-admitted basis through surplus lines brokers.[141]

The Commissions have revised the first prong of the Provider Test to remove the "insurance company" limitation and to clarify that any person that is subject to state or federal

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136 See AIA Letter; D&L Letter; and ISDA Letter.

137 Id.

138 See infra notes 147 and 148 and accompanying text.

139 See AIA Letter; D&L Letter; ISDA Letter; RAA Letter; NAIC Letter; and Travelers Letter.

140 See AIA Letter; D&L Letter; RAA Letter; and Travelers Letter.

141 See RAA Letter and Travelers Letter.

insurance supervision will qualify under the first prong of the Provider Test. As noted above, the Commissions also believe that this revision should address commenters' concerns that the proposed rules could have excluded some foreign insurers since the revised test does not require that a person be domiciled in the United States; it only requires that the person be subject to state or federal insurance supervision.

Several commenters suggested that the proposed Provider Test would permit an insurer that is not organized as an insurance company to evade state insurance oversight by deliberately failing the exemption for insurance products (that is, by issuing a contract that would fail the proposed rules because it would not be issued by an insurance company).[142] These commenters were concerned that if a product were to be considered a swap merely because it was not issued by an insurance company, this would render the regulation of such products outside of the scope of state insurance laws due to the federal preemption of swaps regulation.[143] Commenters noted that a likely consequence of this preemption would be that the same product would be subject to substantially different regulation within a state's jurisdiction based solely on the nature of the issuing person.[144]

The Commissions have revised the first prong of Provider Test to address commenters' concerns that providers of insurance products could evade state insurance regulation by intentionally failing the Provider Test, i.e., marketing the insurance products as swaps or security-based swaps in order to avoid state insurance supervision. As adopted, any person that provides insurance products (and therefore should be subject to state or federal insurance

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142 See ACLI Letter; CAI Letter; NAFA Letter; Nationwide Letter; RAA Letter; and Travelers Letter.

143 Id.

144 Id.

supervision) must, in fact, be subject to state or federal insurance supervision in order to satisfy the first prong of the Provider Test. Persons that are organized as insurance companies or whose business activity is predominantly insurance or reinsurance, but who are not in fact subject to state or federal insurance supervision, would not satisfy the first prong of the Provider Test.

Finally, as discussed below, the Commissions have added a fourth prong to the Provider Test to provide relief for persons that provide insurance products on a non-admitted basis through surplus lines brokers.

"Regulated as Insurance" Limitation

Two commenters recommended that the Commissions remove the provision in the first prong of the Provider Test that states "and such agreement, contract, or transaction is regulated as insurance under the laws of such state or of the United States."[145] These commenters argued that the provision should be deleted because it was redundant with the Product Test and may exclude certain reinsurers and non-admitted insurers, as well as products that may not be specifically "regulated as insurance" in all states.[146]

The Commissions have retained the requirement in the first prong of the Provider Test that an insurance product must be regulated as insurance, but have revised the provision to clarify that an insurance product must be regulated as insurance under applicable state law or the laws of the United States. As discussed above, the Commissions believe that this condition will help prevent products that are not regulated as insurance and are swaps or security-based swaps

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145 See RAA Letter and Travelers Letter.

146 Id. These commenters also recommended the addition of a new prong to the Provider Test to cover domestic or foreign entities that issue insurance products on a non-admitted basis through surplus lines brokers. See discussion below. The Commissions note that the first prong of the Provider Test does not apply to reinsurance contracts and the third prong of the Provider Test, which does apply to reinsurance contracts, does not contain the "regulated as insurance" limitation.

from being characterized as insurance products in order to evade the regulatory regime under the Dodd-Frank Act.

The Commissions have received conflicting comments regarding whether surety bonds are currently offered by persons who do not satisfy the Provider Test, in particular the "regulated as insurance" requirement.[147] If a person who does not satisfy the Provider Test sells a surety bond incidental to other business activity and is not subject to state or federal insurance supervision, it does not mean that such surety bond is a swap or security-based swap. The surety bond may not satisfy the Insurance Safe Harbor, but it would be subject to a facts and circumstances analysis. Similarly, one commenter indicated that title insurance is not always subject to state insurance regulation.[148] Title insurance sold in a state that does not regulate title insurance as insurance would be in the list of Enumerated Products but would not satisfy the Provider Test and, thus would not qualify for the Insurance Safe Harbor. However, this does not mean that title insurance sold in a state that does not regulate title insurance as insurance is a swap or security-based swap. The title insurance may not satisfy the Insurance Safe Harbor, but it would be subject to a facts and circumstances analysis. The Commissions anticipate that many factors would militate against a determination that such a surety bond or title insurance that fails the Provider Test, because it cannot meet the "regulated as insurance" requirement, is a swap or security-based swap rather than insurance.

The Commissions agree that the inclusion of the "regulated as insurance" requirement in the first prong of the Provider Test will have the effect of causing non-admitted insurance

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147 See SFAA Letter. SFAA stated that all states include surety and fidelity bonds as lines of insurance subject to state oversight. However, Travelers stated that surety bonds may not be "specifically" regulated as insurance. See Travelers Letter.

148 See ACLI Letter

products to fall within the swap and security-based swap definitions. In response to commenters' concerns about the ability of non-admitted insurers to qualify under the Provider Test, the Commissions have added a fourth prong to the Provider Test to address providers of non-admitted insurance products.[149]

Providers of Reinsurance

Several commenters recommended that the Commissions expand the third prong of the Provider Test to include domestic reinsurers.[150] One commenter requested that the Commissions remove the third prong of the Provider Test from the final rules because it appears to prohibit a reinsurer from offering a product in a state where it is permitted if any other state prohibits that product.[151] Two commenters requested revisions to the portion of the third prong of the Provider Test that addresses a cedant's reimbursable losses.[152] One commenter argued this portion of the third prong of the Provider Test may conflict with the state-based insurance receivership law.[153]

As noted above, the Commissions have revised the third prong of the Provider Test to remove the limitation that a reinsurance provider has to be located outside of the United States, and thereby address commenters' concerns that domestic reinsurers would not qualify under the reinsurance prong. In addition, in response to commenters' concerns, the Commissions have clarified the third prong of the Provider Test so that it does not prohibit a reinsurer from offering

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149 See supra notes 130, 131, and 132 and accompanying text.

150 See ACLI Letter; CAI Letter; NAIC Letter; and RAA Letter.

151 See RAA Letter. The commenter argued that one state's prohibition on a reinsurance product should not affect the ability of the reinsurer to offer the product in a state where it is permitted.

152 See RAA Letter and Travelers Letter. Both commenters suggested specific edits to the proposed rules.

153 See RAA Letter. RAA stated that in an insurance receivership reinsurers are required to comply with the reinsurance contract and pay all amounts due and owing to the estate of the insolvent cedant even if the estate of the cedant may not necessarily pay the full amount of the underlying claims to the applicable policyholders.

a product in a state where it is permitted, even if that product is prohibited in another state, and have revised the portion of the third prong of the Provider Test that addresses a cedant's reimbursable losses to make it subject to applicable state law so that it does not conflict with state-based insurance receivership law.

c) Grandfather Provision for Existing Insurance Transactions

In the Proposing Release, the Commissions asked whether the proposed rules should include a provision similar to section 302(c)(1) of the Gramm-Leach-Bliley Act that any product regulated as insurance before the date the Dodd-Frank Act was signed into law and provided in accordance with the Provider Test would be considered insurance and not fall within the swap or security-based swap definitions.

In response to comments,[154] the Commissions are adding a new paragraph (ii) to rule 1.3(xxx)(4) under the CEA and new paragraph (b) to rule 3a69-1 under the Exchange Act that provides that an agreement, contract, or transaction entered into on or before the effective date of the Product Definitions will be considered insurance and not fall within the swap and security-based swap definitions, provided that, at such time it was entered into, such agreement, contract, or transaction was provided in accordance with the Provider Test (the "Insurance Grandfather").

As stated in the Proposing Release, the Commissions are aware of nothing in Title VII to suggest that Congress intended for traditional insurance products to be regulated as swaps or security-based swaps.[155] The Commissions have designed the Insurance Safe Harbor to provide greater assurance to market participants that traditional insurance products that were regulated as insurance prior to the Dodd-Frank Act will fall outside the swap and security-based swap

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154 See infra notes 157, 158, 159, and 160 and accompanying text.

155 See Proposing Release at 29821.

definitions. Nevertheless, after considering comments received, the Commissions believe that it is appropriate to adopt the Insurance Grandfather in order to assure market participants that those agreements, contracts, or transactions that meet the conditions set out in the Insurance Grandfather will not fall within the swap or security-based swap definitions.

In order to qualify for the Insurance Grandfather an agreement, contract, or transaction must meet two requirements. First, it must be entered into on or before the effective date of the Product Definitions. The Commissions are linking the Insurance Grandfather to the effective date of the Product Definitions, rather than the date that the Dodd-Frank Act was signed into law, in order to avoid unnecessary market disruption.[156] Second, such agreement, contract, or transaction must be provided in accordance with the Provider Test. In other words, the provider must be subject to state or federal insurance supervision or be a non-admitted insurer or a reinsurer that satisfies the conditions for non-admitted insurers and reinsurers that are set out in the Provider Test. The Commissions note that an agreement, contract or transaction that is provided in accordance with the first prong of the Provider Test must also be regulated as insurance under applicable state law or the laws of the United States.

By adopting the Insurance Grandfather and the Insurance Safe Harbor, the Commissions are excluding agreements, contracts, and transactions for which the Commissions have found no evidence that Congress intended them to be regulated as swaps or security-based swaps, and are providing greater certainty regarding the treatment of agreements, contracts, and transactions currently regulated as insurance.

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[156] The Commissions believe that 60 days after publication of this release should be sufficient time for market participants to enter into pending agreements, contracts, or transactions for which the Insurance Grandfather may provide relief.

Comments

Four commenters addressed whether the final rules should include a grandfather provision that would exclude certain insurance products from the swap or security-based swap definitions.[157] Two commenters suggested that a grandfather provision for all products that were regulated as insurance before the Dodd-Frank Act was signed into law would be appropriate, stating that it would reduce confusion and uncertainty in applying the swap and security-based swap definitions to products that are traditionally regulated as insurance while addressing the Commissions' stated concern that products might be structured as insurance products to evade Dodd-Frank Act requirements.[158] These commenters also stated that it is necessary to add an effective date-based grandfather provision to the final rule providing that any contract or transaction subject to state insurance regulation and entered into prior to any final rules necessary to implement Title VII, including the Product Definitions, are not swaps or security-based swaps.[159] These commenters noted that a grandfather provision based on effective date of all the Title VII rules was needed to address product development and variation that occurred between the date the Dodd-Frank Act was enacted and the effective date of the rules mandated under that statute.[160]

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157 See ACLI Letter; AFGI Letter; CAI Letter; and D&L Letter.

158 See ACLI Letter and CAI Letter. ACLI and CAI argued that products that were regulated as insurance prior to the effective date of the Dodd-Frank Act clearly were not characterized as insurance to avoid the Title VII regulatory regime. See also AFGI Letter; AFGI argued that all insurance contracts issued by state-regulated insurance companies should be excluded from the swap definition but in the alternative, all insurance products regulated as insurance before July 21, 2010 should be grandfathered. See also D&L Letter. D&L stated that prior regulation of insurance products before July 21, 2010 could be a consideration, but not an absolute determinant for exclusion from the swap or security-based swap definitions.

159 See ACLI Letter and CAI Letter.

160 Id.

The Commissions believe that the combination of the Insurance Grandfather along with the Insurance Safe Harbor provides market participants with increased legal certainty with respect to existing agreements, contracts, transactions, and products. In addition, the fact that the Commissions are linking the Insurance Grandfather to the effective date of the Product Definitions, rather than the date that the Dodd-Frank Act was signed into law, takes into account product development and innovation that may have occurred between the date the Dodd-Frank Act was signed into law at the effective date of the Product Definitions. Further, the Commissions believe that a grandfather provision that would exclude all products regulated as insurance before the Dodd-Frank Act was signed into law, as recommended by some commenters,[161] is unnecessary because non-grandfathered regulated insurance transactions generally should fall within the Insurance Safe Harbor. The Commissions believe that market participants could be incentivized to use such a broader grandfather provision to create new swap or security-based swap products with characteristics similar to those of existing categories of regulated insurance contracts for the purpose of evading the Dodd-Frank Act regulatory regime. The Commissions also believe that a broader grandfather provision would be contrary to the explicit direction of sections 722(b) and 767 of the Dodd-Frank Act which provide that swaps and security-based swaps may not be regulated as insurance contracts by any state.[162]

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161 See ACLI Letter; AGFI Letter; and CAI Letter.

162 Section 722(b) of the Dodd-Frank Act provides, (B) Regulation of Swaps Under Federal and State Law.—Section 12 of the Commodity Exchange Act (7 U.S.C. 16) is amended by adding at the end the following: "(h) Regulation of Swaps as Insurance Under Federal and State Law.—A swap—(1) shall not be considered to be insurance; and (2) may not be regulated as an insurance contract under the law of any State."

Section 767 of the Dodd-Frank Act amended section 28(a) of the Exchange Act, 15 U.S.C. 78bb(a), to provide, "A security-based swap may not be regulated as an insurance contract under any provision of State law."

One commenter argued that the Provider Test should not apply to grandfathered contracts. The commenter stated that it should be enough that the product is regulated as insurance.[163] As described above, the grandfather provision will apply only to agreements, contracts, and transactions that are entered into prior to the effective date of the Product Definitions if they were provided in accordance with the Provider Test, including a requirement that an agreement, contract or transaction that is provided in accordance with the first prong of the Provider Test must be regulated as insurance under applicable state law or the laws of the United States. As the Commissions discussed in the Proposing Release, and above in describing the Provider Test, the Commissions believe the requirement that the agreement, contract, or transaction be provided in accordance with the Provider Test should help ensure that persons who are not subject to state or federal insurance supervision are not able to avoid the oversight provided for under Title VII of the Dodd-Frank Act.

d) Alternative Tests

A number of commenters proposed that the Commissions adopt alternative tests to distinguish insurance from swaps and security-based swaps.[164] After considering each of these alternatives, the Commissions are not adopting them.

Several commenters suggested that the sole test for determining whether an agreement, contract, or transaction is insurance should be whether it is subject to regulation as insurance by the insurance commissioner of the applicable state(s).[165] The Commissions find this alternative

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163 See CAI Letter. CAI suggested that for a product to be regulated as insurance it means that it was provided by an insurance company. See supra part II.B.1.b) for a discussion of the need for the Provider Test portion of the Insurance Safe Harbor.

164 See ACLI Letter; AIA Letter; AFGI Letter; CAI Letter; MetLife Letter; NAFA Letter; NAIC Letter; Nationwide Letter; and Travelers Letter.

165 See ACLI Letter; AIA Letter; AFGI Letter; MetLife Letter; and Travelers Letter.

to be unworkable because it does not provide a sufficient means to distinguish agreements, contracts and transactions that are insurance from those that are swaps or security-based swaps. Section 712(d) of the Dodd-Frank Act directs the Commissions to "further define" the terms swap and security-based swap. Neither swaps nor security-based swaps may be regulated as insurance contracts under the laws of any state.[166] While insurance contracts have long been subject to state regulation, swaps and security-based swaps were largely unregulated. Since the Dodd-Frank Act created a new regulatory regime for swaps and specifically provides that "swaps may not be regulated as an insurance contract under the law of any state,[167] the Commissions believe that it is important to have a test that distinguishes insurance from swaps and security-based swaps without relying entirely on the regulatory environment prior to the enactment of the Dodd-Frank Act. The Product Test is an important element of the Insurance Safe Harbor.

Several commenters suggested an approach in which insurance products that qualify for the exclusion contained in section 3(a)(8) of the Securities Act[168] would be excluded from the swap definition.[169] One commenter argued that "Section 3(a)(8) has long been recognized as the definitive provision as to where Congress intends to separate securities products that are subject to SEC regulation from 'insurance' and 'annuity' products that are to be left to state insurance regulation" and that the section 3(a)(8) criteria are well understood and have a long history of

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166 See section 12(h) of the CEA, 7 U.S.C. 16(h) (regarding swaps) and section 28(a)(4) of the Exchange Act, 15 U.S.C. 78bb(a)(4) (regarding security-based swaps).

167 See section 12(h)(2) of the CEA, 7 U.S.C. 16(h)(2).

168 Section 3(a)(8) of the Securities Act excludes the following from all provisions of the Securities Act: Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia.

See infra note 1283 and accompanying text.

169 See ACLI Letter; CAI Letter; NAFA Letter; and Nationwide Letter.

interpretation by the SEC and the courts.[170] Other commenters suggest that because section 3(a)(8) includes both a product and a provider requirement, if the Commissions include it in their final rules, it should be a requirement separate from the Product Test and the Provider Test, and should extend to insurance products that are securities.[171]

While the Commissions agree that the section 3(a)(8) criteria have a long history of interpretations by the SEC and the courts, the Commissions find that it is inappropriate to apply the section 3(a)(8) criteria in this context. Although section 3(a)(8) contains some conditions applicable to insurance providers that are similar to the prongs of the Provider Test, it does not contain any conditions that are similar to the prongs of the Product Test. Moreover, section 3(a)(8) provides an exclusion from the Securities Act and the CFTC has no jurisdiction under the federal securities laws. Congress directed both agencies to further define the terms "swap" and "security-based swap." As such, the Commissions find that it is more appropriate to have a standalone rule that incorporates features that distinguish insurance products from swaps and security-based swaps and over which both Commissions will have joint interpretative authority.

One commenter suggested yet another approach, recommending that insurance be defined as an agreement, contract, or transaction that by its terms:

- Exists for a specified period of time;
- Where the party (the "insured") to the contract promises to make one or more payments such as money, goods or services;

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170 See NAFA Letter.

171 See ACLI Letter and CAI Letter.

- In exchange for another party's promise to provide a benefit of pecuniary value for the loss, damage, injury, or impairment of an identified interest of the insured as a result of the occurrence of a specified event or contingency outside of the parties' control; and
- Where such payment is related to a loss occurring as a result of a contingency or specified event.[172]

The Commissions do not find this alternative preferable to the Commissions' proposal for two reasons. First, the requirements of a specified term and the promise to make payments are present in both insurance products and in agreements, contracts, or transactions that are swaps or security-based swaps and therefore do not help to distinguish between them. A test based solely on these requirements, then, could be over-inclusive and exclude from the Dodd-Frank Act regulatory regime agreements, contracts, and transactions that have not traditionally been considered insurance. Further, the third and fourth requirements of this alternative test collapse into the Product Test's requirement that the loss must occur and be proved, and any payment or indemnification therefor must be limited to the value of the insurable interest.

One commenter suggested a three-part test in lieu of the Product and Provider Tests. Under this test, the terms "swap" and "security-based swap" would exclude any agreement, contract, or transaction that:

- Is issued by a person who is or is required to be organized as an insurance company and subject to state insurance regulation;
- Is the type of contract issued by insurance companies; and
- Is not of the type that the Commissions determine to regulate.[173]

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[172] See NAIC Letter.

This commenter stated that its approach does not contain a definition of insurance, and believes that is preferable to the Commissions' approach, which it believes creates legal uncertainty because any attempted definition of insurance has the potential to be over- or under-inclusive.[174] As discussed above, the Commissions' rules and interpretations are not intended to define insurance. Rather, they provide a safe harbor for certain types of traditional insurance products by reference to factors that may be used to distinguish insurance from swaps and security-based swaps, and a list of products that do not have to satisfy a portion of the safe harbor factors. Agreements, contracts, and transactions that do not qualify for the Insurance Safe Harbor may or may not be insurance, depending upon the facts and circumstances regarding such agreements, contracts and transactions. The Commissions find the first two requirements of the commenter's three-part test to be tautologous, and the third provides no greater certainty than the Commissions' facts and circumstances approach. In addition, the Commissions find that this alternative test could exclude from the Dodd-Frank Act regulatory regime agreements, contracts, and transactions that have not traditionally been considered insurance.

Another commenter proposed different approaches for existing products and new products.[175] Specifically, if an existing type of agreement, contract or transaction is currently reportable as insurance in the provider's regulatory and financial reports under a state or foreign jurisdiction's insurance laws, then that agreement, contract, or transaction would be insurance

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173 See ACLI Letter (Appendix 1). See also CAI Letter. CAI stated that it believes that the approach and test recommended by ACLI is a fundamentally sound method for determining those insurance products that are not swaps or security-based swaps and that should remain subject to state regulation, and is more appropriate than the Commissions' proposals. Nationwide suggested a three-part test to differentiate insurance products from swaps and security-based swaps similar to the test proposed by ACLI. See also Nationwide Letter.

174 See ACLI Letter.

175 See AIA Letter.

rather than a swap or security-based swap. On the other hand, for new products, if this approach were inconclusive, this commenter recommended that the Commissions use the Product Test of the Commissions' rules only.[176] As discussed above, rather than treating existing products and new products differently, the Commissions are providing "grandfather" protection for agreements, contracts, and transactions entered into prior to the effective date of the Products Definitions.[177] Moreover, this commenter's test would eliminate the Provider Test for new products, which the Commissions believe is important to help prevent products that are swaps or security-based swaps from being characterized as insurance.

In sum, the Commissions find that each of the alternatives proposed by commenters could exclude from the Dodd-Frank Act regulatory regime agreements, contracts, and transactions that have not historically been considered insurance, and that should, in appropriate circumstances, be regulated as swaps or security-based swaps. Accordingly, the Commissions do not find these alternatives to be appropriate for delineating the scope of the Insurance Safe Harbor from the swap and security-based swap definitions.

e) "Safe Harbor"

Five commenters recommended that the Product Test, the Provider Test, and related interpretations should be structured as a "safe harbor" so that they do not raise any presumption or inference that products that do not meet the Product Test, Provider Test and related

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176 Id.

177 See supra part II.B.1.c)

interpretations are necessarily swaps or security-based swaps.[178] One commenter suggested that this safe harbor approach could be modeled after Rule 151 under the Securities Act.[179]

As discussed above, the Commissions do not intend to create a presumption that agreements, contracts, or transactions that do not fall within the Insurance Safe Harbor are necessarily swaps or security-based swaps. As stated above, the Commissions are instead adopting final rules that clarify that certain agreements, contracts, or transactions meeting the requirements of a non-exclusive "safe harbor" established by such rules will not be considered to be swaps or security-based swaps. An agreement, contract, or transaction that does not fall within the Insurance Safe Harbor will require further analysis of the applicable facts and circumstances to determine whether it is insurance, and thus not a swap or security-based swap.

f) Applicability of Insurance Exclusion to Security-Based Swaps

Four commenters expressed concerns that the proposed rules were unclear in their application to both swaps and security-based swaps.[180] These commenters argued that the proposed rules do not directly exclude insurance products from the term "security-based swap" because the rules explicitly state that "[t]he term 'swap' does not include" the products that meet the Product and Provider Tests, but do not make the same statement as to the term "security-based swap."[181]

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178 See ACLI Letter; CAI Letter; NAFA Letter (concurring with ACLI and CAI); Nationwide Letter; and Travelers Letter.

179 See ACLI Letter.

180 See ACLI Letter; CAI Letter; NAFA Letter (concurring with ACLI and CAI); and Nationwide Letter (concurring the ACLI and CAI).

181 Id. The commenters suggested that this ambiguity could be resolved by making it clear in the final rules that an excluded product is neither a swap nor a security-based swap.

The Commissions have revised rule 1.3(xxx)(4) under the CEA and rule 3a69-1 under the Exchange Act to clarify that the exclusion contained therein applies to both swaps and security-based swaps.

g) Guarantees

In the Proposing Release, the Commissions requested comment on whether insurance of an agreement, contract, or transaction that falls within the swap or security-based swap definitions should itself be included in the swap or security-based swap definition. The Commissions also requested comment on whether the Commissions should provide guidance as to whether swap or security-based swap guarantees offered by non-insurance companies should be considered swaps or security-based swaps.[182]

Guarantees of Swaps.[183]

No commenter identified any product that insures swaps (that are not security-based swaps or mixed swaps) other than financial guaranty insurance. The CFTC finds that insurance of an agreement, contract, or transaction that falls within the swap definition (and is not a security-based swap or mixed swap) is functionally or economically similar to a guarantee of a swap (that is not a security-based swap or mixed swap) offered by a non-insurance company.[184] Therefore, the CFTC is treating financial guaranty insurance of swaps (that are not security-

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182 See Proposing Release at 29827.

183 The discussion in this subsection relates only to swaps that are not security-based swaps or mixed swaps and has no effect on the laws or regulations applicable to security-based swaps or mixed swaps.

184 The Commissions did not express a view regarding whether financial guaranty insurance is a swap or security-based swap in the Entities Release. See Entities Release at 30689, n.1132.

based swaps or mixed swaps) the same way it is treating all other guarantees of swaps (that are not security-based swaps or mixed swaps), as discussed below.[185]

The CFTC is persuaded that when a swap has the benefit of a guarantee,[186] the guarantee is an integral part of that swap. The CFTC finds that a guarantee of a swap (that is not a security-based swap or mixed swap) is a term of that swap that affects the price or pricing attributes of that swap.[187] When a swap counterparty typically provides a guarantee as credit support for its swap obligations, the market will not trade with that counterparty at the same price, on the same terms, or at all without the guarantee. The guarantor's resources are added to the analysis of the swap; if the guarantor is financially more capable than the swap counterparty, the analysis of the swap becomes more dependent on the creditworthiness of the guarantor. Therefore, the CFTC is interpreting the term "swap" (that is not a security-based swap or mixed swap) to include a guarantee of such swap, to the extent that a counterparty to a swap position would have recourse to the guarantor in connection with the position.[188] The CFTC anticipates

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185 Subsequent references to "guarantees" in this discussion shall thus be deemed to include "financial guaranty insurance policies."

186 For purposes of this release, the CFTC views a guarantee of a swap to be a collateral promise by a guarantor to answer for the debt or obligation of a counterparty obligor under a swap. A guarantee of a swap does not include for purposes of this release: (i) a "guarantee agreement" as defined in CFTC regulation § 1.3(nn), 17 CFR 1.3(nn); (ii) any assumption by a clearing member of financial or performance responsibility to a derivatives clearing organization ("DCO") for swaps cleared by a DCO; or (iii) any guarantee by a DCO with respect to a swap that it clears.

187 E.g., a swap counterparty may specify that a guarantee is a Credit Support Document under an ISDA Master Agreement. If the guarantor fails to comply with or perform under such guarantee, such guarantee expires or terminates, or if such guarantee ceases to be in full force and effect, the "Credit Support Default" Event of Default under the ISDA Master Agreement would generally be triggered, potentially bringing down the entire swap trading relationship between the parties to the ISDA Master Agreement. See generally the standard 1992 ISDA Master Agreement and 2002 ISDA Master Agreement. However, the CFTC finds the presence of a guarantee to be an integral part of a swap and that affects the price or pricing attributes of a swap whether or not such guarantee is a Credit Support Document under an ISDA Master Agreement.

188 This interpretation is consistent with the interpretations of the Commissions in the Entity Definitions Release. See, e.g., Entity Definitions Release at 30689 ("[A]n entity's swap or

that a "full recourse" guarantee would have a greater effect on the price of a swap than a "limited" or "partial recourse" guarantee; nevertheless, the CFTC is determining that the presence of any guarantee with recourse, no matter how robust, is price forming and an integral part of a guaranteed swap.

The CFTC's interpretation of the term "swap" to include guarantees of swaps does not limit or otherwise affect in any way the relief provided by the Insurance Grandfather. In a

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security-based swap positions in general would be attributed to a parent, other affiliate or guarantor for purposes of major participant analysis to the extent that counterparties to those positions would have recourse to that other entity in connection with the position. Positions would not be attributed in the absence of recourse."). A swap backed by a partial or limited recourse guarantee will include the guarantee to the extent of such partial or limited recourse; a blanket guarantee that supports both swap and non-swap obligations will be treated as part of the guaranteed swap only to the extent that such guarantee backstops obligations under a swap or swaps.

In the Entity Definitions Release, the Commissions stated, "we do not believe that it is necessary to attribute a person's swap or security-based swap positions to a parent or other guarantor if the person is already subject to capital regulation by the CFTC or SEC (i.e., swap dealers, security-based swap dealers, major swap participants, major security-based swap participants, FCMs and broker-dealers) or if the person is a U.S. entity regulated as a bank in the United States. Positions of those regulated entities already will be subject to capital and other requirements, making it unnecessary to separately address, via major participant regulations, the risks associated with guarantees of those positions." Id. In a footnote, the Commissions continued, "As a result of this interpretation, holding companies will not be deemed to be major swap participants as a result of guarantees to certain U.S. entities that are already subject to capital regulation." Id.

As a result of interpreting the term "swap" (that is not a security-based swap or mixed swap) to include a guarantee of such swap, to the extent that a counterparty to a swap position would have recourse to the guarantor in connection with the position, and based on the reasoning set forth above from the Entity Definitions Release in connection with major swap participants, the CFTC will not deem holding companies to be swap dealers as a result of guarantees to certain U.S. entities that are already subject to capital regulation. It may, however, be appropriate to regulate as a swap dealer a parent or other guarantor who guarantees swap positions of persons who are not already subject to capital regulation by the CFTC (i.e., who are not swap dealers, major swap participants or FCMs). The CFTC is addressing guarantees provided to non-U.S. entities, and guarantees by non-U.S. holding companies, in its proposed interpretive guidance and policy statement regarding the cross-border application of the swaps provisions of the CEA, 77 FR 41214 (Jul. 12, 2012).

separate release, the CFTC will address the practical implications of interpreting the term "swap" to include guarantees of swaps (the "separate CFTC release").[189]

Comments

Three commenters provided comments regarding the treatment of guarantees. Two commenters[190] opposed treating insurance or guarantees of swaps as swaps. Suggesting that the products are not economically similar, one commented that insurance wraps of swaps do not "necessarily replicate the economics of the underlying swap, and only following default could the wrap provider end up with the same payment obligations as a wrapped defaulting swap counterparty."[191] This commenter also stated that the non-insurance guarantees are not swaps because the result of most guarantees is that the guarantor is responsible for monetary claims against the defaulting party, which in this commenter's view is a different obligation than the arrangement provided by the underlying swap itself.[192]

One commenter supported treating financial guaranty insurance of a swap or security-based swap as itself a swap or a security-based swap. This commenter argued that financial guaranty insurance of a swap or security-based swap transfers the risk of counterparty non-performance to the guarantor, making it an embedded and essential feature of the insured swap or security-based swap. This commenter further argued that the value of such swap or security-

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189 Briefly, in the separate CFTC release the CFTC anticipates proposing reporting requirements with respect to guarantees of swaps under Parts 43 and 45 of the CFTC's regulations and explaining the extent to which the duties and obligations of swap dealers and major swap participants pertaining to guarantees of swaps, as an integral part of swaps, are already satisfied to the extent such obligations are satisfied with respect to the related guaranteed swaps. The CFTC also anticipates addressing in the separate CFTC release the effect, if any, of the interpretation regarding guarantees of swaps on position limits and large trader reporting requirements.

190 See AFGI Letter and ISDA Letter.

191 ISDA Letter.

192 Id.

based swap is largely determined by the likelihood that the proceeds from the financial guaranty insurance policy will be available if the counterparty does not meet its obligations.[193] This commenter maintained that financial guaranty insurance of swaps and security-based swaps serves a very similar function to credit default swaps in hedging counterparty default risk.[194]

The CFTC is persuaded that when a swap (that is not a security-based swap or mixed swap) has the benefit of a guarantee, the guarantee and related guaranteed swap must be analyzed together. The events surrounding the failure of AIG Financial Products ("AIGFP") highlight how guarantees can cause major risks to flow to the guarantor.[195] The CFTC finds that the regulation of swaps and the risk exposures associated with them, which is an essential concern of the Dodd-Frank Act, would be less effective if the CFTC did not interpret the term "swap" to include a guarantee of a swap.

Two commenters cautioned against unnecessary and duplicative regulation. One commented that, because the underlying swap, and the parties to it, will be regulated and reported to the extent required by Title VII, there is no need for regulation of non-insurance guarantees.[196] The other commented that an insurance policy on a swap would be subject to state regulation; without addressing non-insurance guarantees, this commenter stated that additional federal regulation would be duplicative.[197] The CFTC disagrees with these arguments. As stated

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193 See Better Markets Letter.

194 See Better Markets Letter.

195 "AIGFP's obligations were guaranteed by its highly rated parent company . . . an arrangement that facilitated easy money via much lower interest rates from the public markets, but ultimately made it difficult to isolate AIGFP from its parent, with disastrous consequences." Congressional Oversight Panel, The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy 20 (2010).

196 See ISDA Letter.

197 See AFGI Letter.

above, the CFTC is treating financial guaranty insurance of swaps and all other guarantees of swaps in a similar manner because they are functionally or economically similar products. If a guarantee of a swap is not treated as an integral part of the underlying swap, price forming terms of swaps and the risk exposures associated with the guarantees may remain hidden from regulators and may not be regulated appropriately. Moreover, treating guarantees of swaps as part of the underlying swaps ensures that the CFTC will be able to take appropriate action if, after evaluating information collected with respect to the guarantees and the underlying swaps, such guarantees of swaps are revealed to pose particular problems in connection with the swaps markets. In the separate CFTC release, the CFTC will clarify the limited practical effects of the CFTC's interpretation, which should address concerns regarding duplicative regulation.

One commenter also argued that regulating financial guaranty of swaps as swaps would cause monoline insurers to withdraw from the market, which could adversely affect the U.S. and international public finance, infrastructure and structured finance markets, given that insuring a related swap often is integral to the insurance of municipal bonds and other securities.[198] The CFTC finds this argument unpersuasive. The CFTC understands that the 2008 global financial crisis severely affected most monolines and only one remains active in U.S. municipal markets. Thus, it appears that the monolines have, for the most part, already exited these markets. In addition, as stated above, the CFTC will clarify in the separate CFTC release the limited practical effects of the CFTC's interpretation, which should address these concerns.

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[198] See AFGI Letter. Of the members of AFGI, only Assured Guaranty (or its affiliates) is currently writing financial guaranty insurance policies on U.S. municipal obligations.

Guarantees of Security-Based Swaps

The SEC believes that a guarantee of an obligation under a security-based swap, including financial guaranty insurance of a security-based swap, is not a separate security-based swap. Further, the SEC is not adopting an interpretation that a guarantee of a security-based swap is part of the security-based swap. Instead, the SEC will consider requiring, as part of its rulemaking relating to the reporting of security-based swaps,[199] the reporting of information about any guarantees and the guarantors of obligations under security-based swaps in connection with the reporting of the security-based swap transaction itself. In addition, the SEC will consider issues involving cross-border guarantees of security-based swaps in a separate release addressing the cross-border application of Title VII. The SEC notes that security-based swaps are included in the definition of "security" contained in the Securities Act and the Exchange Act.[200] Under the Securities Act, a guarantee of a security also is a "security."[201] Therefore, a guarantee of a security-based swap is a security subject to federal securities law regulation.[202]

2. The Forward Contract Exclusion

As the Commissions explained in the Proposing Release, the definitions of the terms "swap" and "security-based swap" do not include forward contracts.[203] These definitions exclude "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so

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199 See Regulation SBSR Proposing Release infra note 1231.

200 See sections 768(a)(1) and 761(a)(2) of the Dodd-Frank Act (amending sections 2(a)(1) of the Securities Act, 15 U.S.C. 77b(a)(1), and 3(a)(10) of the Exchange Act, 15 U.S.C. 78c(a)(10), respectively).

201 See section 2(a)(1) of the Securities Act, 15 U.S.C. 77b(a)(1).

202 The SEC has previously addressed the treatment of financial guaranty insurance under the federal securities laws. See supra note 58.

203 See Proposing Release at 29827.

long as the transaction is intended to be physically settled."[204] The Commissions provided an interpretation in the Proposing Release regarding the applicability of the exclusion from the swap and security-based swap definition for forward contracts with respect to nonfinancial commodities[205] and securities. The Commissions are restating this interpretation as set forth in the Proposing Release with certain modifications in response to commenters.

a) Forward Contracts in Nonfinancial Commodities

The CFTC provided an interpretation in the Proposing Release regarding the forward contract exclusion for nonfinancial commodities and is restating this interpretation with certain modifications in response to commenters. These clarifications include that the CFTC will interpret the forward contract exclusion consistent with the entire body of CFTC precedent.[206] The CFTC is also clarifying what "commercial participant" means under the "Brent Interpretation."[207] In addition, while the CFTC is withdrawing its 1993 "Energy Exemption"[208] as proposed, it is clarifying that certain alternative delivery procedures will not disqualify a transaction from the forward contract exclusion. In response to comments, the CFTC is providing a new interpretation regarding book-out documentation, as well as additional factors that may be considered in its "facts and circumstances" analysis of whether a particular contract is a forward.

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204 CEA section 1a(47)(B)(ii), 7 U.S.C. 1a(47)(B)(ii).

205 The discussion in subsections (a) and (b) of this section applies solely to the exclusion of nonfinancial commodity forwards from the swap definition in the CEA.

206 See infra part II.B.2(a)(i)(F).

207 Statutory Interpretation Concerning Forward Transactions, 55 FR 39188 (Sep. 25, 1990) ("Brent Interpretation").

208 Exemption for Certain Contracts Involving Energy Products, 58 FR 21286-02 (Apr. 20, 1993) ("Energy Exemption").

i) Forward Exclusion from the Swap and Future Delivery Definitions

(A) Consistent Interpretation

The wording of the forward contract exclusion from the swap definition with respect to nonfinancial commodities is similar, but not identical, to the forward exclusion from the definition of the term "future delivery" that applies to futures contracts, which excludes "any sale of any cash commodity for deferred shipment or delivery."[209]

In the Proposing Release, the CFTC proposed an interpretation clarifying the scope of the exclusion of forward contracts for nonfinancial commodities from the swap definition and from the "future delivery" definition in a number of respects. After considering the comments received, the CFTC is restating substantially all of its interpretation regarding these forward exclusions set forth in the Proposing Release, but with several clarifications in response to commenters.

The CFTC is restating from the Proposing Release that the forward exclusion for nonfinancial commodities in the swap definition will be interpreted in a manner consistent with the CFTC's historical interpretation of the existing forward exclusion with respect to futures contracts, consistent with the Dodd-Frank Act's legislative history.[210] In addition, in response to

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209 CEA section 1a(27), 7 U.S.C. 1a(27).

210 See 156 Cong. Rec. H5248-49 (June 30, 2010) (introducing into the record a letter authored by Senator Blanche Lincoln, Chairman of the U. S. Senate Committee on Agriculture, Nutrition and Forestry, and Christopher Dodd, Chairman U. S. Senate Committee on Banking, Housing, and Urban Affairs, stating that the CFTC is encouraged "to clarify through rulemaking that the exclusion from the definition of swap for 'any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled' is intended to be consistent with the forward contract exclusion that is currently in the [CEA] and the CFTC's established policy and orders on this subject, including situations where commercial parties agree to 'book-out' their physical delivery obligations under a forward contract."). See also 156 Cong. Rec. H5247 (June 30, 2010) (colloquy between U. S. House Committee on Agriculture Chairman Collin Peterson and Representative Leonard Boswell during the debate on

a commenter, the CFTC is clarifying that the entire body of CFTC precedent regarding forwards should apply to the forward exclusions from the swap and future delivery definitions.[211]

The CFTC's historical interpretation has been that forward contracts with respect to nonfinancial commodities are "commercial merchandising transactions."[212] The primary purpose of a forward contract is to transfer ownership of the commodity and not to transfer solely its price risk. As the CFTC has noted and reaffirms today:

> The underlying postulate of the [forward] exclusion is that the [CEA's] regulatory scheme for futures trading simply should not apply to private commercial merchandising transactions which create enforceable obligations to deliver but in which delivery is deferred for reasons of commercial convenience or necessity.[213]

As noted in the Proposing Release, because a forward contract is a commercial merchandising transaction, intent to deliver historically has been an element of the CFTC's

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the Conference Report for the Dodd-Frank Act, in which Chairman Peterson stated: "Excluding physical forward contracts, including book-outs, is consistent with the CFTC's longstanding view that physical forward contracts in which the parties later agree to book-out their delivery obligations for commercial convenience are excluded from its jurisdiction. Nothing in this legislation changes that result with respect to commercial forward contracts.").

211 See Letter from Craig Donahue, Chief Executive Officer, CME Group Inc. ("CME"), dated July 22, 2011 ("CME Letter") (requesting this clarification). But see below regarding the CFTC's response to CME's comment concerning the Brent Interpretation that it may be inconsistent, in CME's view, with more recent CFTC adjudicatory decisions.

212 See, e.g., Brent Interpretation, supra note 207.

213 See Brent Interpretation, supra note 207. The CFTC has reiterated this view in more recent adjudicative orders. See, e.g., In re Grain Land Coop., [2003-2004 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 29,636 (CFTC Nov. 25, 2003); In re Competitive Strategies for Agric., Ltd., [2003-2004 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 29,635 (CFTC Nov. 25, 2003). Courts have expressed this view as well. See, e.g., Salomon Forex, Inc. v. Tauber, 8 F.3d 966, 971 (4th Cir. 1993) ("[C]ash forwards are generally individually negotiated sales . . . in which actual delivery of the commodity is anticipated, but is deferred for reasons of commercial convenience or necessity."); CFTC v. Int'l Fin. Serv. (N.Y.), 323 F. Supp. 2d 482, 495 (S.D.N.Y. 2004). See also CFTC v. Co Petro Mktg. Grp., Inc., 680 F.2d 573, 579-580 (9th Cir. 1982); CFTC v. Noble Metals Int'l, Inc., 67 F.3d 766, 772-773 (9th Cir. 1995; CFTC v. Am. Metal Exch. Corp., 693 F. Supp. 168, 192 (D.N.J. 1988); CFTC v. Morgan, Harris & Scott, Ltd., 484 F. Supp. 669, 675 (S.D.N.Y. 1979) (forward contract exclusion does not apply to speculative transactions in which delivery obligations can be extinguished under the terms of the contract or avoided for reasons other than commercial convenience or necessity).

analysis of whether a particular contract is a forward contract.[214] In assessing the parties' expectations or intent regarding delivery, the CFTC consistently has applied a "facts and circumstances" test.[215] Therefore, the CFTC reads the "intended to be physically settled" language in the swap definition with respect to nonfinancial commodities to reflect a directive that intent to deliver a physical commodity be a part of the analysis of whether a given contract is a forward contract or a swap, just as it is a part of the CFTC's analysis of whether a given contract is a forward contract or a futures contract.

(B) Brent Interpretation

In this interpretation, the CFTC is restating, with certain clarifications in response to commenters, its interpretation from the Proposing Release that the principles underlying the CFTC's "Brent Interpretation" regarding book-outs developed in connection with the forward exclusion from futures apply to the forward exclusion from the swap definition as well. Book-out transactions meeting the requirements specified in the Brent Interpretation that are effectuated through a subsequent, separately negotiated agreement qualify for the safe harbor under the forward exclusions.

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214 The CFTC observed in its decision in In re Wright that "it is well-established that the intent to make or take delivery is the critical factor in determining whether a contract qualifies as a forward." In re Wright, CFTC Docket No. 97-02, 2010 WL 4388247 at *3 (CFTC Oct. 25, 2010) (citing In re Stovall, et al., [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) 20,941 (CFTC Dec. 6, 1979); Brent Interpretation, supra note 207). In Wright, the CFTC noted that "[i]n distinguishing futures from forwards, the [CFTC] and the courts have assessed the transaction as a whole with a critical eye toward its underlying purpose. Such an assessment entails a review of the overall effect of the transaction as well as a determination as to what the parties intended." Id. at *3 (quoting Policy Statement Concerning Swap Transactions, 54 FR 30694 (Jul. 21, 1989) ("Swap Policy Statement") (citations and internal quotations omitted)).

215 In Wright, the CFTC applied its facts and circumstances test in an administrative enforcement action involving hedge-to-arrive contracts for corn, and observed that "[o]ur views of the appropriateness of a multi-factor analysis remain unchanged." Wright, note 214, supra, n.13. The CFTC let stand the administrative law judge's conclusion that the hedge-to-arrive contracts at issue in the case were forward contracts. Id. at **5-6. See also Grain Land, supra note 213; Competitive Strategies for Agric., supra note 213.

As was noted in the Proposing Release, the issue of book-outs first arose in 1990 in the Brent Interpretation[216] because the parties to the crude oil contracts in that case could individually negotiate cancellation agreements, or "book-outs," with other parties.[217] In describing these transactions, the CFTC stated:

> It is noteworthy that while such [book-out] agreements may extinguish a party's delivery obligation, they are separate, individually negotiated, new agreements, there is no obligation or arrangement to enter into such agreements, they are not provided for by the terms of the contracts as initially entered into, and any party that is in a position in a distribution chain that provides for the opportunity to book-out with another party or parties in the chain is nevertheless entitled to require delivery of the commodity to be made through it, as required under the contracts.[218]

Thus, in the scenario at issue in the Brent Interpretation, the contracts created a binding obligation to make or take delivery without providing any right to offset, cancel, or settle on a

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216 See Brent Interpretation, supra note 207. The CFTC issued the Brent Interpretation in response to a federal court decision that held that certain 15-day Brent system crude oil contracts were illegal off-exchange futures contracts. See Transnor (Bermuda) Ltd. v. BP N. Am. Petroleum, 738 F. Supp. 1472 (S.D.N.Y. 1990). The Brent Interpretation provided clarification that the 15-day Brent system crude oil contracts were forward contracts that were excluded from the CEA definition of "future delivery," and thus were not futures contracts. See Brent Interpretation, supra note 207.

217 The Brent Interpretation described these "book-outs" as follows: "In the course of entering into 15-day contracts for delivery of a cargo during a particular month, situations often arise in which two counterparties have multiple, offsetting positions with each other. These situations arise as a result of the effectuation of multiple, independent commercial transactions. In such circumstances, rather than requiring the effectuation of redundant deliveries and the assumption of the credit, delivery and related risks attendant thereto, the parties may, but are not obligated to and may elect not to, terminate their contracts and forego such deliveries and instead negotiate payment-of-differences pursuant to a separate, individually-negotiated cancellation agreement referred to as a 'book-out.' Similarly, situations regularly arise when participants find themselves selling and purchasing oil more than once in the delivery chain for a particular cargo. The participants comprising these 'circles' or 'loops' will frequently attempt to negotiate separate cancellation agreements among themselves for the same reasons and with the same effect described above." Brent Interpretation, supra note 207, at 39190.

218 Id. at 39192.

payment-of-differences basis. The "parties enter[ed] into such contracts with the recognition that they may be required to make or take delivery."[219]

On these facts, the Brent Interpretation concluded that the contracts were forward contracts, not futures contracts:

> Under these circumstances, the [CFTC] is of the view that transactions of this type which are entered into between commercial participants in connection with their business, which create specific delivery obligations that impose substantial economic risks of a commercial nature to these participants, but which may involve, in certain circumstances, string or chain deliveries of the type described . . . are within the scope of the [forward contract] exclusion from the [CFTC's] regulatory jurisdiction.[220]

Although the CFTC did not expressly discuss intent to deliver, the Brent Interpretation concluded that transactions retained their character as commercial merchandising transactions, notwithstanding the practice of terminating commercial parties' delivery obligations through "book-outs" as described. At any point in the chain, one of the parties could refuse to enter into a new contract to book-out the transaction and, instead, insist upon delivery pursuant to the parties' obligations under their contract.

The CFTC also is clarifying that commercial market participants that regularly make or take delivery of the referenced commodity in the ordinary course of their business meet the commercial participant standard of the Brent Interpretation.[221] The CFTC notes that the Brent Interpretation applies to "commercial participants in connection with their business."[222] The

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219 Id. at 39189.

220 Id. at 39192.

221 See CME Letter (noting that, although the Brent Interpretation applies to "commercial market participants," the proposed guidance in the Proposing Release was described as applying to "market participants" (omitting the word "commercial") who "regularly make or take delivery of the referenced commodities . . . in the ordinary course of business." See also Proposing Release at 29829.

222 Brent Interpretation, supra note 207, at 39192.

CFTC intends that the interpretation in this release be consistent with the Brent Interpretation, and accordingly is adding "commercial" before "market participants" in this final interpretation. Such entities qualify for the forward exclusion from both the future delivery and swap definitions for their forward transactions in nonfinancial commodities under the Brent Interpretation even if they enter into a subsequent transaction to "book out" the contract rather than make or take delivery. Intent to make or take delivery can be inferred from the binding delivery obligation for the commodity referenced in the contract and the fact that the parties to the contract do, in fact, regularly make or take delivery of the referenced commodity in the ordinary course of their business.

Further, in this final interpretation, the CFTC clarifies, in response to a comment received, that an investment vehicle taking delivery of gold as part of its investment strategy would not be engaging in a commercial activity within the meaning of the Brent Interpretation.[223] By contrast, were the investment vehicle, for example, to own a gold mine and sell the output of the gold mine for forward delivery, or own a chain of jewelry stores that produces its own jewelry from raw materials and purchase a supply of gold from another entity's gold mine in order to provide raw materials for its jewelry stores, such contracts could qualify as

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[223] See CME Letter. In connection with its comment regarding "market participants" described above, see supra note 221, the CME further requests confirmation that the CFTC intends to apply the Brent Interpretation to market participants who can demonstrate that they meet the standard in the guidance as proposed, but are not themselves commercial actors:

> Because the Commission's interpretation does not explicitly refer to commercial market participants, it would seem to cover financial players as long as those entities regularly make or take delivery of the underlying commodity in connection with their business. Examples of such entities would be hedge funds or other investment vehicles that regularly make or take delivery of commodities (e.g. gold) in conjunction with their line of business – that is, as part of their investment strategies. [CME] asks that the [CFTC] confirm that the Brent safe harbor would be available to these types of market participants that technically are not "commercial" actors.

See CME Letter.

forward contracts under the Brent Interpretation--provided that such contracts otherwise satisfy the terms thereof.

In sum, the CFTC is interpreting the term "commercial" in the context of the Brent Interpretation in the same way it has done since 1990: "related to the business of a producer, processor, fabricator, refiner or merchandiser."[224] While a market participant need not be solely engaged in "commercial" activity to be a "commercial market participant" within the meaning of the Brent Interpretation under this interpretation, the business activity in which it makes or takes delivery must be commercial activity for it to be a commercial market participant. A hedge fund's investment activity is not commercial activity within the CFTC's longstanding view of the Brent Interpretation.

In addition, the CFTC is expanding the Brent Interpretation, which applied only to oil, to all nonfinancial commodities, as proposed.[225] As a result, book-outs are permissible (where the conditions of the Brent Interpretation are satisfied) for all nonfinancial commodities with respect

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[224] Brent Interpretation, supra note 207, at 39191. See also dissent of Commissioner Fowler West (stating that commercial means "in the traditional sense of those who produce, process, use or . . . handle the underlying commodity."). Note that being a commercial market participant with respect to an agreement, contract or transaction in one commodity, or grade of a commodity, neither makes an entity, nor precludes an entity from being, a commercial market participant with respect to an agreement, contract or transaction in a different grade of the commodity or a different commodity. For example, a West Texas Intermediate oil producer may or may not also be a commercial with respect to Brent. Similarly, that same West Texas Intermediate oil producer may or may not have commercial corn operations. In determining whether an entity is a commercial market participant with respect to an agreement, contract or transaction in a commodity, the CFTC will consider the facts and circumstances, though it is not unlikely that an entity that is a commercial market participant with respect to one commodity may also be a commercial market participant with respect to either a different grade of the commodity or a closely related commodity.

[225] See infra part II.B.2(a)(ii), with respect to the CFTC's interpretation concerning nonfinancial commodities.

to the exclusions from the definition of the term "swap" and the definition of the term "future delivery" under the CEA.[226]

(C) Withdrawal of the Energy Exemption

Because the CFTC has expanded the Brent Interpretation to nonfinancial commodities in this final interpretation, the CFTC also has determined to withdraw the Energy Exemption as proposed. In response to comments received, the CFTC is clarifying that certain alternative delivery procedures discussed in the Energy Exemption[227] will not disqualify a transaction from the Brent Interpretation safe harbor.

In the Proposing Release, the CFTC proposed to withdraw the Energy Exemption, which, among other things, expanded the Brent Interpretation to energy commodities other than oil, on the basis that the exemption was no longer necessary in light of the extension of the Brent

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226 The CFTC reminds market participants that this does not mean, as was noted in the Brent Interpretation, that these transactions or persons who engage in them are wholly outside the reach of the CEA for all purposes. See, e.g., CEA section 8(d), 7 U.S.C. 12(d), which directs the CFTC to investigate the marketing conditions of commodities and commodity products and byproducts, including supply and demand for these commodities, cost to the consumer, and handling and transportation charges; CEA sections 6(c), 6(d) and 9(a)(2), 7 U.S.C. 9, 13b, and 13(a)(2), which proscribe any manipulation or attempt to manipulate the price of any commodity in interstate commerce; and CEA section 6(c) as amended by section 753 of the Dodd-Frank Act, which contains prohibitions regarding manipulation and false reporting with respect to any commodity in interstate commerce, including prohibiting any person to (i) "use or employ, or attempt to use or employ . . . any manipulative or deceptive device or contrivance" (section 6(c)(1)); (ii) "to make any false or misleading statement of material fact" to the CFTC or "omit to state in any such statement any material fact that is necessary to make any statement of material fact made not misleading in any material respect" (section 6(c)(2)); and (iii) "manipulate or attempt to manipulate the price of any swap, or of any commodity in interstate commerce . . ." (section 6(c)(3)). See also Rule 180.1(a) under the CEA, 17 CFR 180.1(a) (broadly prohibiting in connection with a commodity in interstate commerce manipulation, false or misleading statements or omissions of material fact to the Commission, fraud or deceptive practices or courses of business, and false reporting).

227 These include pre-transaction netting agreements that result in offsetting physical delivery obligations, "bona fide termination rights," and certain other methods by which parties may settle their delivery obligations. See Energy Exemption, supra note 208, at 21293.

Interpretation to nonfinancial commodities.[228] The Energy Exemption, like the Brent Interpretation, requires binding delivery obligations at the outset, with no right to cash settle or offset transactions.[229] Each requires that book-outs be undertaken pursuant to a subsequent, separately negotiated agreement.

As discussed above, the CFTC is extending the Brent Interpretation to the swap definition and applying it to all nonfinancial commodities for both the swap and future delivery definitions, but is withdrawing the Energy Exemption. With regard to netting agreements that were expressly permitted by the Energy Exemption,[230] the CFTC clarifies that a physical netting agreement (such as, for example, the Edison Electric Institute Master Power Purchase and Sale Agreement) that contains a provision contemplating the reduction to a net delivery amount of future, unintentionally offsetting delivery obligations, is consistent with the intent of the book out provision in the Brent Interpretation--provided that the parties had a bona fide intent, when entering into the transactions, to make or take delivery (as applicable) of the commodity covered by those transactions.

The CFTC also has determined that, notwithstanding the withdrawal of the Energy Exemption, a failure to deliver as a result of the exercise by a party of a "bona fide termination right" does not render an otherwise binding delivery obligation as non-binding.[231] In the Energy Exemption, the CFTC provided the following examples of bona fide termination rights: force

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228 See Proposing Release at 29829. The CFTC also noted that, to avoid any uncertainty, the Dodd-Frank Act supersedes the Swap Policy Statement. Id. at 29829 n. 74. The CFTC reaffirms that such is the case.

229 Compare Energy Exemption, supra note 208, at 21293 with Brent Interpretation, supra note 207, at 39192.

230 See Energy Exemption, supra note 208, at 21293.

231 See also infra part II.B.2(b)(v) for a discussion of liquidated damages.

majeure provisions and termination rights triggered by events of default, such as counterparty insolvency, default or other inability to perform.[232] The CFTC confirms that market participants who otherwise qualify for the forward exclusion may continue to rely on the bona fide termination right concept as set forth in this interpretation, although, as was stated in the Energy Exemption, such right must be bona fide and not for the purpose of evasion. In this regard, the CFTC further clarifies, consistent with the Energy Exemption, that a bona fide termination right must be triggered by something not expected by the parties at the time the contract is entered into.[233]

The Energy Exemption also discussed a number of methods by which parties to energy contracts settle their obligations, including: the seller's passage of title and the buyer's payment and acceptance of the underlying commodity; taking delivery of the commodity in some instances and in others instead passing title to another intermediate purchaser in a chain; and physically exchanging (i.e., delivering) one quality, grade or type of physical commodity for another quality, grade or type of physical commodity.[234] The CFTC clarifies that these settlement methods generally[235] are not inconsistent with the Brent Interpretation.[236]

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232 Energy Exemption, supra note 208, at 21293.

233 Id.

234 Id.

235 The CFTC will carefully scrutinize whether market participants are legitimately relying on the Brent Interpretation safe harbor. For example, if non-commercial market participants are intermediate purchasers in a delivery chain, then the transaction is not actually a commercial merchandising transaction, and the parties cannot rely on the Brent Interpretation safe harbor.

236 By definition, if two parties exchange (i.e., physically deliver) one physical commodity for another physical commodity in settlement of the parties' delivery obligations, each seller has delivered the commodity that is the subject of its delivery obligation under the relevant agreement, contract or transaction. Depending on the settlement timing, such transactions, which resemble barter transactions, would be spot transactions or forward transactions. While the most common forward transaction involves an exchange of a physical commodity for cash, neither the Brent Interpretation nor any other CFTC authority requires payment for a forward delivery to be

(D) Book-out Documentation

The CFTC has taken into consideration comments regarding the documentation of book-outs.[237] Under the Brent Interpretation, what is relevant is that the book out occur through a subsequent, separately negotiated agreement. While the CFTC is sensitive to existing recordkeeping practices for book-outs, in order to prevent abuse of the safe harbor, the CFTC clarifies that in the event of an oral agreement, such agreement must be followed in a commercially reasonable timeframe by a confirmation in some type of written or electronic form.

(E) Minimum Contract Size and Other Contextual Factors

In the Proposing Release, the CFTC requested comment about potentially imposing additional conditions (such as, for example, a minimum contract size) in order for a transaction to qualify as a forward contract under the Brent Interpretation with respect to the future delivery

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made in cash. Thus, a physical exchange of one quality, grade or type of physical commodity for another quality, grade, or type of physical commodity does not affect the characterization of the transaction as a spot or forward transaction. As for the sellers passing title and buyers, instead of taking delivery of the commodity, passing title to another intermediate purchaser in a chain, this is consistent with the description of Brent transactions in the Brent Interpretation, provided that, as set forth therein, delivery is required and "the delivery obligations create substantial economic risk of a commercial nature to the parties required to make or take delivery . . . includ[ing, without limitation,] demurrage, damage, theft or deterioration." That description was based on the industry delivery structure as it existed prior to the Brent Interpretation. To the extent other industries are similarly structured for commercial reasons, the delivery-by-title-and-related-bill-of-lading-transfer delivery method would be able to rely on the Brent Interpretation if it otherwise satisfied the terms thereof. However, to the extent persons seek to establish such a delivery structure for new products and markets (e.g., not actually delivering the commodity to most of the participants in a chain), that could, depending on the applicable facts and circumstances, be viewed as outside the Brent Interpretation safe harbor or evasion. The CFTC expects that the limitation of counterparties eligible to rely on the Brent Interpretation to those with a commercial purpose for entering into the transaction should limit the development of such markets to those with commercial reasons for such a delivery structure.

[237] See Letter from R. Michael Sweeney, Jr., Hunton & Williams LLP, on behalf of the Working Group of Commercial Energy Firms ("WGCEF"), dated July 22, 2011 ("WGCEF Letter").

and swap definitions.[238] The CFTC has determined that a minimum contract size should not be required in order for a contract to qualify as a forward contract under the Brent Interpretation.[239] However, as suggested by a commenter, the CFTC may consider contract size as a contextual factor in determining whether a particular contract is a forward.[240] Moreover, the CFTC may consider other contextual factors when determining whether a contract qualifies as a forward, such as a demonstrable commercial need for the product, the underlying purpose of the contract (e.g. whether the purpose of the claimed forward was to sell physical commodities, hedge risk, or

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238 See Proposing Release at 29831, Request for Comment 27.

239 Most commenters opposed adding a minimum contract size or other conditions to the CFTC's interpretation of the forward exclusion. One commenter argued that such an approach would be inconsistent with CFTC precedent, citing the fact that neither the Brent Interpretation nor subsequent CFTC precedent interpreting the forward exclusion mention contract size. See CME Letter. Another commenter pointed out that Congress did not impose such a requirement, and thus believes that the CFTC should not do so. See Letter from David M. Perlman, Partner, Bracewell & Giuliani LLP, Counsel to the Coalition of Physical Energy Companies ("COPE"), dated July 22, 2011 ("COPE Letter"). Similarly, a third commenter argued that the only condition Congress placed on the forward exclusion is intent to physically settle, and contract size is not relevant to such intent. See Letter from Natural Gas Supply Association/National Corn Growers Association ("NGSA/NCGA"), dated July 22, 2011 ("NGSA/NCGA Letter").

Two commenters questioned the reasonableness in instituting a minimum contract size below which a transaction would become regulated, but otherwise would not. See Letter from Craig G. Goodman, Esq., President, The National Energy Marketers Association ("NEMA"), dated July 21, 2011, ("NEMA Letter") and Letter from Phillip G. Lookadoo on behalf of the International Energy Credit Association ("IECA"), dated July 28, 2011 ("IECA Letter"). Two commenters believed that such an approach would be contrary to the purposes of Dodd-Frank in regulating transactions that would affect systemic risk. See NEMA Letter and Letter from Dan Gilligan and Michael Trunzo, Petroleum Marketers Association of America and New England Fuel Institute ("PMAA/NEFI"), dated July 22, 2011 ("PMAA/NEFI Letter"). One commenter urged that the Brent Interpretation be applied with minimal restrictive overlay. It believed that contract size is a "contextual factor" that may be considered in evaluating the existence of intent to deliver, but should not be viewed as an independent determinant. See ISDA Letter.

One commenter argued that the forward exclusion should be strengthened with additional conditions to preclude evasion. Its suggested conditions include defining the required regularity of delivery (such as a predominance, or "more often than not" standard); providing a quantitative test of bona fide intent to deliver (such as a demonstrable commercial need for the product and justifying non-physical settlement based on a change in commercial circumstances); and re-evaluating the book-outs aspect of the Brent Interpretation. See Better Markets Letter.

240 See ISDA Letter.

speculate), the regular practices of the commercial entity with respect to its general commercial business and its forward and swap transactions more specifically, or whether the absence of physical settlement is based on a change in commercial circumstances. These contextual factors are consistent with the CFTC's historical facts-and-circumstances approach to the forward contract exclusion outside of the Brent Interpretation safe harbor.

Comments

Several commenters believed that the CFTC should codify its proposed interpretation regarding the Brent Interpretation in rule text to provide greater legal certainty.[241] One commenter further commented that the Dodd-Frank Act's legislative history expressly directed the CFTC to clarify through rulemaking that the nonfinancial commodity forward contract exclusion from the swap definition is intended to be consistent with the forward contract exclusion from the term "future delivery."[242] The commenter also stated its view that the interpretation as proposed does not provide notice to the electricity industry as to how to determine whether a nonfinancial commodity agreement is a swap or a nonfinancial commodity forward contract, nor as to which factors the CFTC would consider in distinguishing between swaps and nonfinancial forward contracts.[243] Moreover, another commenter suggested that the

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241 See Letter from Lisa Yoho, Director, Regulatory Affairs, BGA, dated July 22, 2011) ("BGA Letter"); COPE Letter; Letter from Michael Bardee, General Counsel, Federal Energy Regulatory Commission ("FERC"), dated July 22, 2011 ("FERC Staff Letter"); Letter from Stephanie Bird, Chief Financial Officer, Just Energy, dated July 22, 2011 ("Just Energy Letter"); Letter from the Electric Trade Associations (the Electric Power Supply Association, National Rural Electric Cooperative Association, Large Public Power Council, Edison Electric Institute and American Power Association) ("ETA Letter"), dated July 22, 2011.

242 See ETA Letter (citing the "Lincoln-Dodd Letter" printed at 156 Cong. Rec. H5248-249).

243 See ETA Letter. The commenter requests that the CFTC "further define the statutory term 'swap' by defining relevant terms in the Dodd-Frank Act, reconciling the wording used in the various provisions in the CEA as amended by the Dodd-Frank Act, and setting forth in the [CFTC's] rules the factors that are determinative in drawing the distinction between a 'swap' and a

CFTC should include in regulatory text a representative, non-exhaustive list of the kinds of contracts that are excluded from the swap definition.[244]

The CFTC has determined not to codify its interpretation in rule text. The CFTC has never codified its prior interpretations of the forward contract exclusion with respect to the future delivery definition as a rule or regulation;[245] thus, providing an interpretation is consistent with the manner in which the CFTC has interpreted the forward exclusion in the past, which in turn is consistent with the Dodd-Frank Act legislative history.[246] Moreover, Congress did not direct the CFTC to write rules regarding the forward exclusion. The Dodd-Lincoln letter, cited by a commenter in support of its argument, "encourages" the CFTC to clarify the forward exclusion "through rulemaking" in the generic sense of that term (i.e., through the rulemaking process of notice and comment), not specifically through rule text.[247] Similarly, the CFTC is not providing in rule text a representative list of contracts in nonfinancial commodities that are excluded from the swap definition as forwards.

The CFTC believes that its interpretation provides sufficient clarity with respect to the forward contract exclusion from the swap and future delivery definitions.[248] The CFTC also believes that the interpretation provides sufficient notice to the public regarding how the forward

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'nonfinancial commodity forward contract.'" The commenter suggests rule text to codify the CFTC's interpretation regarding the exclusion of nonfinancial commodity forward contracts. Id.

244 See FERC Staff Letter.

245 See, e.g. Brent Interpretation, supra note 207; Energy Exemption, supra note 208; Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options, 50 FR 39656 (Sep. 30, 1985) ("1985 CFTC OGC Interpretation").

246 See supra note 210 and accompanying text.

247 See 156 Cong. Rec. H5248-49 (June 30, 2010).

248 This is particularly true given that the CFTC intends to interpret the forward exclusion from the swap definition consistently with its interpretation of the forward exclusion from the term "future delivery," with which market participants have had decades of experience.

exclusions from the swap and future delivery definitions will be interpreted. As noted above, the CFTC's historical approach to the forward contract exclusion from the future delivery definition developed on a case-by-case basis, not by rule.

Commenters generally supported applying the Brent Interpretation to the forward exclusion from the swap definition and expanding it to all nonfinancial commodities for purposes of the forward exclusion from both the definitions of the terms "future delivery" and "swap."[249] However, in addition to the requests for clarification to which the CFTC has responded in its final interpretation provided above, commenters raise other requests for clarification. One commenter,[250] for example, believed that the CFTC's adjudicatory decisions in Grain Land[251] and Wright[252] should be construed to have expanded the Brent Interpretation's safe harbor. This commenter stated its view that in Grain Land, the CFTC recognized that cancellation provisions or an option to roll the delivery date within flexible hedge-to-arrive contracts did not render the transactions futures contracts, as opposed to forwards. As such, this commenter believed this case may be at odds with the literal terms of the Brent Interpretation regarding book-outs, which required that, to be a forward contract, any cancellation of delivery must be effected through a subsequent, separately negotiated agreement. The commenter argued that cases subsequent to the Brent Interpretation, such as Grain Land and Wright, recognized the need for flexibility and innovation in the commercial merchandising transactions that are eligible

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249 See BGA Letter; COPE Letter; ISDA Letter; IECA Letter; Letter from Stuart J. Kaswell, Executive Vice President & Managing Director, Managed Funds Association ("MFA"), dated July 22, 2011 ("MFA Letter"); NGSA/NCGA Letter; Letter from Charles F. Conner, President and CEO, National Council of Farmer Cooperatives ("NCFC"), dated July 22, 2011 ("NCFC Letter"); NEMA Letter; PMAA/NEFI Letter; WGCEF Letter.

250 See CME Letter.

251 Grain Land, supra note 213.

252 Wright, supra note 214.

for the forward exclusion. Therefore, this commenter requested that the CFTC consider the body of forward contract precedent as a whole and extend the Brent Interpretation's safe harbor to situations like those presented in Grain Land, notwithstanding the absence of a subsequent, separately-negotiated agreement.[253]

While, as noted above, the CFTC has clarified that the entire body of its precedent applies to its interpretation of the forward exclusion for nonfinancial commodities in the swap definition, the CFTC does not believe that there is a conflict between the Brent Interpretation and the Grain Land or Wright cases. In Grain Land, the CFTC concluded that the fact that a contract includes a termination right, standing alone, is not determinative of whether the contract is a forward. Rather, as the CFTC has always interpreted the forward exclusion, it looks to the facts and circumstances of the transaction. Similarly in Wright, which cited Grain Land with approval, the CFTC stated that "[i]n assessing the parties' expectations or intent regarding delivery, the Commission applies a 'facts and circumstances' test rather than a bright-line test focused on the contract's terms . . . ." In contrast, the Brent Interpretation is a safe harbor that assures commercial parties that book-out their contracts through a subsequent, separately negotiated agreement that their contracts will not fall out of the forward exclusion. The CFTC's conclusion that application of its facts-and-circumstances approach demonstrated that the particular contracts at issue in Grain Land and Wright were forwards did not expand the scope of the safe harbor afforded by the Brent Interpretation.[254]

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253 See CME Letter.

254 As described above in the interpretation, the CFTC has addressed CME's other comments on the forward exclusion, including the interpretation's applicability to commercial market participants and CME's hedge fund example.

Several commenters suggested that the Energy Exemption should not be withdrawn. One commenter noted that the Energy Exemption, along with the Brent Interpretation, should inform the CFTC's interpretation of the forward exclusion.[255] Another commenter believed that the Energy Exemption appears entirely consistent with the Dodd-Frank Act and should be included in the rules as a non-exclusive exemption to ensure continued clarity.[256] A third commenter requested clarification that revoking the Energy Exemption will not harm market participants, stating that the Proposing Release did not sufficiently explain the rationale for withdrawing the Energy Exemption or the possible consequences for energy market participants. This commenter sought confirmation that, despite the withdrawal of the Energy Exemption, market participants will be permitted to rely on the Brent Interpretation, as expanded by the Energy Exemption, particularly as it relates to alternative delivery procedures.[257] This commenter expressed concern that by withdrawing the Energy Exemption, the CFTC would be revoking the ability of market participants to rely on pre-transaction netting agreements to offset physical delivery obligations as an alternative to separately negotiating book-outs after entering into the transactions.[258] As discussed above, the CFTC has determined to withdraw the Energy Exemption as proposed, but has provided certain clarifications to address commenters' concerns.

One commenter suggested the deletion of "commercial merchandising transaction" as a descriptive term in the interpretation. Although recognizing its provenance from the Brent Interpretation, this commenter believed that the phrase was anachronistic at that time, and that it

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255 See COPE Letter Appendix.

256 See IECA Letter.

257 See MFA Letter.

258 Ex Parte Communication between MFA and CFTC Staff on September 15, 2011, at http://comments.cftc.gov/PublicComments/ViewExParte.aspx?id=387&SearchText= .

is misleading and narrow in the current evolving commercial environment.[259] Contrary to this commenter's suggestion, the CFTC has determined to retain the phrase "commercial merchandising transaction" in its final interpretation regarding forward contracts. The CFTC characterized forward transactions in this manner in the Brent Interpretation, as well as in its subsequent adjudications. Courts also have characterized forwards as commercial merchandising transactions or cited the CFTC's characterization with approval.[260] Accordingly, the CFTC believes that "commercial merchandising transaction" continues to be an accurate descriptive term for characterizing forward transactions.

Another commenter requested that the CFTC clarify that a subsequent, separately-negotiated agreement to effectuate a book-out under the Brent Interpretation may be oral or written. This commenter noted that the pace at which certain energy markets transact and the frequency with which book-outs may sometimes occur, makes formal written documentation of all book-outs impracticable.[261] The CFTC has provided an interpretation above regarding the documentation of book-outs in response to this commenter's concerns.

ii) Nonfinancial Commodities

In response to commenters,[262] the CFTC is providing an interpretation regarding the scope of the term "nonfinancial commodity" in the forward exclusion from the swap definition.[263]

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259 See ISDA Letter.

260 See, e.g., In re Bybee, 945 F.2d 309, 315 (9th Cir. 1991).

261 See WGCEF Letter.

262 The Commissions requested comment in the Proposing Release on whether they should provide guidance regarding the scope of the term "nonfinancial commodity" and, if so, how and where the line should be drawn between financial and nonfinancial commodities. See Proposing Release at 29832.

The CFTC interprets the term "nonfinancial commodity" to mean a commodity that can be physically delivered and that is an exempt commodity[264] or an agricultural commodity.[265] Unlike excluded commodities, which generally are financial,[266] exempt and agricultural

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263 As noted above, the CEA definition of the term "swap" excludes "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled." CEA section 1a(47)(B)(ii), 7 U.S.C. 1a(47)(B)(ii). Thus, the forward exclusion from the swap definition is limited to transactions in nonfinancial commodities. To the extent the CFTC uses the term "nonfinancial commodity" in other contexts in this release, such as in connection with the Brent Interpretation (including as it applies with respect to the "future delivery" definition), the term will have the same meaning as discussed in this section in those contexts.

264 The CEA defines an "exempt commodity" as "a commodity that is not an excluded commodity or an agricultural commodity." CEA section 1a(20), 7 U.S.C. 1a(20). A security is an excluded commodity as discussed below, and therefore is not an exempt commodity.

265 The CFTC has defined the term "agricultural commodity" in its regulations as follows: (zz) Agricultural commodity. This term means: (1) The following commodities specifically enumerated in the definition of a ''commodity'' found in section 1a of the Act: Wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, but not onions; (2) All other commodities that are, or once were, or are derived from, living organisms, including plant, animal and aquatic life, which are generally fungible, within their respective classes, and are used primarily for human food, shelter, animal feed or natural fiber; (3) Tobacco, products of horticulture, and such other commodities used or consumed by animals or humans as the Commission may by rule, regulation or order designate after notice and opportunity for hearing; and (4) Commodity-based indexes based wholly or principally on underlying agricultural commodities.

Rule 1.3(zz) under the CEA, 17 CFR 1.3(zz). See Agricultural Commodity Definition, 76 FR 41048 (Jul. 13, 2011).

266 The CEA defines an "excluded commodity" as: (i) an interest rate, exchange rate, currency, security, security index, credit risk or measure, debt or equity instrument, index or measure of inflation, or other macroeconomic index or measure; (ii) any other rate, differential, index, or measure of economic or commercial risk, return, or value that is— (I) not based in substantial part on the value of a narrow group of commodities not described in clause (i); or (II) based solely on one or more commodities that have no cash market; (iii) any economic or commercial index based on prices, rates, values, or levels that are not within the control of any party to the relevant contract, agreement, or transaction; or (iv) an occurrence, extent of an occurrence, or contingency (other than a change in the price, rate, value, or level of a commodity not described in clause (i)) that is— (I) beyond the control of the parties to the relevant contract, agreement, or transaction; and (II) associated with a financial, commercial, or economic consequence.

CEA section 1a(19), 7 U.S.C. 1a(19).

commodities by their nature generally are nonfinancial. The requirement that the commodity be able to be physically delivered is designed to prevent market participants from relying on the forward exclusion to enter into swaps based on indexes of exempt or agricultural commodities outside of the Dodd-Frank Act and settling them in cash, which would be inconsistent with the historical limitation of the forward exclusion to commercial merchandising transactions. However, to the extent that a transaction is intended to be physically settled, otherwise meets the terms of the forward contract exclusion and uses an index merely to determine the price to be paid for the nonfinancial commodity intended to be delivered, the transaction may qualify for the forward exclusion from the swap definition.

In addition, the CFTC is providing an interpretation that an intangible commodity (that is not an excluded commodity) which can be physically delivered qualifies as a nonfinancial commodity if ownership of the commodity can be conveyed in some manner and the commodity can be consumed. One example of an intangible nonfinancial commodity that qualifies under this interpretation, as discussed in greater detail below, is an environmental commodity, such as an emission allowance, that can be physically delivered and consumed (e.g., by emitting the amount of pollutant specified in the allowance).[267] The interpretation provided herein recognizes that transactions in intangible commodities can, in appropriate circumstances, qualify as forwards, while setting forth certain conditions to assure that the forward exclusion may not be abused with respect to intangible commodities.

[267] See supra part II.B.2.a)iii), regarding environmental commodities. An emission allowance buyer also can consume the allowance by retiring it without emitting the permitted amount of pollutant.

Comments

Several commenters believed that the CFTC should provide an interpretation regarding the meaning of the term "nonfinancial commodity" to provide clarity to market participants on the applicability of the forward exclusion.[268] The CFTC is providing the interpretation discussed above to address these commenters' concerns but, contrary to one commenter's request, declines to adopt a regulation.[269]

iii) Environmental Commodities

The Commissions requested comment on whether environmental commodities should fall within the forward exclusion from the swap definition and, if so, subject to what parameters.[270] In response to commenters, the CFTC is providing an interpretation regarding the circumstances under which agreements, contracts or transactions in environmental commodities will satisfy the forward exclusion from the swap definition.[271] The CFTC did not propose a definition of the

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268 See Letter from Steven J. Mickelsen, Counsel, 3Degrees Group, Inc., dated July 22, 2011 ("3Degrees Letter"); ETA Letter; and Letter from Kari S. Larsen, General Counsel, Chief Regulatory Officer, Green Exchange LLC, dated July 22, 2011 ("GreenX Letter"). Each of these commenters proposed its own definition of "nonfinancial commodity." The interpretation above incorporates many of their suggestions.

269 See ETA Letter. This is consistent with CFTC practice in providing an interpretation rather than regulations where warranted. In this context, the CFTC is providing an interpretation rather than rule text because the CFTC is not limiting the definition of "nonfinancial commodity" to exempt and agricultural commodities (the latter category includes agricultural commodity indexes (see 17 C.F.R. 1.3(zz)(4))). The definition also requires physical deliverability and, with respect to intangible commodities, ownership transferability and consumability. Whether a commodity has these features may require interpretation. In any case, courts can rely on agency interpretations.

270 See Proposing Release at 29832, Request for Comment 32, asked: Should the forward contract exclusion from the swap definition apply to environmental commodities such as emissions allowances, carbon offsets/credits, or renewable energy certificates? If so, please describe these commodities, and explain how transactions can be physically settled where the commodity lacks a physical existence (or lacks a physical existence other than on paper)? Would application of the forward contract exclusion to such environmental commodities permit transactions that should be subject to the swap regulatory regime to fall outside the Dodd-Frank Act?

271 Because the CFTC has determined, as discussed elsewhere in this release, to interpret the forward exclusion from the swap definition consistently with the forward exclusion from the "future

term "environmental commodity" in the Proposing Release and is not doing so in this release.[272] The CFTC believes it is not necessary to define the term "environmental commodity" because any intangible commodity – environmental or otherwise – that satisfies the terms of the interpretation provided herein is a nonfinancial commodity, and thus an agreement, contract or transaction in such a commodity is eligible for the forward exclusion from the swap definition.[273] The forward exclusion from the swap definition does not apply to commodities themselves, but to certain types of agreements, contracts or transactions in a specified type of commodity (i.e., a "nonfinancial" commodity).[274] Environmental commodities that meet the interpretation regarding nonfinancial commodities discussed in subsection (ii) above are nonfinancial commodities and, therefore, a sale for deferred shipment or delivery in such a commodity, so long as the transaction is intended to be physically settled, may qualify for the forward exclusion from the swap definition.

The intangible nature of environmental, or other, commodities does not disqualify contracts based on such commodities from the forward exclusion from the swap definition, notwithstanding that the core of the forward exclusion is intent to deliver the underlying

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delivery" definition, the discussion in this section applies equally to the forward exclusion from future delivery.

272 See also Letter from Gene Grace, Senior Counsel, American Wind Energy Association ("AWEA"), dated July 22, 2011 ("AWEA Letter") (providing a general description of renewable energy credits ("RECs"), emission allowances, and offsets, which the commenter collectively termed "environmental commodities" for purposes of its letter).

273 Thus, market participants should apply the interpretation to their facts to determine whether their specific circumstances support reliance on the forward exclusion from the swap definition.

274 Several commenters appear to have confused these concepts. The term "commodity" is defined in CEA section 1a(9), 7 U.S.C. 1a(9). The forward exclusion in CEA section 1a(47)(B)(ii), 7 U.S.C. 1a(47)(B)(ii), excludes from the swap definition "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled."

commodity.[275] As commenters noted, securities are intangible (with the exception of the rare certificated security) and yet they are expressly permitted by CEA section 1a(47)(B)(ii)[276] to be the subject of the forward exclusion; this reflects recognition by Congress that the forward exclusion can apply to intangible commodities.[277]

The CFTC understands that market participants often engage in environmental commodity transactions in order to transfer ownership[278] of the environmental commodity (and not solely price risk),[279] so that the buyer can consume the commodity in order to comply with

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275 See supra part II.B.2.a)i)(A).

276 7 U.S.C. 1a(47)(B)(ii).

277 As commenters also note, each Commission or its staff has previously indicated that environmental commodities, in the CFTC's case, and securities, in the SEC's case, can be physically settled. See Letter from Kyle Danish, Van Ness Feldman, P.C., on behalf of Coalition for Emission Reduction Policy ("CERP"), dated July 18, 2011 ("CERP Letter") and 3Degrees Letter. Also, the recent Carbon Report suggested that the forward exclusion could apply to agreements, contracts or transactions in environmental commodities. See Interagency Working Group for the Study on Oversight of Carbon Markets ("Interagency Working Group"), Report on the Oversight of Existing and Prospective Carbon Markets (January 2011) ("Carbon Report"). The Carbon Report specifically stated that - [n]o set of laws currently exist that apply a comprehensive regulatory regime – such as that which exists for derivatives – specifically to secondary market trading of carbon allowances and offsets. Thus, for the most part, absent specific action by Congress, a secondary market for carbon allowances and offsets may operate outside the routine oversight of any market regulator.

278 One commenter maintains that a transaction in an environmental allowance represents a physically-settled transaction because its primary purpose is to transfer ownership of the right to emit a specified unit of pollution. See Letter from Andrew K. Soto, American Gas Association ("AGA"), dated July 22, 2011 ("AGA Letter"). Compare to Proposing Release at 29828 (stating that "[t]he primary purpose of the contract is to transfer ownership of the commodity").

279 Another commenter states that, from a practical standpoint, the buyer must take delivery to satisfy a compliance obligation, which typically requires surrender of allowances and offset credits, and likens such transactions to forward sales of more tangible commodities, noting they are not devices for transferring price risk. See CERP Letter. Compare to Proposing Release at 29828 (stating that "[t]he primary purpose of the contract is . . . not to transfer solely . . . price risk"). This commenter also advises that delivery of RECs and offsets is typically deferred for commercial convenience, consistent with the Brent Interpretation, because "not all of the purchased RECs and offsets are generated at the time of the transaction" and "long-term contracts with deferred delivery are important for renewable energy projects to ensure a consistent revenue stream over a long period of time." See CERP Letter.

the terms of mandatory or voluntary environmental programs.[280] Those two features – ownership transfer and consumption – distinguish such environmental commodity transactions from other types of intangible commodity transactions that cannot be delivered, such as temperatures and interest rates. The ownership transfer and consumption features render such environmental commodity transactions similar to tangible commodity transactions that clearly can be delivered, such as wheat and gold.[281]

For such transactions, in addition to the factors discussed above, intent to deliver is readily determinable,[282] delivery failures generally result from frustration of the parties' intentions,[283] and cash-settlement is insufficient because delivery of the commodity is necessary for compliance purposes.[284] For the foregoing reasons, environmental commodities can be nonfinancial commodities that can be delivered through electronic settlement or contractual

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280 Consumption also can be part of a commercial merchandising transaction in the chain of commerce. See, e.g., Brent Interpretation, supra note 207 (dissent of Commissioner Fowler West) (citing the 1985 CFTC OGC Interpretation and cases cited therein for the proposition that "parties to forward contracts . . . seek to profit in their businesses from producing, processing, distributing, storing, or consuming the commodity").

281 Similarly, the settlement method for the types of environmental commodity transactions described by commenters such as RECs, emission allowances, and offsets are equivalent to that of physical commodities where ownership is transferred by delivering a warehouse receipt from the seller to the buyer, thereby indicating the presence in the warehouse of the contracted for commodity volume. See GreenXLetter. See also REMA letter (averring that "[i]n effect, the REC is an intangible contract right or interest in that specific quantity of energy; thus, it is quite analogous to a warehouse receipt that represents title to a physical commodity"). Another similarity between these environmental commodity transactions and tangible commodities is that it is possible to manipulate the deliverable supply of an environmental commodity just as it is for a tangible commodity. The CFTC reminds market participants of its continuing authority over forwards under the CEA's anti-manipulation provisions prohibiting manipulation, making false and misleading statements and omissions of material fact to the CFTC, fraud and deceptive practices, and false reporting. See supra note 226.

282 See Letter from Jennifer Martin, Executive Director, Center for Research Solutions ("CRS"), dated July 22, 2011 ("CRS Letter").

283 See 3Degrees Letter.

284 See GreenX Letter.

attestation. Therefore, an agreement, contract or transaction in an environmental commodity may qualify for the forward exclusion from the swap definition if the transaction is intended to be physically settled.

Comments

Several commenters responded to the Commission's request for comment regarding the applicability of the forward exclusion from the swap definition for agreements, contracts and transactions in environmental commodities.[285]

Most commenters responding to the Commissions' request for comment concerning the appropriate treatment of agreements, contracts or transactions in environmental commodities asserted that emission allowances, carbon offsets/credits, or RECs should be able to qualify for the forward exclusion from the swap definition. In support of this view, several commenters

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[285] One commenter provided a general description of renewable energy credits ("RECs"), emission allowances, offsets, (which the commenter collectively termed "environmental commodities" for purposes of its letter), and related transactions. See AWEA Letter. According to the commenter, RECs are created by state regulatory bodies in conjunction with the production of electricity from a qualifying renewable energy facility. The forward sale of a REC transfers ownership of the REC from the producing entity to another entity that can use the REC for compliance with an obligation to sell a certain percentage of renewable energy. Many times, this forward sale takes place prior to the construction of a project to enable developers to secure related project financing. See AWEA Letter. See also Letter from Mary Anne Mason, HoganLovells LLP on behalf of Southern California Edison Company, Pacific Gas and Electric Company and San Diego Gas and Electric Company ("California Utilities"), dated July 22, 2011 ("California Utilities Letter") (stating that the California Utilities transact in allowances, under the EPA's and anticipated California cap-and-trade programs, as well as in RECs, in order to comply with or participate in various regulatory and voluntary programs).

The CFTC understands that, in the United States, emission allowances and offsets are issued by the U.S. Environmental Protection Agency ("EPA"), state government entities and private entities. Emission allowances and offsets are transferred between counterparties, often through forward contracts, with the purchasing party obtaining the ability to use the allowances or offsets for compliance with clean air or greenhouse gas regulations. The forward sale of allowances and offsets allows market participants to hedge the compliance obligations associated with expected emissions, or to meet a voluntary emissions reduction commitment or make an environmental claim. See, e.g., AWEA Letter; Letter from Henry Derwent, President and CEO, International Emissions Trading Association, dated July 22, 2011 (defining a carbon offset as a "credit[] granted by a state or regional governmental body or an independent standards organization in an amount equal to the generation of electricity from a qualifying renewable energy facility.").

explained that the settlement process for environmental commodity transactions generally involves "the transfer of title via a tracking system, registry or contractual attestation, in exchange for a cash payment."[286] One commenter stated that this form of settlement demonstrates that the lack of physical existence of a commodity is not relevant to whether a transaction in the commodity physically settles for purposes of the forward exclusion.[287] Another commenter contended that title transfer constitutes physical delivery because the settlement results in the environmental commodity being consumed to meet an environmental obligation or goal, which occurs through "retirement" of the environmental commodity.[288] Other commenters compared the settlement of a transaction in an environmental commodity through an electronic registry system to a warehouse receipt that represents title to a physical commodity.[289]

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286 See 3Degrees Letter. See also WGCEF Letter (advising that "physical delivery takes place the moment that title and ownership in the environmental commodity itself is transferred from the seller to the buyer[,] whether through the execution of a legally binding contract or attestation, or submission of records to a centralized data base, such as a registry"); Letter from the Hons. Jeffrey A. Merkley, Sherrod Brown and Jeanne Shaheen, U.S. Senators, dated January 13, 2012 ("Senators Letter") (relaying that "[t]he purchase or sale of a REC is settled through the transfer of title to the REC, either electronically over a tracking system or via a paper attestation"); Letter from Harold Buchanan, Chief Executive Officer, CE2 Carbon Capital, LLC ("CE2"), dated July 22, 2011 ("CE2 Letter"); Letter from Jason M. Rosenstock, ML Strategies LLC on behalf of The Business Council for Sustainable Energy ("BCSE"), dated January 24, 2012 ("BCSE Letter"); NEMA Letter (stating that RECs must be physically settled through a REC registry, which "ensures that there is a physical megawatt hour from a green generator behind the REC").

287 See 3Degrees Letter. See also GreenX Letter (stating that environmental commodities share the same characteristics as tangible physical commodities "in all key respects," including that they are in limited supply).

288 See CRS Letter. CRS explains that retirement occurs through a registry or electronic tracking system by transfer into a retirement account (or, alternatively, an exchange of paperwork) and that, once retired, an environmental commodity cannot be resold. The CRS also argues that such environmental commodity transactions are commercial merchandising transactions, and thus may be forward contracts, because the primary purpose of the transactions is to transfer ownership so that the purchaser may comply with an applicable environmental program. See also 3Degrees Letter and AWEA Letter.

289 See Letter from Josh Lieberman, General Manager, Renewable Energy Markets Association ("REMA"), dated July 22, 2011 ("REMA Letter") (distinguishing RECs, which allow the buyer to own environmental attributes, from a pure financial swap, where only price risk is transferred);

A few commenters also analogized environmental commodities to securities, which (with the exception of certificated securities) are intangible. Some commenters, for example, asserted that the language of the forward exclusion from the swap definition means that non-physical items can be physically settled because the exclusion, which references securities, "implies that securities – which lack a strict physical existence – may be physically settled."[290]

Some commenters assured the Commissions that applying the forward exclusion to transactions in environmental commodities would not permit transactions that should be subject to the swap regulatory regime to fall outside it. One commenter submitted that intent to deliver with respect to environmental commodities will be readily determinable.[291] Another commenter contended that: environmental commodity contracts almost universally require delivery and that failure to do so is an event of default; to the best of its knowledge, it is rare for such a contract to include the right to unilaterally terminate an agreement under a pre-arranged contractual provision permitting financial settlement;[292] and defaults generally are the result of something frustrating parties' intentions.[293] Still other commenters distinguished environmental commodities from other intangible commodities, such as the nonfinancial commodities (such as

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See also GreenX Letter (likening the settlement of an environmental commodity transaction (where delivery typically would take place by electronic delivery from the registry account of the seller to the registry account of the buyer) to that of transactions in many tangible physical commodities, such as agricultural commodities and metals, where settlement is evidenced by an electronic transfer of a warehouse receipt in the records of the warehouse and the underlying commodity does not move — it remains in the warehouse or vault — but its ownership changes)).

290 See CRS Letter. See also CERP Letter (claiming that Congress did not intend for the phrase "physically settled" in the forward exclusion to be limited to tangible commodities because, like environmental commodities, securities only exist "on paper."). See also AWEA Letter.

291 See CRS Letter ("unlike a stock or a bond, which can be resold for its cash value, purchasers of environmental commodities intend to take delivery of RECs or carbon offsets for either compliance purposes or in order to make an environmental claim regarding their renewable energy use or carbon footprint."). See also GreenX Letter.

292 Such a provision would preclude reliance on the forward exclusion.

293 See 3Degrees Letter.

interest rates and temperatures) that the CFTC referred to in its Adaptation Notice of Proposed Rulemaking,[294] because RECs and emissions allowances or offsets can be physically transferred from one account to another, whereas "it is not possible to move and physically transfer an interest rate or a temperature reading."[295]

As discussed above, the CFTC has addressed the foregoing concerns of commenters by providing an interpretation that agreements, contracts and transactions in environmental commodities may qualify for the forward exclusion from the swap definition.

One commenter stated its view that the forward exclusion from the swap definition should not be available for carbon transactions because they should be standardized and conducted on open, transparent and regulated exchanges.[296] This commenter acknowledged the possibility that carbon transactions can be physically settled (as the statute requires of excluded forward contracts) but argued that, in light of the fact that there is no cost associated with making or taking delivery of carbon, there is no cost to store it, and there is no delay in delivering it, a forward exclusion for carbon transactions may allow financial speculators to escape regulation otherwise required by the Dodd-Frank Act. The CFTC believes that if a transaction satisfies the terms of the statutory exclusion, the CFTC lacks the authority to deprive the transaction of the exclusion, absent evasion.[297]

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294 See Adaptation of Regulations to Incorporate Swaps, 76 FR 33066, June 7, 2011.

295 See California Utilities Letter.

296 See Letter from Michelle Chan, Director, Economic Policy Programs, Friends of the Earth, dated July 22, 2011.

297 While the commenter contended that "the intangible nature of carbon makes it much easier for speculators or those simply seeking to hedge carbon price risk to take delivery of the carbon itself rather than enter into a derivatives transaction," as the CFTC states in section VII.A.2.c), infra, deciding to enter into a forward transaction rather than a swap does not constitute evasion. Thus, if the transaction in question is a forward contract, that is the end of the analysis, absent the presence of other factors that may indicate evasion. See AWEA Letter.

One commenter stated that "[i]n the solar industry, RECs are often traded by an individual consumer as an assignment of a right owned by that consumer."[298] This commenter also advised that many individual consumers transact forward contracts through solar REC ("SREC") aggregators at a fixed price. The CFTC notes[299] that a transaction entered into by a consumer cannot be a forward transaction, and accordingly should not be the subject of an interpretation of the forward exclusion.[300]

One commenter takes the position that, because EPA emission allowances are issued in transactions with the EPA, only resales of such allowances (secondary market transactions) could be swaps because the EPA's initial issuance of allowances would be excluded from the swap definition under CEA section 1a(47)(B)(ix).[301] The CFTC declines to address the commenter's legal conclusion regarding the application of CEA section 1a(47)(B)(ix), but agrees that an emission allowance created by the EPA is a nonfinancial commodity and that agreements, contracts and transactions in such allowances may fall within the forward exclusion from the swap definition.

iv) Physical Exchange Transactions

The Commissions received a comment letter seeking clarification that physical exchange transactions are forward contracts excluded from the swap definition.[302] As described by the commenter, physical exchange transactions involve "a gas utility entering into a transaction with

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298 See Letter from Katherine Gensler, Director, Regulatory Affairs, SEIA, dated August 5, 2011 ("SEIA Letter").

299 See Proposing Release at 29832 n.104.

300 However, in section II.B.3., infra, the Commissions provide an interpretation regarding the applicability of the swap definition to consumer transactions.

301 See Letter from Lauren Newberry, Jeffrey C. Fort, Jeremy D. Weinstein, and Christopher B. Berendt, Environmental Markets Association, dated July 21, 2011.

302 See AGA Letter.

another gas utility or other market participant to take delivery of natural gas at one delivery point in exchange for the same quantity of gas to be delivered at an alternative delivery point . . . for the primary purpose of transferring ownership of the physical commodity in order to rationalize the delivery of physical supplies to where they are needed" at a price "generally reflecting the difference in value at the delivery points."[303] This commenter stated that "exchange transactions create binding obligations on each party to make and take delivery of physical commodities [, i]n essence constituting paired forward contracts that are intended to go to physical delivery."[304] The commenter added that, to the extent an exchange transaction payment is based on an index price, such pricing is not severable from the physical exchange.[305]

The CFTC interprets the exchange transactions described by the commenter, to the extent they are for deferred delivery, as examples of transactions in nonfinancial commodities that are within the forward exclusion from the definition of the terms "swap" and "future delivery." Based on the information supplied by the commenter, they are commercial merchandising transactions, the primary purpose of which is to transfer ownership of natural gas between two parties who intend to physically settle such transactions. That exchange transactions may involve, in addition to gas deliveries at two separate delivery points, a cash payment by one party to the other reflecting the difference in value of the gas at different delivery points, or that such payment may be based on an index, does not necessarily affect the nature of the transactions as forward transactions.[306] For an exchange transaction to fall within the forward exclusion,

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303 Id. This commenter noted that gas utilities often can receive gas at more than one interconnection or delivery point on a pipeline.

304 Id.

305 Id.

306 However, if such payment stems from an embedded option, the interpretation set forth in the embedded option section of this release, see infra part II.B.2(b)(v), also would be relevant to

though, the parties to the transaction must intend for the transaction to be physically settled, and the exchange transaction must satisfy all applicable interpretations set forth herein, including that relating to book-outs.[307]

v) Fuel Delivery Agreements

The CFTC understands that fuel delivery agreements can generally be described as agreements whereby two or more parties agree to divide the cost of acquiring fuel for generation facilities based on some formula or factors, which can include, for example, their respective financial contributions to developing the source of the fuel (e.g., a natural gas field). One example of a fuel delivery agreement could involve a joint power agency providing to a municipal utility a long-term supply of natural gas from a natural gas project developed by the joint power agency and other entities to provide fuel for, among others, the joint power agency's and the municipal utility's natural gas-fired electric generating facilities. The municipal utility would pay the joint power agency through direct capital contributions to the entity formed to develop the natural gas project for the cost of developing it. In addition, the municipal utility would pay the joint power agency a monthly fee for the natural gas supplied from the natural gas project. The monthly fee would be composed of an operating cost fee component, an interstate pipeline transportation cost fee component and an operating reserve cost fee component. The

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determining whether an exchange transaction were covered by the forward exclusion from the swap definition.

307 While the commenter also states that "[g]as utilities contract with interstate pipelines for capacity rights to have their gas supplies delivered to specific delivery points," its discussion of exchange transactions appears unrelated to such capacity rights. Therefore, the CFTC's guidance on exchange transactions does not address exchange transactions with capacity elements, which, depending on their structures, may be covered by the guidance set forth in the embedded option section of this release or by the CFTC's recent Commodity Options release. See infra note 317. Conversely, that parties to an exchange transaction separately enter into a capacity transaction with a pipeline operator to transport natural gas delivered via an exchange transaction is not relevant to today's guidance regarding exchange transactions.

municipal utility's natural gas-fired electric generating facility would be used to supply a portion of its expected retail electric load.

Such agreements are forward transactions if they otherwise meet the interpretation set forth in this release regarding the forward exclusions (e.g., no optionality other than as permitted by the interpretation). Monthly or other fees that are not in the nature of option premiums do not convert the transactions from forwards to options. Because the transactions as described above do not appear to exhibit optionality as to delivery, and no other aspect of the transactions as described above seem to exhibit optionality, the fees would not seem to resemble option premiums.[308]

vi) Cleared/Exchange-Traded Forwards

In the Proposing Release, the Commissions requested comment regarding whether forwards executed on trading platforms should fall within the forward exclusion from the swap definition and, if so, subject to what parameters.[309] One commenter requested that the CFTC adopt a non-exclusive safe harbor providing that exchange-traded contracts with respect to which more than 50 percent of contracts, on average on a rolling three-month basis, go to delivery and where 100 percent of the counterparties are commercial counterparties, are neither futures nor swaps ("50/100 Forward Safe Harbor").[310] This commenter further requested that the CFTC

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308 This interpretation is limited to the facts and circumstances described herein; the CFTC is not opining on different facts or circumstances, which could change the CFTC's interpretation.

309 See Proposing Release at 29831-29832, Request for Comment 30.

310 See Letter from Peter Krenkel, President and CEO, NGX, dated Nov. 4, 2010, resubmitted by email to CFTC staff on Sept. 14, 2011 ("NGX Letter"). One other commenter addressed a related issue, asserting that the Commissions should clarify that cleared forwards between commercial participants should be permitted under the forward contract exclusion. See Ex Parte Communication among Evolution Markets Inc. ("Evolution"), Ogilvy Government Relations ("Ogilvy") and CFTC staff on May 18, 2011 at http://comments.cftc.gov/PublicComments/ViewExParte.aspx?id=197&SearchText=.

provide an appropriate transition period once those thresholds are breached. This commenter contended that two hallmarks of the exchange-traded forward markets, which it characterized as "a relatively new development," are that the participants generally are commercials and a high percentage of contracts go to delivery, notwithstanding netting of delivery obligations.[311] This commenter added that, while parties to such contracts intend to go to delivery when they enter into them, their delivery needs may change as time passes.

The CFTC declines to address this request for the 50/100 Forward Safe Harbor, which raises policy issues that are beyond the scope of this rulemaking. Should the CFTC consider the implications of the requested 50/100 Forward Safe Harbor, including possible additional conditions for relief, it would be appropriate for the CFTC to obtain further comment from the public on this discrete proposal. For the same reasons, the CFTC declines to address at this time the comment requesting that the CFTC take the view that cleared forwards between commercial participants fall within the scope of the forward contract exclusion.

b) Commodity Options and Commodity Options Embedded in Forward Contracts

i) Commodity Options[312]

The CFTC noted in the Proposing Release[313] that the statutory swap definition explicitly provides that commodity options are swaps, that it had proposed revisions to its existing options rules in parts 32 and 33 of its regulations[314] with respect to the treatment of commodity options under the Dodd-Frank Act, and that it had requested comment on those proposed revisions in that

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311 Id.

312 As used in this release, the term "commodity option" refers to an option that is subject to the CEA.

313 See Proposing Release at 29829-30.

314 17 CFR Parts 32 and 33.

rulemaking proceeding.[315] Accordingly, the CFTC did not propose an additional interpretation in the Proposing Release with respect to commodity options.

The CFTC reaffirms that commodity options are swaps under the statutory swap definition, and is not providing an additional interpretation regarding commodity options in this release. The CFTC recently addressed commodity options in the context of a separate final rulemaking and interim final rulemaking, under its plenary options authority in CEA section 4c(b).[316] There, the CFTC adopted a modified trade option exemption, and has invited public comment on the interim final rules.[317]

Comments

Several commenters in response to the Proposing Release argued that commodity options should not be regulated as swaps.[318] In general, these commenters believed that commodity options should qualify for the forward exclusion from the swap definition, emphasizing similarities between commodity options and forward contracts on nonfinancial commodities.[319]

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315 See Commodity Options and Agricultural Swaps, 76 FR 6095 (Feb. 3, 2011) (proposed).

316 7 U.S.C. 6c(b).

317 See Commodity Options, 77 FR 25320 (Apr. 27, 2012).

318 See Letter from Brian Knapp, Policy Advisor, American Petroleum Institute ("API"), dated January 31, 2012 ("API Letter"); BGA Letter; COPE Letter; ETA Letter; Just Energy Letter; NGSA/NCGA Letter; and WGCEF Letter.

319 For example, one commenter asserted that, similar to a forward contract on a nonfinancial commodity, a commodity option conveys no ability for a party to unilaterally require a financial settlement. Reasoning that both commodity options and forward contracts on nonfinancial commodities are intended to settle by physical delivery, this commenter contended that they should have the same regulatory treatment. See COPE Letter. Similarly, another commenter argued that the forward exclusion "plainly covers" commodity options because they are: (i) contracts for the sale of physical, nonfinancial commodities, (ii) for deferred delivery, and (iii) intended to be physically settled, given that purchasers have an absolute right to physical delivery and sellers have an absolute obligation to physically deliver the amounts called for by the purchasers if the option is exercised. See NGSA/NCGA Letter. A third commenter recommended that the CFTC interpret the forward exclusion "broadly" to include options that, if exercised, become forwards in nonfinancial commodities in light of the particular circumstances

The CFTC is not providing an interpretation that commodity options qualify as forward contracts in nonfinancial commodities. Such an approach would be contrary to the plain language of the statutory swap definition, which explicitly provides that commodity options are swaps.[320] This approach also would be a departure from the CFTC's and its staff's longstanding interpretation of the forward exclusion with respect to the term "future delivery,"[321] which the CFTC has determined above to apply to the forward exclusion from the swap definition as well.[322] Further, the CFTC notes that it has recently issued final and interim final rules adopting a modified version of the CFTC's existing trade option exemption.[323]

ii) Commodity Options Embedded in Forward Contracts

The CFTC is restating the interpretation regarding forwards with embedded options from the Proposing Release, but with certain modifications based on comments received. The CFTC is providing additional interpretations regarding forwards with embedded volumetric optionality, optionality in the form of evergreen and renewal provisions, and optionality with respect to delivery points and delivery dates.

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of the electricity industry, where electric companies use commodity options to efficiently meet the demands of electric customers by hedging or mitigating commercial risks due to seasonal and geographically unique weather and load patterns and fluctuations. See ETA letter. In the alternative, a fourth commenter requested that the CFTC exercise its plenary options authority under CEA section 4c(b), 7 U.S.C. 6c(b), to establish a separate regulatory regime for commodity options analogous to the trade option exemption under former CFTC Rule 32.4. See WGCEF Letter. See 17 CFR 32.4 (2011).

320 See CEA section 1a(47)(A)(i), 7 U.S.C. 1a(47)(A)(i) (defining a swap as, among other things, "a put, call . . . or option of any kind . . .for the purchase or sale . . . of . . . commodities") and CEA section 1a(47)(B), 7 U.S.C. 1a(47)(B) (not excluding commodity options from the swap definition).

321 See 1985 CFTC OGC Interpretation, supra note 245. In this regard, an option cannot be a forward under the CFTC's precedent, because under the terms of the contract the optionee has the right, but not the obligation, to make or take delivery, while under a forward contract, both parties must have binding delivery obligations: one to make delivery and the other to take delivery.

322 See supra part II.B.2(a)(i)(A).

323 See supra note 317.

As was noted in the Proposing Release, the question of the application of the forward exclusion from the swap definition with respect to nonfinancial commodities, where commodity options are embedded in forward contracts (including embedded options to cash settle such contracts), is similar to that arising under the CEA's existing forward contract exclusion from the definition of the term "future delivery."[324] The CFTC's Office of General Counsel addressed forward contracts that contained embedded options in the 1985 CFTC OGC Interpretation,[325] which recently was adhered to by the CFTC in its adjudicatory Order in the Wright case.[326] While both were issued prior to the effective date of the Dodd-Frank Act, the CFTC believes that, as was stated in the Proposing Release, it is appropriate to apply this interpretation to the treatment of forward contracts in nonfinancial commodities that contain embedded options under the Dodd-Frank Act. [327]

In Wright, the CFTC stated that it traditionally has engaged in a two-step analysis of "embedded options" in which the first step focuses on whether the option operates on the price or the delivery term of the forward contract and the second step focuses on secondary trading.[328] As was stated in the Proposing Release, these same principles can be applied with respect to the

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324 See Proposing Release at 29830.

325 See 1985 CFTC OGC Interpretation, supra note 245.

326 Wright, supra note 214.

327 See Proposing Release at 29830.

328 Wright, supra note 214, at n.5. In Wright, the CFTC affirmed the Administrative Law Judge's holding that an option embedded in a hedge-to-arrive contract did not violate CFTC rules regarding the sale of agricultural trade options. The CFTC first concluded that the puts at issue operated to adjust the forward price and did not render the farmer's overall obligation to make delivery optional. Then, turning to the next step of the analysis, the CFTC explained that "the put and [hedge-to-arrive contract] operated as a single contract, and in most cases were issued simultaneously . . . .We do not find that any put was severed from its forward or that either of [the put or the hedge-to-arrive contract] was traded separately from the other. We hold that in these circumstances, no freestanding option came into being . . . ." Id. at *7.

forward contract exclusion from the swap definition for nonfinancial commodities in the Dodd-Frank Act, too.[329] Utilizing these principles, the CFTC is providing a final interpretation that a forward contract that contains an embedded commodity option or options[330] will be considered an excluded nonfinancial commodity forward contract (and not a swap) if the embedded option(s):

1. may be used to adjust the forward contract price,[331] but do not undermine the overall nature of the contract as a forward contract;
2. do not target the delivery term, so that the predominant feature of the contract is actual delivery; and
3. cannot be severed and marketed separately from the overall forward contract in which they are embedded.[332]

In evaluating whether an agreement, contract, or transaction qualifies for the forward contract exclusions from the swap definition for nonfinancial commodities, the CFTC will look to the specific facts and circumstances of the transaction as a whole to evaluate whether any embedded optionality operates on the price or delivery term of the contract, and whether an embedded

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329 See Proposing Release at 29830.

330 Options in the plural would include, for example, a situation in which the embedded optionality involves option combinations, such as costless collars, that operate on the price term of the agreement, contract, or transaction.

331 For example, a forward with an embedded option with a formulaic strike price based on an index value that may not be known until after exercise would be a forward if it meets the rest of the 3 components of this interpretation. Triggering an option to buy or sell one commodity based on the price of a different commodity reaching a specified level, such as in a cross-commodity transaction, does not constitute an adjustment to the forward contract price within the meaning of this 3-part interpretation.

332 See Wright, supra note 214, at **6-7.

commodity option is marketed or traded separately from the underlying contract.[333] Such an approach will help assure that commodity options that should be regulated as swaps do not circumvent the protections established in the Dodd-Frank Act through the forward contract exclusion for nonfinancial commodities instead.

The CFTC also is providing an interpretation, in response to commenters,[334] with respect to forwards with embedded volumetric optionality.[335] Several commenters asserted that agreements, contracts, and transactions that contain embedded "volumetric options," and that otherwise satisfy the terms of the forward exclusions, should qualify as excluded forwards, notwithstanding their embedded optionality.[336] The CFTC believes that agreements, contracts,

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333 This facts and circumstances approach to determining whether a particular embedded option takes a transaction out of the forward contract exclusion for nonfinancial commodities is consistent with the CFTC's historical approach to determining whether a particular embedded option takes a transaction out of the forward contract exclusion from the definition of the term "future delivery" in the CEA. See id. at *5 ("As we have held since Stovall, the nature of a contract involves a multi-factor analysis . . . .").

334 The CFTC requested comment on, among other things: whether there are other factors that should be considered in determining how to characterize forward contracts with embedded options with respect to nonfinancial commodities; and whether there are provisions in forward contracts with respect to nonfinancial commodities, other than delivery and price, containing embedded optionality. See Proposing Release at 29832.

335 One commenter characterized "volumetric optionality" as the optionality in a contract settling by physical delivery and used to meet varying customer demand for a commodity." See WGCEF Letter. See also BGA Letter (stating that "it is commonplace for energy suppliers to enter into commercial transactions with customers (local distribution companies, electric utility companies, industrial, commercial and residential customers, power plants, etc.), which provide volumetric, price and delivery-related flexibility and variability"). BGA claims that commercial transactions containing embedded volumetric optionality "include, but are not limited to, full requirements contracts, interruptible load agreements, capacity contracts, tolling agreements, energy management agreements, natural gas transportation contracts and natural gas storage contracts." Id.

336 See, e.g., WGCEF Letter (submitting that "'volumetric optionality' is [a] separate and distinct concept from 'deliverability optionality'"); BGA Letter; AGA Letter; Letter from Jeffrey Perryman, Director, Contracts and Compliance, Atmos Energy Holdings, Inc. ("Atmos"), dated July 22, 2011 ("Atmos Letter"); NGSA/NCGA Letter; Letter from Paul M. Architzel, Wilmer Hale LLP on behalf of ONEOK, Inc. ("ONEOK"), dated July 22, 2011 ("ONEOK Letter"); COPE Letter.

and transactions with embedded volumetric optionality may satisfy the forward exclusions from the swap and future delivery definitions under certain circumstances. Accordingly, the CFTC is providing an interpretation that an agreement, contract, or transaction falls within the forward exclusion from the swap and future delivery definitions, notwithstanding that it contains embedded volumetric optionality, when:

1. the embedded optionality does not undermine the overall nature of the agreement, contract, or transaction as a forward contract;
2. the predominant feature of the agreement, contract, or transaction is actual delivery;
3. the embedded optionality cannot be severed and marketed separately from the overall agreement, contract, or transaction in which it is embedded;[337]
4. the seller of a nonfinancial commodity underlying the agreement, contract, or transaction with embedded volumetric optionality intends, at the time it enters into the agreement, contract, or transaction to deliver the underlying nonfinancial commodity if the optionality is exercised;
5. the buyer of a nonfinancial commodity underlying the agreement, contract or transaction with embedded volumetric optionality intends, at the time it enters into the agreement, contract, or transaction, to take delivery of the underlying nonfinancial commodity if it exercises the embedded volumetric optionality;
6. both parties are commercial parties;[338] and

[337] When a forward contract includes an embedded option that is severable from the forward contract, the forward can remain subject to the forward contract exclusion, if the parties document the severance of the embedded option component and the resulting transactions, i.e. a forward and an option. Such an option would be subject to the CFTC's regulations applicable to commodity options.

7. the exercise or non-exercise of the embedded volumetric optionality is based primarily on physical factors,[339] or regulatory requirements,[340] that are outside the control of the parties and are influencing demand for, or supply of, the nonfinancial commodity.[341]

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338 See discussion in section II.B.2.(a)(i)(B), supra.

339 See, e.g., BGA Letter (advising that "[v]ariability associated with an energy customer's physical demand is influenced by factors outside the control of . . . energy suppliers (and sometimes . . . consumers) . . . including, but not limited to, load growth, weather and certain operational considerations (e.g., available transportation capacity to deliver physical natural gas purchased on the spot market)").

340 Volumetric optionality in this category would include, for example, a supply contract entered into to satisfy a regulatory requirement that a supplier procure, or be able to provide upon demand, a specified volume of commodity (e.g., electricity). To the extent the optionality covers an amount of the commodity in excess of the regulatory requirement, such optionality would not necessarily be covered by this aspect of the guidance, though it may nevertheless be covered by the guidance if such excess volumetric optionality is based on physical factors within the meaning of the guidance. For example, the California Utilities explained that the California Public Utilities Commission ("CPUC") requires them to file a supply plan with the CPUC demonstrating that they have procured sufficient capacity resources (including reserves) needed to serve their aggregate system load on a monthly and yearly basis. See California Utilities Letter. Each utility's system requirement is 100 percent of its peak-hourly forecast load plus a 15-17 percent reserve margin. The California Utilities enter into resource adequacy agreements to procure electric power generating capacity to meet these requirements. The ability to call on the additional 15 to 17% reserve reflected in such an agreement is covered by the regulatory requirements part of this element. To the extent the California Utilities may have a business need to procure additional capacity resources beyond the foregoing regulatory requirement (e.g., because they wish to maintain a slightly larger reserve margin than required due to a recent upswing in unscheduled plant outages due to aging plants), that may be covered under the interpretation if the additional capacity is required due to physical factors beyond the control of the parties (i.e., the unscheduled outage, in the foregoing example).

341 In other words, the predominant basis for failing to exercise the option would be that the demand or supply (as applicable) that the optionality was intended to satisfy, if needed, never materialized, materialized at a level below that for which the parties contracted or changed due to physical factors or regulatory requirements outside the parties' control. Such failure to exercise, or an exercise for a reduced amount of the underlying commodity, could, for example, be due to colder than expected weather during the summer decreasing demand for air conditioning, in turn decreasing demand for power to run the air conditioning. The Commission does not interpret this to mean that absolutely all factors involved in the decision to exercise an option must be beyond the parties' control, but rather the decision must be predominantly driven by factors affecting supply and demand that are beyond a parties control. This also means that the forward contract with embedded volumetric optionality needs to be a commercially appropriate method for securing the purchase or sale of the nonfinancial commodity for deferred shipment at the time it is

The first two elements of the interpretation for embedded volumetric optionality, which mirror the CFTC's historical embedded option interpretation discussed above, have been modified to reflect that embedded volumetric optionality relates to delivery rather than price. As noted above, the predominant feature of a forward contract is a binding, albeit deferred, delivery obligation. It is essential that any embedded option in a forward contract as to volume must not undermine a forward contract's overall purpose.[342] The CFTC recognizes that the nature of commercial operations are such that supply and demand requirements cannot always be accurately predicted and that forward contracts that allow for some optionality as to the amount of a nonfinancial commodity actually delivered offer a great deal of value to commercial participants. Where an agreement, contract, or transaction requires delivery of a non-nominal volume of a nonfinancial commodity, even if an embedded volumetric option is exercised, the CFTC believes that the predominant feature of the contract, notwithstanding the embedded volumetric optionality, is actual delivery. This is the case in many forward contracts that have an embedded option that allows a party to buy or sell an additional amount of a commodity beyond the fixed amount called for in the underlying forward contract. For instance, a forward contract could call for the delivery of 10,000 bushels of wheat and include an option for an additional 5,000 bushels of wheat.[343]

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entered into. The CFTC cautions market participants that, to the extent a party relies on the forward exclusion from the swap or future delivery definitions, notwithstanding that there is volumetric optionality, if that volumetric optionality is inconsistent with the seventh element of the interpretation, the agreement, contract or transaction may be an option.

342 See discussion in part II.B.2.(a)(i)(B), supra. See also supra note 321.

343 In evaluating whether the predominant feature of a transaction is actual delivery, the CFTC will look at the contract as a whole. Thus, with respect to this contract, the CFTC would consider the intent element of the forward exclusions to be satisfied because the contract requires the seller to deliver a non-nominal volume of a commodity (i.e., 10,000 bushels of wheat), viewing the contract as a whole. As a result, if the other elements of the guidance above are satisfied, this

The third element is substantially the same as the third element of the interpretation above with respect to commodity options embedded in forward contracts generally.

The fourth and fifth elements are designed to ensure that both parties intend to make or take delivery (as applicable), subject to the relevant physical factors or regulatory requirements, which may lead the parties to deliver more or less than originally intended. This distinguishes a forward contract from a commodity option, where only the option seller must at all times be prepared to deliver during the term of the option. The sixth element is intended to ensure that the interpretation is not abused by market participants not engaged in a commercial business involving the nonfinancial commodity underlying the embedded volumetric optionality.[344]

The seventh element is based on comments stating that parties to agreements, contracts, and transactions with embedded volumetric optionality intend to make or take delivery (as applicable) of a commodity, and that it is merely the volume of a commodity that would be required to be delivered if the option is exercised, that varies. It is designed to ensure that the volumetric optionality is primarily driven by physical factors or regulatory requirements that influence supply and demand and that are outside the parties' control, and that the optionality is a

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contract would be a forward contract, even if the party did not exercise the option for the additional 5,000 bushels.

344 The fact that the CFTC is expressly including the fourth through sixth elements in the embedded optionality guidance for volumetric options but not elsewhere does not mean that intent to deliver and the ability to make or take delivery expressed in these elements are not part of the facts and circumstances the CFTC will consider in the context of determining whether other agreements, contracts, and transactions qualify for the forward exclusions. Intent to deliver and the ability to make or take delivery have long been a part of the CFTC's facts-and-circumstances approach to making that determination, and they remain so. The CFTC is emphasizing these elements in this guidance because the CFTC has not previously expressed the view that an agreement, contract, or transaction with embedded volumetric optionality which affects the delivery term may qualify as a forward if these facts and circumstances are present.

commercially reasonable way to address uncertainty associated with those factors.[345] Element seven must be interpreted with the other elements set forth here. For instance, even if the optionality is consistent with element seven, such optionality cannot undermine the overall nature of the contract as a forward contract as discussed above.

As discussed in the interpretation regarding forwards with embedded optionality discussed above, in evaluating whether an agreement, contract or transaction with embedded volumetric optionality qualifies for the forward exclusions, the CFTC will look to the relevant facts and circumstances of the transaction as a whole to evaluate whether the transaction qualifies for the forward exclusions from the definitions of the terms "swap" and "future delivery."

The CFTC is providing further interpretations to explain how it would treat some of the specific contracts described in the comment letters. According to one commenter, a "full requirements contract" can be described as a "contract where the seller agrees to provide all requirements for a specific customer's location or delivery point."[346] According to another commenter, "[a] full requirements contract . . . is a well-established concept in contract law" and

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345 See, e.g., AGA Letter (advising that "[i]n general, retail demand for natural gas is weather driven . . . as a result [of which], a gas utility's peaking supplies must have significant flexibility . . . [and g]as utilities . . . use a variety of contracts with gas suppliers to physically deal with peak periods of demand"); BGA Letter (citing gas supply curtailment due to a pipeline outage and power generation curtailment by an Independent System Operator for operational reasons as factors outside the control of energy suppliers and which could impact the amount of a commodity delivered). The CFTC understands BGA's comment to address involuntary curtailments, but also recognizes that power buyers may agree in advance that the relevant Regional Transmission Organization or Independent System Operator may, in order to maintain system reliability, curtail power deliveries to the buyers. While voluntary curtailments are within the control of the power buyer, the potential system reliability issue is not. Therefore, such voluntary curtailments would be within the guidance because, if triggered, they would be based on a physical factor (e.g., supply constraints).

346 See Letter from Keith M. Sappenfield, II, Director, US Regulatory Affairs, Encana Marketing (USA) Inc. ("Encana"), dated July 22, 2011 ("Encana Letter").

"[i]n a requirements contract, the purchaser . . . deals exclusively with one supplier."[347] This commenter added that, while the amount of commodity delivered can vary, it is based on an objective need and that the Uniform Commercial Code imposes on the buyer "an obligation to act in good faith with respect to the varying amount that is called for delivery."[348] Based upon this description, the CFTC believes that a going commercial concern with an exclusive supply contract has no option but to get its supply requirements met through that exclusive supplier consistent with the terms of the contract. Any instance where nominal or zero delivery occurred would have to be because the commercial requirements changed or did not materialize. Furthermore, any variability in delivery amounts under the contract appears to be driven directly by the buyer's commercial requirements and is not dependent upon the exercise of any commodity option by the contracting parties.

Accordingly, full requirements contracts, as described above, appear not to contain embedded volumetric options. Therefore, a full requirements contract may qualify for the forward exclusion under the same facts and circumstances analysis applicable to all other

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347 See ONEOK Letter. The CFTC notes that this commenter discussed full requirements contracts in the context of supply agreements between one of its affiliates and retail customers. If such customers are non-commercial customers, such contracts are not forwards, but nevertheless they may not be swaps under the Commissions' guidance regarding the non-exhaustive list of consumer transactions, or otherwise if they have characteristics or factors described under the consumer transaction interpretation, see infra part II.B.3.

348 See, e.g., NY UCC § 2-306(1) (stating that "[a] term which measures the quantity by the output of the seller or the requirements of the buyer means such actual output or requirements as may occur in good faith . . . ."). This commenter cited Corbin on Contracts for the proposition that the mere fact that the quantity term of the contract is "the buyer's needs or requirements" does not render the requirements contract "a mere options contract" because "the buyer's promise is not illusory . . . [but] is conditional upon the existence of an objective need for the commodity." See ONEOK Letter (citing Corbin on Contracts § 6.5 at 240-53 (1995)).

agreements, contracts, and transactions that might be forwards. The same analysis would apply to an output contract satisfying the terms of this interpretation.[349]

With respect to capacity contracts, transmission (or transportation) services agreements, and tolling agreements, the CFTC understands that: (i) capacity contracts are generally products designed to ensure that sufficient physical generation capacity is available to meet the needs of an electrical system;[350] (ii) transmission (or transportation) services agreements are generally agreements for the use of electricity transmission lines (or gas pipelines) that allow a power generator to transmit electricity (or gas supplier to transport gas) to a specific location;[351] and (iii) tolling agreements, as described by commenters, provide a purchaser the right to the capacity, energy, ancillary services and any other product derived from a specified generating unit, all based upon a delivered fuel price and agreed heat rate.[352]

Such agreements, contracts and transactions, may have features that will satisfy the "forwards with embedded volumetric optionality" interpretation discussed above, or, like full requirements contracts, may not contain embedded volumetric options and may satisfy other portions of the forward interpretations herein. For example, according to one commenter, the delivery obligations in some tolling agreements are not optional which is indicative that the predominant feature of such tolling agreements is actual delivery.[353] It is also possible, based on

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349 See Letter from Phillip G. Lookadoo, Esq., Reed Smith LLP and Jeremy D. Weinstein, Esq. on behalf of IECA dated May 23, 2012 (suggesting that output contracts, in addition to full requirements contracts, should be within the forward exclusion). An output contract has been defined as "a contract pursuant to which the obligor's duty to supply the promised commodity is quantified (and therefore limited) by reference to its production thereof." See Boyd v. Kmart Corp., 110 F.3d 73 (10th Cir. 1997).

350 See California Utilities Letter.

351 See NEMA Letter.

352 See California Utilities Letter.

353 Id.

descriptions provided to the CFTC, that tolling agreements could fit within the interpretation concerning certain physical agreements, contracts, or transactions,[354] or other interpretations herein.

Some commenters focused on forwards with embedded volumetric optionality in the natural gas industry. For example, one commenter stated that "peaking supply" natural gas contracts do not render delivery optional. Although the purchaser has the option to specify when and if the quantity of gas will be delivered on any given day, this commenter asserted that there is no cash settlement alternative. If the purchaser does not exercise the right to purchase, then the right is terminated. The seller under the transaction must deliver the entire quantity of gas that the purchaser specifies, or pay liquidated damages. Moreover, the option is not severable and cannot be marketed separately from the supply agreement itself.[355] Similarly, another commenter said that there is no ability to sever an embedded option from a natural gas forward contract. Moreover, it stated that the ability for a gas purchaser to specify a quantity of gas for a certain day is not to encourage speculative activity; rather, it is because the exact quantity of gas to be needed on that future day is unknown, and many gas purchasers have weather-dependent needs that cannot accurately be predicted in advance.[356]

Depending on the relevant facts and circumstances, these types of agreements, contracts, and transactions – capacity contracts, transmission (or transportation) services agreements, tolling agreements, and peaking supply contracts – may satisfy the elements of the "forwards with embedded volumetric options" interpretation set forth above , or may satisfy other portions

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354 See infra part II.B.2.(b)(iii).

355 See AGA Letter.

356 See Atmos Letter.

of this interpretation. If they do, they would fall within the forward exclusions from the swap and future delivery definitions.

In addition, the CFTC is providing an interpretation in response to a comment that contracts with evergreen or extension terms should be considered forwards.[357] The CFTC is clarifying that an extension term in a commercial contract, such as a renewal term in a five year power purchase agreement (which, due to the renewal, would require additional deliveries), is not an option on the delivery term within the meaning of the CFTC's interpretation, and consequently would not render such a contract ineligible for the forward exclusions from the definitions of the terms "swap" and "future delivery." Similarly, an evergreen provision, which automatically renews a contract (and, as such, would require additional deliveries)[358] absent the parties affirmatively terminating it, would not render such a contract ineligible for the forward exclusions from the swap or future delivery definitions.[359] When the Proposing Release stated that a forward contract containing an embedded option that does not "target the delivery term" is an excluded forward contract,[360] it meant that the embedded option does not affect the delivery amount.[361]

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357 See IECA Letter.

358 The CFTC refers in this and the prior sentence to "additional deliveries" because the IECA's example involves an agreement calling for delivery of a physical nonfinancial commodity.

359 Using extension or evergreen provisions to avoid delivery, however, as was the case with the "rolling spot" contracts at issue in CFTC v. Zelener, 373 F.3d 861 (7th Cir. 2004), could constitute evasion or violate other provisions of the CEA (e.g., CEA section 4(a), 7 U.S.C. 6(a)). This interpretation does not limit the CFTC's other interpretations in this release regarding when delivery does not occur (e.g., the Brent Interpretation).

360 See NGSA/NCGA Letter (requesting clarification of the phrase "target the delivery term.").

361 See Proposing Release at 29830, n.81.

Also, in response to a commenter,[362] the CFTC clarifies that embedded optionality as to delivery points and delivery dates will not cause a transaction that otherwise qualifies as a forward contract to be considered a swap. The CFTC emphasizes, however, that delivery must occur at some delivery point and on some date, or the lack of delivery must be due to the transaction being booked out or otherwise be consistent with the CFTC's interpretation regarding the forward exclusions from the swap and future delivery definitions.

Comments

Commenters generally supported the CFTC's proposed interpretation regarding forwards with embedded options, but many believed that it should be modified or expanded. As noted above, several commenters believed that forward contracts with embedded options that contain optionality as to the quantity/volume of the nonfinancial commodity to be delivered should qualify as forwards, and that the CFTC's proposed interpretation (which only mentions price optionality) should be modified accordingly.[363] In this regard, several commenters focused on forwards with embedded volumetric options in the natural gas industry.[364] One commenter noted that, although the 1985 CFTC OGC Interpretation distinguishes forward contracts from trade options, it is based on a limited number of agricultural contract examples, so additional guidance is needed, particularly in light of the wide range of cash market and commercial merchandising contracting practices in which delivery terms and amounts vary.[365]

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362 See COPE Letter.

363 See AGA Letter; API Letter; Atmos Letter; ONEOK Letter; NGSA/NCGA Letter; WGCEF Letter.

364 See AGA Letter; Atmos Letter.

365 See ONEOK Letter. This commenter noted that it offers its customers a number of types of contracts for delivery of natural gas under which the amount called for delivery may vary. In each of these types of contracts, this commenter stated that both parties intend the contracts to result in delivery of the commodity, as needed. The purpose of these contracts is to ensure that

In addition, another commenter requested more generally that any embedded option (for example, price, quantity, delivery point, delivery date, contract term) that does not permit a unilateral election of financial settlement based upon the value change in an underlying cash market should not render the contract a swap.[366]

As discussed above, the CFTC has provided an additional interpretation with respect to forwards with embedded volumetric options to address commenters' concerns. The CFTC also has provided an interpretation above, regarding price optionality, optionality with respect to delivery points and delivery dates specifically in response to this commenter, and optionality as to certain contract terms (such as evergreen and renewal provisions) to address particular concerns raised by commenters. The CFTC declines to adopt a more expansive approach with respect to "any" embedded option.

One commenter requested that an option to purchase or sell a physical commodity, whether embedded in a forward contract or stand alone, should either (i) fall within the statutory forward exclusion from the swap definition, or (ii) alternatively, if deemed by the CFTC to be a swap, should be exempt from the swap definition pursuant to a modified trade option exemption pursuant to CEA section 4c(b).[367] The CFTC has modified its proposed interpretation regarding forwards with embedded options as discussed above; contracts with embedded options that are

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customers, most of which are gas or electric utilities, have an adequate supply of natural gas regardless of day-to-day changes in demand that may be caused by variation in weather, operational considerations, or other factors. They are not designed for one-way price protection as would be the case with an option. See ONEOK Letter.

366 See COPE Letter, Appendix.

367 See WGCEF Letter; 7 U.S.C. 6c(b).

swaps under this final interpretation may nevertheless qualify for the modified trade option exemption recently adopted by the CFTC and discussed above.[368]

Another commenter urged the CFTC to broadly exempt commercial forward contracting from swap regulation by generally excluding from the swap definition any forward contract with embedded optionality between end users "whose primary purpose is consistent with that of an 'end user', and in which any embedded option is directly related to 'end use.'"[369] The CFTC believes that this interpretation is vague and overbroad, and declines to adopt it.

Another commenter believed that the CFTC's "facts and circumstances" approach to forwards with embedded options does not provide the legal certainty required by nonfinancial entities engaging in commercial contracts in the normal course of business.[370] This commenter further argued that many option-like contract terms could be determined to "target the delivery term" under a facts and circumstances analysis.[371]

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368 77 FR 25320 (Aug. 27, 2012). Encana believed that the guidance on forwards with embedded options should include embedded physical delivery options because it asserted that many of the contracts currently used by participants in the wholesale natural gas market contain an option for the physical delivery of natural gas. See Encana Letter. To the extent that Encana's comment goes beyond volumetric optionality, commodity options are discussed supra in section II.B.2(b).

369 See Letter from Roger Cryan, Vice President for Milk Marketing and Economics, National Milk Producers Federation ("NMPF"), dated July 22, 2011 ("NMPF Letter").

370 See ETA Letter. Similarly, COPE comments that a nonfinancial commodity forward contract that, "by its terms," is intended to settle physically should be permitted to contain optionality without being transformed into a swap unless such optionality negates the physical settlement element of the contract. That is, if one party can exercise an option to settle the contract financially based upon the value change in an underlying cash market, then the intent for physical settlement is not contained in "the four corners of the contract" and may render the contract a swap. See COPE Letter. As discussed elsewhere in this release, the CFTC historically has eschewed approaches to the forward exclusion that rely on the "four corners of the contract," which can provide a roadmap to evasion of statutory requirements.

371 Accordingly, this commenter believed that the CFTC should provide in its rules that an embedded option or embedded optionality will not result in a nonfinancial forward being a swap unless: (i) delivery is optional; (ii) financial settlement is allowed; and (iii) transfer and trading of the option separately from the forward is permitted. See ETA Letter.

The CFTC has long applied a facts-and-circumstances approach to the forward exclusion, including with respect to forwards with embedded options, and thus it is an approach with which market participants are familiar. That approach balances the need for legal certainty against the risk of providing opportunities for evasion.[372] The CFTC's additional interpretation noted above, including clarification about the meaning of the phrase "target the delivery term," and forwards with embedded volumetric optionality, provides enhanced legal certainty in response to the commenter's concerns.[373]

Request for Comment

The CFTC's interpretation regarding forwards with volumetric options is an interpretation of the CFTC and may be relied upon by market participants. However, the CFTC believes that it would benefit from public comment about its interpretation, and therefore requests public comment on all aspects of its interpretation regarding forwards with embedded volumetric options,[374] and on the following questions:

1. Are the elements set forth in the interpretation to distinguish forwards with embedded volumetric optionality from commodity options appropriate? Why or why not?

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372 See also NCFC Letter (supporting the CFTC's guidance because it provides legal certainty).

373 See also Commodity Options, 77 FR 25320, 25324 n. 25 (Apr. 27, 2012) (discussing the CFTC's conclusion that an "option[] to redeem" under the USDA Commodity Credit Corporation's marketing loan program constitutes a cotton producer's contractual right to repay its marketing loan and "redeem" the collateral (cotton) to sell in the open market).

374 Separately, it is expected that CFTC staff will be issuing no-action relief with respect to the conditions of the modified trade option exemption (except the enforcement provisions retained in § 32.3(d)) until December 31, 2012. This extension will afford the CFTC an opportunity to review and evaluate the comments received on both the interpretation above regarding embedded volumetric optionality, and the modified trade option exemption, in order to determine whether any changes thereto are appropriate.

2. Are there additional elements that would be appropriate? Please describe and provide support for why such elements would serve to distinguish forwards with embedded volumetric optionality from commodity options.

3. Is the seventh element that, to ensure that an agreement, contract, or transaction with embedded volumetric optionality is a forward and not an option, the volumetric optionality is based primarily on physical factors, or regulatory requirements, that are outside the control of the parties and are influencing demand for, or supply of, the nonfinancial commodity, necessary and appropriate? Why or why not? Is the statement of this element sufficiently clear and unambiguous? If not, what adjustments would be appropriate?

4. Are there circumstances where volumetric optionality is based on other factors? Please describe. Would such factors, if made a part of the interpretation, serve to distinguish forwards with embedded volumetric optionality from commodity options? If so, how?

5. Does the interpretation provide sufficient guidance as to whether agreements, contracts, or transactions with embedded volumetric optionality permitting a nominal amount, or no amount, of a nonfinancial commodity to be delivered are forwards or options, viewing the agreements, contracts, or transactions as a whole, if they satisfy the seven elements of the interpretation? Why or why not? Does this interpretation encourage evasion, or do the seven elements sufficiently distinguish forwards from agreements, contracts, and transactions that may evade commodity options regulation?

6. Is the interpretation sufficiently clear with respect to capacity contracts, transmission (or transportation) services agreements, peaking supply contracts, or tolling agreements? Why or why not? Do capacity contracts, transmission (or transportation) services agreements, peaking supply contracts, or tolling agreements generally have features that satisfy

the forwards with volumetric options interpretation included in this release? If so, which ones? If not, why not? Could these types of agreements, contracts, and transactions qualify for the forward exclusions under other parts of the interpretation set forth above? Are there material differences in the structure, operation, or economic effect of these types of agreements, contracts, and transactions as compared to full requirements contracts that are relevant to whether such agreements, contracts, and transactions are options under the CEA? Please explain. If so, what are the material differences?

7. Do the agreements, contracts, and transactions listed in question no. 6 above have embedded optionality in the first instance? Based on descriptions by commenters, it appears that they may have a binding obligation for delivery, but have no set amount specified for delivery. Instead, delivery (including the possibility of nominal or zero delivery) is determined by the terms and conditions contained within the agreement, contract, or transaction (including, for example, the satisfaction of a condition precedent to delivery, such as a commodity price or temperature reaching a level specified in the agreement, contract, or transaction). That is, the variation in delivery is not driven by the exercise of embedded optionality by the parties. Do the agreements, contracts, and transactions listed in question no. 6 exhibit these kinds of characteristics? If so, should the CFTC consider them in some manner other than its forward interpretation? Why or why not?

iii) Certain Physical Commercial Agreements, Contracts or Transactions

The CFTC is providing an interpretation in response to comments regarding certain physical commercial agreements for the supply and consumption of energy that provide flexibility, such as tolls on power plants, transportation agreements on natural gas pipelines, and

natural gas storage agreements.[375] Commenters recognized that these types of agreements, contracts or transactions may have option-like features, but analogized them to leases and concluded that they were forwards rather than swaps. One commenter, for example, characterized taking power produced pursuant to a physical tolling agreement -- which can involve one party thereto providing fuel for a generation plant and having the exclusive right to take the power produced by that plant from the fuel provided -- thus, in effect, "renting" the plant to the extent the plant is used to produce power from the fuel provided -- as more akin to a lease than to an option. [376]

The CFTC will interpret an agreement, contract or transaction not to be an option if the following three elements are satisfied: (1) the subject of the agreement, contract or transaction is usage of a specified facility or part thereof rather than the purchase or sale of the commodity that is to be created, transported, processed or stored using the specified facility; (2) the agreement, contract or transaction grants the buyer the exclusive use of the specified facility or part thereof during its term, and provides for an unconditional obligation on the part of the seller to grant the buyer the exclusive use of the specified facility or part thereof;[377] and (3) the payment for the use of the specified facility or part thereof represents a payment for its use rather than the option to

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375 See BGA Letter and California Utilities Letter. This interpretation also may apply to firm transmission agreements pursuant to which transmission service may not be interrupted for any reason except during an emergency when continued delivery of power is not possible. See http://www.interwest.org/wiki/index.php?title=Firm_transmission_service.

376 See California Utilities Letter.

377 In this regard, the usage rights offered for sale should be limited to the capacity of the specified facility. While overselling such capacity would not per se be inconsistent with satisfying the terms of this interpretation, the CFTC cautions market participants that overselling not based on reasonable commercial expectations of the use of the specified facility could lead the contract to be deemed evasion and lead to an agreement, contract or transaction being considered a swap, as it would undermine the "right" being offered. For example, given physical constraints of the power grid and gas pipelines, overselling transmission or transportation capacity would be per se inconsistent with satisfying the terms of this interpretation.

use it. In such agreements, contracts and transactions, while there is optionality as to whether the person uses the specified facility, the person's right to do so is legally established, does not depend upon any further exercise of an option and merely represents a decision to use that for which the lessor already has paid. In this context, the CFTC would not consider actions such as scheduling electricity transmission, gas transportation or injection of gas into storage to be exercising an option if all three elements of the interpretation above are satisfied. As with the interpretation regarding forwards with embedded options generally, discussed above, in evaluating whether flexible physical commercial agreements that meet the 3-part test qualify for the forward exclusions, the CFTC will look to the specific facts and circumstances of the agreement, contract or transaction as a whole to evaluate whether the agreement, contract or transaction qualifies for the forward exclusions from the definitions of "swap" and "future delivery."

However, in the alternative, if the right to use the specified facility is only obtained via the payment of a demand charge or reservation fee, and the exercise of the right (or use of the specified facility or part thereof) entails the further payment of actual storage fees, usage fees, rents, or other analogous service charges not included in the demand charge or reservation fee, such agreement, contract or transaction is a commodity option subject to the swap definition.

Comments

Two commenters addressed "lease-like" physical agreements, contracts or transactions.[378] One of these commenters asserted that there are many physical commercial agreements for the supply and consumption of energy that effectively provide leases on flexible energy assets, such as tolls on power plants, transportation agreements on natural gas pipelines and natural gas

[378] See BGA Letter and California Utilities Letter.

storage agreements.[379] According to this commenter, these assets have the capability to be turned on and off to meet fluctuating demand due to weather and other factors; physical contracts around these assets transfer that delivery flexibility to the contract holder. The commenter believed that these types of commercial arrangements should not be considered commodity options, but rather should be excluded forwards. The other commenter described tolling agreements as having the characteristics of a lease, in that the purchasing entity obtains the exclusive right to the use of the power plant during the term of the agreement.[380] This commenter asserted that such agreements should not be considered commodity options, but rather forwards because the obligations are not contingent. The CFTC is providing the above interpretation that these types of agreements, contracts and transactions are not commodity options if the above conditions are satisfied, but may qualify for the forward exclusions under the facts and circumstances, in response to these commenters' concerns.

iv) Effect of Interpretation on Certain Agreements, Contracts and Transactions

In the Proposing Release,[381] the CFTC requested comment regarding how its proposed interpretation concerning the forward contract exclusion would affect full requirements

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379 See BGA Letter.

380 See California Utilities Letter.

381 See Request for Comment 35, which stated: How would the proposed interpretive guidance set forth in this section affect full requirements contracts, capacity contracts, reserve sharing agreements, tolling agreements, energy management agreements, and ancillary services? Do these agreements, contracts, or transactions have optionality as to delivery? If so, should they—or any other agreement, contract, or transaction in a nonfinancial commodity that has optionality as to delivery—be excluded from the swap definition? If so, please provide a detailed analysis of such agreements, contracts, or transactions and how they can be distinguished from options that are to be regulated as swaps pursuant to the Dodd-Frank Act. To what extent are any such agreements, contracts, or transactions in the electric industry regulated by the Federal Energy Regulatory Commission ("FERC"), State regulatory authorities, regional transmission organizations (''RTOs''), independent system operators (''ISOs'') or market monitoring units associated with RTOs or ISOs?

contracts, reserve sharing agreements, tolling agreements, energy management agreements and ancillary services. The CFTC asked whether such agreements, contracts or transactions have optionality as to delivery and, if so, whether they, or any other agreement, contract or transaction in a nonfinancial commodity, should be excluded from the swap definition.[382]

Commenters generally believed that such types of agreements, contracts and transactions, although they may contain delivery optionality, should be considered forwards rather than swaps or commodity options.[383] By contrast, one commenter believed that traded power markets involve many types of contracts that are actually exchanges of cash flows based on referenced values and that have no relevant characteristics of physical delivery.[384]

With the exception of energy management agreements, which are discussed below, the interpretations that the CFTC has already provided above may apply to such types of agreements, contracts and transactions. Specifically, to the extent that such types of agreements,

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See Proposing Release at 29832.

382 Id.

383 See Atmos Letter; BGA Letter; California Utilities Letter; COPE Letter; ETA Letter; Encana Letter; FERC Staff Letter; IECA Letter; NEMA Letter; ONEOK Letter; and Letter from Kenneth R. Carretta, General Regulatory Counsel – Markets, PSEG Services Corp., on behalf of the Public Service Electric and Gas Company, PSEG Power LLC, and PSEG Energy Resources & Trade LLC ("PSEG Companies"), dated July 22, 2011 ("PSEG Letter").

384 See Better Markets Letter. This commenter stated that ancillary services are in substance swaps based on congestion costs between two transmission points, measured by the difference between actual prices assigned at those points by the grid operator. Capacity contracts are often documented using trading agreements for transactions in physicals, but this commenter believed that they constitute swaps that are used to hedge the price risk associated with periodic auctions of the contracts to provide reliable capacity to the grid operator. This commenter asserted that such contracts do not meet the CFTC's appropriate tests to exclude them, which should be made explicit in the guidance. This commenter stated that basic power contracts often do not meet the intent to deliver test because power buyers and sellers each schedule delivery to/from the grid, and such transactions can be settled based on readily available price differentials rather than scheduling capacity and load as a pair. At a minimum, this commenter believed that guidance should be provided to require that, in order to demonstrate intent to deliver, secondary delivery-related costs (e.g., congestion charges and penalties to which those scheduling capacity and load on the grid are subject) must be allocated by contract. Id.

contracts and transactions are forwards with embedded volumetric options, the CFTC has provided an additional interpretation in section II.B.2.b)iii) above. To the extent such types of agreements, contracts or transactions are physical commercial agreements, contracts or transactions discussed in section II.B.2.b)iii), supra, the CFTC has provided an interpretation in that section. To the extent such types of agreements, contracts and transactions are considered commodity options, the CFTC has addressed commodity options under the separate rulemaking establishing a modified trade option exemption.[385] And to the extent that such types of agreements, contracts, and transactions, such as ancillary services, occur in Regional Transmission Organizations or Independent System Operators, or entered into between entities described in section 201(f) of the Federal Power Act,[386] they may be addressed through the public interest waiver process in CEA section 4(c)(6).[387]

With regard to Energy Management Agreements ("EMAs"), in general, commenters expressed the view that EMAs are forwards, and not swaps, although they did not provide analysis to support that conclusion.[388] They also did not provide a working definition of EMAs. The CFTC understands that EMAs can cover a number of services and transactions, which can include spot, forward and swap transactions. EMAs can include services such as: (i) acting as a financial intermediary by substituting one party's credit and liquidity for those of a less credit worthy owner of illiquid energy producing assets (i.e. the other party to the EMA) to facilitate

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385 See supra note 317.

386 16 U.S.C. 824(f).

387 7 U.S.C. 6(c)(6).

388 See, e.g., Encana Letter and BGA Letter.

the owner's purchase of fuel and sale of power;[389] (ii) providing market information to assist the owner in developing and refining a risk-management plan for the plant;[390] and (iii) procuring fuel, arranging delivery and storage, selling excess power not needed to serve load for another party.[391] The entity carrying out these activities may receive a portion of the revenue generated from such activities as compensation for its efforts. Because commenters did not provide a working definition of EMAs, the CFTC cannot state categorically that EMAs are or are not swaps. However, if the fuel acquisition, sales of excess generation and any other transactions executed under the auspices of an EMA are not swaps, nothing about the fact that the transactions are executed as a result of or pursuant to an EMA transforms the transactions into swaps. For example, if one party hires another party to enter into spot or forward transactions on its behalf, the fact that their relationship is governed by an EMA does not render those transactions swaps.[392] Conversely, were swaps to be executed by one party on behalf of another party as a result of, or pursuant to, an EMA, the parties thereto would need to consider their respective roles thereunder (e.g. principal versus agent) and whether commodity trading advisor, introducing broker, futures commission merchant, or other registration or other elements of the Dodd-Frank Act regime were implicated. At a minimum, the fact that a swap was executed would implicate reporting and recordkeeping requirements.[393]

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389 See, e.g., The Royal Bank of Scotland Group plc, Order Approving Notice to Engage in Activities Complementary to a Financial Activity, 2008 Federal Reserve Bulletin volume 94.

390 Id.

391 See, e.g., Energy Management Agreement between Long Island Lighting Company and Long Island Power Authority, available at http://www.lipower.org/pdfs/company/papers/contract/energy.pdf.

392 Similarly, using an EMA would not render swaps entered as a result of or pursuant to an EMA spot or forward transactions.

393 This interpretation is limited to the facts and circumstances described herein; the CFTC is not opining on different facts or circumstances, which could change the CFTC's interpretation.

v) Liquidated Damages Provisions

The Commissions also received several comments discussing contractual liquidated damages provisions. The CFTC is clarifying that the presence, in an agreement, contract, or transaction involving physical settlement of a nonfinancial commodity, of a liquidated damages provision (which may be referred to by another name, such as a "cover costs" or "cover damages" provision) does not necessarily render such an agreement, contract, or transaction ineligible for the forward exclusion.[394] Such a provision in an agreement, contract, or transaction is consistent with the use of the forward exclusion, provided that the parties intend the transaction to be physically settled.[395] However, liquidated damages provisions can be used to mask a lack of intent to deliver.[396] In light of the possibility for evasion of the Dodd-Frank Act, the CFTC will continue to utilize its historical facts-and-circumstances approach in determining whether the parties to a particular agreement, contract, or transaction with a liquidated damage provision have the requisite intent to deliver.

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394 With respect to performance guarantees, the fact that a failure to deliver a nonfinancial commodity triggers a payment under a performance guaranty does not excuse the performance, nor render delivery optional. Accordingly, such a payment trigger would not itself preclude an agreement, contract, or transaction from being covered by the forward exclusion from the swap or future delivery definitions. But see supra part II.B.1.g), which provides that the CFTC is interpreting the term "swap" (that is not a security-based swap or mixed swap) to include a guarantee of such swap, to the extent that a counterparty to a swap position would have recourse to the guarantor in connection with the position.

395 See 1985 CFTC OGC Interpretation, supra note 245 (stating generally that while "[s]ome contracts provide for a liquidated damages of penalty clause if the producer fails to deliver, the presence of such clauses in a contract does not change the analysis of the nature of the contract [if] . . . it is intended that delivery of the physical crop occur, absent destruction of all or a portion of the crop by forces which neither party can control"). See generally Corbin on Contracts § 58.1 (characterizing liquidated damages provisions as designed to "[d]etermin[e] the amount of damages that are recoverable for a breach of contract").

396 In that regard, see 1985 CFTC OGC Interpretation, supra note 245 (stating that "a contract provision which permitted a producer to avoid delivery for a reason other than for an intervening condition not in the control of either party could change any conclusion about the nature of the contract").

Comments

One commenter notes that a commercial merchandising arrangement involving a nonfinancial commodity may provide that the remedy for a failure to make or take delivery is the payment of a market-rate replacement price, a payment on a performance guaranty, or "cover damages" to compensate the non-breaching party for the failure of the other party to fulfill its contractual obligations.[397] Such a contractual damages or remedy provision, this commenter contended, is not analogous to a financial settlement option in a trading instrument.[398] This commenter further asserted that one party or the other may be unable to perform, or excused or prevented for commercial reasons from performing, its contractual obligations to make or take delivery of a nonfinancial commodity, and therefore may be liable to the other party for a monetary payment, calculated in accordance with the contract.[399]

Another commenter noted that physically settled gas contracts, including peaking contracts (both for daily and monthly supply), bullet day contracts and weather contracts, use the NAESB Base Contract, which does not provide for financial settlement other than a liquidated damages provision, which would compensate a utility for its cost of obtaining alternative supply

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397 See ETA Letter.

398 Id. This commenter cited FERC Order No. 890, which recognizes that "[w]hile any party to any contract can choose to fail to perform, that does not convey a contractual right to fail to perform" and that the Edison Electric Institute Master Power Purchase and Sale Agreement ("EEI MPPSA") clearly obligates the supplier to provide power, except in cases of force majeure. As the ETA explains, "[t]he EEI MPPSA is a master agreement frequently used to document transactions for deferred delivery and receipt of nonfinancial electric energy, and the terms of the ISDA North American Power Annex contain substantially identical master agreement provisions . . . ." Id.

399 According to this commenter, parties typically include liquidated damages provisions in their agreements, contracts and transactions to address situations in which "one party or the other may be unable, excused or prevented for commercial reasons from performing its contractual obligations to deliver or receive [the relevant commodity]," not to serve as "a financial settlement 'option' analogous to a financial settlement option in a trading instrument." Id.

at the prevailing market price if the seller fails to deliver.[400] This commenter stated its view that the seller has no real opportunity to arbitrage its obligation to deliver based on changes in price, and the purchaser has no incentive to fail to take delivery of its specified quantities of gas, because they are needed for the physical operations of its system.[401]

The CFTC generally agrees with these comments regarding liquidated damages provisions, and has provided the final interpretation described above to address them.

c) Security Forwards[402]

As the Commissions stated in the Proposing Release, the Commissions believe it is appropriate to address how the exclusions from the swap and security-based swap definitions apply to security forwards and other purchases and sales of securities.[403] The Commissions are restating the interpretation set out in the Proposing Release without modification.

The Dodd-Frank Act excludes purchases and sales of securities from the swap and security-based swap definitions in a number of different clauses.[404] Under these exclusions, purchases and sales of securities on a fixed or contingent basis[405] and sales of securities for

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400 See AGA Letter.

401 Id. See also Atmos Letter (stating that there is no financial incentive for a seller to fail to deliver natural gas under contracts used in the natural gas industry, as the standard remedy for such a failure to deliver is to pay liquidated damages sufficient to compensate the purchaser for having to obtain its required natural gas).

402 The discussion above regarding the exclusion from the swap definition for forward contracts on nonfinancial commodities does not apply to the exclusion from the swap and security-based swap definitions for security forwards or to the distinction between security forwards and security futures products.

403 See Proposing Release at 29830.

404 See sections 1a(47)(B)(ii), (v), and (vi) of the CEA, 7 U.S.C. 1a(47)(B)(ii), (v), and (vi).

405 See section 1a(47)(B)(v) of the CEA, 7 U.S.C. 1a(47)(B)(v) (excluding from the swap and security-based swap definitions "any agreement, contract, or transaction providing for the purchase or sale of 1 or more securities on a fixed basis that is subject to [the Securities Act and Exchange Act]"); and section 1a(47)(B)(vi) of the CEA, 7 U.S.C. 1a(47)(B)(vi) (excluding from the swap and security-based swap definitions "any agreement, contract, or transaction providing

deferred shipment or delivery that are intended to be physically delivered[406] are explicitly excluded from the swap and security-based swap definitions.[407] The exclusion from the swap and security-based swap definitions of a sale of a security for deferred shipment or delivery involves an agreement to purchase one or more securities, or groups or indexes of securities, at a future date at a certain price.

As with other purchases and sales of securities, security forwards are excluded from the swap and security-based swap definitions. The sale of the security in this case occurs at the time the forward contract is entered into with the performance of the contract deferred or delayed.[408] If such agreement, contract, or transaction is intended to be physically settled, the Commissions believe it would be within the security forward exclusion and therefore outside the swap and security-based swap definitions.[409] Moreover, as a purchase or sale of a security, the Commissions believe it also would be within the exclusions for the purchase or sale of one or more securities on a fixed basis (or, depending on its terms, a contingent basis) and, therefore, outside the swap and security-based swap definitions.[410]

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for the purchase or sale of 1 or more securities on a contingent basis that is subject to [the Securities Act and Exchange Act], unless the agreement, contract, or transaction predicates the purchase or sale on the occurrence of a bona fide contingency that might reasonably be expected to affect or be affected by the creditworthiness of a party other than a party to the agreement, contract, or transaction").

406 See section 1a(47)(B)(ii) of the CEA, 7 U.S.C. 1a(47)(B)(ii).

407 The Commissions note that calling an agreement, contract, or transaction a swap or security-based swap does not determine its status. See supra part II.D.1.

408 A purchase or sale of a security occurs at the time the parties become contractually bound, not at the time of settlement (regardless of whether cash or physically settled). See Securities Offering Reform, 70 FR 44722 (Aug. 3, 2005).

409 See section 1a(47)(B)(ii) of the CEA, 7 U.S.C. 1a(47)(B)(ii).

410 See sections 1a(47)(B)(v) and (vi) of the CEA, 7 U.S.C. 1a(47)(B)(v) and (vi).

In the Proposing Release, the Commissions provided the following specific interpretation in the context of forward sales of mortgage-backed securities ("MBS") guaranteed or sold by the Federal National Mortgage Association ("Fannie Mae"), the Federal Home Loan Mortgage Corporation ("Freddie Mac"), and the Government National Mortgage Association ("Ginnie Mae").[411] The Commissions are restating their interpretation regarding such forward sales.

MBS guaranteed or sold by Fannie Mae, Freddie Mac and Ginnie Mae are eligible to be sold in the "To-Be-Announced" ("TBA") market, which is essentially a forward or delayed delivery market.[412] The TBA market has been described as one that "allows mortgage lenders essentially to sell the loans they intend to fund even before the loans are closed."[413] In the TBA market, the lender enters into a forward contract to sell MBS and agrees to deliver MBS on the settlement date in the future. The specific MBS that will be delivered in the future may not yet be created at the time the forward contract is entered into.[414] In a TBA transaction, the seller and the buyer agree to five terms before entering into the transaction: (i) the type of security, which will usually be a certain type of MBS guaranteed or sold by Fannie Mae, Freddie Mac or Ginnie Mae and the type of mortgage underlying the MBS; (ii) the coupon or interest rate; (iii) the face value (the total dollar amount of MBS the purchaser wishes to purchase); (iv) the price; and (v)

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411 The Commissions provided the interpretation in the Proposing Release in response to commenters on the ANPR. See Proposing Release at 29830. These commenters requested clarification that forward sales of MBS guaranteed or sold by Fannie Mae, Freddie Mac and Ginnie Mae would not be included in the swap and security-based swap definitions in order to provide the certainty needed to avoid unnecessary disruption of this market. Id.

412 Task Force on Mortgage-Backed Securities Disclosure, "Staff Report: Enhancing Disclosure in the Mortgage-Backed Securities Markets," part II.E.2 (Jan. 2003), which is available at http://www.sec.gov/news/studies/mortgagebacked.htm ("MBS Staff Report").

413 Id.

414 Id.

the settlement date.[415] The purchaser will contract to acquire a specified dollar amount of MBS, which may be satisfied when the seller delivers one or more MBS pools at settlement.[416]

The Commissions are confirming that such forward sales of MBS in the TBA market would fall within the exclusion for sales of securities on a deferred settlement or delivery basis even though the precise MBS are not in existence at the time the forward MBS sale is entered into.[417] Moreover, as the purchase or sale of a security, the Commissions also are confirming that such forward sales of MBS in the TBA market would fall within the exclusions for the purchase or sale of one or more securities on a fixed basis (or, depending on its terms, a contingent basis) and therefore would fall outside the swap and security-based swap definitions.[418]

Comments

The Commissions received two comments on the interpretation regarding security forwards. One commenter recommended that the Commissions codify in the text of the final rules the interpretation regarding forward sales of MBS in the TBA market.[419] The Commissions

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415 Id.

416 Id. The good delivery guidelines, titled "Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities," which govern the mechanics of trading and settling MBS, contain specific guidelines for trading and settling MBS guaranteed or sold by Fannie Mae, Freddie Mac and Ginnie Mae in the TBA market. The good delivery guidelines outline the basic terms and conditions for trading, confirming, delivering and settling MBS. The good delivery guidelines set forth the basic characteristics that MBS guaranteed or sold by Fannie Mae, Freddie Mac and Ginnie Mae must have to be able to be delivered to settle an open TBA transaction. Id. The Securities Industry and Financial Markets Association ("SIFMA") is the successor to the Bond Market Association and publishes the good delivery guidelines, which are available at http://www.sifma.org/services/standard-forms-and-documentation/securitized-products/.

417 See section 1a(47)(B)(ii) of the CEA, 7 U.S.C. 1a(47)(B)(ii).

418 See sections 1a(47)(B)(v) and (vi) of the CEA, 7 U.S.C. 1a(47)(B)(v) and (vi).

419 See Letter from Lisa M. Ledbetter, Vice President and General Counsel, Legislative & Regulatory Affairs, Freddie Mac, Jul. 21, 2011.

are not codifying the interpretation because codification will create a bright-line test. The Commissions note that the analysis as to whether any product falls within the exclusion for sales of securities on a deferred settlement or delivery basis requires flexibility, including the consideration of applicable facts and circumstances. Because the interpretation regarding forward sales of MBS in the TBA market is based on particular facts and circumstances, the Commissions do not believe that a bright-line test is appropriate.

Another commenter suggested that the Commissions narrow the exclusion for contracts for the purchase and sale of securities for subsequent delivery as applied to security-based swaps because parties can use the formal characterization of a delivery contract for securities to disguise a transaction that is substantively a security-based swap.[420] This commenter was concerned because this commenter believes that the securities subject to such a delivery obligation are often easily convertible into cash, which facilitates cash settlement without actual delivery.[421] As such, this commenter suggested that the Commissions should provide a test for determining whether parties have a bona fide intent to deliver.[422] This commenter recommended that such test should prohibit cash settlement options in contracts for subsequent delivery and should not consider a party that frequently unwinds physical positions with cash settlements using side agreements as having the requisite intent to deliver.[423] The Commissions are not providing a test at this time for determining whether parties have a bona fide intent to deliver because the analysis as to whether sales of securities for deferred shipment or delivery are intended to be physically delivered is a facts and circumstances determination and a bright-line

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420 See Better Markets Letter.

421 Id.

422 Id.

423 Id.

test will not allow for the flexibility needed in such analysis. Further, the Commissions note that the purchase and sale of a security occurs at the time the forward contract is entered into.[424]

3. Consumer and Commercial Agreements, Contracts, and Transactions

The Commissions noted in the Proposing Release that "[c]onsumers enter into various types of agreements, contracts, and transactions as part of their household and personal lives that may have attributes that could be viewed as falling within the swap or security-based swap definition.[425] Similarly, businesses and other entities, whether or not for profit, also enter into agreements, contracts, and transactions as part of their operations relating to, among other things, acquisitions or sales of property (tangible and intangible), provisions of services, employment of individuals, and other matters that could be viewed as falling within the definitions."[426]

Commenters on the ANPR pointed out a number of areas in which a broad reading of the swap and security-based swap definitions could cover certain consumer and commercial arrangements that historically have not been considered swaps or security-based swaps.[427] Examples of such instruments cited by those commenters included evidences of indebtedness with a variable rate of interest; commercial contracts containing acceleration, escalation, or indexation clauses; agreements to acquire personal property or real property, or to obtain mortgages; employment, lease, and service agreements, including those that contain contingent payment arrangements; and consumer mortgage and utility rate caps.[428]

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424 See supra note 408.

425 See Proposing Release at 29832.

426 Id.

427 Id.

428 Id.

The Commissions also stated in the Proposing Release that they "do not believe that Congress intended to include these types of customary consumer and commercial agreements, contracts, or transactions in the swap or security-based swap definition, to limit the types of persons that can enter into or engage in them, or to otherwise to subject these agreements, contracts, or transactions to the regulatory scheme for swaps and security-based swaps."[429]

Accordingly, the Commissions proposed an interpretation in the Proposing Release to assist consumers and commercial and non-profit entities in understanding whether certain agreements, contracts, or transactions that they enter into would be regulated as swaps or security-based swaps.[430] The Commissions are adopting the interpretation set out in the Proposing Release with certain modifications in response to commenters.[431]

With respect to consumers, the Commissions have determined that the types of agreements, contracts, or transactions that will not be considered swaps or security-based swaps

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429 Id. If these types of arrangements were subject to Title VII, the persons that could enter into or engage in them could be restricted because Title VII imposes restrictions on entering into swaps and security-based swaps with persons who are not eligible contract participants ("ECPs"). See sections 723(1), 763(e), and 768(b) of the Dodd-Frank Act. The Dodd-Frank Act amended the Securities Act and the Exchange Act to require that security-based swap transactions involving a person that is not an ECP must be registered under the Securities Act and effected on a national securities exchange, and also amended the CEA to require that swap transactions involving a person that is not an ECP must be entered into on, or subject to the rules of, a board of trade designated as a contract market. Id. The Commissions note that many consumers and commercial and non-profit entities may not be ECPs. See section 1a(18) of the CEA, 7 U.S.C. 1a(18). Further, if these types of arrangements were subject to Title VII, they would be subject to the full regulatory scheme for swaps and security-based swaps created by Title VII. These requirements could increase costs for consumers and commercial and non-profit entities and potentially disrupt their ability to enter into these arrangements.

430 See Proposing Release at 29832-33.

431 See infra note 447 and accompanying text.

when entered into by consumers (natural persons) as principals (or by their agents)[432] primarily for personal, family, or household purposes, include:[433]

- agreements, contracts, or transactions to acquire or lease real or personal property, to obtain a mortgage, to provide personal services, or to sell or assign rights owned by such consumer (such as intellectual property rights);
- agreements, contracts, or transactions to purchase products or services for personal, family or household purposes at a fixed price or a capped or collared price, at a future date or over a certain time period (such as agreements to purchase for personal use or consumption nonfinancial energy commodities, including agreements to purchase home heating fuel or agreements involving residential fuel storage, in either case, where the consumer takes delivery of and uses the fuel, and the counterparty is a merchant that delivers in the service area where the consumer resides);[434]

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[432] For example, a mortgage broker may arrange a rate lock on behalf of a consumer borrower.

[433] The Commissions are not addressing here the applicability of any other provisions of the CEA, the federal securities laws or the Commissions' regulations to such agreements, contracts or transactions.

[434] These agreements, contracts, or transactions require the parties respectively to make and take delivery of the underlying commodity to each other directly; delivery may be deferred for convenience or necessity. But see section 2(c)(2)(D) of the CEA, 7 U.S.C. 2(c)(2)(D), generally prohibiting certain leveraged, margined or financed agreements, contracts and transactions with non-ECPs when actual delivery does not occur within 28 days). The Commissions view consumer agreements, contracts, and transactions involving periodic or future purchases of consumer products and services as transactions that are not swaps. This interpretation does not extend to consumer agreements, contracts or transactions containing embedded optionality or embedded derivatives other than those discussed in the text associated with this footnote. This analysis of consumer contracts is separate from the forward contract analysis for commercial merchandising transactions discussed in supra part II.B.2. The CFTC continues to view the forward contract exclusion for nonfinancial commodities as limited to commercial merchandising transactions.

- agreements, contracts, or transactions that provide for an interest rate cap or lock on a consumer loan or mortgage, where the benefit of the rate cap or lock is realized only if the loan or mortgage is made to the consumer;
- consumer loans or mortgages with variable rates of interest or embedded interest rate options, including such loans with provisions for the rates to change upon certain events related to the consumer, such as a higher rate of interest following a default;[435]
- service agreements, contracts, or transactions that are consumer product warranties, extended service plans, or buyer protection plans, such as those purchased with major appliances and electronics;[436]
- consumer options to acquire, lease, or sell real or personal property, such as options to lease apartments or purchase rugs and paintings, and purchases made through consumer layaway plans;[437]
- consumer agreements, contracts, or transactions where, by law or regulation, the consumer may cancel the transaction without legal cause;[438] and

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435 An example of a consumer loan with a variable rate of interest is credit card debt that includes a "teaser" rate. The teaser rate is a low, adjustable introductory interest rate that is temporary.

436 One commenter indicated that such service agreements, contracts, or transactions may be regulated as insurance in some but not all states. However, the Commissions believe that it is appropriate to address these agreements, contracts, or transactions in the context of their guidance regarding consumer and commercial arrangements. See NAIC Letter.

437 The Commissions believe that options entered into by consumers that result in physical delivery of the commodity, if exercised, are not the type of agreements, contracts or transactions that Congress intended to regulate as swaps or security-based swaps. Conversely, options entered into by consumers that cash settle based on the difference between the market price and the contract price of a commodity are not within the scope of this interpretation.

438 Examples of these types of transactions include consumer transactions that may be cancelled pursuant to the Federal Reserve Board's Regulation Z, 12 CFR Part 226 (i.e. certain consumer credit transactions that involve a lien on the consumer's principal dwelling), consumer

- consumer guarantees of credit card debt, automobile loans, and mortgages of a friend or relative.

The Commissions have included in the interpretation above several additional examples of consumer arrangements that the Commissions do not consider to be swaps or security-based swaps. These additional examples have been included in response to commenters[439] and the Commissions' determination that such additional examples would assist consumers in identifying other agreements, contracts, or transactions that they enter into that would not be regulated as swaps or security-based swaps.[440]

The types of commercial agreements, contracts, or transactions that involve customary business arrangements (whether or not involving a for-profit entity) and will not be considered swaps or security-based swaps under this interpretation include:

- employment contracts and retirement benefit arrangements;
- sales, servicing, or distribution arrangements;
- agreements, contracts, or transactions for the purpose of effecting a business combination transaction;[441]

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mail/telephone orders that may be cancelled when orders have not been filled under 16 CFR Part 435, and other consumer transactions that have cancellations rights conferred by statute or regulation.

439 See supra note 96 and accompanying text. See also infra notes 436, 454 and 455 and accompanying text.

440 The additional example regarding consumer options to acquire, lease, or sell real or personal property was added in response to a commenter on the ANPR. See Letter from White & Case LLP, dated September 20, 2010. The Commissions also are providing as additional examples consumer agreements, contracts, or transactions where, by law or regulation, the consumer may cancel the transaction without legal cause, and consumer guarantees of credit card debt, automobile loans, and mortgages of a friend or relative.

441 These business combination transactions include, for example, a reclassification, merger, consolidation, or transfer of assets as defined under the federal securities laws or any tender offer subject to section 13(e) and/or section 14(d) or (e) of the Exchange Act, 15 U.S.C. 78m(e) and/or

- the purchase, sale, lease, or transfer of real property, intellectual property, equipment, or inventory;
- warehouse lending arrangements in connection with building an inventory of assets in anticipation of a securitization of such assets (such as in a securitization of mortgages, student loans, or receivables);[442]
- mortgage or mortgage purchase commitments, or sales of installment loan agreements or contracts or receivables;
- fixed or variable interest rate commercial loans or mortgages entered into by banks[443] and non-banks, including the following:
    - fixed or variable interest rate commercial loans or mortgages entered into by the Farm Credit System institutions and Federal Home Loan Banks;
    - fixed or variable interest rate commercial loans or mortgages with embedded interest rate locks, caps, or floors, provided that such embedded interest rate locks, caps, or floors are included for the sole purpose of

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78n(d) or (e). These business combination agreements, contracts, or transactions can be contingent on the continued validity of representations and warranties and can contain earn-out provisions and contingent value rights.

442 The Commissions believe that such lending arrangements included in this category are traditional borrower/lender arrangements documented using, for example, a loan agreement or indenture, as opposed to a synthetic lending arrangement documented in the form of, for example, a total return swap. The Commissions also note that securitization transaction agreements also may contain contingent obligations if the representations and warranties about the underlying assets are not satisfied.

443 While the Commissions have included fixed or variable interest rate commercial loans entered into by banks, the Commissions understand that the CEA does not apply to, and the CFTC may not exercise regulatory authority over, identified banking products, and that the definitions of the terms "security-based swap" and "security-based swap agreement" do not include identified banking products. See infra note 488, regarding identified banking products. However, such loans and mortgages provided by certain banks may not qualify as identified banking products because those banks may not satisfy the definition of "bank" for purposes of the "identified banking products" definition. See 7 U.S.C. 27(a).

providing a lock, cap, or floor on the interest rate on such loan or mortgage and do not include additional provisions that would provide exposure to enhanced or inverse performance, or other risks unrelated to the interest rate risk being addressed;

- fixed or variable interest rate commercial loans or mortgages with embedded interest rate options, including such loans or mortgages that contain provisions causing the interest rate to change upon certain events related to the borrower, such as a higher rate of interest following a default, provided that such embedded interest rate options do not include additional provisions that would provide exposure to enhanced or inverse performance, or other risks unrelated to the primary reason the embedded interest rate option is included; and

- commercial agreements, contracts, and transactions (including, but not limited to, leases, service contracts, and employment agreements) containing escalation clauses linked to an underlying commodity such as an interest rate or consumer price index.

In response to commenters,[444] the Commissions have included in the interpretation above several additional examples of commercial arrangements that the Commissions do not consider to be swaps or security-based swaps.

The Commissions intend for this interpretation to enable consumers to engage in transactions relating to their households and personal or family activities without concern that such arrangements would be considered swaps or security-based swaps. Similarly, with respect

[444] See infra notes 456 and 461 and accompanying text.

to commercial business arrangements, this interpretation should allow commercial and non-profit entities to continue to operate their businesses and operations without significant disruption and provide that the swap and security-based swap definitions are not read to include commercial and non-profit operations that historically have not been considered to involve swaps or security-based swaps.

The types of agreements, contracts, and transactions discussed above are not intended to be exhaustive of the customary consumer or commercial arrangements that should not be considered to be swaps or security-based swaps. There may be other, similar types of agreements, contracts, and transactions that also should not be considered to be swaps or security-based swaps. In determining whether similar types of agreements, contracts, and transactions entered into by consumers or commercial entities are swaps or security-based swaps, the Commissions intend to consider the characteristics and factors that are common to the consumer and commercial transactions listed above:

- they do not contain payment obligations, whether or not contingent, that are severable from the agreement, contract, or transaction;
- they are not traded on an organized market or over-the-counter; and
- in the case of consumer arrangements, they:
  - involve an asset of which the consumer is the owner or beneficiary, or that the consumer is purchasing, or they involve a service provided, or to be provided, by or to the consumer, or
- in the case of commercial arrangements, they are entered into:
  - by commercial or non-profit entities as principals (or by their agents) to serve an independent commercial, business, or non-profit purpose, and

- other than for speculative, hedging, or investment purposes.

Two of the key components reflected in these characteristics that distinguish these agreements, contracts, and transactions from swaps and security-based swaps are that: (i) the payment provisions of the agreement, contract, or transaction are not severable; and (ii) the agreement, contract, or transaction is not traded on an organized market or over-the-counter, and therefore such agreement, contract, or transaction does not involve risk-shifting arrangements with financial entities, as would be the case for swaps and security-based swaps.[445] In response to commenters,[446] the Commissions clarify that merely because an agreement, contract, or transaction is assignable does not mean that it is "traded" or that the agreement, contract, or transaction is a swap or security-based swap. An assignment of a contractual obligation must be analyzed to assure that the result is not to sever the payment obligations.

This interpretation is not intended to be the exclusive means for consumers and commercial or non-profit entities to determine whether their agreements, contracts, or transactions fall within the swap or security-based swap definition. If there is a type of agreement, contract, or transaction that is not enumerated above, or does not have all the characteristics and factors that are listed above (including new types of agreements, contracts, or transactions that may be developed in the future), the agreement, contract, or transaction will be

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445 There also are alternative regulatory regimes that have been enacted as part of the Dodd-Frank Act specifically to provide enhanced protections to consumers relating to various consumer transactions. See, e.g., the Consumer Financial Protection Act of 2010, Pub L. 111-203, tit. X, 124 Stat. 1376 (Jul. 21, 2010) (establishing the Bureau of Consumer Financial Protection to regulate a broad category of consumer products and amending certain laws under the jurisdiction of the Federal Trade Commission); the Mortgage Reform and Anti-Predatory Lending Act, Pub L. 111-203, tit. XIV, 124 Stat. 1376 (Jul. 21, 2010) (amending existing laws, and adding new provisions, related to certain mortgages). Some of these agreements, contracts, or transactions are subject to regulation by the Federal Trade Commission and other federal financial regulators and state regulators.

446 See infra note 470.

evaluated based on its particular facts and circumstances. Parties to such an agreement, contract or transaction may also seek an interpretation from the Commissions as to whether the agreement, contract or transaction is a swap or security-based swap.

Comments

Eleven commenters provided comments on the proposed interpretation set forth in the Proposing Release regarding consumer and commercial arrangements.[447] While most commenters supported the proposed interpretation, these commenters suggested certain changes.

Four commenters recommended that the Commissions codify the proposed interpretation regarding consumer and commercial arrangements.[448] The Commissions are not codifying the interpretation. The interpretation is intended to provide guidance to assist consumers and commercial and non-profit entities in evaluating whether certain arrangements that they enter into will be regulated as swaps or security-based swaps. The interpretation is intended to allow the flexibility necessary, including the consideration of the applicable facts and circumstances by the Commissions, in evaluating consumer and commercial arrangements to ascertain whether they may be swaps or security-based swaps. The representative characteristics and factors taken together are indicators that a consumer or commercial arrangement is not a swap or security-based swap and the Commissions have provided specific examples demonstrating how these characteristics and factors apply to some common types of consumer and commercial arrangements. However, as the interpretation is not intended to be a bright-line test for

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447 See BGA Letter; Letter from The Coalition for Derivatives End-Users, Jul. 22, 2011, ("CDEU Letter"); ETA Letter; Letter from Robbie Boone, Vice President, Government Affairs, Farm Credit Council, Jul. 22, 2011 ("FCC Letter"); FERC Staff Letter; Letter from Warren N. Davis, Of Counsel, Sutherland Asbill & Brennan LLP, on behalf of the Federal Home Loan Banks, Jul. 22, 2011 ("FHLB Letter"); IECA Letter; ISDA Letter; Just Energy Letter; PMAA/NEFI Letter; and SEIA Letter.

448 See ETA Letter; FERC Letter; IECA Letter; and Just Energy Letter.

determining whether a particular consumer or commercial arrangement is a swap or security-based swap, if the particular arrangement does not meet all of the identified characteristics and factors, the arrangement will be evaluated based on its particular facts and circumstances.

One commenter was concerned that the interpretation itself implicitly suggests that many types of consumer and commercial arrangements could be swaps, although none of these arrangements historically has been considered a swap.[449] The Commissions do not intend to suggest that many types of consumer and commercial arrangements that historically have not been considered swaps are within the swap or security-based swap definitions. The Commissions provided the interpretation in response to comments received on the ANPR. Commenters on the ANPR identified areas in which a broad reading of the swap and security-based swap definitions could cover certain consumer and commercial arrangements that historically have not been considered swaps or security-based swaps.[450] The Commissions believe it is appropriate to provide the interpretation to allow consumers and commercial and non-profit entities to engage in such transactions without concern that such arrangements would be considered swaps or security-based swaps.

One commenter requested that the Commissions remove the term "customary" from the description of consumer and commercial arrangements in the interpretation.[451] The Commissions note that the use of the term "customary" was not intended to limit the interpretation, but rather was used to describe certain types of arrangements that consumers and businesses may normally or generally enter into. The Commissions also note that the term

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449 See IECA Letter.

450 See Proposing Release at 29832.

451 See ISDA Letter.

"customary" is itself not a separate representative characteristic or factor for purposes of the interpretation.

This commenter also requested that specific examples of consumer and commercial arrangements that are not swaps or security-based swaps include "any other similar agreements, contracts, or transactions."[452] The specific examples are not intended to be an exhaustive list and the Commissions do not believe that it is necessary to include a general catchall provision. The interpretation also includes a list of representative characteristics and factors to be used to analyze other consumer and commercial arrangements.

Several commenters suggested additional examples of consumer and commercial arrangements that the Commissions should not consider to be swaps or security-based swaps.[453] One commenter suggested that the Commissions should expand the example of "consumer agreements, contracts, or transactions to purchase products or services at a fixed price or a capped or collared price, at a future date or over a certain time period (such as agreements to purchase home heating fuel)" to include all nonfinancial energy commodities in the parenthetical example.[454] The Commissions have modified the identified consumer example to include all nonfinancial energy commodities. The parenthetical example was not intended to be limited to agreements to purchase home heating fuel.

One commenter suggested that the Commissions should include as an additional example residential fuel storage contracts.[455] The Commissions agree that these arrangements should not

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452 Id.

453 See CDEU Letter; FCC Letter; FERC Letter; FHLB Letter; ISDA Letter; Just Energy Letter; PMAA/NEFI Letter; and SEIA Letter.

454 See Just Energy Letter.

455 See PMAA/NEFI Letter.

be considered swaps or security-based swaps, provided that they are residential fuel storage contracts where the consumer takes delivery of and consumes the fuel, and the counterparty is a merchant (or agent of a merchant) that delivers in the service area where the consumer's residence is located. Although the consumer may not immediately consume the fuel contracted for, because it will ultimately consume the fuel for personal, family, or household purposes, such a transaction is a type of customary consumer transaction excluded from the swap and security-based swap definitions.

Three commenters requested clarification that commercial loans and mortgages would fall within the interpretation regardless of whether entered into by a bank or non-bank.[456] Two of these commenters were concerned that the specific example was limited to commercial loans and mortgages entered into by non-banks and did not address commercial loans and mortgages entered into by financial institutions that are banks but whose loans and mortgages do not qualify as identified banking products.[457] The Commissions are revising the example to clarify that it includes fixed or variable interest rate commercial loans or mortgages entered into by both banks and non-banks, including such loans and mortgages entered into by the Farm Credit System institutions and Federal Home Loan Banks. The Commissions understand that the CEA does not apply to, and the CFTC may not exercise regulatory authority over, and the definitions of the terms "security-based swap" and "security-based swap agreement" do not include, any fixed or variable interest rate commercial loan or mortgage entered into by a bank that is an identified banking product.[458] However, loans and mortgages provided by certain banks may not qualify as

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456 See CDEU Letter; FCC Letter; and FHLB Letter.

457 See FCC Letter and FHLB Letter.

458 See infra note 488, regarding identified banking products.

identified banking products because those banks do not satisfy the definition of "bank" for purposes of the "identified banking products" definition.[459] According to commenters,[460] while this definition of "bank" includes insured depository institutions, certain foreign banks, credit unions, institutions regulated by the Federal Reserve and trust companies, it does not include certain other financial institutions that provide commercial loans or mortgages, such as government-sponsored enterprises (including the Federal Home Loan Banks) and certain cooperatives (including the Farm Credit System institutions).

Three commenters suggested that the Commissions should include as additional examples commercial rate lock agreements and commercial loans with interest rate caps, floors, or options.[461] The Commissions agree that these arrangements should not be considered swaps or security-based swaps, provided that the interest rate locks, caps, or floors, or interest rate options are embedded in the commercial loans or mortgages and not entered into separately from the commercial loans and mortgages, and are including these arrangements as examples in the interpretation. However, the Commissions are limiting the interpretation to embedded interest rate locks, caps, or floors, and interest rate options because interest rate locks, caps, or floors, or interest rate options that are entered into separately from the commercial loans and mortgages fall within the swap definition.[462] In order to further distinguish these arrangements from swaps

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459 See 7 U.S.C. 27(a). See also FCC Letter and FHLB Letter.

460 See supra note 457.

461 See CDEU Letter; FCC Letter; and FHLB Letter. These commenters indicated that such arrangements are similar to the arrangements included in the list of examples of consumer arrangements that the Commissions would not consider to be swaps or security-based swaps.

462 See section 1a(47)(A)(i) of the CEA, 7 U.S.C. 1a(47)(A)(i). Similarly, with respect to consumer agreements, contracts and transactions providing for an interest rate cap or an interest rate lock on a consumer loan or mortgage, the Commissions are limiting this example to interest rate caps and interest rate locks entered into in connection with the consumer loan or mortgage and prior to closing on the loan or mortgage. For this purpose, both because obtaining a consumer loan or

and security-based swaps, the interpretation provides the following: (i) the embedded interest rate lock, cap, or floor must be included for the sole purpose of providing a lock, cap, or floor on the interest rate on such loan or mortgage and may not include additional provisions that would provide exposure to enhanced or inverse performance, or other risks unrelated to the interest rate risk being addressed, and (ii) the embedded interest rate option may not include additional provisions that would provide exposure to leverage, inverse performance, or other risks unrelated to the primary reason the embedded interest rate option is included in the commercial loan or mortgage.

Four commenters suggested additional examples of commercial arrangements that relate to nonfinancial energy commodities.[463] These arrangements are more appropriately addressed in the context of the forward contract exclusion for nonfinancial commodities[464] or the trade option exemption.[465]

One commenter supported the representative characteristics and factors the Commissions set forth to distinguish consumer and commercial arrangements from swaps and security-based

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mortgage can involve a great deal of documentation, which can be entered into at different times during the process, and because consumers may have some flexibility as to their deadline for deciding when to include or exclude an interest rate cap or lock in their consumer loans or mortgages, the Commissions will consider an interest rate cap or lock to be entered into in connection with a consumer loan or mortgage if it is included in the final terms of the loan at closing.

463 See BGA Letter (commercial physical transactions in the natural gas and electric power markets should also fall under the category of exemptions from the swap definition); FERC Letter (commercial transactions executed or traded on RTOs/ISOs should be included in the interpretation); Just Energy Letter (commercial arrangements to purchase products or services at a fixed price or a capped or collared price, at a future date or over a certain time period); and PMAA/NEFI Letter (petroleum fuel and gas storage contracts between bona fide commercial market participants or entities other than financial entities).

464 See supra part II.B.2. The Commissions note that they provided the interpretation regarding consumer arrangements because the CFTC in the past has not interpreted the forward contract exclusion for nonfinancial commodities to apply to consumer arrangements. See supra note 434.

465 See supra note 317 and accompanying text.

swaps.[466] Two commenters were concerned with certain of these characteristics and factors because these commenters believed that such characteristics and factors are common in a wide variety of consumer and commercial arrangements.[467] Both commenters suggested that the Commissions remove "for other than speculative, hedging or investment purposes" from the interpretation because many of the types of transactions listed as examples may be undertaken for speculative, hedging or investment purposes and because all commercial merchandising transactions are "risk-shifting" of commercial obligations and risks, and "hedge" the enterprise's commercial risks.[468] The Commissions are not revising the interpretation to remove or otherwise modify this representative characteristic and factor. The Commissions believe that commercial arrangements undertaken for speculative, hedging or investment purposes may be a swap or a security-based swap depending on the particular facts and circumstances of the arrangement.

One of these commenters also suggested the Commissions remove "do not contain payment obligations that are severable" from the interpretation because assignment of rights and delegation of obligations are common in a wide variety of consumer and commercial transactions.[469] The Commissions are not revising the interpretation to remove or otherwise modify this representative characteristic and factor. The Commissions believe that the severability of payment obligations could be indicative of a consumer or commercial arrangement that may be a swap or a security-based swap depending on the particular facts and circumstances of the arrangement because the severability of payment obligations could be

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466 See FCC Letter.

467 See ETA Letter and ISDA Letter.

468 Id.

469 See ISDA Letter.

indicative of an instrument that is merely an exchange of payments, such as is the case with swaps and security-based swaps.

One of these commenters also suggested that the Commissions remove "not traded on an organized market or over the counter" from the interpretation because many of the types of contracts listed as examples are assignable and frequently assigned or traded.[470] The other commenter did not suggest removing this factor, but requested that the factor be modified to provide that the arrangement is not traded on a "registered entity" in order not to include transactions on organized wholesale electricity markets.[471] The Commissions are not revising the interpretation to remove or otherwise modify this representative characteristic and factor. The Commissions believe that the trading of an instrument on an organized market or over the counter could be indicative of a consumer or commercial arrangement that may be a swap or a security-based swap depending on the particular facts and circumstances of the arrangement. However, as noted above, the Commissions are clarifying that merely because an arrangement is assignable does not mean that it is "traded" or that the arrangement is a swap or security-based swap. An assignment of a contractual obligation must be analyzed to assure that the result is not to sever the payment obligations.

Further, as noted above, the representative characteristics and factors are not intended to be a bright-line test for determining whether a particular consumer or commercial arrangement is a swap or security-based swap. These representative characteristics and factors taken together are indicators that a consumer or commercial arrangement is not a swap or security-based swap. These representative characteristics and factors also do not imply or presume that a consumer or

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470 Id.

471 See ETA Letter.

commercial arrangement that does not meet all of these characteristics and factors is a swap or security-based swap. As noted above, if a particular arrangement does not meet all of these characteristics and factors, the parties will need to evaluate the arrangement based on the particular facts and circumstances. Moreover, as noted above, if there is a type of consumer or commercial arrangement that does not meet all of these characteristics and factors, a party to the arrangement can seek an interpretation from the Commissions as to whether the arrangement is outside the scope of the swap and security-based swap definitions.

Residential Exchange Program

One commenter requested that the CFTC further define the term "swap" to exclude consumer benefits under the Pacific Northwest Electric Power Planning and Conservation Act of 1980 ("Northwest Power Act")[472] and transactions under the "Residential Exchange Program" ("REP").[473] According to this commenter, the REP was established by Congress "[t]o extend the benefits of low cost Federal System hydro power to residential and small farm electric power consumers throughout the Pacific Northwest Region."[474] Based on the commenter's description,

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472 16 U.S.C. Chapter 12H.

473 Letter from Virginia K. Schaeffer, Attorney, Office of General Counsel, Bonneville Power Administration, Jul. 22, 2011 ("BPA Letter"). This commenter refers to the implementation of Section 5(c) of the Northwest Power Act, 16 U.S.C. 839c(c), as the "Residential Exchange Program." See Id.

474 See BPA Letter. This commenter explained that, under the REP: "a Pacific Northwest electric utility has a right to . . . sell power to Bonneville at the utility's average system cost (ASC) of providing that power . . . . Bonneville[] is required to purchase that power at the utility's ASC, and then sell an equivalent amount of power back to the utility at Bonneville's rates[,] which are based in substantial part on low cost Federal hydro power. As required by the Residential Exchange Statute, the amount of such power "exchanged" is based on the related utility's residential and small farm customer's power needs (also known as "loads") in the Pacific Northwest Region. Under this "exchange," no actual power is transferred to or from Bonneville. Instead, consistent with Congressional intent, the exchange transaction is implemented as an accounting device that avoids the costs and burdens associated with a physical exchange of power and that results in the payment of funds by Bonneville to the REP exchanging utilities. Reduced

REP transactions do not appear to be among the types of transactions historically considered swaps or security-based swaps. Although the REP transactions described by the commenter share some features with spread options (e.g., they settle in cash based on the difference between two price sources),[475] in both swaps and security-based swaps, each party assumes market risk.[476] By contrast, neither party assumes or hedges risk in an REP transaction.[477] Instead, the Commissions view an REP transaction essentially as a subsidy provided to residential and small farm utility customers.[478] Accordingly, the Commissions do not consider the REP transactions described by the commenter to be swaps or security-based swaps.

> to the essentials, the Residential Exchange Statute as implemented in . . . REP contracts results in Bonneville making cash payments for the positive difference between the utility's ASC and Bonneville's lower rate multiplied by the qualifying residential and small farm loads. And, as required under the Residential Exchange Statute, the entire monetary benefit Bonneville provides to the REP exchanging utilities is in turn passed through to the residential and small farm power consumers of that utility."
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> Id.

475 A spread option is "an option in which the payout is based on the difference in performance between two assets." Superderivatives, "Spread option in EQ" definition, available at http://www.sdgm.com/Support/Glossary.aspx?letter=S. See also S.J. Denga and S.S. Oren, Electricity derivatives and risk management, Science Direct at 945 (2006), available at http://www.ieor.berkeley.edu/~oren/pubs/Deng%20and%20Oren-86.pdf (defining a spark spread options as "cross-commodity options paying out the difference between the price of electricity sold by generators and the price of the fuels used to generate it"); Chicago Mercantile Exchange, Soybean-Corn Price Ratio Options Fact Card (describing its soybean-corn price ratio option contract as "an option on the ratio between the price of the referencing Soybean futures contract and the price of the referencing Corn futures contract . . . ."), available at http://www.cmegroup.com/trading/agricultural/files/AC-440-Soybean-CornRatioOptionsFC.pdf.

476 Even a hedging party assumes the risk that the market can move against its hedging position, causing the hedge to reduce the profit it otherwise would have made on an unhedged position.

477 The fact that the Commissions are relying in part on this aspect of REP transactions to interpret such transactions to be neither swaps nor security-based swaps does not mean that market participants should conclude, in other contexts, that a lack of market risk removes an agreement, contract, or transaction from the swap and security-based swap definitions. The Commissions' conclusion as to REP transactions is based on the unique facts and circumstances presented by the commenter.

478 See, e.g., Paul M. Murphy, Northwest Public Power Association, Background and Summary of the Residential Exchange Program Settlement Agreement, March 16, 2011, available at http://www.nwppa.org/cwt/external/wcpages/wcmedia/documents/background_and_summary_of

Loan Participations

The Commissions provided an interpretation in the Proposing Release regarding the treatment of loan participations.[479] The Commissions are restating the interpretation set out in the Proposing Release with certain modifications in response to commenters.[480]

Loan participations arise when a lender transfers or offers a participation in the economic risks and benefits of all or a portion of a loan or commitment it has entered into with a borrower to another party as an alternative or precursor to assigning to such person the loan or commitment or an interest in the loan or commitment.[481] The Commissions understand that two types of loan participations exist in the market today,[482] LSTA-style participations[483] and LMA-style participations.[484] LSTA-style participations transfer a beneficial ownership interest in the

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_rep_settlement_agreement.pdf (characterizing the REP as "require[ing] BPA to subsidize the residential and small farm consumers of the higher cost utilities in the Pacific Northwest").

479 See Proposing Release at 29834.

480 See infra note 504 and accompanying text.

481 See Loan Market Association, "Guide to Syndicated Loans," section 6.2.4 ("A [loan] participation…is made between the existing lender and the participant. This creates new contractual rights between the existing lender and the participant which mirror existing contractual rights between the existing lender and the borrower. However this is not an assignment of those existing rights and the existing lender remains in a direct contractual relationship with the borrower."), available at http://www.lma.eu.com/uploads/files/Introductory_Guides/Guide_to_Par_Syndicated_Loans.pdf.

482 See Letter from R. Bram Smith, Executive Director, The Loan Syndications and Trading Association, Jan. 25, 2011 ("January LSTA Letter"); Letter from Elliot Ganz, General Counsel, The Loan Syndications and Trading Association, Mar. 1, 2011 ("March LSTA Letter"); and Letter from Clare Dawson, Managing Director, The Loan Market Association, Feb. 23, 2011. The Commissions understand that neither type of loan participation is a "synthetic" transaction. See March LSTA Letter. Both types of loan participations are merely transfers of cash loan positions and the ratio of underlying loan to participation is always one to one. Id.

483 The LSTA is The Loan Syndications and Trading Association.

484 The LMA is The Loan Market Association.

underlying loan or commitment to the participant.[485] LMA-style participations do not transfer a beneficial ownership interest in the underlying loan or commitment to the participant, but rather create a debtor-creditor relationship between the grantor and the participant under which a future beneficial ownership interest is conveyed.[486]

Depending on the facts and circumstances, a loan participation may be a security under the federal securities laws and, as such, the loan participation would be excluded from the swap definition as the purchase and sale of a security on a fixed or contingent basis.[487] In addition, depending on the facts and circumstances, a loan participation may be an identified banking product and, as such, would be excluded from CFTC jurisdiction and from the security-based swap and security-based swap agreement definitions.[488]

The Commissions believe it is important to provide further guidance as to the other circumstances in which certain loan participations would not fall within the swap and security-based swap definitions. Consistent with the proposal, the Commissions do not interpret the swap and security-based swap definitions to include loan participations that reflect an ownership interest in the underlying loan or commitment. The Commissions believe that for a loan participation to not be considered a swap or security-based swap, the loan participation must

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485 See Letter from Clare Dawson, Managing Director, The LMA, Jul. 22, 2011 ("July LMA Letter").

486 See Id. The participant may exercise an "elevation" right and request that the grantor use commercially reasonable efforts to cause the participant to become the legal owner, by assignment, of the underlying loan or commitment. Id.

487 See sections 1a(47)(B)(v) and (vi) of the CEA, 7 U.S.C. 1a(47)(b)(v) and (vi), as amended by section 721(a)(21) of the Dodd-Frank Act (excluding purchases and sales of a security on a fixed or contingent basis, respectively from the swap definition).

488 See section 403(a) of the Legal Certainty for Bank Products Act of 2000, 7 U.S.C. 27a(a), as amended by section 725(g)(2) of the Dodd-Frank Act (providing that, under certain circumstances, the CEA shall not apply to, and the CFTC shall not exercise regulatory authority over, identified banking products, and the definitions of the terms "security-based swap" and "security-based swap agreement" shall not include identified banking products).

represent a current or future direct or indirect ownership interest in the loan or commitment that is the subject of the loan participation.

In evaluating whether the loan participation represents such an ownership interest, the Commissions believe the following characteristics should be present:

- The grantor of the loan participation is a lender under, or a participant or sub-participant in, the loan or commitment that is the subject of the loan participation.
- The aggregate participation in the loan or commitment that is the subject of the loan participation does not exceed the principal amount of such loan or commitment. Further, the loan participation does not grant, in the aggregate, to the participant in such loan participation a greater interest than the grantor holds in the loan or commitment that is the subject of the loan participation.
- The entire purchase price for the loan participation is paid in full when acquired and not financed. The Commissions believe a purchase price would not be paid in full if the grantor of the loan participation extends financing to the participant or if such participant levers its purchase, including by posting collateral to secure a future payment obligation.
- The loan participation provides the participant all of the economic benefit and risk of the whole or part of the loan or commitment that is the subject of the loan participation.

These characteristics, which were identified by commenters,[489] are intended to distinguish loan participations from swaps and security-based swaps based on loans. The first

[489] See infra note 504 and accompanying text. See also infra notes 490, 491, and 492 and accompanying text.

characteristic above addresses the ownership of the underlying loan or commitment. Swaps and security-based swaps may be created using a synthetic or derivative structure that does not require ownership of the underlying loan.[490] The second characteristic above addresses the ratio of the participation to the underlying loan or commitment. Swaps and security-based swaps based on loans may involve synthetic exposure to a loan that is a multiple of the principal amount.[491] The third characteristic above addresses leverage in the financing of a loan participation. Leverage could be indicative of an instrument that is merely an exchange of payments and not a transfer of the ownership of the underlying loan or commitment, such as may be the case with a swap or security-based swap.[492] The fourth characteristic above addresses the level of participation in the economic benefits and risks of the underlying loan or commitment. This characteristic is indicative of ownership when analyzed with the other characteristics and, as noted above, swaps and security-based swaps may be created using a synthetic or derivative structure that does not require ownership of the underlying loan.

The Commissions agree with commenters that the loan participation does not have to be a "true participation," as the Commissions had stated in their interpretation in the Proposing Release,[493] in order for the loan participation to fall outside the swap and security-based swap definitions.[494] The Commissions note that the "true participation" analysis is used to determine whether a transaction has resulted in the underlying assets being legally isolated from a

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490 See July LMA Letter.

491 Id.

492 Id.

493 Proposing Release at 29834.

494 See infra note 503 and accompanying text.

transferor's creditors for U.S. bankruptcy law purposes.[495] This analysis is unrelated to and does not inform whether a loan participation is a swap or security-based swap. This analysis also may be subject to varying interpretations.[496] Further, the Commissions understand that this analysis could result in certain loan participations that reflect an ownership interest in the underlying loan or commitment being included in the swap and security-based swap definitions, which the Commissions do not intend.[497]

Rather, as noted above, the Commissions believe that the analysis as to whether a loan participation is outside the swap and security-based swap definitions should be based on whether the loan participation reflects an ownership interest in the underlying loan or commitment. The Commissions understand that the characteristics noted above are indicative, based on comments received,[498] of whether a loan participation represents such an ownership interest. Further, in response to commenters,[499] the Commissions are clarifying that the interpretation applies to loan participations that are entered into both with respect to outstanding loans and with respect to a lender's commitments to lend and fund letters of credit (e.g., under a revolving credit facility).

The Commissions believe that the interpretation will prevent disruption in the syndicated loan market for loan participations. Loan participations facilitate a lender's diversification of its portfolio holdings, provide a key component of the efficient settlement process, and enhance

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495 Id.

496 Id.

497 Id.

498 See supra note 482. See infra note 501.

499 See infra note 506 and accompanying text.

liquidity in the global syndicated loan market.[500] The interpretation will enable this market to continue operating as it did prior to the enactment of Title VII.

Comments

Commenters supported the interpretation that certain loan participations should not be included in the swap and security-based swaps definitions.[501] Commenters agreed with the proposal that a loan participation should represent a current and future direct or indirect ownership interest in the loan or commitment that is the subject of the loan participation.[502] However, commenters disagreed with the proposal that a loan participation should be required to be a "true participation" in order for the loan participation to fall outside the swap and security-based swap definitions because LMA-style participations do not represent a beneficial ownership in the underlying loan or commitment such that they would be considered a true participation.[503] Commenters requested that the Commissions remove this factor and instead recognize additional

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500 See January LSTA Letter.

501 See FCC Letter; Letter from Richard M. Whiting, Executive Director and General Counsel, Financial Services Roundtable, Jul. 22, 2011 ("FSR Letter"); July LMA Letter; Letter from R. Bram Smith, Executive Director, The LSTA, Jul. 22, 2011 ("July LSTA Letter"); MFA Letter; and Letter from Kenneth E. Bentsen, Jr., Executive Vice President, Public Policy and Advocacy, SIFMA, Jul. 22, 2011 ("SIFMA Letter").

502 See FSR Letter; July LMA Letter; July LSTA Letter; MFA Letter; and SIFMA Letter. Commenters indicated that both LSTA-style participations and LMA-style participations represent a current or future direct or indirect ownership interest in the related loan or commitment. Id.

503 See July LMA Letter; July LSTA Letter; MFA Letter; and SIFMA Letter. These commenters indicated that neither LMA-style participations nor certain LSTA-style participations are true participations. See July LMA Letter; July LSTA Letter; and SIFMA Letter. Further, according to the July LSTA Letter, "[l]oan market participants in the United States will likely interpret the 'true participation' requirement as a requirement that loan participations must qualify for 'true sale' treatment in order to avoid classification as a 'swap.' A 'true sale' or 'true participation' analysis is a test aimed at determining whether a transaction has resulted in the underlying assets being legally isolated from the transferor's creditors for U.S. bankruptcy law purposes. Its underlying purpose is to distinguish between a sale and a financing, not between a sale and a swap." If this is the case, certain LSTA-style participations, which typically are offered in the United States, could be determined under a "true sale" analysis to be a financing and not a true participation. See July LSTA Letter.

factors.[504] The Commissions agree that a loan participation does not have to be a true participation in order for the loan participation to fall outside the swap and security-based swap definitions and are revising the interpretation as noted above.

One commenter also indicated that loan participations are entered into both with respect to outstanding loans and with respect to a lender's commitments to lend and fund letters of credit (e.g., under a revolving credit facility).[505] This commenter requested that the Commissions revise the proposed interpretation to reflect both outstanding loans and a lender's commitments.[506] The Commissions agree and are revising the interpretation to reflect both outstanding loans and loan commitments as noted above.

C. Final Rules and Interpretations Regarding Certain Transactions Within the Scope of the Definitions of the Terms "Swap" and "Security-Based Swap"

1. In General

In light of provisions in the Dodd-Frank Act that specifically address certain foreign exchange products, the Commissions in the Proposing Release proposed rules to clarify the status of products such as foreign exchange forwards, foreign exchange swaps, foreign exchange

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504 See July LMA Letter; July LSTA Letter; MFA Letter; and SIFMA Letter. Commenters recommended that the Commissions revise the interpretation by providing that the Commissions do not interpret the swap and security-based swap definitions to include loan participations in which (1) the participant is acquiring a current or future direct or indirect ownership interest in the related loan or commitment, and (2) the agreement pursuant to which the participant is acquiring such an interest (i) is a participation agreement that is, or any similar agreement of a type that has been, is presently, or in the future becomes, customarily entered into in the primary or secondary loan markets, (ii) requires the grantor to represent that it is a lender under, or a participant or sub-participant in, the loan or commitment, (iii) provides that the participant is entitled to receive from the grantor all of the economic benefit of the whole or part of a loan or commitment to the extent of payments received by the grantor in respect of such loan or commitment, and (iv) requires that 100% of the purchase price calculated with respect to the loan or commitment is paid on the settlement date. See id. The characteristics identified by these commenters are reflected in the Commission's revised interpretation.

505 See July LMA Letter.

506 Id.

options, non-deliverable forwards involving foreign exchange ("NDFs"), and cross-currency swaps. The Commissions also proposed a rule to clarify the status of forward rate agreements and provided interpretations regarding: (i) combinations and permutations of, or options on, swaps or security-based swaps; and (ii) contracts for differences ("CFDs").

The Commissions are adopting the rules as proposed without modification and are restating the interpretations provided in the Proposing Release without modification. In addition, the Commissions are providing additional interpretations regarding foreign exchange spot transactions and retail foreign currency options.

As adopted, rule 1.3(xxx)(2) under the CEA and rule 3a69-2 under the Exchange Act explicitly define the term "swap" to include certain foreign exchange-related products and forward rate agreements unless such products are excluded by the statutory exclusions in subparagraph (B) of the swap definition.[507] In adopting these rules, the Commissions do not mean to suggest that the list of agreements, contracts, and transactions set forth in rule 1.3(xxx)(2) under the CEA and rule 3a69-2(b) under the Exchange Act is an exclusive list.

2. Foreign Exchange Products

a) Foreign Exchange Products Subject to the Secretary's Swap Determination: Foreign Exchange Forwards and Foreign Exchange Swaps

The CEA, as amended by the Dodd-Frank Act, provides that "foreign exchange forwards" and "foreign exchange swaps" shall be considered swaps under the swap definition unless the Secretary of the Treasury ("Secretary") issues a written determination that either foreign exchange swaps, foreign exchange forwards, or both: (i) should not be regulated as swaps; and (ii) are not structured to evade the Dodd-Frank Act in violation of any rule

[507] See section 1a(47)(B) of the CEA, 7 U.S.C. 1a(47)(B).

promulgated by the CFTC pursuant to section 721(c) of the Dodd-Frank Act.[508] A foreign exchange forward is defined in the CEA as "a transaction that solely involves the exchange of two different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange."[509] A foreign exchange swap, in turn, is defined as:

> "a transaction that solely involves—
> (A) an exchange of 2 different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange; and
> (B) a reverse exchange of the 2 currencies described in subparagraph (A) at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange."[510]

Under the Dodd-Frank Act, if foreign exchange forwards or foreign exchange swaps are no longer considered swaps due to a determination by the Secretary, nevertheless, certain provisions of the CEA added by the Dodd-Frank Act would continue to apply to such transactions.[511] Specifically, those transactions still would be subject to certain requirements for

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508 See section 1a(47)(E)(i) of the CEA, 7 U.S.C. 1a(47)(E)(i). The Secretary published in the Federal Register a request for comment as to whether an exemption from the swap definition for foreign exchange swaps, foreign exchange forwards, or both, is warranted, and on the application of the statutory factors that the Secretary must consider in making a determination regarding whether to exempt these products. See Determinations of Foreign Exchange Swaps and Forwards, 75 FR 66829 (Oct. 28, 2010). Subsequently, the Secretary published in the Federal Register a proposed determination to exempt both foreign exchange swaps and foreign exchange forwards from the definition of the term "swap" in the CEA. See Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, Notice of Proposed Determination, 76 FR 25774 (May 5, 2011) ("Notice of Proposed Determination"). The comment period on the Secretary's proposed determination closed on June 6, 2011. A final determination has not yet been issued.

509 See section 1a(24) of the CEA, 7 U.S.C. 1a(24).

510 See section 1a(25) of the CEA, 7 U.S.C. 1a(25).

511 The Secretary's determination also does not affect the CFTC's jurisdiction over retail foreign currency agreements, contracts, or transactions pursuant to section 2(c)(2) of the CEA, 7 U.S.C. 2(c)(2). See section 1a(47)(F)(ii) of the CEA, 7 U.S.C. 1a(47)(F)(ii).

reporting swaps, and swap dealers and major swap participants engaging in such transactions still would be subject to certain business conduct standards.[512]

The Commissions are adopting the rules as proposed to explicitly define by rule the term "swap" to include foreign exchange forwards and foreign exchange swaps (as those terms are defined in the CEA),[513] in order to include in one rule the definitions of those terms and the related regulatory authority with respect to foreign exchange forwards and foreign exchange swaps.[514] The final rules incorporate the provision of the Dodd-Frank Act that foreign exchange forwards and foreign exchange swaps will no longer be considered swaps if the Secretary issues the written determination described above to exempt such products from the swap definition.[515] The final rules also reflect the continuing applicability of certain reporting requirements and business conduct standards in the event that the Secretary makes such a determination.[516]

Comments

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512 See, e.g., sections 1a(47)(E)(iii) and (iv) of the CEA, 7 U.S.C. 1a(47)(E)(iii) and (iv) (reporting and business conduct standards, respectively). In addition, a determination by the Secretary does not exempt any foreign exchange forward or foreign exchange swap traded on a designated contract market or a swap execution facility, or cleared by a derivatives clearing organization, from any applicable antifraud or anti-manipulation provision under the CEA. See sections 1a(47)(F)(i) and 1b(c) of the CEA, 7 U.S.C. 1a(47)(F)(i) and 1b(c).

513 See rules 1.3(xxx)(3)(iii) and (iv) under the CEA and rule 3a69-2(c)(3) and (4) under the Exchange Act.

514 See rules 1.3(xxx)(2)(i)(C) and (D) under the CEA and rules 3a69-2(b)(1)(iii) and (iv) under the Exchange Act. The rules further provide that foreign exchange forwards and forward exchange swaps are not swaps if they fall within one of the exclusions set forth in subparagraph (B) of the statutory swap definition. See rule 1.3(xxx)(2)(ii) under the CEA and rule 3a69-2(b)(2) under the Exchange Act.

515 See rule 1.3(xxx)(3) under the CEA and rule 3a69-2(c) under the Exchange Act.

516 See rule 1.3(xxx)(3)(ii) under the CEA and rule 3a69-2(c)(2) under the Exchange Act. The exclusion of foreign exchange forwards and foreign exchange swaps would become effective upon the Secretary's submission of the determination to exempt to the appropriate Congressional Committees. See sections 1a(47)(E)(ii) and 1b of the CEA, 7 U.S.C. 1a(46)(E)(ii) and 1b.

Two commenters recommended that the Commissions defer action on defining foreign exchange swaps and foreign exchange forwards in their regulations until the Secretary has made his final determination about whether to exempt them.[517] One commenter believed that finalizing the Commissions' proposal prior to the Secretary's final determination would be "premature."[518] The other commenter believed that the industry will be "better positioned" to assess the need to clarify the scope of the swap definition with respect to foreign exchange derivatives after the Secretary has made his determination.[519] The Commissions understand that, if the final rules are effective before the Secretary issues a written determination, market participants entering into foreign exchange forwards and foreign exchange swaps might incur costs in order to comply with the requirements of the CEA (as amended by the Dodd-Frank Act) that could be rendered unnecessary if the Secretary subsequently were to issue a written determination to exempt.[520] The Commissions, however, believe the final rules are necessary because in the event the Secretary issues a written determination to exempt, certain reporting requirements and business conduct standards will continue to apply to the exempted instruments, and the final rules set forth those requirements that will continue to apply.

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517 See CME Letter and SIFMA Letter.

518 See CME Letter. This commenter also believes that if the Secretary exempts foreign exchange swaps and foreign exchange forwards from the swap definition, it would create an "awkward" situation both for the CFTC and market participants, given that options on such products would be swaps but the products into which they exercise would not be swaps, and would result in a lack of clarity and consistency for market participants. Id.

519 See SIFMA Letter.

520 These costs market participants may incur relate to the upfront and ongoing costs associated with the regulation of Title VII instruments generally. See infra parts X and XI, for a discussion of these costs. The Commissions also note that the final rules will reduce (and may eliminate), the costs of determining whether foreign exchange swaps and foreign exchange forwards are subject to Title VII, as well as the costs associated with determining which provisions of the new Title VII regulatory regime will apply to these instruments. Id.

Further, the Commissions do not believe that adopting the rules is premature, as the Secretary may issue a determination at any time, and the Secretary's authority to do so is independent of the Commissions' authority to issue these rules to further define the term "swap."[521] The Commissions' final rules are consistent with this statutory framework by specifically providing that, in the event a determination to exempt is issued, foreign exchange swaps and foreign exchange forwards will not be considered swaps, and will be subject only to those CEA requirements that are specified in the statute.[522] As such, the final rules accommodate the possibility of (rather than the certainty of) an exemptive determination made by the Secretary.

Moreover, commenters provided no support for the assertion that the situation would be awkward for market participants because options on foreign exchange forwards and foreign exchange swaps will be swaps, regardless of whether the Secretary determines to exempt the underlying transactions from the swap definition. The Commissions note that Congress drew the distinction in the statute between foreign currency options and foreign exchange forwards and foreign exchange swaps. The Commissions conclude that adopting these final rules would not

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521 Compare section 712(d)(1) of the CEA (Commissions' joint rulemaking authority to further define the term "swap"), with section 1a(47)(E) and 1b of the CEA (Secretary's authority to determine to exempt foreign exchange swaps and foreign exchange forwards from the definition of "swap.").

522 See rule 1.3(xxx)(3)(ii) under the CEA and rule 3a69-2(c)(2) under the Exchange Act. The statutory requirements that remain applicable, notwithstanding a written determination by the Secretary to exempt, are that foreign exchange swaps and foreign exchange forwards shall be reported to either a swap data repository, or, if there is no swap data repository that would accept such swaps or forwards, to the CFTC pursuant to section 4r of the CEA, 7 U.S.C. 6r, within such time period as the CFTC may by rule or regulation prescribe, and any party to a foreign exchange swap or forward that is a swap dealer or major swap participant shall conform to the business conduct standards contained in section 4s(h) of the CEA, 7 U.S.C. 6s(h). Section 1a(47)(E)(iii) and (iv) of the CEA, 7 U.S.C. 1a(47)(E)(iii) and (iv).

contribute to a lack of clarity or consistency for market participants, regardless of any determination the Secretary makes.

b) Foreign Exchange Products Not Subject to the Secretary's Swap Determination

The Commissions are adopting rules as proposed stating that a determination by the Secretary that foreign exchange forwards or foreign exchange swaps, or both, should not be regulated as swaps would not affect certain other products involving foreign currency, such as foreign currency options, NDFs, currency swaps and cross-currency swaps.[523] The rules explicitly define the term "swap" to include such products, irrespective of whether the Secretary makes a determination to exempt foreign exchange forwards or foreign exchange swaps from the swap definition.[524]

i) Foreign Currency Options[525]

As discussed above, the statutory swap definition includes options, and it expressly enumerates foreign currency options. It encompasses any agreement, contract, or transaction:

> (i) that is a put, call, cap, floor, collar, or similar option of any kind that is for the purchase or sale, or based on the value, of 1 or more interest <u>or other rates, currencies,</u> commodities, securities, instruments of

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523 <u>See</u> rule 1.3(xxx)(3)(v) under the CEA and rule 3a69-2(c)(5) under the Exchange Act.

524 <u>See</u> rule 1.3(xxx)(2)(i) under the CEA and rule 3a69-2(b)(1) under the Exchange Act. The final rules provide, however, that none of these products are swaps if they fall within one of the exclusions set forth in subparagraph (B) of the statutory swap definition. <u>See</u> rule 1.3(xxx)(2)(ii) under the CEA and rule 3a69-2(b)(2) under the Exchange Act. Also, the rules do not define the term "swap" to include currency swaps because they are already included in the statutory definition, but the rules clarify that currency swaps are not subject to the Secretary's determination. <u>See</u> section 1a(47)(A)(iii)(VII) of the CEA, 7 U.S.C. 1a(47)(A)(iii)(VII); rule 1.3(xxx)(3)(v)(A) under the CEA; and rule 3a69-2(c)(5)(i) under the Exchange Act.

525 This discussion is not intended to address, and has no bearing on, the CFTC's jurisdiction over foreign currency options in other contexts. <u>See</u>, <u>e.g.</u>, CEA sections 2(c)(2)(A)(iii) and 2(c)(2)(B)-(C), 7 U.S.C. 2(c)(2)(A)(iii) and 2(c)(2)(B)-(C) (off-exchange options in foreign currency offered or entered into with retail customers).

> indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind.[526]

Foreign exchange options traded on a national securities exchange ("NSE"), however, are securities under the federal securities laws and not swaps or security-based swaps.[527]

Any determination by the Secretary, discussed above, that foreign exchange forwards or foreign exchange swaps should not be regulated as swaps would not impact foreign currency options because a foreign currency option is neither a foreign exchange swap nor a foreign exchange forward, as those terms are defined in the CEA. The Commissions did not receive any comments either on the proposed rule further defining the term "swap" to include foreign currency options or the proposed rule clarifying that foreign currency options are not subject to the Secretary's determination to exempt foreign exchange swaps and foreign exchange forwards.[528] Consequently, the Commissions are adopting rules to explicitly define the term "swap" to include foreign currency options (other than foreign currency options traded on an NSE).[529] The rules also state that foreign currency options are not foreign exchange forwards or foreign exchange swaps under the CEA.[530]

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526 See section 1a(47)(A)(i) of the CEA, 7 U.S.C. 1a(47)(A)(i) (emphasis added).

527 See section 1a(47)(B)(iv) of the CEA, 7 U.S.C. 1a(47)(B)(iv).

528 A comment regarding the CFTC's jurisdiction over retail foreign currency options is discussed below.

529 See rule 1.3(xxx)(2)(ii) under the CEA and rule 3a69-2(b)(1) under the Exchange Act. The final rules treat the terms foreign currency options, currency options, foreign exchange options, and foreign exchange rate options as synonymous. Moreover, for purposes of the final rules, foreign currency options include options to enter into or terminate, or that otherwise operate on, a foreign exchange swap or foreign exchange forward, or on the terms thereof. As discussed above, foreign exchange options traded on an NSE are securities and therefore are excluded from the swap definition. See supra note 527 and accompanying text.

530 See rule 1.3(xxx)(3)(v) under the CEA and rule 3a69-2(c)(5) under the Exchange Act.

ii) Non-Deliverable Forward Contracts Involving Foreign Exchange

As explained by the Commissions in the Proposing Release,[531] an NDF generally is similar to a forward foreign exchange contract,[532] except that at maturity the NDF does not require physical delivery of currencies; rather, the contract typically is settled in a reserve currency, such as U.S. dollars. One of the currencies involved in the transaction, usually an emerging market currency, may be subject to capital controls or similar restrictions, and is therefore said to be "nondeliverable."[533] If the spot market exchange rate on the settlement date is greater (in foreign currency per dollar terms) than the previously agreed forward exchange rate, the party to the contract that is long the nondeliverable (e.g. emerging market) currency must pay its counterparty the difference between the contracted forward price and the spot market rate, multiplied by the notional amount.[534]

NDFs are not expressly enumerated in the swap definition, but as was stated in the Proposing Release,[535] they satisfy clause (A)(iii) of the swap definition because they provide for a future (executory) payment based on an exchange rate, which is an "interest or other rate[]"

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531 See Proposing Release at 29836.

532 A deliverable forward foreign exchange contract is an obligation to buy or sell a specific currency on a future settlement date at a fixed price set on the trade date. See Laura Lipscomb, Federal Reserve Bank of New York, "An Overview of Non-Deliverable Foreign Exchange Forward Markets," 1 (May 2005) (citation omitted) ("Fed NDF Overview").

533 See id. at 1-2 (citation omitted).

534 See id. at 2. Being long the emerging market currency means that the holder of the NDF contract is the "buyer" of the emerging market currency and the "seller" of dollars. Conversely, if the emerging market currency appreciates relative to the previously agreed forward rate, the holder of the contract that is short the emerging market currency must pay its counterparty the difference between the spot market rate and the contracted forward price, multiplied by the notional amount. See id. at 2, n.4.

535 See Proposing Release at 29836.

within the meaning of clause (A)(iii).[536] Each party to an NDF transfers to its counterparty the risk of the exchange rate moving against the counterparty, thus satisfying the requirement that there be a transfer of financial risk associated with a future change in rate. This financial risk transfer in the context of an NDF is not accompanied by a transfer of an ownership interest in any asset or liability. Thus, an NDF is a swap under clause (A)(iii) of the swap definition.[537]

Moreover, the Commissions have determined that NDFs do not meet the definitions of "foreign exchange forward" or "foreign exchange swap" set forth in the CEA.[538] NDFs do not involve an "exchange" of two different currencies (an element of the definition of both a foreign exchange forward and a foreign exchange swap); instead, they are settled by payment in one currency (usually U.S. dollars).[539]

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536 See section 1a(47)(A)(iii) of the CEA, 7 U.S.C. 1a(47)(A)(iii) (providing that a swap is an agreement, contract, or transaction "that provides on an executory basis for the exchange, on a fixed or contingent basis, of 1 or more payments based on the value or level of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind, or any interest therein or based on the value thereof, and that transfers, as between the parties to the transaction, in whole or in part, the financial risk associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset (including any enterprise or investment pool) or liability that incorporates the financial risk so transferred . . . .").

537 In addition, as was noted in the Proposing Release, at least some market participants view NDFs as swaps today, and thus NDFs also may fall within clause (A)(iv) of the swap definition as "an agreement, contract, or transaction that is, or in the future becomes, commonly known to the trade as a swap." See Proposing Release at 29836. See also section 1a(47)(A)(iv) of the CEA, 7 U.S.C. 1a(47)(A)(iv). Cf. rule 35.1(b)(1)(i) under the CEA, 17 CFR 35.1(b)(1)(i) (providing that the definition of "swap agreement" includes a "forward foreign exchange agreement," without reference to convertibility or delivery).

538 In the Notice of Proposed Determination, the Secretary stated that his authority to issue a determination "is limited to foreign exchange swaps and forwards and does not extend to other foreign exchange derivatives" and noted that "NDFs may not be exempted from the CEA's definition of ''swap'' because they do not satisfy the statutory definitions of a foreign exchange swap or forward." See Notice of Proposed Determination.

539 Likewise, the Commissions have determined that a foreign exchange transaction, which initially is styled as or intended to be a "foreign exchange forward," and which is modified so that the parties settle in a reference currency (rather than settle through the exchange of the 2 specified

Notwithstanding their "forward" label, NDFs also do not fall within the forward contract exclusion of the swap definition because currency is outside the scope of the forward contract exclusion for nonfinancial commodities.[540] Nor have NDFs traditionally been considered commercial merchandising transactions. Rather, as the Commissions observed in the Proposing Release,[541] NDF markets appear to be driven in large part by speculation[542] and hedging,[543] which features are more characteristic of swap markets than forward markets.

Comments

Commenters who addressed the nature of NDFs believed that NDFs should not be considered swaps, but rather should be categorized as foreign exchange forwards. In general, commenters maintained that NDFs are functionally and economically equivalent to foreign exchange forwards, and therefore should be treated in the same manner for regulatory purposes.[544] In support of this view, commenters made several arguments, including that both

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currencies), does not conform with the definition of "foreign exchange forward" in the CEA. See infra note 626.

540 Currency is an excluded commodity under the CEA. See section 1a(19)(i) of the CEA, 7 U.S.C. 1a(19)(i). In accordance with the interpretation regarding nonfinancial commodities, which as discussed above, see supra part II.B.2(a), are exempt and agricultural commodities that can be physically delivered, currency does not qualify as a nonfinancial commodity for purposes of the forward exclusion from the swap definition.

541 See Proposing Release at 29836.

542 See Fed NDF Overview at 5 ("[E]stimates vary but many major market participants estimate as much as 60 to 80 percent of NDF volume is generated by speculative interest, noting growing participation from international hedge funds.") and 4 ("[D]ealers note that much of the volume in Chinese yuan NDFs is generated by speculative positioning based on expectations for an alteration in China's current, basically fixed exchange rate.") (italics in original).

543 See id. at 4 (noting that "[much of the] Korean won NDF volume[,] . . . estimated to be the largest of any currency, . . . is estimated to originate with international investment portfolio managers hedging the currency risk associated with their onshore investments").

544 See CDEU Letter; Letter from The Committee on Investment of Employee Benefit Assets, dated Jul. 22, 2011 ("CIEBA Letter"); Letter from Bruce C. Bennett, Covington & Burling LLP, dated Jul. 22, 2011 ("Covington Letter"); and Letter from Karrie McMillan and Cecelia Calaby, the

NDFs and foreign exchange forwards require the same net value to be transferred between counterparties; the purpose for using them is the same – to cover foreign currency exchange risk; both are typically short term transactions; and both may be cleared by CLS Bank.[545]

In addition, commenters believed that not treating NDFs as foreign exchange forwards or foreign exchange swaps would be contrary to both domestic and international market practices. As specific examples, commenters noted that NDFs typically are traded as part of a bank's or broker's foreign exchange desk; the Federal Reserve Bank of New York has described an NDF in a 1998 publication as an instrument "similar to an outright forward," except that there is no physical delivery or transfer of the local currency; the Bank for International Settlements ("BIS") categorizes NDFs in its "outright forward" category; various European regulations do not distinguish between the two transaction types; standard foreign exchange trading documentation includes both net- and physically-settled foreign exchange transactions in general definitions of foreign exchange transactions; and special rules under the U.S. tax code apply equally to physically settled and cash settled foreign exchange forwards.[546]

Commenters also raised potential negative consequences to certain U.S. market participants if NDFs are not considered to be foreign exchange forwards. For example, one commenter argued that treating NDFs as swaps will put U.S. corporations doing business in emerging markets at a disadvantage relative to U.S. corporations doing business solely in developed markets.[547] This commenter stated that NDFs are widely used by U.S. corporations

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Investment Company Institute/American Bar Association Securities Association, dated Jul. 22, 2011 ("ICI/ABASA Letter").

545 See Covington Letter and ICI/ABASA Letter. CLS Bank operates the largest multi-currency cash settlement system to eliminate settlement risk in the foreign exchange market.

546 See Covington Letter and ICI/ABASA Letter.

547 See Covington Letter.

that do business in emerging markets to hedge their exposure to the currencies of those markets, and that regulating NDFs as swaps would significantly increase the cost of hedging those exposures.[548]

With respect to the Commissions' legal conclusion that NDFs are not foreign exchange forwards, and thus are not subject to the Secretary's determination, one commenter stated that the Commissions' reading of the definition of the term "foreign exchange forward" as not including NDFs is "too restrictive."[549] In this regard, this commenter believed that the term "exchange" should be read to include "the economic exchange that occurs in net settlement rather than being narrowly read as the physical 'exchange' of two different currencies."

One commenter, in contrast, agreed with the Commissions' interpretation that NDFs are not encompassed within the definition of the term "foreign exchange forward."[550] This commenter requested, though, that the CFTC exempt NDFs from the swap definition, using its exemptive authority under section 4(c) of the CEA.[551]

While commenters raised a number of objections to the Commissions' proposal to define NDFs as swaps, these objections primarily raise policy arguments. No commenter has provided a persuasive, alternative interpretation of the statute's plain language in the definition of the term "foreign exchange forward" to overcome the Commissions' conclusion that, under the CEA, NDFs are swaps, not foreign exchange forwards.

One commenter believed that the Commissions' interpretation of "exchange of 2 different currencies" as used in the foreign exchange forward definition is too restrictive, and

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548 See supra note 520.

549 See ICI/ABASA Letter.

550 See CIEBA Letter.

551 7 U.S.C. 6(c).

that the phrase should be read broadly to mean an economic exchange of value in addition to physical exchange; the Commissions believe that this contention is misplaced.[552] This commenter essentially asks the Commissions to interpret the statutory language to mean an exchange of foreign currencies themselves, as well as an exchange based on the value of such currencies. However, only the word "exchange" appears in the relevant definitions, reinforcing the conclusion that Congress intended the definition of "foreign exchange forward" to be distinct from other types of transactions covered by the definition of "swap" in the CEA. Moreover, the language of each definition emphasizes that these transactions may "solely" involve an exchange. The ordinary meaning of the verb "exchange" is to "barter" [553] or "part with, give or transfer for an equivalent,"[554] i.e., each party is both giving to and receiving from the other party. This does not occur under an NDF, in which only a single party makes a payment.

Elsewhere in the CEA, Congress used explicit language that potentially could provide support for a broader interpretation of the type advocated by this commenter, but such language is absent from the definition of the term "foreign exchange forward." For example, section 2(a)(1)(C)(ii) confers exclusive jurisdiction on the CFTC over "contracts of sale for future delivery of a group or index of securities (or any interest therein or based upon the value thereof) [that meet certain requirements]" (emphasis added). If the phrase "exchange of 2 different currencies" had been intended to include economic exchanges of value, as suggested by this commenter, that phrase would have included language similar to "based on the value thereof" to indicate that other mechanisms of transferring value may occur in these particular types of

552 See ICI/ABASA Letter.

553 See Webster's New World Dictionary (3d College Ed. 1988).

554 See Black's Law Dictionary.

transactions. Instead, as noted above, Congress limited the scope of each of these particular transactions by using the words "solely involves the exchange of 2 different currencies" (emphasis added). The Commissions conclude that the use of the word "solely" provides further support for the Commissions' interpretation that exchange means an actual interchange of the 2 different currencies involved in the transaction.[555]

iii) Currency Swaps and Cross-Currency Swaps

A currency swap[556] and a cross-currency swap[557] each generally can be described as a swap in which the fixed legs or floating legs based on various interest rates are exchanged in different currencies. Such swaps can be used to reduce borrowing costs, to hedge currency

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555 This commenter's request that the CFTC exempt NDFs from the swap definition using its exemptive authority under section 4(c) of the CEA, 7 U.S.C. 6(c), and that the SEC exercise its exemptive authority under section 36 of the Exchange Act, 78 U.S.C. 78mm, with respect to NDFs, is beyond the scope of this rulemaking.

556 A swap that exchanges a fixed rate against a fixed rate is known as a currency swap. See Federal Reserve System, "Trading and Capital-Markets Activities Manual," section 4335.1 (Jan. 2009).

557 Cross-currency swaps with a fixed leg based on one rate and a floating leg based on another rate, where the two rates are denominated in different currencies, are generally referred to as cross-currency coupon swaps, while those with a floating leg based on one rate and another floating leg based on a different rate are known as cross-currency basis swaps. Id. Cross-currency swaps also include annuity swaps and amortizing swaps. In cross-currency annuity swaps, level cash flows in different currencies are exchanged with no exchange of principal; annuity swaps are priced such that the level payment cash flows in each currency have the same net present value at the inception of the transaction. An amortizing cross-currency swap is structured with a declining principal schedule, usually designed to match that of an amortizing asset or liability. Id.

See also Derivatives ONE, "Cross Currency Swap Valuation" ("A cross currency swap is swap of an interest rate in one currency for an interest rate payment in another currency . . . . This could be considered an interest rate swap with a currency component."), available at http://www.derivativesone.com/cross-currency-swap-valuation/; Financial Accounting Standards Board, "Examples Illustrating Application of FASB Statement No. 138," Accounting for Certain Derivative Instruments and Certain Hedging Activities, section 2, Example 1, at 3 ("The company designates the cross-currency swap as a fair value hedge of the changes in the fair value of the loan due to both interest and exchange rates."), available at http://www.fasb.org/derivatives/examples.pdf.

exposure, and to create synthetic assets[558] and are viewed as an important tool, given that they can be used to hedge currency and interest rate risk in a single transaction.

Currency swaps and cross-currency swaps are not foreign exchange swaps as defined in the CEA because, although they may involve an exchange of foreign currencies, they also require contingent or variable payments in different currencies. Because the CEA defines a foreign exchange swap as a swap that "solely" involves an initial exchange of currencies and a reversal thereof at a later date, subject to certain parameters, currency swaps and cross-currency swaps would not be foreign exchange swaps. Similarly, currency swaps and cross-currency swaps are not foreign exchange forwards because foreign exchange forwards "solely" involve an initial exchange of currencies, subject to certain parameters, while currency swaps and cross-currency swaps contain additional elements, as discussed above.

Currency swaps are expressly enumerated in the statutory definition of the term "swap."[559] Cross-currency swaps, however, are not.[560] Accordingly, based on the foregoing considerations, the Commissions are adopting rules explicitly defining the term "swap" to include cross-currency swaps.[561] The rules also state that neither currency swaps nor cross-currency swaps are foreign exchange forwards or foreign exchange swaps as those terms are defined in the CEA. The Commissions did not receive any comments either on the rule further defining the term "swap" to include cross-currency swaps or the rule clarifying that cross-

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558 BMO Capital Markets, "Cross Currency Swaps," available at http://www.bmocm.com/products/marketrisk/intrderiv/cross/default.aspx.

559 See section 1a(47)(A)(iii)(VII) of the CEA, 7 U.S.C. 1a(47)(A)(iii)(VII).

560 Clause (A)(iii) of the swap definition expressly refers to a cross-currency rate swap. See section 1a(47)(A)(iii)(V) of the CEA, 7 U.S.C. 1a(47)(A)(iii)(V). Although the swap industry appears to use the term "cross-currency swap," rather than "cross-currency rate swap" (the term used in section 1a(47)(A)(iii)(V) of the CEA), the Commissions interpret these terms as synonymous.

561 See rule 1.3(xxx)(2)(i)(A) under the CEA and rule 3a69-2(b)(1)(i) under the Exchange Act.

currency swaps and currency swaps are not subject to the Secretary's determination to exempt foreign exchange swaps and foreign exchange forwards.

c) Interpretation Regarding Foreign Exchange Spot Transactions

The CEA generally does not confer regulatory jurisdiction on the CFTC with respect to spot transactions.[562] In the context of foreign currency, spot transactions typically settle within two business days after the trade date ("T+2").[563] The accepted market practice of a two-day settlement for spot foreign currency transactions has been recognized by the CFTC[564] and the courts.[565]

The Commissions recognize that the new foreign exchange forward definition in the CEA, which was added by the Dodd-Frank Act and which applies to an exchange of two different currencies "on a specific future date," could be read to apply to any foreign exchange transaction that does not settle on the same day. Such a reading could render most foreign exchange spot transactions foreign exchange forwards under the CEA; as a result, such transactions would be subject to the CEA reporting and business conduct standards requirements applicable to foreign exchange forwards even if the Secretary determines to exempt foreign

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562 But see supra note 227.

563 Bank for International Settlements, Triennial Central Bank Survey, Report on Global Foreign Exchange Market Activity in 2010 at 32 (Dec. 2010) (defining a foreign exchange spot transaction to provide for cash settlement within 2 business days); Sam Y. Cross, Federal Reserve Bank of New York, "All About . . . The Foreign Exchange Market in the United States" at 31-32 (1998).

564 See CFTC Division of Trading and Markets, Report on Exchange of Futures for Physicals at 124-127 (1987) (noting that foreign currency spot transactions settle in 2 days).

565 See CFTC v. Frankwell Bullion, Ltd., 99 F.3d 299, 300 (9th Cir. 1996) ("Spot transactions in foreign currencies call for settlement within two days."); CFTC v. Int'l Fin. Servs. (NewYork), Inc., 323 F. Supp. 2d 482, 495 (S.D.N.Y.2004) (noting that spot transactions ordinarily call for settlement within two days); Bank Brussels Lambert, S.A. v. Intermetals Corp., 779 F.Supp. 741, 742 (S.D.N.Y. 1991) (same). But the Commissions understand that the settlement cycle for spot transactions exchanging Canadian dollars for U.S. dollars (or vice versa) is T+1. See Cross, supra 563, at 31.

exchange forwards from the definition of "swap." The Commissions do not believe that Congress intended, solely with respect to foreign exchange transactions, to extend the reach of the CEA to transactions that historically have been considered spot transactions. At the same time, however, the Commissions do not want to enable market participants simply to label as "spot" foreign exchange transactions that regularly settle after the relevant foreign exchange spot market settlement deadline, or with respect to which the parties intentionally delay settlement, both of which would be properly categorized as foreign exchange forwards, or CEA section 2(c)(2) transactions (discussed separately below), in order to avoid applicable foreign exchange regulatory requirements.

Accordingly, the Commissions are providing an interpretation that a bona fide foreign exchange spot transaction, i.e., a foreign exchange transaction that is settled on the customary timeline of the relevant spot market, is not within the definition of the term "swap." In general, a foreign exchange transaction will be considered a bona fide spot transaction if it settles via an actual delivery of the relevant currencies within two business days. In certain circumstances, however, a foreign exchange transaction with a longer settlement period concluding with the actual delivery of the relevant currencies may be considered a bona fide spot transaction depending on the customary timeline of the relevant market.[566] In particular, as discussed below, the Commissions will consider a foreign exchange transaction that is entered into solely to effect the purchase or sale of a foreign security to be a bona fide spot transaction where certain conditions are met.

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566 In this regard, while the Commissions will look at the relevant facts and circumstances, they will not expect that an unintentional settlement failure or delay for operational reasons or due to a market disruption will undermine the character of a bona fide spot foreign exchange transaction as such.

The CFTC will consider the following to be a bona fide spot foreign exchange transaction: an agreement, contract or transaction for the purchase or sale of an amount of foreign currency equal to the price of a foreign security with respect to which (i) the security and related foreign currency transactions are executed contemporaneously in order to effect delivery by the relevant securities settlement deadline and (ii) actual delivery of the foreign security and foreign currency occurs by such deadline (such transaction, a "Securities Conversion Transaction").[567] For Securities Conversion Transactions, the CFTC will consider the relevant foreign exchange spot market settlement deadline to be the same as the securities settlement deadline. As noted above, while the CFTC will look at the relevant facts and circumstances, it does not expect that an unintentional settlement failure or delay for operational reasons or due to a market disruption will undermine the character of a bona fide spot foreign exchange transaction as such.

The CFTC also will interpret a Securities Conversion Transaction as not leveraged, margined or financed within the meaning of section 2(c)(2)(C) of the CEA.[568] While it is possible to view the fact that the buyer of a currency in a such a transaction does not pay for the currency until it is delivered as leverage (in that the buyer puts nothing down until taking delivery, thus achieving 100% leverage) or a financing arrangement, the CFTC does not interpret

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567 The interpretation herein with respect to Security Conversion Transactions is limited to such transactions.

568 7 U.S.C. 2(c)(2)(C). Similarly, a Securities Conversion Transaction is not an option, option on a futures contract or futures contract and thus would not be subject to CEA section 2(c)(2)(B), 7 U.S.C. 2(c)(2)(B). Of course, optionality as to settlement would render the transaction an option and is inconsistent with a "spot" characterization.

it as such for purposes of CEA section 2(c)(2)(C).[569] Congress recognized that settlement of bona fide spot foreign exchange transactions typically takes two days.[570] The fact that Congress expressly excluded these types of bona fide spot foreign exchange transactions does not mean that Congress intended to subject Security Conversion Transactions to regulation under the retail foreign exchange regime.[571] For the foregoing reasons, the CFTC will interpret a Securities Conversion Transaction as not leveraged, margined or financed within the meaning of section 2(c)(2)(C) of the CEA.[572]

Comments

One commenter requested clarification regarding the status of foreign exchange spot transactions.[573] This commenter recommended that the Commissions clarify that foreign exchange spot transactions, which this commenter defined as "transactions of one currency into another that settle within a customary settlement cycle," are neither foreign exchange forwards

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569 Cf. 12 C.F.R. § 220.8(b)(1) under Regulation T (12 C.F.R. Part 220) (generally permits a customer to purchase a security (including a foreign security) in a cash account, rather than a margin account, even if the customer has no collateral in the account, if payment for the security is made within the appropriate payment period). Similarly, if a foreign exchange buyer in a Securities Conversion Transaction posts no margin or collateral on the trade date, the CFTC does not consider that transaction to be "margined" within the meaning of 7 U.S.C. 2(c)(2)(C)(i)(I)(bb).

570 See section 2(c)(2)(C)(i)(II) of the CEA, 7 U.S.C. 2(c)(2)(C) ("[s]ubclause (I) of this clause shall not apply to . . . a contract of sale that . . . results in delivery within 2 days").

571 The CFTC notes, for example, that Congress recognized that settlement in various spot markets in commodities other than foreign exchange can be longer than two days. See CEA section 2(c)(2)(D)(ii)(III)(aa) (disapplying the DCM-trading requirement for certain commodity transactions with non-ECPs when the contract "results in actual delivery within 28 days or such other longer period as the [CFTC] may determine by rule or regulation based on the typical commercial practice in cash or spot markets for the commodity involved").

572 This interpretation is not intended to address, and has no bearing on, the CFTC's interpretation of the term "actual delivery" as set forth in section 2(c)(2)(D)(ii)(III)(aa), 7 C.F.R. 2(c)(2)(D)(ii)(III)(aa). See Retail Commodity Transactions under the Commodity Exchange Act, 76 FR 77670, Dec. 14, 2011.

573 See SIFMA Letter.

nor swaps.[574] Another commenter indicated that the customary settlement cycle for purchases of most non-U.S. denominated securities is "T+3" (in some securities markets, such as South Africa, the settlement cycle can take up to seven days), and requires the buyer to pay for the foreign securities in the relevant foreign currency.[575] Typically, according to this commenter, a broker-dealer or bank custodian acting on behalf of the buyer or seller will enter into a foreign currency transaction to settle on a T+3 basis (or the relevant settlement period) as well. Timing the foreign exchange transaction to settle at the same time as the securities transaction benefits the customer by reducing his or her exposure to currency risk on the securities transaction between trade date and settlement date. The Commissions have provided the interpretation described above regarding the interplay between the foreign exchange forward definition, the meaning of "leveraged, margined or financed" under section 2(c)(2)(C) of the CEA, and bona fide foreign exchange spot transactions to address these commenters' concerns.

d) Retail Foreign Currency Options

The CFTC is providing an interpretation regarding the status of retail foreign currency options that are described in section 2(c)(2)(B) of the CEA.[576] As noted above, the Commissions

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574 Id. In this commenter's view, such clarification is necessary to avoid the statutory foreign exchange forward definition "unwittingly captur[ing] many typical foreign exchange spot transactions . . . settl[ing] within a customary settlement cycle," which this commenter stated is generally "T+2" in the United States, but can be "T+3" in some other countries.

575 See Letter from Phoebe A. Papageorgiou, Senior Counsel, American Bankers Ass'n and James Kemp, Managing Director, Global Foreign Exchange Division, dated April 18, 2012 ("ABA/Global FX Letter"). This commenter requested clarification that the purchase, sale or exchange of a foreign currency by a bank on behalf of a retail customer for the sole purpose of effecting a purchase or sale of a foreign security or in order to clear or settle such purchase or sale, when the settlement period for such FX transaction is within the settlement cycle for such foreign security, is excluded from the retail foreign exchange under the CEA. The CFTC has provided the clarification regarding the meaning of "leveraged, margined or financed" under section 2(c)(2)(C) of the CEA to address this commenter's concern.

576 7 U.S.C. 2(c)(2)(B).

proposed to include foreign currency options generally within the definition of the term "swap," subject to the statutory exclusions in subparagraph (B) of the definition. The statutory exclusions from the swap definition encompass transactions described in sections 2(c)(2)(C) and (D) of the CEA, but not those in section 2(c)(2)(B) of the CEA.[577] Section 2(c)(2)(B) of the CEA applies to futures, options on futures and options on foreign currency (other than foreign currency options executed or traded on a national securities exchange), and permits such transactions to be entered into with counterparties who are not ECPs[578] on an off-exchange basis by certain enumerated regulated entities.[579] No issue arises with respect to futures or options on futures in foreign currency that are covered by section 2(c)(2)(B) of the CEA, because they are

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577 See section 1a(47)(B)(i) of the CEA, 7 U.S.C. 1a(47)(B)(i). Sections 2(c)(2)(B), (C), and (D) of the CEA, 7 U.S.C. 2(c)(2)(B), (C), and (D), govern certain types of off-exchange transactions in commodities, including foreign currency, in which one of the parties to the transaction is not an ECP.

578 ECPs are defined in section 1a(18) of the CEA, 7 U.S.C. 1a(18).

579 Section 2(c)(2)(B)(i) of the CEA provides: (i) This Act applies to, and the Commission shall have jurisdiction over, an agreement, contract, or transaction in foreign currency that— (I) is a contract of sale of a commodity for future delivery (or an option on such a contract) or an option (other than an option executed or traded on a national securities exchange registered pursuant to section 6(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78f(a)); and (II) is offered to, or entered into with, a person that is not an eligible contract participant, unless the counterparty, or the person offering to be the counterparty, of the person is [certain regulated counterparties enumerated in the statute.] 7 U.S.C. 2(c)(2)(B)(i). Thus, under section 2(c)(2)(B)(i) of the CEA, the CEA's exchange-trading requirement generally applies with respect to futures, options on futures, and options on foreign currency. See section 4(a) of the CEA, 7 U.S.C. 6(a) (generally requiring futures contracts to be traded on or subject to the rules of a DCM); section 4c(b) of the CEA, 7 U.S.C. 6c(b) (prohibiting trading options subject to the CEA contrary to CFTC rules, regulations or orders permitting such trading); Part 32 of the CFTC's rules, 17 CFR Part 32 (generally prohibiting entering into options subject to the CEA (other than options on futures) other than on or subject to the rules of a DCM); and CFTC Rule 33.3(a), 17 CFR 33.3(a) (prohibiting entering into options on futures other than on or subject to the rules of a DCM). However, if the counterparty to the non-ECP is an enumerated regulated entity identified in section 2(c)(2)(B)(i)(II) of the CEA, 7 U.S.C. 2(c)(2)(B)(i)(II), the CEA's exchange-trading requirement does not apply. Accordingly, an enumerated regulated entity – including a banking institution regulated by the OCC – can, pursuant to section 2(c)(2)(B) of the CEA, lawfully enter into a future, an option on a future, or an option on foreign currency with a non-ECP counterparty on an off-exchange basis.

expressly excluded from the statutory swap definition.[580] Commodity options, including options on foreign currency, however, are not excluded from the swap definition (other than foreign currency options executed or traded on a national securities exchange).

The CFTC notes that, in further defining the term "swap" to include foreign currency options, the Proposing Release stated that the proposal was not intended to address, and had no bearing on, the CFTC's jurisdiction over foreign currency options in other contexts, specifically citing section 2(c)(2)(B) of the CEA.[581] Nonetheless, the CFTC acknowledges the ambiguity in the statute regarding the status of off-exchange foreign currency options with non-ECPs that are subject to section 2(c)(2)(B) of the CEA. While foreign currency options are swaps, they also are subject to section 2(c)(2)(B) of the CEA when entered into off-exchange with non-ECPs, and there is no statutory exclusion from the swap definition for section 2(c)(2)(B) transactions. If foreign currency options were deemed to be swaps, then, pursuant to section 2(e) of the CEA, as added by the Dodd-Frank Act, [582] they could not be entered into by non-ECP counterparties, except on a DCM. This would render the provisions of section 2(c)(2)(B) of the CEA, permitting off-exchange foreign currency options with non-ECPs by enumerated regulated entities, a nullity.

The CFTC believes that Congress did not intend the swap definition to overrule and effectively repeal another provision of the CEA in such an oblique fashion.[583] Nor is there

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580 See section 1a(47)(B)(i) of the CEA, 7 U.S.C. 1a(47)(B)(i).

581 See Proposing Release at 29835 n.125.

582 7 U.S.C. 2(e).

583 The CFTC notes in this regard that repeals by implication are strongly disfavored by the courts. See, e.g., Village of Barrington, Ill. v. Surface Transp. Bd., 636 F.3d 650, 662 (D.C. Cir. 2011) ("Repeals by implication, however, are strongly disfavored 'absent a clearly expressed congressional intention'") (quoting Branch v. Smith, 538 U.S. 254, 273, 123 S.Ct. 1429 (2003)); Agri Processor Co., Inc. v. N.L.R.B., 514 F.3d 1, 4 (D.C. Cir. 2008) ("[a]mendments by

anything in the legislative history of the Dodd-Frank Act to suggest a congressional intent to prohibit only one type of off-exchange foreign currency transaction with non-ECPs (out of the three types of off-exchange foreign currency transactions with non-ECPs that are addressed in CEA section 2(c)(2)(B)). The omission of section 2(c)(2)(B) of the CEA from the exclusions set forth in the statutory swap definition appears to be a scrivener's error.[584] Accordingly, the CFTC is applying the exclusion from the swap definition to foreign currency options described in CEA section 2(c)(2)(B).

3. Forward Rate Agreements

The Commissions are adopting rules as proposed to explicitly define the term "swap" to include forward rate agreements ("FRAs").[585] The Commissions did not receive any comments on the proposed rules regarding the inclusion of FRAs in the swap definition.

In general, an FRA is an over-the-counter contract for a single cash payment, due on the settlement date of a trade, based on a spot rate (determined pursuant to a method agreed upon by the parties) and a pre-specified forward rate. The single cash payment is equal to the product of the present value (discounted from a specified future date to the settlement date of the trade) of the difference between the forward rate and the spot rate on the settlement date multiplied by the notional amount. The notional amount itself is not exchanged.[586]

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implication, like repeals by implication, are not favored" and "will not be found unless an intent to repeal [or amend] is 'clear and manifest.'") (quoting United States v. Welden, 377 U.S. 95, 102 n. 12, 84 S.Ct. 1082 (1964) and Rodriguez v. United States, 480 U.S. 522, 524, 107 S.Ct. 1391 (1987)).

584 See, e.g., Singer and Singer, Sutherland Statutes and Statutory Construction §47:38 (7th ed. 2011) ("Words may be supplied in a statute . . . where omission is due to inadvertence, mistake, accident, or clerical error").

585 See rules 1.3(xxx)(2)(i)(E) under the CEA and rule 3a69-2(b)(1)(v) under the Exchange Act.

586 See generally "Trading and Capital-Markets Activities Manual," supra note 556, section 4315.1 ("For example, in a six-against-nine-month (6x9) FRA, the parties agree to a three-month rate

An FRA provides for the future (executory) payment based on the transfer of interest rate risk between the parties as opposed to transferring an ownership interest in any asset or liability.[587] Thus, the Commissions believe that an FRA satisfies clause (A)(iii) of the swap definition.[588]

Notwithstanding their "forward" label, FRAs do not fall within the forward contract exclusion from the swap definition. FRAs do not involve nonfinancial commodities and thus are outside the scope of the forward contract exclusion. Nor is an FRA a commercial merchandising transaction, as there is no physical product to be delivered in an FRA.[589] Accordingly, the

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that is to be netted in six months' time against the prevailing three-month reference rate, typically LIBOR. At settlement (after six months), the present value of the net interest rate (the difference between the spot and the contracted rate) is multiplied by the notional principal amount to determine the amount of the cash exchanged between the parties . . . . If the spot rate is higher than the contracted rate, the seller agrees to pay the buyer the differences between the prespecified forward rate and the spot rate prevailing at maturity, multiplied by a notional principal amount. If the spot rate is lower than the forward rate, the buyer pays the seller.").

587 It appears that at least some in the trade view FRAs as swaps today. See, e.g., The Globecon Group, Ltd., "Derivatives Engineering: A Guide to Structuring, Pricing and Marketing Derivatives," 45 (McGraw-Hill 1995) ("An FRA is simply a one-period interest-rate swap."); DerivActiv, Glossary of Financial Derivatives Terms ("A swap is . . . a strip of FRAs."), available at http://www.derivactiv.com/definitions.aspx?search=forward+rate+agreements. Cf. Don M. Chance, et. al, "Derivatives in Portfolio Management," 29 (AIMR 1998) ("[An FRA] involves one specific payment and is basically a one-date swap (in the sense that a swap is a combination of FRAs[,] with some variations)."). Thus, FRAs also may fall within clause (A)(iv) of the swap definition, as "an agreement, contract, or transaction that is, or in the future becomes, commonly known to the trade as a swap." See section 1a(47)(a)(iv) of the CEA, 7 U.S.C. 1a(47)(a)(iv).

588 See section 1a(47)(A)(iii) of the CEA, 7 U.S.C. 1a(47)(A)(iii). CFTC regulations have defined FRAs as swap agreements. See rule 35.1(b)(1)(i) under the CEA, 17 CFR 35.1(b)(1)(i); Exemption for Certain Swap Agreements, 58 FR 5587 (Jan. 22, 1993). The CFTC recently repealed that rule and amended Part 35 of its rules in light of the enactment of Title VII of the Dodd-Frank Act. See Agricultural Swaps, 76 FR 49291 (Aug. 10, 2011).

589 See Regulation of Hybrid and Related Instruments, 52 FR 47022, 47028 (Dec. 11, 1987) (stating "[FRAs] do not possess all of the characteristics of forward contracts heretofore delineated by the [CFTC]").

Commissions believe that the forward contract exclusion from the swap definition for nonfinancial commodities does not apply to FRAs.[590]

Based on the foregoing considerations, the Commissions are adopting rules to provide greater clarity by explicitly defining the term "swap" to include FRAs. As with the foreign exchange-related products discussed above, the final rules provide that FRAs are not swaps if they fall within one of the exclusions set forth in subparagraph (B) of the swap definition.

4. Combinations and Permutations of, or Options on, Swaps and Security-Based Swaps

Clause (A)(vi) of the swap definition provides that "any combination or permutation of, or option on, any agreement, contract, or transaction described in any of clauses (i) through (v)" of the definition is a swap.[591] The Commissions provided an interpretation regarding clause (A)(vi) in the Proposing Release.[592] The Commissions received no comments on the interpretation provided in the Proposing Release regarding combinations and permutations of, or options on, swaps and security-based swaps and are restating their interpretation of clause (A)(vi) of the swap definition with one technical correction and one clarification.

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590 The Commissions note that Current European Union law includes FRAs in the definition of "financial instruments." See Markets in Financial Instruments Directive (MiFID), "Directive 2004/39/EC of the European Parliament and of the Council," Annex I(C), 4, 5, 10 (Apr. 21, 2004), available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2004L0039:20070921:EN:PDF. European Commission legislation on derivatives, central clearing, and trade repositories applies to FRAs that are traded over-the-counter and, thus, would subject such transactions to mandatory clearing, reporting and other regulatory requirements. See Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories, tit. I, art. 2 (1(3b)), 7509/1/12 REV 1 (Mar. 19, 2012).

591 See section 1a(47)(vi) of the CEA, 7 U.S.C. 1a(47)(vi). Clause (A)(vi) of the swap definition refers specifically to other types of swaps in the swap definition. However, because section 3(a)(68) of the Exchange Act defines a security-based swap as a swap [with some connection to a security], clause (A)(vi) of the swap definition is relevant to determining whether any combination or permutation of, or option on, a security-based swap is a security-based swap.

592 See Proposing Release at 29838.

Clause (A)(vi) means, for example, that an option on a swap or security-based swap (commonly known as a "swaption") would itself be a swap or security-based swap, respectively. The Commissions also interpret clause (A)(vi) to mean that a "forward swap" would itself be a swap or security-based swap, respectively.[593] By listing examples here, the Commissions do not intend to limit the broad language of clause (A)(vi) of the swap definition, which is designed to capture those agreements, contracts and transactions that are not expressly enumerated in the CEA swap definition but that nevertheless are swaps.[594]

5. Contracts for Differences

As the Proposing Release notes, the Commissions have received inquiries over the years regarding the treatment of CFDs under the CEA and the federal securities laws.[595] A CFD generally is an agreement to exchange the difference in value of an underlying asset between the time at which a CFD position is established and the time at which it is terminated.[596] If the value

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593 Forward swaps are also commonly known as forward start swaps, or deferred or delayed start swaps. A forward swap can involve two offsetting swaps that both start immediately, but one of which ends on the deferred start date of the forward swap itself. For example, if a counterparty wants to hedge its risk for four years, starting one year from today, it could enter into a one-year swap and a five-year swap, which would partially offset to create a four-year swap, starting one year forward. A forward swap also can involve a contract to enter into a swap or security-based swap at a future date or with a deferred start date. A forward swap is not a nonfinancial commodity forward contract or security forward, both of which are excluded from the swap definition and discussed elsewhere in this release.

594 This category could include categories of agreements, contracts or transactions that do not yet exist as well as more esoteric swaps that exist but that Congress did not refer to by name in the statutory swap definition.

595 See Proposing Release at 29838.

596 See Ontario Securities Commission, Staff Notice 91-702, "Offerings of Contracts for Difference and Foreign Exchange Contracts to Investors in Ontario," at part IV.1 (defining a CFD as "a derivative product that allows an investor to obtain economic exposure (for speculative, investment or hedging purposes) to an underlying asset . . . such as a share, index, market sector, currency or commodity, without acquiring ownership of the underlying asset"), available at http://www.osc.gov.on.ca/documents/en/Securities-Category9/sn_20091030_91-702_cdf.pdf (Oct. 30, 2009); Financial Services Authority, Consultation Paper 7/20, "Disclosure of Contracts for Difference - Consultation and draft Handbook text," at part 2.2 (defining a CFD on a share as

increases, the seller pays the buyer the difference; if the value decreases, the buyer pays the seller the difference. CFDs can be traded on a number of products, including treasuries, foreign exchange rates, commodities, equities, and stock indexes. Equity CFDs closely mimic the purchase of actual shares. The buyer of an equity CFD receives cash dividends and participates in stock splits.[597] In the case of a long position, a dividend adjustment is credited to the client's account. In the case of a short position, a dividend adjustment is debited from the client's account. CFDs generally are traded over-the-counter (though they also are traded on the Australian Securities Exchange) in a number of countries outside the United States.

The Commissions provided an interpretation in the Proposing Release regarding the treatment of CFDs. The Commissions are restating the interpretation set out in the Proposing Release without modification.

CFDs, unless otherwise excluded, fall within the scope of the swap or security-based swap definition, as applicable.[598] Whether a CFD is a swap or security-based swap will depend on the underlying product of that particular CFD transaction. Because CFDs are highly variable and a CFD can contain a variety of elements that would affect its characterization, the Commissions believe that market participants will need to analyze the features of the underlying product of any particular CFD in order to determine whether it is a swap or a security-based

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"a derivative product that gives the holder an economic exposure, which can be long or short, to the change in price of a specific share over the life of the contract"), available at http://www.fsa.gov.uk/pubs/cp/cp07_20.pdf (Nov. 2007).

597 See, e.g., Int'l Swaps and Derivatives Ass'n, "2002 ISDA Equity Derivatives Definitions," art. 10 (Dividends) and 11 (Adjustments and Modifications Affecting Indices, Shares and Transactions).

598 In some cases, depending on the facts and circumstances, the SEC may determine that a particular CFD on an equity security, for example, should be characterized as constituting a purchase or sale of the underlying equity security and, therefore, be subject to the requirements of the federal securities laws applicable to such purchases or sales.

swap. The Commissions are not adopting rules or additional interpretations at this time regarding CFDs.

Comments

Two commenters requested that the Commissions clarify that non-deliverable forward contracts are not CFDs.[599] These commenters requested that the Commissions determine that NDFs involving foreign exchange are not swaps. Given that the Commissions are defining NDFs as swaps and that CFDs involving foreign currency also would be swaps, there is no need to distinguish NDFs involving foreign exchange from CFDs involving foreign exchange.

D. Certain Interpretive Issues

1. Agreements, Contracts, or Transactions That May Be Called, or Documented Using Form Contracts Typically Used for, Swaps or Security-Based Swaps

The Commissions are restating the interpretation provided in the Proposing Release regarding agreements, contracts, or transactions that may be called, or documented using form contracts typically used for, swaps or security-based swaps with one modification in response to a commenter.[600]

As was noted in the Proposing Release,[601] individuals and companies may generally use the term "swap" to refer to certain of their agreements, contracts, or transactions. For example, they may use the term "swap" to refer to an agreement to exchange real or personal property between the parties or to refer to an agreement for two companies that produce fungible products and with delivery obligations in different locations to perform each other's delivery obligations

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599 See Covington Letter and ICI/ABASA Letter.

600 See infra note 606.

601 See Proposing Release at 29839.

instead of their own.[602] However, the name or label that the parties use to refer to a particular agreement, contract, or transaction is not determinative of whether it is a swap or security-based swap.[603]

It is not dispositive that the agreement, contract, or transaction is documented using an industry standard form agreement that is typically used for swaps and security-based swaps,[604] but it may be a relevant factor.[605] The key question is whether the agreement, contract, or transaction falls within the statutory definitions of the term "swap" or "security-based swap" (as further defined and interpreted pursuant to the final rules and interpretations herein) based on its

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602 For example, a company obligated to deliver its product to a customer in Los Angeles would instead deliver the product in Albany to a different company's customer on behalf of that other company. In return, the company with the obligation to deliver a product to its customer in Albany would deliver the product instead in Los Angeles to the customer of the company obligated to deliver its product to that customer in Los Angeles.

603 See, e.g., Haekel v. Refco, 2000 WL 1460078, at *4 (CFTC Sept. 29, 2000) ("[T]he labels that parties apply to their transactions are not necessarily controlling"); Reves v. Ernst & Young, 494 U.S. 56, 61 (1990) (stating that the purpose of the securities laws is "to regulate investments, in whatever form they are made and by whatever name they are called") (emphasis in original).

604 As noted in the Proposing Release, the CFTC consistently has found that the form of a transaction is not dispositive in determining its nature, citing Grain Land, supra note 213, at *16 (CFTC Nov. 25, 2003) (holding that contract substance is entitled to at least as much weight as form); In the Matter of First Nat'l Monetary Corp., [1984–1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,698 at 30,974 (CFTC Aug. 7, 1985) ("When instruments have been determined to constitute the functional equivalent of futures contracts neither we nor the courts have hesitated to look behind whatever self-serving labels the instruments might bear."); Stovall, supra note 63 (holding that the CFTC "will not hesitate to look behind whatever label the parties may give to the instrument"). As also noted in the Proposing Release, the form of a transaction is not dispositive in determining whether an agreement, contract, or transaction falls within the regulatory regime for securities. See SEC v. Merch. Capital, LLC, 483 F.3d 747, 755 (11th Cir. 2007) ("The Supreme Court has repeatedly emphasized that economic reality is to govern over form and that the definitions of the various types of securities should not hinge on exact and literal tests.") (quoting Williamson v. Tucker, 645 F.2d 404, 418 (5th Cir. 1981)); Robinson v. Glynn, 349 F.3d 166, 170 (4th Cir. 2003) ("What matters more than the form of an investment scheme is the 'economic reality' that it represents . . . .") (internal citation omitted); Caiola v. Citibank, N.A., New York, 295 F.3d 312, 325 (2d Cir. 2002) (quoting United Housing Foundation v. Foreman, 421 U.S. 837, 848 (1975) ("In searching for the meaning and scope of the word 'security' . . . the emphasis should be on economic reality")). See Proposing Release at 29839 n. 152.

605 The Commissions note, though, that documentation is not controlling in evaluating whether an agreement, contract or transaction is a swap, security-based swap, or neither.

terms and other characteristics. Even if one effect of an agreement is to reduce the risk faced by the parties (for example, the "swap" of physical delivery obligations described above may reduce the risk of non-delivery), the agreement would not be a swap or security-based swap unless it otherwise meets one of those statutory definitions, as further defined by the Commissions. If the agreement, contract, or transaction satisfies the swap or security-based swap definitions, the fact that the parties refer to it by another name would not take it outside the Dodd-Frank Act regulatory regime. Conversely, if an agreement, contract, or transaction is not a swap or security-based swap, as those terms are defined in the CEA and the Exchange Act and the rules and regulations thereunder, the fact that the parties refer to it, or document it, as a swap or security-based swap will not subject that agreement, contract, or transaction to regulation as a swap or a security-based swap.

Comments

The Commissions requested comment regarding what agreements, contracts, or transactions that are not swaps or security-based swaps are documented using industry standard form agreements that are typically used for swaps and security-based swaps, and asked for examples thereof and details regarding their documentation, including why industry standard form agreements typically used for swaps and security-based swaps are used. One commenter stated its view that documentation can be a relevant factor in determining whether an agreement, contract or transaction is a swap or security-based swap.[606] The Commissions are persuaded by the commenter and are modifying the interpretation to clarify that in determining whether an

[606] See IECA Letter. This commenter noted that "[e]ven though swaps are commonly documented on the ISDA Master Agreements without annexes, physical transactions under such agreements with power or natural gas annexes are not swaps because they are physically settled forward contracts that are exempt under 1a47(B)"). Id.

agreement, contract or transaction is a swap or security-based swap, documentation may be a relevant (but not dispositive) factor.

2. Transactions in Regional Transmission Organizations and Independent System Operators

The CFTC declines to address the status of transactions in Regional Transmission Organizations ("RTOs") and Independent System Operators ("ISOs"), including financial transmission rights ("FTRs") and ancillary services, within this joint definitional rulemaking. As was noted in the Proposing Release, section 722 of the Dodd-Frank Act specifically addresses certain instruments and transactions regulated by FERC that also may be subject to CFTC jurisdiction. Section 722(f) added CEA section 4(c)(6),[607] which provides that, if the CFTC determines that an exemption for FERC-regulated instruments or other specified electricity transactions would be in accordance with the public interest, then the CFTC shall exempt such instruments or transactions from the requirements of the CEA. Given that specific statutory directive, the treatment of these FERC-regulated instruments and transactions should be considered under the standards and procedures specified in section 722 of the Dodd-Frank Act for a public interest waiver, rather than through this joint rulemaking to further define the terms "swap" and "security-based swap."[608]

The CFTC notes that it has been engaged in discussions with a number of RTOs and ISOs regarding the possibility of a petition seeking an exemption pursuant to CEA section 4(c)(6) for certain RTO and ISO transactions. The CFTC also notes that the status of some RTO and ISO transactions may have been addressed in the interpretation above regarding embedded

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607 7 U.S.C. 6(c)(6).

608 The Commissions note that this approach should not be taken to suggest any finding by the Commissions as to whether or not FTRs or any other FERC-regulated instruments or transactions are swaps (or futures contracts).

options and the forward exclusion from the swap definition,[609] and/or indirectly through the CFTC's recent interim final rulemaking relating to trade options.[610]

Comments

The CFTC received a number of comments discussing transactions in RTOs and ISOs.[611] These commenters argued that the CFTC should further define the term "swap" to exclude transactions executed or traded on RTOs and ISOs.[612] One commenter argued that the CEA section 4(c)(6) exemptive approach will leave regulatory ambiguity for market participants, since the CFTC might not grant an exemption, later revoke an existing exemption, grant a partial or conditional exemption, or limit an exemption to existing products.[613] This commenter also noted that FERC has complete regulatory authority over RTOs and ISOs and their transactions, and that Congress expected the CFTC and FERC to avoid duplicative, unnecessary regulation.[614] Another commenter argued that the CFTC should exclude RTO and ISO transactions in the same manner as insurance has been excluded.[615] A third commenter stated that RTO and ISO transactions are commercial merchandising transactions and thus forwards or, alternatively, that defining them as swaps is inconsistent with the text, goals, and purpose of the Dodd-Frank Act.[616]

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609 See supra part II.B.2(a).

610 See supra note 317.

611 See COPE Letter; ETA Letter; and FERC Staff Letter.

612 Id.

613 See COPE Letter.

614 Id.

615 See ETA Letter.

616 See FERC Staff Letter.

By contrast, one commenter asserted that FTRs are in substance swaps and should be regulated as such.[617]

Two commenters supported the CFTC's use of its section 722(f) authority to exempt FERC-regulated transactions and other transactions in RTOs or ISOs.[618] As discussed above, section 722(f) of the Dodd-Frank Act added new section 4(c)(6) to the CEA specifically addressing how the CFTC should approach certain instruments and transactions regulated by FERC that also may be subject to CFTC jurisdiction. The CFTC continues to believe, as was stated in the Proposing Release, that such an approach is the more appropriate means of considering issues relating to the instruments and transactions specified in CEA section 4(c)(6). One commenter's argument that the CEA section 4(c)(6) exemptive approach will cause regulatory ambiguity is not a convincing basis on which to forego a process specifically designated by Congress for the issue at hand.[619] The CFTC also believes that the ability to tailor exemptive relief, after notice and public comment, to the complex issues presented by transactions on RTOs and ISOs, is further reason to favor such an approach over the more general directive to further define the terms "swap" and "security-based swap" that is the subject of this rulemaking.

In response to one commenter's contentions that FERC has complete regulatory authority over RTOs and ISOs and their transactions, and that Congress expected the CFTC and FERC to avoid duplicative, unnecessary regulation, the CFTC notes that Congress addressed this issue not

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617 See Better Markets Letter.

618 See NEMA Letter and WGCEF Letter.

619 See COPE Letter.

by excluding RTO and ISO transactions from the comprehensive regime for swap regulation, but rather by enacting the exemptive process in CEA section 4(c)(6).

And in response to another commenter's contention that the CFTC should exclude RTO and ISO transactions in the same manner as insurance has been excluded, the CFTC notes that Congress provided neither an exemptive process equivalent to CEA section 4(c)(6) for insurance, nor an energy market-equivalent to the McCarran-Ferguson Act.[620]

As noted above, FERC staff opines that defining RTO and ISO transactions as swaps would be inconsistent with the text, goals, and purpose of the Dodd-Frank Act. The CFTC can consider concerns of the sort expressed by FERC staff in connection with any petition for a CEA section 4(c)(6) exemption that may be submitted to the CFTC.[621] Interested parties on all sides of the issue would receive an opportunity to comment on the scope and other aspects of any proposed exemptive relief at that time.

III. The Relationship between the Swap Definition and the Security-Based Swap Definition

A. Introduction

Title VII of the Dodd-Frank Act defines the term "swap" under the CEA,[622] and also defines the term "security-based swap" under the Exchange Act.[623] Pursuant to the regulatory framework established in Title VII, the CFTC has regulatory authority over swaps and the SEC has regulatory authority over security-based swaps. The Commissions are further defining the terms "swap" and "security-based swap" to clarify whether particular agreements, contracts, or

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620 15 U.S.C. §§ 1011-1015.

621 CEA section 4(c)(6) requires the CFTC to determine that an exemption pursuant to such section "is consistent with the public interest and the purposes of th[e CEA]." 7 U.S.C. 6(c)(6).

622 See section 1a(47) of the CEA, 7 U.S.C. 1a(47).

623 See section 3(a)(68) of the Exchange Act, 15 U.S.C. 78c(a)(68).

transactions are swaps or security-based swaps based on characteristics including the specific terms and conditions of the instrument and the nature of, among other things, the prices, rates, securities, indexes, or commodities upon which the instrument is based.

Because the discussion below is focused on whether particular agreements, contracts, or transactions are swaps or security-based swaps, the Commissions use the term "Title VII instrument" in this release to refer to any agreement, contract, or transaction that is included in either the definition of the term "swap" or the definition of the term "security-based swap." Thus, the term "Title VII instrument" is synonymous with "swap or security-based swap."[624]

The determination of whether a Title VII instrument is either a swap or a security-based swap should be made based on the facts and circumstances relating to the Title VII instrument prior to execution, but no later than when the parties offer to enter into the Title VII instrument.[625] If the Title VII instrument itself is not amended, modified, or otherwise adjusted during its term by the parties, its characterization as a swap or security-based swap will not change during its duration because of any changes that may occur to the factors affecting its character as a swap or security-based swap.[626]

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624 In some cases, the Title VII instrument may be a mixed swap. Mixed swaps are discussed further in section IV below.

625 The determination must be made no later than when the parties offer to enter into the Title VII instrument because persons are prohibited from offering to sell, offering to buy or purchase, or selling a security-based swap to any person who is not an ECP unless a registration statement is in effect as to the security-based swap. See section 5(e) of the Securities Act. This analysis also would apply with respect to mixed swaps and security-based swap agreements. With respect to swaps, the determination also would need to be made no later than the time that provisions of the CEA and the regulations thereunder become applicable to a Title VII Instrument. For instance, certain duties apply to swaps prior to execution. See Daily Trading Records under Rule 23.202 under the CEA, 17 CFR 23.202, and Subpart H of Part 23 of the CFTC's regulations, 17 CFR Part 23, Subpart H (Business Conduct Standards for Swap Dealers and Major Swap Participants Dealing with Counterparties, Including Special Entities).

626 See infra part III.G.5(a), for a discussion regarding the evaluation of Title VII Instruments on security indexes that move from broad-based to narrow-based or narrow-based to broad-based.

Classifying a Title VII instrument as a swap or security-based swap is straightforward for most instruments. However, the Commissions provided an interpretation in the Proposing Release to clarify the classification of swaps and security-based swaps in certain areas and to provide an interpretation regarding the use of certain terms and conditions in Title VII instruments. The Commissions are restating the interpretation set out in the Proposing Release with certain modifications to the interpretation regarding TRS.

B. Title VII Instruments Based on Interest Rates, Other Monetary Rates, and Yields

Parties frequently use Title VII instruments to manage risks related to, or to speculate on, changes in interest rates, other monetary rates or amounts, or the return on various types of assets. Broadly speaking, Title VII instruments based on interest or other monetary rates would be swaps, whereas Title VII instruments based on the yield or value of a single security, loan, or narrow-based security index would be security-based swaps. However, market participants and financial professionals sometimes use the terms "rate" and "yield" in different ways. The Commissions proposed an interpretation in the Proposing Release regarding whether Title VII instruments that are based on interest rates, other monetary rates, or yields would be swaps or security-based swaps and are restating the interpretation, but with a modification to the list of examples of reference rates to include certain secured lending rates under money market rates.[627] The Commissions find that this interpretation is an appropriate way to address Title VII instruments based on interest rates, other monetary rates, or yields and is designed to reduce

[627] These secured lending rates are the Eurepo, The Depository Trust & Clearing Corporation's General Collateral Finance Repo Index, the Repurchase Overnight Index Average Rate and the Tokyo Repo Rate.

costs associated with determining whether such instruments are swaps or security-based swaps.[628]

1. Title VII Instruments Based on Interest Rates or Other Monetary Rates that are Swaps

The Commissions believe that when payments exchanged under a Title VII instrument are based solely on the levels of certain interest rates or other monetary rates that are not themselves based on one or more securities, the instrument would be a swap and not a security-based swap.[629] Often swaps on interest rates or other monetary rates require the parties to make payments based on the comparison of a specified floating rate (such as the London Interbank Offered Rate ("LIBOR")) to a fixed rate of interest agreed upon by the parties. A rate swap also may require payments based on the differences between two floating rates, or it may require that the parties make such payments when any agreed-upon events with respect to interest rates or other monetary rates occur (such as when a specified interest rate crosses a threshold, or when the spread between two such rates reaches a certain point). The rates referenced for the parties' obligations are varied, and examples of such rates include the following:

Interbank Offered Rates: an average of rates charged by a group of banks for lending money to each other or other banks over various periods of time, and other similar interbank rates,[630] including, but not limited to, LIBOR (regardless of currency);[631] the Euro Interbank

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628 See supra part I, under "Overall Economic Considerations".

629 See infra part III.F, regarding the use of certain terms and conditions.

630 Interbank lending rates are measured by surveys of the loan rates that banks offer other banks, or by other mechanisms. The periods of time for such loans may range from overnight to 12 months or longer.

The interbank offered rates listed here are frequently called either a "reference rate," the rate of "reference banks," or by a designation that is specific to the service that quotes the rate. For some of the interbank offered rates listed here, there is a similar rate that is stated as an interbank bid

Offered Rate ("Euribor"); the Canadian Dealer Offered Rate ("CDOR"); and the Tokyo Interbank Offered Rate ("TIBOR");[632]

Money Market Rates: a rate established or determined based on actual lending or money market transactions, including, but not limited to, the Federal Funds Effective Rate; the Euro Overnight Index Average ("EONIA" or "EURONIA") (which is the weighted average of overnight unsecured lending transactions in the Euro-area interbank market); the EONIA Swap Index; the Eurepo (the rate at which, at 11.00 a.m. Brussels time, one bank offers, in the euro-zone and worldwide, funds in euro to another bank if in exchange the former receives from the latter the best collateral within the most actively-traded European repo market); the Australian dollar RBA 30 Interbank Overnight Cash Rate; the Canadian Overnight Repo Rate Average ("CORRA"); The Depository Trust & Clearing Corporation's General Collateral Finance ("GCF") Repo Index (an average of repo rates collateralized by U.S. Treasury and certain other securities); the Mexican interbank equilibrium interest rate ("TIIE"); the NZD Official Cash Rate; the Sterling Overnight Interbank Average Rate ("SONIA") (which is the weighted average

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rate, which is the average rate at which a group of banks bid to borrow money from other banks. For example, the bid rate similar to LIBOR is called LIBID.

631 Today, LIBOR is used as a rate of reference for the following currencies: Australian Dollar, Canadian Dollar, Danish Krone, Euro, Japanese Yen, New Zealand Dollar, Pound Sterling, Swedish Krona, Swiss Franc, and U.S. Dollar.

632 Other interbank offered rates include the following (with the country or city component of the acronym listed in parentheses): AIDIBOR (Abu Dhabi); BAIBOR (Buenos Aires); BKIBOR (Bangkok); BRAZIBOR (Brazil); BRIBOR/BRIBID (Btatislava); BUBOR (Budapest); CHIBOR (China); CHILIBOR (Chile); CIBOR (Copenhagen); COLIBOR (Columbia); HIBOR (Hong Kong); JIBAR (Johannesburg); JIBOR (Jakarta); KAIBOR (Kazakhstan); KIBOR (Karachi); KLIBOR (Kuala Lumpur); KORIBOR ((South) Korea); MEXIBOR (Mexico); MIBOR (Mumbai); MOSIBOR (Moscow); NIBOR (Norway); PHIBOR (Philippines); PRIBOR (Prague); REIBOR/REIBID (Reykjavik); RIGIBOR/RIGIBID (Riga); SHIBOR (Shanghai); SIBOR (Singapore); SOFIBOR (Sofia); STIBOR (Stockholm); TAIBOR (Taiwan); TELBOR (Tel Aviv); TRLIBOR and TURKIBOR (Turkey); VILIBOR (Vilnius); VNIBOR (Vietnam); and WIBOR (Warsaw).

of unsecured overnight cash transactions brokered in London by the Wholesale Markets Brokers' Association ("WMBA")); the Repurchase Overnight Index Average Rate ("RONIA") (which is the weighted average rate of all secured overnight cash transactions brokered in London by WMBA); the Swiss Average Rate Overnight ("SARON"); the Tokyo Overnight Average Rate ("TONAR") (which is based on uncollateralized overnight average call rates for interbank lending); and the Tokyo Repo Rate (average repo rate of active Japanese repo market participants).

Government Target Rates: a rate established or determined based on guidance established by a central bank including, but not limited to, the Federal Reserve discount rate, the Bank of England base rate and policy rate, the Canada Bank rate, and the Bank of Japan policy rate (also known as the Mutan rate);

General Lending Rates: a general rate used for lending money, including, but not limited to, a prime rate, rate in the commercial paper market, or any similar rate provided that it is not based on any security, loan, or group or index of securities;

Indexes: a rate derived from an index of any of the foregoing or following rates, averages, or indexes, including but not limited to a constant maturity rate (U.S. Treasury and certain other rates),[633] the interest rate swap rates published by the Federal Reserve in its "H.15 Selected Interest Rates" publication, the ISDAFIX rates, the ICAP Fixings, a constant maturity swap, or a rate generated as an average (geometric, arithmetic, or otherwise) of any of the

[633] A Title VII instrument based solely on the level of a constant maturity U.S. Treasury rate would be a swap because U.S. Treasuries are exempted securities that are excluded from the security-based swap definition. Conversely, a Title VII instrument based solely on the level of a constant maturity rate on a narrow-based index of non-exempted securities under the security-based swap definition would be a security-based swap.

foregoing, such as overnight index swaps ("OIS") – provided that such rates are not based on a specific security, loan, or narrow-based group or index of securities;

Other Monetary Rates: a monetary rate including, but not limited to, the Consumer Price Index ("CPI"), the rate of change in the money supply, or an economic rate such as a payroll index; and

Other: the volatility, variance, rate of change of (or the spread, correlation or difference between), or index based on any of the foregoing rates or averages of such rates, such as forward spread agreements, references used to calculate the variable payments in index amortizing swaps (whereby the notional principal amount of the agreement is amortized according to the movement of an underlying rate), or correlation swaps and basis swaps, including but not limited to, the "TED spread"[634] and the spread or correlation between LIBOR and an OIS.

As discussed above, the Commissions believe that when payments under a Title VII instrument are based solely on any of the foregoing, such Title VII instrument would be a swap.

Comments

Two commenters believed that constant maturity swaps always should be treated as swaps, rather than mixed swaps, because they generally are viewed by market participants as rates trades instead of trades on securities.[635] According to the commenters, the "bulk" of constant maturity swaps are based on exempted securities, but the commenters noted that the constant maturity leg may be based on a number of different rates or yields, including, among

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634 The TED spread is the difference between the interest rates on interbank loans and short-term U.S. government debt (Treasury bills or "T-bills"). The latter are exempted securities that are excluded from the statutory definition of the term "security-based swap." Thus, neither any aspect of U.S. Treasuries nor interest rates on interbank loans can form the basis of a security-based swap. For this reason, a Title VII instrument on a spread between interbank loan rates and T-bill rates also would be a swap, not a security-based swap.

635 See CME Letter and SIFMA Letter.

other things, U.S. Treasury yields, Treasury auction rates, yields on debt of foreign governments, and debt related to indices of mortgage-backed securities.[636] As discussed above, the Commissions are adopting the interpretation as proposed. The statutory language of the swap and security-based swap definitions explicitly states that a Title VII instrument that is based on a non-exempted security should be a security-based swap and not a swap.[637]

2. Title VII Instruments Based on Yields

The Commissions proposed an interpretation in the Proposing Release clarifying the status of Title VII instruments in which one of the underlying references of the instrument is a "yield." The Commissions received no comments on the interpretation set out in the Proposing Release regarding Title VII instruments based on yields and are restating the interpretation without modification. In cases when a "yield" is calculated based on the price or changes in price of a debt security, loan, or narrow-based security index, it is another way of expressing the price or value of a debt security, loan, or narrow-based security index. For example, debt securities often are quoted and traded on a yield basis rather than on a dollar price, where the yield relates to a specific date, such as the date of maturity of the debt security (i.e., yield to maturity) or the date upon which the debt security may be redeemed or called by the issuer (e.g., yield to first whole issue call).[638]

Except in the case of certain exempted securities, when one of the underlying references of the Title VII instrument is the "yield" of a debt security, loan, or narrow-based security index in the sense where the term "yield" is used as a proxy for the price or value of the debt security loan, or narrow-based security index, the Title VII instrument would be a security-based swap.

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636 Id.

637 See supra note 633.

638 See, e.g., Securities Confirmations, 47 FR 37920 (Aug. 27, 1982).

And, as a result, in cases where the underlying reference is a point on a "yield curve" generated from the different "yields" on debt securities in a narrow-based security index (e.g., a constant maturity yield or rate), the Title VII instrument would be a security-based swap. However, where certain exempted securities, such as U.S. Treasury securities, are the only underlying reference of a Title VII instrument involving securities, the Title VII instrument would be a swap. Title VII instruments based on exempted securities are discussed further below.

The above interpretation would not apply in cases where the "yield" referenced in a Title VII instrument is not based on a debt security, loan, or narrow-based security index of debt securities but rather is being used to reference an interest rate or monetary rate as outlined above in subsection one of this section. In these cases, this "yield" reference would be considered equivalent to a reference to an interest rate or monetary rate and the Title VII instrument would be, under the interpretation in this section, a swap (or mixed swap depending on other references in the instrument).

3. Title VII Instruments Based on Government Debt Obligations

The Commissions provided an interpretation in the Proposing Release regarding instances in which the underlying reference of the Title VII instrument is a government debt obligation. The Commissions received no comments on the interpretation provided regarding instances in which the underlying reference of the Title VII instrument is a government debt obligation and are restating such interpretation without modification.

The security-based swap definition specifically excludes any agreement, contract, or transaction that meets the definition of a security-based swap only because it "references, is based upon, or settles through the transfer, delivery, or receipt of an exempted security under [section 3(a)(12) of the Exchange Act], as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in [section 3(a)(29) of the

Exchange Act] . . .), unless such agreement, contract, or transaction is of the character of, or is commonly known in the trade as, a put, call, or other option."[639]

As a result of this exclusion in the security-based swap definition for "exempted securities,"[640] if the only underlying reference of a Title VII instrument involving securities is, for example, the price of a U.S. Treasury security and the instrument does not have any other underlying reference involving securities, then the instrument would be a swap. Similarly, if the Title VII instrument is based on the "yield" of a U.S. Treasury security and does not have any other underlying reference involving securities, then the instrument also would be a swap, regardless of whether the term "yield" is a proxy for the price of the security.

Foreign government securities, by contrast, were not "exempted securities" as of the date of enactment of the Futures Trading Act of 1982[641] and thus do not explicitly fall within this exclusion from the security-based swap definition. Therefore, if the underlying reference of the Title VII instrument is the price, value, or "yield" (where "yield" is a proxy for price or value) of a foreign government security, or a point on a yield curve derived from a narrow-based security index composed of foreign government securities, then the instrument is a security-based swap.

C. Total Return Swaps

The Commissions are restating the interpretation regarding TRS set out in the Proposing Release with certain changes with respect to quanto and compo equity TRS and loan TRS based

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639 Section 3(a)(68)(C) of the Exchange Act, 15 U.S.C. 76c(a)(68)(C).

640 As of January 11, 1983, the date of enactment of the Futures Trading Act of 1982, Pub. L. 97-444, 96 Stat. 2294, section 3(a)(12) of the Exchange Act, 15 U.S.C. 78c(a)(12), provided that, among other securities, "exempted securities" include: i) securities which are direct obligations of, or obligations guaranteed as to principal or interest by, the United States; ii) certain securities issued or guaranteed by corporations in which the United States has a direct or indirect interest as designated by the Secretary of the Treasury; and iii) certain other securities as designated by the SEC in rules and regulations.

641 Pub. L. 97-444, 96 Stat. 2294 (1983).

on two or more loans, and to reflect that TRS can overlie reference items other than securities, loans, and indexes of securities or loans.[642] The Commissions find that this interpretation is an appropriate way to address TRS and is designed to reduce the cost associated with determining whether a TRS is a swap or a security-based swap.[643]

As was described in the Proposing Release,[644] a TRS is a Title VII instrument in which one counterparty, the seller of the TRS, makes a payment that is based on the price appreciation and income from an underlying security or security index.[645] A TRS also can overlie a single loan, two or more loans and other underliers. The other counterparty, the buyer of the TRS, makes a financing payment that is often based on a variable interest rate, such as LIBOR (or other interbank offered rate or money market rate, as described above), as well as a payment based on the price depreciation of the underlying reference. The "total return" consists of the price appreciation or depreciation, plus any interest or income payments.[646] Accordingly, where a TRS is based on a single security or loan, or a narrow-based security index, the TRS would be a security-based swap.[647]

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642 While this guidance focuses on TRS overlying securities and loans, TRS also may overlie other commodities. Such TRS may be structured differently due to the nature of the underlying.

643 See supra part I, under "Overall Economic Considerations."

644 See Proposing Release at 29842.

645 Where the underlying security is an equity security, a TRS is also known as an "equity swap." A bond may also be the underlying security of a TRS.

646 If the total return is negative, the seller receives this amount from the buyer. TRS can be used to synthetically reproduce the payoffs of a position. For example, two counterparties may enter into a 3-year TRS where the buyer of the TRS receives the positive total return on XYZ security, if any, and the seller of the TRS receives LIBOR plus 30 basis points and the absolute value of the negative total return on XYZ security, if any.

647 However, if the underlying reference of the TRS is a broad-based security index, it is a swap (and an SBSA) and not a security-based swap. In addition, a TRS on an exempted security, such as a U.S. Treasury, under section 3(a)(12) of the Exchange Act, 15 U.S.C. 78c(a)(12), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Exchange Act, 15 U.S.C. 78c(a)(29), as in effect on the date of

In addition, the Commissions are providing a final interpretation providing that, generally, the use of a variable interest rate in the TRS buyer's payment obligations to the seller is incidental to the purpose of, and the risk that the counterparties assume in, entering into the TRS, because such payments are a form of financing reflecting the seller's (typically a security-based swap dealer) cost of financing the position or a related hedge, allowing the TRS buyer to receive payments based on the price appreciation and income of a security or security index without purchasing the security or security index. As stated in the Proposing Release, the Commissions believe that when such interest rate payments act merely as a financing component in a TRS, or in any other security-based swap, the inclusion of such interest rate terms would not cause the TRS to be characterized as a mixed swap.[648] Financing terms may also involve adding or subtracting a spread to or from the financing rate,[649] or calculating the financing rate in a currency other than that of the underlying reference security or security index.[650]

However, where such payments incorporate additional elements that create additional interest rate or currency exposures that are unrelated to the financing of the security-based swap, or otherwise shift or limit risks that are related to the financing of the security-based swap, those

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enactment of the Futures Trading Act of 1982), is a swap (and an SBSA), and not a security-based swap. Similarly, and as discussed in more detail below, an LTRS based on two or more loans that are not securities ("non-security loans") are swaps, and not security-based swaps.

648 See infra part IV.

649 See, e.g., Moorad Chowdry, "Total Return Swaps: Credit Derivatives and Synthetic Funding Instruments," at 3–4 (noting that the spread to the TRS financing rate is a function of: the credit rating of the counterparty paying the financing rate; the amount, value, and credit quality of the reference asset; the dealer's funding costs; a profit margin; and the capital charge associated with the TRS), available at http://www.yieldcurve.com/Mktresearch/LearningCurve/TRS.pdf.

650 For example, a security-based swap on an equity security priced in U.S. dollars in which payments are made in Euros based on the U.S. dollar/Euro spot rate at the time the payment is made would not be a mixed swap. As the Commissions stated in the Proposing Release, under these circumstances, the currency is merely referenced in connection with the method of payment, and the counterparties are not hedging the risk of changes in currency exchange rates during the term of the security-based swap See Proposing Release at 29842, n. 176.

additional elements may cause the security-based swap to be a mixed swap. For example, where the counterparties embed interest-rate optionality (e.g., a cap, collar, call, or put) into the terms of a security-based swap in a manner designed to shift or limit interest rate exposure, the inclusion of these terms would cause the TRS to be both a swap and a security-based swap (i.e., a mixed swap). Similarly, if a TRS is also based on non-security-based components (such as the price of oil, or a currency), the TRS would also be a mixed swap.[651]

The Commissions also are providing an additional interpretation regarding a quanto equity swap, in response to comments raised by one commenter,[652] and for illustrative purposes, a similar but contrasting product, a compo equity swap. A quanto equity swap, which "can provide a U.S. investor with currency-protected exposure to a non-U.S. equity index by translating the percentage equity return in the currency of such non-U.S. equity index into U.S. dollars,"[653] can be described as:

> an equity swap in which [(1)] the underlying is denominated in a currency (the foreign currency) other than that in which the equity swap is denominated (the domestic currency) . . . [and (2) t]he final value of the underlying is denominated in the foreign currency and is converted into the domestic currency using the exchange rate prevailing at inception[,] result[ing in] the investor . . . . not [being] exposed to currency risk.[654]

While a quanto equity swap, therefore, effectively "exposes the dealer on the foreign leg of the correlation product to a variable notional principal amount that changes whenever the

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651 See Mixed Swaps, infra part IV.

652 See SIFMA Letter.

653 Id.

654 Handbook of Corporate Equity Derivatives and Equity Capital Markets ("Corporate Equity Derivatives Handbook"), § 1.2.10, at 23, available at, http://media.wiley.com/product_data/excerpt/05/11199759/1119975905-83.pdf <last visited May 4, 2012>.

exchange rate or the foreign index fluctuates,"[655] such exposure results from the choice of hedges for the quanto equity swap, not from the cash flows of the quanto equity swap itself.[656] Thus, that exposure could be viewed as created in the seller by the act of entering into the quanto equity swap, rather than as a transfer between the parties, as is required by the third prong of the statutory swap definition. Consequently, the dealer's exchange rate exposure could be seen as incidental to the securities exposure desired by the party initiating the quanto equity swap.

The Commissions view a quanto equity swap as a security-based swap, and not a mixed swap, where (i) the purpose of the quanto equity swap is to transfer exposure to the return of a security or security index without transferring exposure to any currency or exchange rate risk; and (ii) any exchange rate or currency risk exposure incurred by the dealer due to a difference in the currency denomination of the quanto equity swap and of the underlying security or security index is incidental to the quanto equity swap and arises from the instrument(s) the dealer chooses to use to hedge the quanto equity swap and is not a direct result of any expected payment obligations by either party under the quanto equity swap.[657]

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655 James M. Mahoney, Correlation Products and Risk Management Issues, FRBNY ECONOMIC POLICY REVIEW / OCTOBER 1995 at 2, available at, http://www.ny.frb.org/research/epr/95v01n3/9510maho.pdf <last visited May 4, 2012>.

656 While applicable in general, this logic, which merely expands upon the principle that the character of a Title VII instrument as either a swap or a security-based swap should follow the underlying factors which are incorporated into the cash flows of the instrument – a security, yield, loan, or other trigger for SEC jurisdiction or as a commodity triggering CFTC jurisdiction (or both for joint jurisdiction), should not be extrapolated to other Title VII instruments, for which other principles may override.

657 Although the SIFMA Letter describes quanto equity swaps in terms of equity indexes, if the underlying reference of a quanto equity swap is a single security, the result would be the same. The Commissions also note that if a security index underlying a quanto equity swap is not narrow-based, the quanto equity swap is a swap. In that event, it is not a mixed swap because no element of the quanto equity swap is a security-based swap and, to be a mixed swap, a Title VII instrument must have both swap and security-based swap components.

By contrast, in a compo equity swap, the parties assume exposure to, and the total return is calculated based on, both the performance of specified foreign stocks and the change in the relevant exchange rate.[658] Because the counterparty initiating a transaction can choose to avoid currency exposure by entering into a quanto equity swap, the currency exposure obtained via a compo equity swap is not incidental to the equity exposure for purposes of determining mixed swap status. In fact, investors seeking synthetic exposure to foreign securities via a TRS may also be seeking exposure to the exchange rate between the currencies, as evidenced by the fact that a number of mutual funds exist in both hedged and unhedged versions to provide investors exposure to the same foreign securities with or without the attendant currency exposure.[659] Consequently, a compo equity swap is a mixed swap.[660]

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658 See generally Corporate Equity Derivatives Handbook, supra note 654, § 1.2.9, at 21-23.

659 See, e.g., Descriptive Brochure: The Tweedy, Browne Global Value Fund II - Currency Unhedged at 1, available at http://www.tweedy.com/resources/gvf2/TBGVF-II_verJuly2011.pdf <last visited May 4, 2012> (comparing the Tweedy, Browne Global Value Fund II - Currency Unhedged and the Tweedy, Browne Global Value Fund (which hedges its currency exposure) and stating that "[t]he only material difference [between the funds] is that the Unhedged Global Value Fund generally does not hedge currency risk [and] is designed for long-term value investors who wish to focus their investment exposure on foreign stock markets, and their associated non-U.S. currencies" and "[b]y establishing the Tweedy, Browne Global Value Fund II – Currency Unhedged, we were acknowledging that many investors may view exposure to foreign currency as another form of diversification when investing outside the U.S., and/or may have strong opinions regarding the future direction of the U.S. dollar."). See also the PIMCO Foreign Bond Fund (Unhedged) Fact Sheet at 1 (stating that "[t]he fund seeks to capture the returns of non-U.S. bonds including potential returns due to changes in exchange rates. In a declining dollar environment foreign currency appreciation may augment the returns generated by investments in foreign bonds."), available at http://investments.pimco.com/ShareholderCommunications/External%20Documents/Foreign%20Bond%20Fund%20(Unhedged)%20Institutional.pdf <last visited May 4, 2012> and the PIMCO Foreign Bond Fund (U.S. Dollar-Hedged) INSTL Fact Sheet at 1 (stating that "[t]he fund seeks to capture the returns of non-U.S. bonds but generally hedges out most currency exposure in order to limit the volatility of returns."), available at http://investments.pimco.com/ShareholderCommunications/External%20Documents/Foreign%20Bond%20Fund%20(U.S.%20Dollar-Hedged)%20Institutional.pdf <last visited May 4, 2012>.

660 Such swaps are examples of swaps with payments that "incorporate additional elements that create additional . . . currency exposures . . . unrelated to the financing of the security-based swap

In response to comments,[661] the Commissions also are providing an interpretation with respect to the treatment of loan TRS ("LTRS") on two or more loans. As noted above, the second prong of the security-based swap definition includes a swap that is based on "a single security or loan, including any interest therein or on the value thereof." Thus, an LTRS based on a single loan, as mentioned above, is a security-based swap. The Commissions believe, however, that an LTRS based on two or more non-security loans are swaps, and not security-based swaps.[662] An LTRS on a group or index of such non-security loans is not covered by the first prong of the security-based swap definition--swaps based on a narrow-based security index--because the definition of the term "narrow-based security index" in both the CEA and the Exchange Act only applies to securities, and not to non-security loans.[663] An LTRS, moreover, is not covered by the third prong of the security-based swap definition because it is based on the total return of such loans, and not events related thereto. Accordingly, an LTRS on two or more loans that are non-security loans is a swap and not a security-based swap.[664]

. . . that may cause the security-based swap to be a mixed swap." See Proposing Release at 29842.

661 See infra note 667 and accompanying text.

662 Depending on the facts and circumstances loans may be notes or evidences of indebtedness that are securities. See section 3(a)(10) of the Exchange Act. In this section, the Commissions address only groups or indexes of loans that are not securities.

663 See CEA section 1a(35), 7 U.S.C. 1a(35), and section 3(a)(55) of the Exchange Act, 15 U.S.C. 78c(a)(55).

664 The same would be true with respect to swaps (e.g., options, CFDs, NDFs), other than LTRS or loan index credit default swaps, on two or more loans that are not securities.

Comments

The Commissions received three comments with respect to the interpretation provided on TRS in the Proposing Release.[665] One of these commenters addressed the Commissions' interpretation on security-based TRS.[666] The other two commenters requested that the Commissions clarify the treatment of LTRS on two or more loans.[667]

One commenter asserted that the terms of a TRS that create interest rate or currency exposures incidental to the primary purpose of the TRS should not cause a transaction that otherwise would be deemed to be a security-based swap to be characterized as a mixed swap.[668] This commenter agreed with the Commissions that the scope of the mixed swap category of Title VII instruments is intended to be narrow and that, when variable interest rates are used for financing purposes incidental to counterparties' purposes, and risks assumed, in entering into a TRS, the TRS is a security-based swap and not a mixed swap.[669]

This commenter also opined that the Commissions' interpretation that "where such payments incorporate additional elements that create additional interest rate or currency exposures . . . unrelated to the financing of the [TRS], or otherwise shift or limit risks that are related to the financing of the [TRS], those additional elements may cause the [TRS] to be a mixed swap" could be seen as requiring a quantitative analysis to determine whether a reference

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665 See July LSTA Letter; Letter from David Lucking, Allen & Overy LLP, dated May 26, 2011 ("Allen & Overy Letter"); and SIFMA Letter.

666 See SIFMA Letter.

667 See Allen & Overy Letter and July LSTA Letter.

668 See SIFMA Letter.

669 Id.

to interest rates or currencies in a TRS is solely for financing purposes or creates additional exposure that might be construed as extending beyond those purposes.[670]

The Commissions are clarifying that a quantitative analysis is not necessarily required in order to determine whether a TRS is a mixed swap. Any analysis, quantitative or qualitative, clearly demonstrating the nature of a payment (solely financing-related, unrelated to financing or a combination of the two) can suffice.[671]

The Commissions also are clarifying that market participants are not necessarily required to compare their financing rates to market financing rates in order to determine whether the financing leg of a TRS is merely a financing leg or is sufficient to render the TRS a mixed swap. Because a number of factors can influence how a particular TRS is structured,[672] the Commissions cannot provide an interpretation applicable to all situations. If the financing leg of a TRS reflects the dealer's financing costs on a one-to-one basis, the Commissions would view such leg as a financing leg. Adding a spread would not alter that conclusion if the spread is consistent with the dealer's course of dealing generally, with respect to a particular type of TRS or with respect to a particular counterparty. The Commissions believe that this would be the

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670 Id. SIFMA added that such a determination could require market participants to determine whether a specific interest rate or spread referenced in the TRS is sufficiently in line with market rates to constitute a financing leg of a transaction under the proposed test. SIFMA continues by noting that there are a number of examples where a TRS can provide for some interest rate or currency exposure incidental to the primary purpose of the TRS, describing a quanto equity swap as an example.

671 To the extent a market participant is uncertain as to the results of such an analysis, it may seek informal guidance from the Commissions' staffs or use the process established in this release, see infra part VI, for seeking formal guidance from the Commissions as to the nature of a Title VII instrument as a swap, security-based swap or mixed swap.

672 For example, the Commissions would expect a dealer perceived by the market to constitute a higher counterparty risk to have higher funding costs generally, which might affect its TRS financing costs. To the extent such a dealer passed through its higher TRS financing costs to its TRS counterparty, such a pass-through simply would reflect the dealer's specific circumstances, and would not transform the TRS from a security-based swap into a mixed swap.

case even if the spread is "off-market," if the deviance from a market spread is explained by factors unique to the dealer (e.g., the dealer has high financing costs), to the TRS (e.g., the underlying securities are highly illiquid, so financing them is more costly than would be reflected in a "typical" market spread for other TRS) or to then-current market conditions (e.g., a share repurchase might make shares harder for a dealer to procure in order to hedge its obligations under a TRS to pay its counterparty the capital appreciation of a security, resulting in higher financing costs due to the decrease in shares outstanding, assuming demand for the shares does not change). If the spread is designed to provide exposure to an underlying reference other than securities, however, rather than to reflect financing costs, such a TRS is a mixed swap.

Market participants are better positioned than are the Commissions to determine what analysis, and what supporting information and materials, best establish whether the nature of a particular payment reflects financing costs alone, or something more. Moreover, the Commissions expect that a dealer would know if the purpose of the payment(s) in question is to cover its cost of financing a position or a related hedge.[673] In such cases, a detailed analysis should not be necessary.

One commenter noted the nature of quanto equity swaps as TRS and maintained that such a transaction "is equivalent to a financing of a long position in the underlying non-U.S. equity index[]" and that the currency protection is incidental to the financing element, which is the primary purpose of the TRS.[674] As discussed above, the Commissions have provided a final

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673 The Commissions expect that dealers know their financing costs and can readily explain the components of the financing leg paid by their TRS counterparties.

674 Id. SIFMA distinguished quanto equity swaps from the examples of mixed swaps that the Commissions provided in the Proposing Release, characterizing them as "very different."

interpretation regarding the appropriate classification of Title VII instruments that are quanto equity swaps and compo equity swaps.

Two commenters requested that the Commissions clarify the status of LTRS on two or more loans.[675] Both commenters stated that while the statutory definition of the term "security-based swap" provides that swaps based on a single loan are security-based swaps, it does not explicitly provide whether swaps on indexes of loans are security-based swaps.[676] They requested clarification regarding the treatment of loan based swaps, including both LTRS and loan index credit default swaps.[677]

The Commissions have provided the final interpretation discussed above regarding LTRS based on two or more loans that are not securities. The Commissions acknowledge that this interpretation results in different treatment for an LTRS on two non-security loans (a swap), as opposed to a Title VII instrument based on two securities (a security-based swap). This result, however, is dictated by the statute.

D. Security-Based Swaps Based on a Single Security or Loan and Single-Name Credit Default Swaps

The Commissions provided an interpretation in the Proposing Release regarding security-based swaps based on a single security or loan and single-name CDS[678] and are restating such interpretation with certain modifications in response to commenters.[679] The second prong of the

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675 See Allen & Overy Letter and July LSTA Letter.

676 See Allen & Overy Letter. Allen & Overy notes that a Title VII Instrument that references two securities is a security-based swap. It believes that treating an LTRS on two or more loans as a swap would result in functionally and potentially economically similar products being treated in an arbitrarily different way, contrary to the spirit of the Dodd-Frank Act.

677 The Commissions address the comments regarding loan index credit default swaps below. See infra note 768 and accompanying text.

678 See Proposing Release at 29843.

679 See infra note 689 and accompanying text.

statutory security-based swap definition includes a swap that is based on "a single security or loan, including any interest therein or on the value thereof."[680] The Commissions believe that under this prong of the security-based swap definition, a single-name CDS that is based on a single reference obligation would be a security-based swap because it would be based on a single security or loan (or any interest therein or on the value thereof).

In addition, the third prong of the security-based swap definition includes a swap that is based on the occurrence of an event relating to a "single issuer of a security," provided that such event "directly affects the financial statements, financial condition, or financial obligations of the issuer."[681] This provision applies generally to event-triggered swap contracts. With respect to a CDS, such events could include, for example, the bankruptcy of an issuer, a default on one of an issuer's debt securities, or the default on a non-security loan of an issuer.[682]

The Commissions believe that if the payout on a CDS on a single issuer of a security is triggered by the occurrence of an event relating to that issuer, the CDS is a security-based swap under the third prong of the statutory security-based swap definition.[683]

In relation to aggregations of transactions under a single ISDA Master Agreement,[684] the Commissions are revising the example that was included in the Proposing Release referring to

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680 Section 3(a)(68)(A)(ii)(II) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(II). The first prong of the security-based swap definition is discussed below. See infra part III.G.

681 Section 3(a)(68)(A)(ii)(III) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(III).

682 The Commissions understand that in the context of credit derivatives on asset-backed securities or MBS, the events include principal writedowns, failure to pay principal and interest shortfalls.

683 The Commissions understand that some single-name CDS now trade with fixed coupon payments expressed as a percentage of the notional amount of the transaction and payable on a periodic basis during the term of the transaction. See Markit, "The CDS Big Bang: Understanding the Changes to the Global CDS Contract and North American Conventions," 3, available at http://www.markit.com/cds/announcements/resource/cds_big_bang.pdf. The Commissions are restating their view that the existence of such single-name CDS does not change their interpretation.

single-name CDS to clarify that the interpretation regarding aggregations of transactions is non-exclusive and thus not limited to either CDS or single-reference instruments.[685]

The Commissions believe that each transaction under an ISDA Master Agreement would need to be analyzed to determine whether it is a swap or security-based swap. For example, the Commissions believe that a number of Title VII instruments that are executed at the same time and that are documented under one ISDA Master Agreement, but in which a separate confirmation is sent for each instrument, should be treated as an aggregation of such Title VII instruments, each of which must be analyzed separately under the swap and security-based swap definitions.[686] The Commissions believe that, as a practical and economic matter, each such Title VII instrument would be a separate and independent transaction. Thus, such an aggregation of Title VII instruments would not constitute a Title VII instrument based on one "index or group"[687] under the security-based swap definition but instead would constitute multiple Title VII instruments. The Commissions find that this interpretation is an appropriate way to address CDS, TRS or other Title VII instruments referencing a single security or loan or entity that is documented under a Master Agreement or Master Confirmation and is designed to reduce the cost associated with determining whether such instruments are swaps or security-based swaps.[688]

Comments

The Commissions received two comments regarding the interpretation regarding aggregation of Title VII instruments under a single ISDA Master Agreement. One commenter

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684 See Proposing Release at 29843.

685 See infra note 689 and accompanying text.

686 See infra note 691.

687 The security-based swap definition further defines "index to include an "index or group of securities." See section 3(a)(68)(E) of the Exchange Act, 15 U.S.C. 78c(a)(68)(E).

688 See supra part I, under "Overall Economic Considerations".

requested that the Commissions clarify that the interpretation applies to other types of instruments, such as TRS, in addition to CDS.[689] The commenter also stated that the interpretation should be helpful with respect to use of a "Master Confirmation" structure, which the commenter described as use of general terms in a "Master Confirmation" that apply to a number of instruments with separate underlying references but for which a separate "Supplemental Confirmation" is sent for each separate component.[690]

A second commenter agreed with the Commissions' interpretation that a number of single-name CDS that are executed at the same time and that are documented under one ISDA Master Agreement, but in which a separate confirmation is sent for each CDS, should not be treated as a single index CDS and stated that this approach is consistent with market practice.[691]

As discussed above, in response to comments the Commissions are expanding the example so it is clear that it applies beyond just CDS.[692]

E. Title VII Instruments Based on Futures Contracts

The Commissions proposed an interpretation in the Proposing Release regarding the treatment, generally, of swaps based on futures contracts.[693] The Commissions are restating the

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689 See July LSTA Letter.

690 Id.

691 See Letter from Richard M. McVey, Chairman and Chief Executive Officer, MarketAxess Holdings, Inc. ("MarketAxess"), July 22, 2011 ("MarketAxess Letter").

692 The Commissions believe, based on the July LSTA Letter, that the "Master Confirmation" structure the commenter described is the same general structure as the aggregation of single-name CDS the Commissions provided as an example in the Proposing Release, but that a "Master Confirmation" structure may not be limited to single-reference instruments or to CDS and instead may be used for a broader range of instruments. See July LSTA Letter. The Commissions note that the following are examples of "Master Confirmation" structure to which the interpretive guidance would apply: 2009 Americas Master Equity Derivatives Confirmation Agreement, Stand-alone 2007 Americas Master Variance Swap Confirmation Agreement, and 2004 Americas Interdealer Master Equity Derivatives Confirmation Agreement and March 2004 Canadian Supplement to the Master Confirmation. The Commissions believe the broader example in this release provides the clarification the commenter requested.

interpretation they provided in the Proposing Release without modification. The Commissions also discussed in the Proposing Release the unique circumstance involving certain futures contracts on foreign government debt securities and requested comment as to how Title VII instruments on these futures contracts should be treated.[694] In response to commenters,[695] the Commissions are adopting a rule regarding the treatment of Title VII instruments on certain futures contracts on foreign government debt securities.[696]

A Title VII instrument that is based on a futures contract will either be a swap or a security-based swap, or both (i.e., a mixed swap), depending on the nature of the futures contract, including the underlying reference of the futures contract. Thus, a Title VII instrument where the underlying reference is a security future is a security-based swap.[697] In general, a Title VII instrument where the underlying reference is a futures contract that is not a security future is a swap.[698] As the Commissions noted in the Proposing Release,[699] Title VII instruments

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693 See Proposing Release at 29843-44.

694 Id.

695 See infra note 718 and accompanying text.

696 See rule 1.3(bbbb) under the CEA and rule 3a68-5 under the Exchange Act.

697 A security future is defined in both the CEA and the Exchange Act as a futures contract on a single security or a narrow-based security index, including any interest therein or based on the value thereof, except an exempted security under section 3(a)(12) of the Exchange Act, 15 U.S.C. 78c(a)(12), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Exchange Act, 15 U.S.C. 78c(a)(29), as in effect on the date of enactment of the Futures Trading Act of 1982).

The term security future does not include any agreement, contract, or transaction excluded from the CEA under sections 2(c), 2(d), 2(f), or 2(g) of the CEA, 7 U.S.C. 2(c), 2(d), 2(f), or 2(g), as in effect on the date of enactment of the Commodity Futures Modernization Act of 2000 ("CFMA") or Title IV of the CFMA. See section 1a(44) of the CEA, 7 U.S.C. 1a(44), and section 3(a)(55) of the Exchange Act, 15 U.S.C. 78c(a)(55).

698 Depending on the underlying reference of the futures contract, though, such swaps could be SBSAs. For example, a swap on a future on the S&P 500 index would be an SBSA.

699 See Proposing Release at 29843.

involving certain futures contracts on foreign government debt securities present a unique circumstance, which is discussed below.

Rule 3a12-8 under the Exchange Act exempts certain foreign government debt securities, for purposes only of the offer, sale, or confirmation of sale of futures contracts on such foreign government debt securities, from all provisions of the Exchange Act which by their terms do not apply to an "exempted security," subject to certain conditions.[700] To date, the SEC has enumerated within rule 3a12-8 the debt securities of 21 foreign governments solely for purposes of futures trading ("21 enumerated foreign governments").[701]

The Commissions recognize that as a result of rule 3a12-8, futures contracts on the debt securities of the 21 enumerated foreign governments that satisfy the conditions of rule 3a12-8 are subject to the CFTC's exclusive jurisdiction and are not considered security futures. As a result, applying the interpretation above to a Title VII instrument that is based on a futures contract on the debt securities of these 21 enumerated foreign governments would mean that the Title VII instrument would be a swap.[702] The Commissions note, however, that the conditions in rule

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700 Specifically, rule 3a12-8 under the Exchange Act requires as a condition to the exemption that the foreign government debt securities not be registered under the Securities Act (or be the subject of any American depositary receipt registered under the Securities Act) and that futures contracts on such foreign government debt securities "require delivery outside the United States, [and] any of its possessions or territories, and are traded on or through a board of trade, as defined in [section 2 of the CEA, 7 U.S.C. 2]." See rules 3a12-8(a)(2) and 3a12-8(b) under the Exchange Act, 17 CFR 240.3a12-8(a)(2) and 240.3a12-8(b). These conditions were "designed to minimize the impact of the exemption on securities distribution and trading in the United States . . . ." See Exemption for Certain Foreign Government Securities for Purposes of Futures Trading, 49 FR 8595 (Mar. 8, 1984) at 8596-97 (citing Futures Trading Act of 1982).

701 See rule 3a12-8(a)(1) under the Exchange Act (designating the debt securities of the governments of the United Kingdom, Canada, Japan, Australia, France, New Zealand, Austria, Denmark, Finland, the Netherlands, Switzerland, Germany, Ireland, Italy, Spain, Mexico, Brazil, Argentina, Venezuela, Belgium, and Sweden).

702 The Commissions note, by contrast, that a Title VII instrument that is based on the price or value of, or settlement into, a futures contract on the debt securities of one of the 21 enumerated foreign governments and that also has the potential to settle directly into such debt securities would be a

3a12-8 were established specifically for purposes of the offer and sale of "qualifying foreign futures contracts" (as defined in rule 3a12-8)[703] on the debt securities of the 21 enumerated foreign governments,[704] not Title VII instruments based on futures contracts on the debt securities of the 21 enumerated governments. Further, the Commissions note that the Dodd-Frank Act did not exclude swaps on foreign government debt securities generally from the definition of the term "security-based swap." Accordingly, a Title VII instrument that is based directly on foreign government debt securities, including those of the 21 enumerated governments, is a security-based swap or a swap under the same analysis as any other Title VII instruments based on securities.

The Commissions indicated in the Proposing Release that they would evaluate whether Title VII instruments based on futures contracts on the debt securities of the 21 enumerated foreign governments that satisfy the conditions of rule 3a12-8 should be characterized as swaps, security-based swaps, or mixed swaps.[705] In response to commenters,[706] the Commissions are adopting rule 1.3(bbbb) under the CEA and rule 3a68-5 under the Exchange Act, which address the treatment of these Title VII instruments.

The final rules provide that a Title VII instrument that is based on or references a qualifying foreign futures contract on the debt securities of one or more of the 21 enumerated

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security-based swap and, depending on other features of the Title VII instrument, possibly a mixed swap.

703 Rule 3a12-8(b) under the Exchange Act defines "qualifying foreign futures contracts" as "contracts for the purchase or sale of a designated foreign government security for future delivery, as 'future delivery' is defined in 7 U.S.C. 2, provided such contracts require delivery outside the United States, any of its possessions or territories, and are traded on or through a board of trade, as defined at 7 U.S.C. 2." 17 CFR 240.3a12-8(b).

704 See supra note 700.

705 See Proposing Release at 29844.

706 See infra note 718 and accompanying text.

foreign governments is a swap and not a security-based swap, provided that the Title VII instrument satisfies the following conditions:

- The futures contract on which the Title VII instrument is based or that is referenced is a qualifying foreign futures contract (as defined in rule 3a12-8)[707] on the debt securities of any one or more of the 21 enumerated foreign governments that satisfies the conditions of rule 3a12-8;
- The Title VII instrument is traded on or through a board of trade (as defined in section 1a(6) of the CEA);
- The debt securities on which the qualifying foreign futures contract is based or referenced and any security used to determine the cash settlement amount pursuant to the fourth condition below are not covered by an effective registration statement under the Securities Act or the subject of any American depositary receipt covered by an effective registration statement under the Securities Act;
- The Title VII instrument may only be cash settled; and
- The Title VII instrument is not entered into by the issuer of the securities upon which the qualifying foreign futures contract is based or referenced (including any security used to determine the cash payment due on settlement of such Title VII instrument), an affiliate (as defined in the Securities Act and the rules and regulations thereunder)[708] of the issuer, or an underwriter with respect to such securities.

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[707] See supra note 703.

[708] See, e.g., rule 405 under the Securities Act, 17 CFR 230.405.

Under the first condition, the final rules provide that the futures contract on which the Title VII instrument is based or referenced must be a qualifying foreign futures contract that satisfies the conditions of rule 3a12-8 and may only be based on the debt of any one or more of the enumerated 21 foreign governments. If the conditions of rule 3a12-8 are not satisfied, then there cannot be a qualifying foreign futures contract, the futures contract is a security future, and a swap on such a security future is a security-based swap.

The second condition of the final rules provides that the Title VII instrument on the qualifying foreign futures contract must itself be traded on or through a board of trade because a qualifying foreign futures contract on the debt securities of one or more of the 21 enumerated foreign governments itself is required to be traded on a board of trade. The Commissions believe that swaps on such futures contracts should be traded subject to rules applicable to such futures contracts themselves.

The third condition of the final rules provides that the debt securities on which the qualifying foreign futures contract is based or referenced and any security used to determine the cash settlement amount pursuant to the fourth condition cannot be registered under the Securities Act or be the subject of any American depositary receipt registered under the Securities Act. This condition is intended to prevent circumvention of registration and disclosure requirements of the Securities Act applicable to foreign government issuances of their securities. This condition is similar to a condition included in rule 3a12-8.[709]

The fourth condition of the final rules provides that the Title VII instrument must be cash settled. Although, as the Commissions recognize, rule 3a12-8 permits a qualifying foreign futures contract to be physically settled so long as delivery is outside the United States, any of its

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[709] See supra note 700.

possessions or territories,[710] in the context of Title VII instruments, only cash settled Title VII instruments based on qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments will be considered swaps. The Commissions believe that this condition is appropriate in order to provide consistent treatment of Title VII instruments based on qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments with the Commissions' treatment of swaps and security-based swaps generally.[711]

The fifth condition of the final rules provides that for a Title VII instrument to be a swap under such rules, it cannot be entered into by the issuer of the securities upon which the qualifying foreign futures contract is based or referenced (including any security used to determine the cash payment due on settlement of such Title VII instrument), an affiliate of the issuer, or an underwriter of the issuer's securities. The Commissions have included this condition to address the concerns raised by the SEC in the Proposing Release that the characterization of a Title VII instrument that is based on a futures contract on the debt securities of one of the 21 enumerated foreign governments may affect federal securities law provisions relating to the distribution of the securities upon which the Title VII instrument is based or referenced.[712]

The Dodd-Frank Act included provisions that would not permit issuers, affiliates of issuers, or underwriters to use security-based swaps to offer or sell the issuers' securities underlying a security-based swap without complying with the requirements of the Securities

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710 Id.

711 See infra part III.H.

712 See Proposing Release at 29844.

Act.[713] This provision applies regardless of whether the Title VII instrument allows the parties to physically settle any such security-based swap. In addition, the Dodd-Frank Act provided that any offer or sale of security-based swaps to non-ECPs would have to be registered under the Securities Act.[714] For example, if a Title VII instrument that is based on a futures contract on the debt securities of one of the 21 enumerated foreign governments is characterized as a swap, and not a security-based swap, then the provisions of the Dodd-Frank Act enacted to ensure that there could not be offers and sales of securities made without compliance with the Securities Act, either by issuers, their affiliates, or underwriters or to non-ECPs, would not apply to such swap transactions.

Only those Title VII instruments that are based on qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments and that satisfy these five conditions will be swaps, not security-based swaps. The Commissions note that the final rules are intended to provide consistent treatment (other than with respect to method of settlement) of qualifying foreign futures contracts and Title VII instruments based on qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments.[715] The Commissions understand that many of the qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments trade with substantial volume through foreign trading venues

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713 See section 2(a)(3) of the Securities Act, 15 U.S.C. 77b(a)(3), as amended by the Dodd-Frank Act.

714 See section 5 of the Securities Act, 15 U.S.C. 77e, as amended by the Dodd-Frank Act.

715 The Commissions note that the final rules provide consistent treatment of qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments and Title VII instruments based on qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments unless the Title VII instrument is entered into by the issuer of the securities upon which the qualifying foreign futures contract is based or referenced (including any security used to determine the cash payment due on settlement of such Title VII instrument), an affiliate of the issuer, or an underwriter with respect to such securities.

under the conditions set forth in rule 3a12-8[716] and permitting swaps on such futures contracts subject to similar conditions would not raise concerns that such swaps could be used to circumvent the conditions of rule 3a12-8 and the federal securities laws concerns that such conditions are intended to protect.[717] Further, providing consistent treatment for qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments and Title VII instruments based on futures contracts on the debt securities of the 21 enumerated foreign governments will allow trading of these instruments through designated contract markets on which such futures are listed.

The Commissions recognize that the rules may result in a different characterization of a Title VII instrument that is based directly on a foreign government debt security and one that is based on a qualifying foreign futures contract on a debt security of one of the 21 enumerated foreign governments. However, the Commissions note that this is the case today (i.e., different treatments) with respect to other instruments subject to CFTC regulation and/or SEC regulation, such as futures on broad-based security indexes and futures on a single security or narrow-based security index.

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716 For the quarter that ended December 31, 2011, the trading volume reported to the CFTC of qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments made available for trading by direct access from the U.S. on foreign trading venues granted direct access no-action relief by the CFTC that exceeded 100,000 contracts per quarter from the U.S. were as follows: (i) 7,985,959 contracts for 3 Year Treasury Bond Futures on the Australian Securities Exchange's ASX Trade24 platform; (ii) 1,872,592 contracts for 10-Year Government of Canada Bond Futures on the Bourse de Montreal; (iii) 47,874,911 contracts for Euro Bund Futures on Eurex Deutschland ("Eurex"); (iv) 26,434,713 contracts for Euro Bobl Futures on Eurex; (v) 30,489,427 contracts for Euro Schatz Futures on Eurex; and (vi) 8,292,222 contracts for Long Gilt Futures on the NYSE LIFFE.

717 See supra note 712 and accompanying text.

Comments

Commenters did not address the interpretation as it applied to Title VII instruments based on futures contracts generally. Two commenters addressed Title VII instruments based on futures contracts on debt securities of the 21 enumerated foreign governments.[718] Both commenters requested that the Commissions treat these Title VII instruments as swaps.[719] The Commissions agree that these instruments should be treated as swaps under certain conditions and, therefore, are adopting rule 1.3(bbbb) under the CEA and rule 3a68-5 under the Exchange Act as discussed above to treat Title VII instruments based on qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments as swaps, provided such Title VII instruments satisfy certain conditions.

F. Use of Certain Terms and Conditions in Title VII Instruments

The Commissions provided an interpretation in the Proposing Release regarding the use of certain fixed terms in Title VII instruments and are restating that interpretation without modification.[720] The Commissions are aware that market participants' setting of certain fixed terms or conditions of Title VII instruments may be informed by the value or level of a security, rate, or other commodity at the time of the execution of the instrument. The Commissions believe that, in evaluating whether a Title VII instrument with such a fixed term or condition is a swap or security-based swap, the nature of the security, rate, or other commodity that informed

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[718] See CME Letter and SIFMA Letter.

[719] Id. Both commenters stated their belief that the range of factors considered by the SEC in designating the debt securities of the 21 enumerated foreign governments as exempted securities indicated that there is sufficient disclosure about the 21 enumerated foreign governments and their securities such that the further disclosure should not be necessary. Both commenters also indicated that subjecting futures contracts on the debt securities of the 21 enumerated foreign governments to CFTC regulation, while subjecting Title VII instruments based on these futures contracts to SEC regulation, would be problematic. Id.

[720] See Proposing Release at 29845.

the setting of such fixed term or condition should not itself impact the determination of whether the Title VII instrument is a swap or a security-based swap, provided that the fixed term or condition is set at the time of execution and the value or level of that fixed term or condition may not vary over the life of the Title VII instrument.[721]

For example, a Title VII instrument, such as an interest rate swap, in which floating payments based on three-month LIBOR are exchanged for fixed rate payments of five percent would be a swap, and not a security-based swap, even if the five percent fixed rate was informed by, or quoted based on, the yield of a security, provided that the five percent fixed rate was set at the time of execution and may not vary over the life of the Title VII instrument.[722] Another example would be where a private sector or government borrower that issues a five-year, amortizing $100 million debt security with a semi-annual coupon of LIBOR plus 250 basis points also, at the same time, chooses to enter into a five-year interest rate swap on $100 million notional in which this same borrower, using the same amortization schedule as the debt security, receives semi-annual payments of LIBOR plus 250 basis points in exchange for five percent fixed rate payments. The fact that the specific terms of the interest rate swap (e.g., five-year, LIBOR plus 250 basis points, $100 million notional, fixed amortization schedule) were set at the time of execution to match related terms of a debt security does not cause the interest rate swap to become a security-based swap. However, if the interest rate swap contained additional terms

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721 This interpretation relates solely to the determination regarding whether a Title VII instrument is a swap or security-based swap. The Commissions are not expressing a view regarding whether such Title VII instrument would be a security-based swap agreement.

722 However, to the extent the fixed term or condition is set at a future date or at a future value or level of a security, rate, or other commodity rather than the value or level of such security, rate, or other commodity at the time of execution of the Title VII instrument, the discussion above would not apply, and the nature of the security, rate, or other commodity used in determining the terms or conditions would be considered in evaluating whether the Title VII instrument is a swap or security-based swap.

that were in fact contingent on a characteristic of the debt security that may change in the future, such as an adjustment to future interest rate swap payments based on the future price or yield of the debt security, then this Title VII instrument would be a security-based swap that would be a mixed swap.

Comments

One commenter agreed with the Commissions' interpretation generally, but believed that the Commissions should broaden the interpretation to allow a swap to reflect "resets," or changes in the referenced characteristic of a security, where those "resets" or changes are "intended to effect a purpose other than transmitting the risk of changes in the characteristic itself," without causing a Title VII instrument that is not a security-based swap to become a security-based swap.[723]

The Commissions are not expanding the interpretation to allow "resets" of a fixed rate derived from a security. The interpretation is consistent with the statutory swap and security-based swap definitions. The Commissions believe that a Title VII instrument based on a rate that follows a security, and that may "reset" or change in the future based on changes in that security, is a security-based swap. Further, any amendment or modification of a material term of a Title VII instrument would result in a new Title VII instrument and a corresponding reassessment of the instrument's status as either a swap or a security-based swap.[724]

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[723] See ISDA Letter.

[724] See infra part III.G.5(a).

G. The Term "Narrow-Based Security Index" in the Security-Based Swap Definition

1. Introduction

As noted above, a Title VII instrument in which the underlying reference of the instrument is a ''narrow-based security index'' is a security-based swap subject to regulation by the SEC, whereas a Title VII instrument in which the underlying reference of the instrument is a security index that is not a narrow-based security index (i.e., the index is broad-based) is a swap subject to regulation by the CFTC. The Commissions proposed an interpretation and rules regarding usage of the term "narrow-based security index" in the security-based swap definition, including:

- the existing criteria for determining whether a security index is a narrow-based security index and the applicability of past guidance of the Commissions regarding those criteria to Title VII instruments;
- new criteria for determining whether a CDS where the underlying reference is a group or index of entities or obligations of entities (typically referred to as an "index CDS") is based on an index that is a narrow-based security index;
- the meaning of the term "index";
- rules governing the tolerance period for Title VII instruments on security indexes traded on DCMs, SEFs, foreign boards of trade ("FBOTs"), security-based SEFs, or NSEs, where the security index temporarily moves from broad-based to narrow-based or from narrow-based to broad-based; and
- rules governing the grace period for Title VII instruments on security indexes traded on DCMs, SEFs, FBOTs, security-based SEFs, or NSEs, where the security index

moves from broad-based to narrow-based or from narrow-based to broad-based and the move is not temporary.[725]

As discussed below, the Commissions are restating the interpretation set forth in the Proposing Release with certain further clarifications and adopting the rules as proposed with certain modifications.

2. Applicability of the Statutory Narrow-Based Security Index Definition and Past Guidance of the Commissions to Title VII Instruments

The Commissions provided an interpretation in the Proposing Release regarding the applicability of the statutory definition of the term "narrow-based security index" and past guidance of the Commissions relating to such term to Title VII instruments.[726] The Commissions are restating the interpretation set out in the Proposing Release without modification.

As defined in the CEA and Exchange Act,[727] an index is a narrow-based security index if, among other things, it meets any one of the following four criteria:

- it has nine or fewer component securities;
- a component security comprises more than 30 percent of the index's weighting;
- the five highest weighted component securities in the aggregate comprise more than 60 percent of the index's weighting; or

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725 See Proposing Release at 29845-58.

726 See Proposing Release at 29845-48.

727 Sections 3(a)(55)(B) and (C) of the Exchange Act, 15 U.S.C. 78c(a)(55)(B) and (C), include a definition of "narrow-based security index" in the same paragraph as the definition of security future. See also sections 1a(35)(A) and (B) of the CEA, 7 U.S.C. 1a(35)(A) and (B). A security future is a contract for future delivery on a single security or narrow-based security index (including any interest therein or based on the value thereof). See section 3(a)(55) of the Exchange Act, 15 U.S.C. 78c(a)(55), and section 1a(44) of the CEA, 7 U.S.C. 1a(44).

- the lowest weighted component securities comprising, in the aggregate, 25 percent of the index's weighting have an aggregate dollar value of average daily trading volume of less than $50,000,000 (or in the case of an index with more than 15 component securities, $30,000,000), except that if there are two or more securities with equal weighting that could be included in the calculation of the lowest weighted component securities comprising, in the aggregate, 25 percent of the index's weighting, such securities shall be ranked from lowest to highest dollar value of average daily trading volume and shall be included in the calculation based on their ranking starting with the lowest ranked security.[728]

The first three criteria apply to the number and concentration of the "component securities" in the index. The fourth criterion applies to the average daily trading volume of an index's "component securities."[729]

This statutory narrow-based security index definition focuses on indexes composed of equity securities and certain aspects of the definition, in particular the evaluation of average daily trading volume, are designed to take into account the trading patterns of individual stocks.[730] However, the Commissions, pursuant to authority granted in the CEA and the Exchange Act,[731] previously have extended the definition to other categories of indexes but modified the definition

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[728] See section 3(a)(55)(B) of the Exchange Act, 15 U.S.C. 78c(a)(55)(B). See also sections 1a(35)(A) and (B) of the CEA, 7 U.S.C. 1a(35)(A) and (B).

[729] The narrow-based security index definition in the CEA and Exchange Act also excludes from its scope security indexes that satisfy certain specified criteria. See sections 3(a)(55)(C)(i) – (vi) of the Exchange Act, 15 U.S.C. 78c(a)(55)(C)(i) – (vi), and sections 1a(35)(B)(i) – (vi) of the CEA, 7 U.S.C. 1a(35)(B)(i) – (vi).

[730] See Joint Order Excluding Indexes Comprised of Certain Index Options From the Definition of Narrow-Based Security Index, 69 FR 16900 (Mar. 31, 2004) ("March 2004 Index Options Joint Order").

[731] See section 1a(35)(B)(vi) of the CEA, 7 U.S.C. 1a(35)(B)(vi), and section 3(a)(55)(C)(vi) of the Exchange Act, 15 U.S.C. 78c(a)(55)(C)(vi).

to take into account the characteristics of those other categories. Specifically, the Commissions have previously provided guidance regarding the application of the narrow-based security index definition to futures contracts on volatility indexes[732] and debt security indexes.[733] Today, then, there exists guidance for determining what constitutes a narrow-based security index.

Volatility indexes are indexes composed of index options. The Commissions issued a joint order in 2004 to define when a volatility index is not a narrow-based security index. Under this joint order, a volatility index is not a narrow-based security index if the index meets all of the following criteria:

- the index measures the magnitude of changes (as calculated in accordance with the order) in the level of an underlying index that is not a narrow-based security index pursuant to the statutory criteria for equity indexes discussed above;
- the index has more than nine component securities, all of which are options on the underlying index;
- no component security of the index comprises more than 30 percent of the index's weighting;
- the five highest weighted component securities of the index in the aggregate do not comprise more than 60 percent of the index's weighting;
- the average daily trading volume of the lowest weighted component securities in the underlying index (those comprising, in the aggregate, 25 percent of the underlying index's weighting) have a dollar value of more than $50,000,000 (or $30,000,000 in

732 See March 2004 Index Options Joint Order.

733 See Joint Final Rules: Application of the Definition of Narrow-Based Security Index to Debt Securities Indexes and Security Futures on Debt Securities, 71 FR 39434 (Jul. 13, 2006) ("July 2006 Debt Index Release").

the case of an underlying index with 15 or more component securities), except if there are 2 or more securities with equal weighting that could be included in the calculation of the lowest weighted component securities comprising, in the aggregate, 25 percent of the underlying index's weighting, such securities shall be ranked from lowest to highest dollar value of average daily trading volume and shall be included in the calculation based on their ranking starting with the lowest ranked security;

- options on the underlying index are listed and traded on an NSE registered under section 6(a) of the Exchange Act;[734] and
- the aggregate average daily trading volume in options on the underlying index is at least 10,000 contracts calculated as of the preceding 6 full calendar months.[735]

With regard to debt security indexes, the Commissions issued joint rules in 2006 ("July 2006 Debt Index Rules") to define when an index of debt securities[736] is not a narrow-based security index. The first three criteria of that definition are similar to the statutory definition for equities and the order regarding volatility indexes in that a debt security index would not be narrow-based if:

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[734] 15 U.S.C. 78f(a).

[735] See March 2004 Index Options Joint Order. In 2009, the Commissions issued a joint order that provided that, instead of the index options having to be listed on an NSE, the index options must be listed on an exchange and pricing information for the index options, and the underlying index, must be computed and disseminated in real time through major market data vendors. See Joint Order To Exclude Indexes Composed of Certain Index Options From the Definition of Narrow-Based Security Index, 74 FR 61116 (Nov. 23, 2009) (expanding the criteria necessary for exclusion under the March 2004 Index Options Joint Order to apply to volatility indexes for which pricing information for the underlying broad-based security index, and the options that compose such index, is current, accurate, and publicly available).

[736] Under the rules, debt securities include notes, bonds, debentures or evidence of indebtedness. See rule 41.15(a)(1)(i) under the CEA, 17 CFR 41.15(a)(1)(i) and rule 3a55-4(a)(1)(i) under the Exchange Act, 17 CFR 240.3a55-4(a)(1)(i). See also July 2006 Debt Index Release.

- it is comprised of more than nine debt securities that are issued by more than nine non-affiliated issuers;
- the securities of any issuer included in the index do not comprise more than 30 percent of the index's weighting; and
- the securities of any five non-affiliated issuers in the index do not comprise more than 60 percent of the index's weighting.

In the July 2006 Debt Index Rules, instead of the statutory average daily trading volume test, however, the Commissions adopted a public information availability requirement. Under this requirement, assuming the aforementioned number and concentration criteria were satisfied, a debt security index would not be a narrow-based security index if the debt securities or the issuers of debt securities in the index met any one of the following criteria:

- the issuer of the debt security is required to file reports pursuant to section 13 or section 15(d) of the Securities Exchange Act of 1934;[737]
- the issuer of the debt security has a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more;
- the issuer of the debt security has outstanding securities that are notes, bonds, debentures, or evidence of indebtedness having a total remaining principal amount of at least $1 billion;
- the security is an exempted security as defined in section 3(a)(12) of the Securities Exchange Act of 1934[738] and the rules promulgated thereunder; or

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[737] 15 U.S.C. 78m or 78o(d).

[738] 15 U.S.C. 78c(a)(12).

- the issuer of the security is a government of a foreign country or a political subdivision of a foreign country.[739]

In the Dodd-Frank Act, Congress included the term "narrow-based security index" in the security-based swap definition, and thus the statutory definition of the term "narrow-based security index"[740] also applies in distinguishing swaps (on security indexes that are not narrow-based, also known as "broad-based") and security-based swaps (on narrow-based security indexes).[741] The Commissions have determined that their prior guidance with respect to what constitutes a narrow-based security index in the context of volatility indexes[742] and debt security indexes[743] applies in determining whether a Title VII instrument is a swap or a security-based swap, except as the rules the Commissions are adopting provide for other treatment with respect to index CDS as discussed below.[744]

To make clear that the Commissions are applying the prior guidance and rules to Title VII instruments, the Commissions are adopting rules to further define the term "narrow-based security index" in the security-based swap definition. Under paragraph (1) of rule 1.3(yyy) under the CEA and paragraph (a) of rule 3a68-3 under the Exchange Act, for purposes of the

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739 See July 2006 Debt Index Rules. The July 2006 Debt Index Rules also provided that debt securities in the index must satisfy certain minimum outstanding principal balance criteria, established certain exceptions to these criteria and the public information availability requirement, and provided for the treatment of indexes that include exempted securities (other than municipal securities).

740 See sections 3(a)(55)(B) and (C) of the Exchange Act, 15 U.S.C. 78c(a)(55)(B) and (C). See also sections 1a(35)(A) and (B) of the CEA, 7 U.S.C. 1a(35)(A) and (B).

741 The statutory definition of the term ''narrow-based security index'' for equities, and the Commissions' subsequent guidance as to what constitutes a narrow-based security index with respect to volatility and debt indexes, is applicable in the context of distinguishing between futures contracts and security futures products.

742 See March 2004 Index Options Joint Order.

743 See July 2006 Debt Index Rules.

744 See infra part III.G.3.

security-based swap definition, the term "narrow-based security index" has the same meaning as the statutory definition set forth in section 1a(35) of the CEA and section 3(a)(55) of the Exchange Act,[745] and the rules, regulations, and orders issued by the Commissions relating to such definition. As a result, except as the rules the Commissions are adopting provide for other treatment with respect to index CDS as discussed below,[746] market participants generally may use the Commissions' past guidance in determining whether certain Title VII instruments based on a security index are swaps or security-based swaps.

The Commissions also are providing an interpretation and adopting additional rules establishing criteria for indexes composed of securities, loans, or issuers of securities referenced by an index CDS.[747] The interpretation and rules also address the definition of an "index"[748] and the treatment of broad-based security indexes that become narrow-based and narrow-based indexes that become broad-based, including rule provisions regarding tolerance and grace periods for swaps on security indexes that are traded on CFTC-regulated trading platforms and security-based swaps on security indexes that are traded on SEC-regulated trading platforms.[749] These rules and interpretation are discussed below.

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745 7 U.S.C. 1a(35) and 15 U.S.C. 78c(a)(55).

746 See infra part III.G.3.

747 Id.

748 See infra part III.G.4.

749 See infra part III.G.5.

3. Narrow-Based Security Index Criteria for Index Credit Default Swaps

a) In General

The Commissions provided an interpretation in the Proposing Release regarding the narrow-based security index criteria for index CDS and are restating it without modification.[750] While the Commissions understand that the underlying reference for most cleared CDS is a single entity or an index of entities rather than a single security or an index of securities, the underlying reference for CDS also could be a single security or an index of securities.[751] A CDS where the underlying reference is a single entity (i.e., a single-name CDS), a single obligation of a single entity (e.g., a CDS on a specific bond, loan, or asset-backed security, or any tranche or series of any bond, loan, or asset-backed security), or an index CDS where the underlying reference is a narrow-based security index or the issuers of securities in a narrow-based security index is a security-based swap. An index CDS where the underlying reference is not a narrow-based security index or the issuers of securities in a narrow-based security index (i.e., a broad-based index) is a swap.[752]

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750 See Proposing Release at 29847-48.

751 See, e.g., Markit, "Markit CDX" (describing the Markit CDX indexes and the number of "names" included in each index), available at http://www.markit.com/en/products/data/indices/credit-and-loan-indices/cdx/cdx.page; Markit, "Markit iTraxx Indices," (stating that the "Markit iTraxx indices are comprised of the most liquid names in the European and Asian markets") (emphasis added), available at http://www.markit.com/en/products/data/indices/credit-and-loan-indices/itraxx/itraxx.page . Examples of indexes based on securities include the Markit ABX.HE and CMBX indexes. See Markit, "Markit ABX.HE," (describing the Markit ABX.HE index as "a synthetic tradeable index referencing a basket of 20 subprime mortgage-backed securities"), available at http://www.markit.com/en/products/data/indices/structured-finance-indices/abx/abx.page; and Markit, "Markit CMBX," (describing the Markit CMBX index as "a synthetic tradeable index referencing a basket of 25 commercial mortgage-backed securities"), available at http://www.markit.com/en/products/data/indices/structured-finance-indices/cmbx/cmbx.page.

752 Similarly, an option to enter into a single-name CDS or a CDS referencing a narrow-based security index as described above would be a security-based swap, while an option to enter into a CDS on a broad-based security index or the issuers of securities in a broad-based security index

The statutory definition of the term "narrow-based security index," as explained above, was designed with the U.S. equity markets in mind.[753] Thus, the statutory definition is not necessarily appropriate for determining whether an index underlying an index CDS is broad or narrow-based. Nor is the guidance that the Commissions have previously issued with respect to the narrow-based security index definition discussed above necessarily appropriate, because that guidance was designed to address and was uniquely tailored to the characteristics of volatility indexes and debt security indexes in the context of futures. Accordingly, the Commissions are clarifying that the guidance that the Commissions have previously issued with respect to the narrow-based security index definition discussed above does not apply to index CDS. Instead, the Commissions are adopting rules as discussed below that include separate criteria for determining whether an index underlying an index CDS is a narrow-based security index.

The Commissions are further defining the term "security-based swap," and the use of the term "narrow-based security index" within that definition, to modify the criteria applied in the context of index CDS in assessing whether the index is a narrow-based security index. The third prong of the security-based swap definition includes a Title VII instrument based on the occurrence of an event relating to the "issuers of securities in a narrow-based security index," provided that such event directly affects the "financial statements, financial condition, or financial obligations of the issuer."[754] The first prong of the security-based swap definition includes a Title VII instrument that is based on a narrow-based security-index.[755] Because the

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would be a swap. Index CDS where the underlying reference is a broad-based security index would be SBSAs. The SEC has enforcement authority with respect to swaps that are SBSAs, as discussed further in section V., infra.

753 See July 2006 Debt Index Rules.

754 Section 3(a)(68)(A)(ii)(III) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(III).

755 Section 3(a)(68)(A)(ii)(I) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(I).

third prong of the security-based swap definition relates to issuers of securities, while the first prong of such definition relates to securities, the Commissions are further defining both the term "narrow-based security index" and the term "issuers of securities in a narrow-based security index" in the context of the security-based swap definition as applied to index CDS. The Commissions believe it is important to further define both terms in order to assure consistent analysis of index CDS.[756] While the wording of the two definitions as adopted differs slightly, the Commissions expect that they will yield the same substantive results in distinguishing narrow-based and broad-based index CDS.[757]

b) Rules Regarding the Definitions of "Issuers of Securities in a Narrow-Based Security Index" and "Narrow-Based Security Index" for Index Credit Default Swaps

The Commissions proposed rules to further define the terms "issuers of securities in a narrow-based security index" and "narrow-based security index" in order to provide appropriate criteria for determining whether an index composed of issuers of securities referenced by an index CDS and an index composed of securities referenced by an index CDS are narrow-based security indexes.[758] The Commissions are adopting rules 1.3(zzz) and 1.3(aaaa) under the CEA and rules 3a68-1a and 3a68-1b under the Exchange Act as proposed with certain modifications.[759]

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[756] Because they apply only with respect to index CDS, the definitions of "issuers of securities in a narrow-based security index" and "narrow-based security index" as adopted do not apply with respect to other types of event contracts, whether analyzed under the first or third prong.

[757] For example, if the reference entities included in one index are the same as the issuers of securities included in another index, application of the two definitions should result in both indexes being either broad-based or narrow-based.

[758] See Proposing Release at 29848.

[759] The discussion throughout this section refers to "reference entities" and "issuers" in discussing the final rules. The term "reference entity" is defined in paragraph (c)(3) of rule 1.3(zzz) under the CEA and rule 3a68-1a under the Exchange Act and the term "issuer" is defined in paragraph

In formulating the criteria in the final rules, and consistent with the guidance and rules the Commissions have previously issued and adopted regarding narrow-based security indexes in the context of security futures, the Commissions believe that there should be 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, in order to reduce the likelihood that non-narrow-based indexes referenced in index CDS or the component securities or issuers of securities in that index would be readily susceptible to manipulation, as well as to help prevent the misuse of material non-public information through the use of CDS based on such indexes.

To satisfy these objectives, the Commissions are adopting rules that are based on the criteria developed for debt indexes discussed above[760] but that tailor these criteria to address index CDS.[761] These criteria are included solely for the purpose of defining the terms "narrow-

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(c)(3) of rule 1.3(aaaa) under the CEA and rule 3a68-1b under the Exchange Act. The final rules provide that the term "reference entity" includes: (i) an issuer of securities; (ii) an issuer of securities that is an issuing entity of asset-backed securities is a reference entity or issuer, as applicable; and (iii) an issuer of securities that is a borrower with respect to any loan identified in an index of borrowers or loans is a reference entity. The final rules provide that the term "issuer" includes: (i) an issuer of securities; and (ii) an issuer of securities that is an issuing entity of asset-backed securities is a reference entity or issuer, as applicable. See paragraph (c)(3) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

760 See discussion of July 2006 Debt Index Rules.

761 The Commissions note that the language of the rules is intended, in general, to be consistent with the criteria developed for debt indexes discussed above. Certain changes from the criteria developed for debt indexes are necessary to address differences between futures on debt indexes and index CDS. Certain other changes are necessary because the rules for debt indexes define under what conditions an index is not a narrow-based security index, whereas the rules for index CDS define what is a narrow-based security index. For example, an index is not a narrow-based security index under the rule for debt indexes if it is not a narrow-based security index under either subparagraph (a)(1) or paragraph (a)(2) of the rule. See July 2006 Debt Index Rules. Under the rules for index CDS, however, an index is a narrow-based security index if it meets the requirements of both of the counterpart paragraphs in the rules regarding index CDS (paragraphs (1)(i) and (1)(ii) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and paragraphs (a)(1) and paragraph (a)(2) of rules 3a68-1a and 3a68-1b under the Exchange Act), even though the criteria

based security index" and "issuers of securities in a narrow-based security index" in the first and third prongs of the security-based swap definition with respect to index CDS and will not affect any other interpretation or use of the term "narrow-based security index" or any other provision of the Dodd-Frank Act, the CEA, or the Exchange Act.

Further, in response to commenters,[762] the Commissions are clarifying that if an index CDS is based on an index of loans that are not securities,[763] an event relating to a loan in the index, such as a default on a loan, is an event "relating to" the borrower.[764] To the extent that the borrower is an issuer of securities, the index CDS based on such index of loans will be analyzed under the third prong of the security-based swap definition in the same manner as any other index CDS.

Comments

The Commissions received two general comments requesting that the proposed rules further defining the terms "issuers of securities in a narrow-based security index" and "narrow-based security index" be simplified.[765] One commenter believed that the rules were exceedingly complicated.[766] Another commenter thought that the criteria should allow transactions to be

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in the debt index rules and the rules for index CDS include generally the same criteria and structure.

762 See infra note 768 and accompanying text.

763 If the loans underlying the index of loans are securities, the index CDS would be analyzed in the same manner as any other index CDS based on an index of securities.

764 An index CDS referencing loans also may be based on events relating to the borrower, such as bankruptcy, and to defaults on any obligation of the borrower.

765 See ISDA Letter and MarketAxess Letter.

766 See MarketAxess Letter. This commenter stated that "The Proposed Rules layout an exceedingly complex process for determining whether an index CDS is broad-based or narrow-based." Id.

readily and transparently classifiable as a swap or security-based swap.[767] The commenters did not provide analysis supporting their comments or recommend language changes.

The Commissions are adopting the rules regarding index CDS essentially as proposed with certain modifications to address commenters' concerns. While the final rules contain a number of elements that are similar or identical to elements contained in the statutory narrow-based security index definition, in order to enable the narrow-based security index definition to apply appropriately to index CDS, the final rules contain some alternative tests to those set forth in the statutory definition.

The Commissions also recognize the diversity of Title VII instruments. While the final rules for index CDS are based on the July 2006 Debt Index Rules, the substantive differences between the final rules in the index CDS and the equity or debt security contexts are intended to reflect the particular characteristics of the CDS marketplace, in which, for example, index components may be entities (issuers of securities) as well as specific equity and debt securities.

The Commissions also received three comments requesting clarification regarding the applicability of the index CDS rules to CDS based on indexes of loans.[768] One commenter noted that the Commissions did not address in the Proposing Release the question of whether an index composed exclusively of loans should be treated as a narrow-based security index.[769] This commenter noted that because the first and third prongs of the statutory security-based swap definition do not explicitly reference loans, the statutory definition does not expressly categorize Title VII instruments based on more than one loan, or contingent on events that occur with

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767 See ISDA Letter.

768 See Allen & Overy Letter; July LSTA Letter; and SIFMA Letter.

769 See Allen & Overy Letter.

respect to more than one loan borrower, unless such borrowers are also "issuers of securities."[770] Based on this commenter's view of the statutory definition, this commenter requested that the Commissions clarify the treatment of indexes composed exclusively of loans.[771] Another commenter provided similar comments and also requested clarification regarding the treatment of CDS based on indexes of loans.[772] A third commenter stated its view that the third prong of the statutory security-based swap definition implies that Title VII instruments on a basket of loans are security-based swaps if the lenders would satisfy the criteria for issuers of a "narrow-based security index" and encouraged the Commissions to clarify this issue.[773] The Commissions agree with commenters that an index CDS based on an index of loans that are not securities is analyzed under the third prong of the statutory security-based swap definition and, therefore, are clarifying the treatment of these Title VII instruments above.[774]

i) Number and Concentration Percentages of Reference Entities or Securities

The Commissions believe that the first three criteria of the debt security index test (which are based on the statutory narrow-based security index definition) discussed above (i.e., the number and concentration weighting requirements) are appropriate to apply to index CDS,

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770 Id.

771 Id.

772 See July LSTA Letter. This commenter noted that prong (III) of the statutory security-based swap definition does not clearly reference borrowers of loans or indexes of borrowers. However, this commenter noted that because most borrowers that are named as reference entities in loan CDS transactions are corporate entities that issue equity interests to one or more shareholders (although they may not issue public securities or become subject to public reporting requirements), this commenter believes that prong (III) can be interpreted to include swaps that reference a single borrower or borrowers of loans in an index. Id.

773 See SIFMA Letter.

774 The Commissions also are providing guidance with respect to TRS based on two or more loans that are not securities. See supra part III.C.

whether CDS on indexes of securities or indexes of issuers of securities.[775] Accordingly, the Commissions are adopting the first three criteria of rule 1.3(zzz) under the CEA and rule 3a68-1a under the Exchange Act as proposed with certain modifications in response to commenters' concerns.[776] These rules contain the same number and concentration criteria as proposed, but modify the method of calculating affiliation among issuers and reference entities in response to commenters.[777] Further, in response to commenters,[778] the Commissions are providing an additional interpretation with respect to the application of these criteria to two particular types of CDS, commonly known as "nth-to-default CDS" and "tranched CDS."

The first three criteria provide that, for purposes of determining whether an index CDS is a security-based swap under section 3(a)(68)(A)(ii)(III) of the Exchange Act,[779] the term "issuers of securities in a narrow-based security index" includes issuers of securities identified in an index (including an index referencing loan borrowers) in which:

- Number: There are nine or fewer non-affiliated issuers of securities that are reference entities included in the index, provided that an issuer of securities shall not be deemed a reference entity included in the index unless (i) a credit event with respect to such reference entity would result in a payment by the credit protection seller to the credit protection buyer under the index CDS based on the related notional amount allocated to such reference entity; or (ii) the fact of such credit event or the calculation in accordance with clause (i) above of the amount owed with respect to such credit event

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775 See infra notes 792 and 793 and accompanying text.

776 See paragraphs (a)(1)(i)-(iii) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rules 3a68-1a and 3a68-1b under the Exchange Act.

777 See infra note 804 and accompanying text.

778 See infra notes 795 and 796 and accompanying text.

779 15 U.S.C. 78c(a)(68)(A)(ii)(III).

is taken into account in determining whether to make any future payments under the index CDS with respect to any future credit events;

- Single Component Concentration: The effective notional amount allocated to any reference entity included in the index comprises more than 30 percent of the index's weighting; or
- Largest Five Component Concentration: The effective notional amount allocated to any five non-affiliated reference entities included in the index comprises more than 60 percent of the index's weighting.[780]

Similarly, the Commissions are adopting as proposed the first three criteria of rule 1.3(aaaa) under the CEA and rule 3a68-1b under the Exchange Act. These three criteria provide that, for purposes of determining whether an index CDS is a security-based swap under section 3(a)(68)(A)(ii)(I) of the Exchange Act,[781] the term "narrow-based security index" includes an index in which essentially the same criteria apply, substituting securities for issuers. Under these criteria, the term "narrow-based security index" would mean an index in which:

- Number: There are nine or fewer securities, or securities that are issued by nine or fewer non-affiliated issuers, included in the index, provided that a security shall not be deemed a component of the index unless (i) a credit event with respect to the issuer

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780 These rules refer to the "effective notional amount" allocated to reference entities or securities in order to address potential situations in which the means of calculating payout across the reference entities or securities is not uniform. Thus, if one or more payouts is leveraged or enhanced by the structure of the transaction (i.e., 2x recovery rate), that amount would be the "effective notional amount" for purposes of the 30 percent and 60 percent tests in paragraphs (1)(i)(B) and (1)(i)(C) of rules 1.3(zzz) and 1.3(aaaa) and paragraphs (a)(1)(ii) and (a)(1)(iii) of rules 3a68-1a and 3a68-1b. Similarly, if the aggregate notional amount under a CDS is not uniformly allocated to each reference entity or security, then the portion of the notional amount allocated to each reference entity or security (which may be by reference to the product of the aggregate notional amount and an applicable percentage) would be the "effective notional amount."

781 15 U.S.C. 78c(a)(68)(A)(ii)(I).

of such security or a credit event with respect to such security would result in a payment by the credit protection seller to the credit protection buyer under the index CDS based on the related notional amount allocated to such security, or (ii) the fact of such credit event or the calculation in accordance with clause (i) above of the amount owed with respect to such credit event is taken into account in determining whether to make any future payments under the index CDS with respect to any future credit events;

- Single Component Concentration: The effective notional amount allocated to the securities of any issuer included in the index comprises more than 30 percent of the index's weighting; or
- Largest Five Component Concentration: The effective notional amount allocated to the securities of any five non-affiliated issuers included in the index comprises more than 60 percent of the index's weighting.

Thus, the applicability of the final rules depends on conditions relating to the number of non-affiliated reference entities or issuers of securities, or securities issued by non-affiliated issuers, as applicable, included in an index and the weighting of notional amounts allocated to the reference entities or securities included in the index, as applicable. These first three criteria of the final rules evaluate the number and concentration of the reference entities or securities included in the index, as applicable, and ensure that an index with a small number of reference entities, issuers, or securities or concentrated in only a few reference entities, issuers, or securities is narrow-based, and thus where such index is the underlying reference of an index

CDS, the index CDS is a security-based swap. Further, as more fully described below,[782] the final rules provide that a reference entity or issuer of securities included in an index and any of that reference entity's or issuer's affiliated entities (as defined in the final rules) that also are included in the index are aggregated for purposes of determining whether the number and concentration criteria are met.

Specifically, the final rules provide that an index meeting any one of certain identified conditions would be a narrow-based security index. The first condition in paragraph (1)(i)(A) of rule 1.3(zzz) under the CEA and paragraph (a)(1)(i) of rule 3a68-1a under the Exchange Act is that there are nine or fewer non-affiliated issuers of securities that are reference entities in the index. An issuer of securities counts toward this total only if a credit event with respect to such entity would result in a payment by the credit protection seller to the credit protection buyer under the index CDS based on the notional amount allocated to such entity, or if the fact of such a credit event or the calculation of the payment with respect to such credit event is taken into account when determining whether to make any future payments under the index CDS with respect to any future credit events.

Similarly, the first condition in paragraph (1)(i)(A) of rule 1.3(aaaa) under the CEA and paragraph (a)(1)(i) of rule 3a68-1b under the Exchange Act provides that a security counts toward the total number of securities in the index only if a credit event with respect to such security, or the issuer of such security, would result in a payment by the credit protection seller to the credit protection buyer under the index CDS based on the notional amount allocated to such security, or if the fact of such a credit event or the calculation of the payment with respect

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782 See infra part III.G.3(b)(ii), for a discussion of the affiliation definition applicable to calculating the number and concentration criteria. As noted above, the Commissions are modifying the method of calculating affiliation for purposes of these criteria.

to such credit event is taken into account when determining whether to make any future payments under the index CDS with respect to any future credit events.

These provisions are intended to ensure that an index concentrated in a few reference entities or securities, or a few reference entities that are affiliated (as defined in the final rules) or a few securities issued by issuers that are affiliated, are within the narrow-based security index definition.[783] These provisions also are intended to ensure that an entity is not counted as a reference entity included in the index, and a security is not counted as a security included in the index, unless a credit event with respect to the entity, issuer, or security affects payout under a CDS on the index.[784]

Further, as this condition is in the alternative (i.e., *either* there must be a credit event resulting in a payment under the index CDS *or* a credit event is considered in determining future CDS payments), the tests encompass all index CDS. For example, and in response to a commenter,[785] the test would cover an nth-to-default CDS,[786] in which default with respect to a specified component of an index (such as the first default or fifth default) triggers the CDS payment, even if the CDS payment is not made with respect to such particular credit event. As another example, and in response to another commenter,[787] the test applies to a tranched CDS[788]

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783 This requirement is generally consistent with the definition of "narrow-based security index" in section 1a(35)(A) of the CEA, 7 U.S.C. 1a(35)(A), and section 3(a)(55)(B) of the Exchange Act, 15 U.S.C. 78c(a)(55)(B), and the July 2006 Debt Index Rules.

784 Id.

785 See infra note 795 and accompanying text.

786 An "nth-to-default CDS" is a CDS in which the payout is linked to one in a series of defaults (such as first-, second- or third-to-default), with the contract terminating at that point. See SIFMA Letter.

787 See infra note 796 and accompanying text.

788 A "tranched CDS" is a CDS in which the counterparties agree to buy and sell credit protection on only a portion of the potential losses that could occur on an underlying portfolio of reference

if the payments are made on only a tranche, or portion, of the potential aggregate notional amount of the CDS (often expressed as a percentage range of the total notional amount of the CDS) because the CDS payment takes into account a credit event with respect to an index component, even if the credit event itself does not result in such a payment.

The second condition, in paragraphs (1)(i)(B) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and paragraphs (a)(1)(ii) of rules 3a68-1a and 3a68-1b under the Exchange Act, is that the effective notional amount allocated to any reference entity or security of any issuer included in the index comprises more than 30 percent of the index's weighting.

The third condition, in paragraphs (1)(i)(C) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and paragraphs (a)(1)(iii) of rules 3a68-1a and 3a68-1b under the Exchange Act, is that the effective notional amount allocated to any five non-affiliated reference entities, or to the securities of any five non-affiliated issuers, included in the index comprises more than 60 percent of the index's weighting.

Given that Congress determined that these concentration percentages are appropriate to characterize an index as a narrow-based security index, and the Commissions have determined they are appropriate for debt security indexes in the security futures context,[789] the Commissions believe that these concentration percentages are appropriate to apply to the notional amount allocated to reference entities and securities in order to apply similar standards to indexes that are the underlying references of index CDS. Moreover, with respect to both the number and

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entities. The portion is typically denoted as a specified percentage range of aggregate losses (e.g., 2 percent to 5 percent, meaning the credit protection seller would not make payments until aggregate losses exceed 2 percent of the notional of the transaction, and would no longer be obligated to make payments after aggregate losses reach 5 percent). See SIFMA Letter.

789 See July 2006 Debt Index Rules.

concentration criteria, the markets have had experience with these criteria with respect to futures on equity indexes, volatility indexes, and debt security indexes.[790]

Comments

One commenter expressed its view that the Commissions should increase the percentage test in the largest five component concentration.[791] The Commissions are adopting the number and concentration criteria as proposed. The statutory definition of the term "security-based swap" references the definition of the term "narrow-based security index" contained in the Exchange Act and the CEA,[792] which includes the same number and concentration percentages as the Commissions are adopting in this release. The Commissions are not modifying the statutory definition to change the percentages. The statutory definition included the concentration percentages, which the Commissions understand are intended to assure that a security index could not be used as a surrogate for the underlying securities in order to avoid application of the federal securities laws. The Commissions also previously determined to retain these statutory percentages in connection with rules relating to debt security indexes in the security futures context.[793] The Commissions believe that these percentages are similarly appropriate to apply to indexes on which index CDS are based. Moreover, with respect to the number and concentration criteria, as these are in the statutory definition of the term "narrow-based security index" applicable to security futures, market participants have experience in analyzing indexes, including equity, volatility and debt security indexes, to determine

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790 As noted above, the Commissions are modifying the method of calculating affiliation for purposes of the number and concentration criteria. See infra part III.G.3(b)(ii).

791 See ISDA Letter. According to this commenter, the "operational complexity" of the number and concentration criteria will increase costs and compliance risks. Id.

792 See 15 U.S.C. 78c(a)(55)(B) and 7 U.S.C. 1a(35).

793 See July 2006 Debt Index Rules.

compliance with these criteria. As discussed below,[794] though, the Commissions are modifying the affiliation definition used in analyzing the number and concentration criteria for an index.

Two commenters requested clarification regarding nth-to-default CDS, stating their view that such CDS should be treated as security-based swaps to reflect their single-entity triggers.[795] Two commenters requested clarification regarding tranched index CDS, including whether the CDS would be classified based on the underlying index.[796] As discussed above, the Commissions are providing an interpretation on the applicability of the first three criteria of the rules to nth-to-default CDS and tranched CDS. As noted above, the Commissions believe the rules encompass all index CDS, regardless of the type or payment structure, such as whether there is a single-entity payment based on credit events of other index components or whether the payment is based on a specific entity.

ii) Affiliation of Reference Entities and Issuers of Securities With Respect to Number and Concentration Criteria

The Commissions are adopting the affiliation definition that applies when calculating the number and concentration criteria with certain modifications from the proposal to address commenters' concerns.[797] The final rules provide that the terms "reference entity included in the index" and "issuer of the security included in the index" include a single reference entity or issuer of securities included in an index, respectively, or a group of affiliated reference entities or

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794 See infra part III.G.3(b)(ii).

795 See ISDA Letter and SIFMA Letter. One of these commenters noted that such an approach also made sense for nth-to-default CDS because they are typically based on baskets of less than 10 securities. See ISDA Letter.

796 See Markit Letter and SIFMA Letter. One of these commenters stated that classifying tranches underlying index CDS according to attachment or detachment points is not appropriate because it is impossible to know for certain at inception of the CDS the number of credit events that will ultimately affect actual payments, which typically depend on the severity of loss associated with each credit event. See SIFMA Letter.

797 See infra note 804 and accompanying text.

issuers included in an index, respectively.[798] For purposes of the rules, affiliated reference entities or issuers of securities included in an index or securities included in an index issued by affiliated issuers will be counted together for determining whether the number and concentration criteria are met. However, with respect to asset-backed securities, the final rules provide that each reference entity or issuer of securities included in an index that is an issuing entity of an asset-backed security is considered a separate reference entity or issuer, as applicable, and will not be considered affiliated with other reference entities or issuers of securities included in the index.

The final rules provide that a reference entity or issuer of securities included in an index is affiliated with another reference entity or issuer of securities included in the index if it controls, is controlled by, or is under common control with, that other reference entity or issuer.[799] The final rules define control, solely for purposes of this affiliation definition, to mean ownership of more than 50 percent of a reference entity's or issuer's equity or the ability to direct the voting of more than 50 percent of a reference entity's or issuer's voting equity.[800] The affiliation definition in the final rules differs from the definition included in the proposal, which provided for a control threshold of 20 percent ownership.[801] This change is based on the Commissions' consideration of comments received.[802] By using a more than 50 percent (i.e.,

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798 See paragraph (c)(4) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

799 See paragraph (c)(1) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

800 See paragraph (c)(2) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

801 See Proposing Release at 29849.

802 See infra note 804 and accompanying text. The Commissions note that another alternative would have been to include a requirement that the entities satisfy the 20 percent control threshold and also be consolidated with each other in financial statements. The Commissions did not include a

majority ownership) test rather than a 20 percent ownership test for the control threshold, there is a greater likelihood that there will be an alignment of economic interests of the affiliated entities that is sufficient to aggregate reference entities or issuers of securities included in an index for purposes of the number and concentration criteria.[803]

As the affiliation definition is applied to the number criterion, affiliated reference entities or issuers of securities included in an index will be viewed as a single reference entity or issuer of securities to determine whether there are nine or fewer non-affiliated reference entities included in the index or securities that are issued by nine or fewer non-affiliated issuers. Similarly, as the affiliation definition is applied to the concentration criteria, the notional amounts allocated to affiliated reference entities included in an index or the securities issued by a group of affiliated issuers of securities included in an index must be aggregated to determine the level of concentration of the components of the index for purposes of the 30-percent and 60-percent concentration criteria.

Comments

Three commenters requested that the Commissions revise the affiliation definition that applies when calculating the number and concentration criteria to increase the control threshold from 20 percent ownership to majority ownership.[804] These commenters noted that majority

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requirement that the entities be consolidated with each other in financial statements because they do not believe that the scope of the affiliation definition should be exposed to the risk of future changes in accounting standards. Further, the use of a majority ownership control threshold (more than 50 percent) is generally consistent with consolidation under generally accepted accounting principles. See FASB ASC section 810-10-25, Consolidation – Overall – Recognition (stating that consolidation is appropriate if a reporting entity has a controlling financial interest in another entity and a specific scope exception does not apply).

803 In such a case, as noted by commenters, the affiliated entities are viewed as part of group for which aggregation of these entities is appropriate. See infra note 806 and accompanying text.

804 See ISDA Letter (requesting a threshold of at least 50 percent); Markit Letter (requesting a threshold of at least 50 percent); and SIFMA Letter (requesting a threshold of majority

ownership is consistent with current market practice, including the definition of affiliate included in the 2003 ISDA Credit Derivatives Definitions.[805] One commenter also stated its belief that affiliated entities should only be aggregated where the reference entities' credit risks are substantially similar and credit decisions are made by the same group of individuals.[806] This commenter stated its view that 20 percent ownership is too low and that majority ownership is necessary for credit risk and credit decisions to be aligned enough as to warrant collapsing two issuers into one for purposes of the number and concentration criteria.[807]

As stated above, the Commissions are modifying the affiliation definition that applies when calculating the number and concentration criteria in response to commenters to use an affiliation test based on majority ownership. Based on commenters' letters, the Commissions understand that the current standard CDS documentation and the current approach used by certain index providers for index CDS with respect to the inclusion of affiliated entities in the same index use majority ownership rather than 20 percent ownership to determine affiliation. The Commissions are persuaded by commenters that, in the case of index CDS only it is more appropriate to use majority ownership because majority-owned entities are more likely to have their economic interests aligned and be viewed by the market as part of a group. The

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ownership, or 51 percent). One commenter also requested that the Commissions clarify the application of the affiliation definition. See Markit Letter. The Commissions have provided above and in infra part III.G.3(b)(ii), several examples illustrating the application of the affiliation definition in response to this commenter.

805 Id.

806 See SIFMA Letter. The ISDA Letter provide a similar rationale that "the control threshold was too low and potentially disruptive when viewed against entities that the swap markets now trade as separate entities. In the CDS market, for example, entities that share ownership ties of substantially more than 20 percent trade quite independently. These entities may have completely disparate characteristics for the purpose of an index grouping of one sort or another." See ISDA Letter.

807 See SIFMA Letter.

Commissions believe that revising the affiliation definition in this manner for purposes of calculating the number and concentration criteria responds to commenters' concerns that the percentage control threshold may inadvertently include entities that are not viewed as part of a group. Thus, as revised, the affiliation definition will include only those reference entities or issuers included in an index that satisfy the more than 50 percent (i.e., majority ownership) control threshold. The Commissions believe that determining affiliation in this manner for purposes of calculating the number and concentration criteria responds to the commenters' concerns.

The Commissions also believe that the modified affiliation definition addresses commenters' concerns noted above[808] that the rules further defining the terms "issuers of securities in a narrow-based security index" and "narrow-based security index" should be simplified. The modified affiliation definition enables market participants to make an affiliation determination for purposes of calculating the number and concentration criteria by measuring the more than 50 percent (i.e., majority ownership) control threshold.

iii) Public Information Availability Regarding Reference Entities and Securities

In addition to the number and concentration criteria, the debt security index test also includes, as discussed above, a public information availability test. The public information availability test is intended as the substitute for the average daily trading volume ("ADTV") provision in the statutory narrow-based security index definition. An ADTV test is designed to take into account the trading of individual stocks and, because Exchange Act registration of the security being traded is a listing standard for equity securities, the issuer of the security being

[808] See supra note 765 and accompanying text.

traded must be subject to the reporting requirements under the Exchange Act. Based on the provisions of the statutory ADTV test, the Commissions have determined that the ADTV test is not useful for purposes of determining the status of the index on which the index CDS is based because index CDS most commonly reference entities, which do not "trade," or debt instruments, which commonly are not listed, and, therefore, do not have a significant trading volume. However, the underlying rationale of such provision, that there is sufficient trading in the securities and therefore public information and market following of the issuer of the securities, applies to index CDS.

In general, if an index is not narrow-based under the number and concentration criteria, it will be narrow-based if one of the reference entities or securities included in the index fails to meet at least one of the criteria in the public information availability test. This test was designed to reduce the likelihood that broad-based debt security indexes or the component securities or issuers of securities in that index would be readily susceptible to manipulation. The fourth condition in the index CDS rules sets out a similar public information availability test that is intended solely for purposes of determining whether an index underlying a CDS is narrow-based.[809] The Commissions are adopting the public information availability test essentially as proposed with certain modifications to address commenters' concerns, including modifications to the definition of affiliation for purposes of satisfying certain criteria of the public information availability test.[810]

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809 See Proposing Release at 29850.

810 See infra notes 845, 847, 849 and 867 and accompanying text.

The Commissions are adopting final rules under which an index CDS will be considered narrow-based (except as discussed below) if a reference entity or security included in the index does not meet any of the following criteria:[811]

- the reference entity or the issuer of the security included in the index is required to file reports pursuant to the Exchange Act or the regulations thereunder;
- the reference entity or the issuer of the security included in the index is eligible to rely on the exemption provided in rule 12g3-2(b) under the Exchange Act;[812]
- the reference entity or the issuer of the security included in the index has a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more;[813]
- the reference entity or the issuer of the security included in the index (other than a reference entity or an issuer of the security included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Exchange Act[814]) has outstanding notes, bonds, debentures, loans, or evidences of indebtedness (other than revolving credit facilities) having a total remaining principal amount of at least $1 billion;[815]

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811 See paragraphs (a)(1)(iv)(A)-(G) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

812 17 CFR 240.12g3-2(b).

813 See July 2006 Debt Index Rules (noting that issuers having worldwide equity market capitalization of $700 million or more are likely to have public information available about them).

814 15 U.S.C. 78c(a)(77).

815 See July 2006 Debt Index Rules (noting that issuers having at least $1 billion in outstanding debt are likely to have public information available about them).

- the reference entity included in the index is an issuer of an exempted security, or the security included in the index is an exempted security, each as defined in section 3(a)(12) of the Exchange Act[816] and the rules promulgated thereunder (except a municipal security);
- the reference entity or the issuer of the security included in the index is a government of a foreign country or a political subdivision of a foreign country; or
- if the reference entity or the issuer of the security included in the index is an issuing entity of asset-backed securities as defined in section 3(a)(77) of the Exchange Act,[817] such asset-backed security was issued in a transaction registered under the Securities Act and has publicly available distribution reports.

However, so long as the effective notional amounts allocated to reference entities or securities included in the index that satisfy the public information availability test comprise at least 80 percent of the index's weighting, failure by a reference entity or security included in the index to satisfy the public information availability test will be disregarded if the effective notional amounts allocated to that reference entity or security comprise less than five percent of the index's weighting.[818] In this situation, the public information availability test for purposes of the index would be satisfied.

The determination as to whether an index CDS is narrow-based is conditioned on the likelihood that information about a predominant percentage of the reference entities or securities

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816 15 U.S.C. 78c(a)12.

817 15 U.S.C. 78c(a)(77).

818 See paragraph (b) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

included in the index is publicly available.[819] For example, a reference entity or an issuer of securities included in the index that is required to file reports pursuant to the Exchange Act or the regulations thereunder makes regular and public disclosure through those filings. Moreover, a reference entity or an issuer of securities included in the index that does not file reports with the SEC but that is eligible to rely on the exemption in rule 12g3-2(b) under the Exchange Act (i.e., foreign private issuers) is required to make certain types of financial information publicly available in English on its website or through an electronic information delivery system generally available to the public in its primary trading markets.[820]

The Commissions believe that other reference entities or issuers of securities included in the index that do not file reports with the SEC, but that have worldwide equity market capitalization of $700 million or more, have at least $1 billion in outstanding debt obligations (other than in the case of issuing entities of asset-backed securities), issue exempted securities (other than municipal securities), or are foreign sovereign entities either are required to or are otherwise sufficiently likely, solely for purposes of the "narrow-based security-index" and

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819 Most of the thresholds in the public information availability test are similar to those the Commissions adopted in their joint rules regarding the application of the definition of the term "narrow-based security index" to debt security indexes and security futures on debt securities. See July 2006 Debt Index Rules. The July 2006 Debt Index Rules also included an additional requirement regarding the minimum principal amount outstanding for each security in the index. The Commissions have not included this requirement in rule 1.3(zzz) under the CEA and rule 3a68-1a under the Exchange Act. That requirement was intended as a substitute criterion for trading volume because the trading volume of debt securities with a principal amount outstanding above that minimum amount was found to be generally larger than debt securities with a principal amount outstanding below that minimum amount. See July 2006 Debt Index Release. There is no similar criterion that would be applicable in the context of index CDS. The numerical thresholds also are similar to those the SEC adopted in other contexts, including in the existing definitions of "well-known seasoned issuer" and "large accelerated filer." See rule 405 under the Securities Act, 17 CFR 230.405, and rule 12b-2 under the Exchange Act, 17 CFR 240.12b-2.

820 17 CFR 240.12g3-2(b).

"issuers of securities in a narrow-based security index" definitions, to have public information available about them.[821]

In response to commenters,[822] the Commissions are modifying the outstanding debt threshold criterion in the public information availability test to include any indebtedness, including loans, so long as such indebtedness is not a revolving credit facility. The Commissions believe that expanding the definition of indebtedness to include loans (other than revolving credit) for purposes of the debt threshold determination is consistent with the view that entities that have significant outstanding indebtedness likely will have public information available about them.[823]

As more fully described below,[824] for purposes of satisfying one of these issuer eligibility criteria, the final rules provide that a reference entity or an issuer of securities included in an index may rely upon the status of an affiliated entity as an Exchange Act reporting company or foreign private issuer or may aggregate the worldwide equity market capitalization or outstanding indebtedness of an affiliated entity, regardless of whether such affiliated entity itself or its securities are included in the index.

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821 It is important to note that the public information availability test is designed solely for purposes of distinguishing between index CDS that are swaps and index CDS that are security-based swaps. The proposed criteria are not intended to provide any assurance that there is any particular level of information actually available regarding a particular reference entity or issuer of securities. Meeting one or more of the criteria for the limited purpose here – defining the terms "narrow-based security index" and "issuers of securities in a narrow-based security index" in the first and third prongs of the security-based swap definition with respect to index CDS – would not substitute for or satisfy any other requirement for public disclosure of information or public availability of information for purposes of the federal securities laws.

822 See infra note 845 and accompanying text.

823 See July 2006 Debt Index Release.

824 See infra part III.G.3(b)(iv), for a discussion regarding the affiliation definition applicable to the public information availability test. As noted above, the Commissions are modifying the method of calculating affiliation for purposes of this test.

In the case of indexes including asset-backed securities, or reference entities that are issuing entities of asset-backed securities, information about the reference entity or issuing entity of the asset-backed security will not alone be sufficient and, consequently, the rules provide that the public information availability test will be satisfied only if certain information also is available about the asset-backed securities. An issuing entity (whether or not a reference entity) of asset-backed securities will meet the public information availability test if such asset-backed securities were issued in a transaction for which the asset-backed securities issued (which includes all tranches)[825] were registered under the Securities Act and distribution reports about such asset-backed securities are publicly available. In response to commenters,[826] the Commissions note that distribution reports, which sometimes are referred to as servicer reports, delivered to the trustee or security holders, as the case may be, are filed with the SEC on Form 10-D. In addition, because of the lack of public information regarding many asset-backed securities, despite the size of the outstanding amount of securities,[827] the rules do not permit such reference entities and issuers to satisfy the public information availability test by having at least $1 billion in outstanding indebtedness. Characterizing an index with reference entities or securities for which public information is not likely to be available as narrow-based, and thus index CDS where the underlying references or securities are such indexes as security-based swaps, should help to ensure that the index cannot be used to circumvent the federal securities laws, including those relating to Securities Act compliance and the antifraud, antimanipulation

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825 Under this part of the public information availability test, all offerings of the asset-backed securities will have to be covered by a registration statement under the Securities Act, including all tranches, so that public information would exist for any tranche included in an index. However, as noted below, CDS that are offered to ECPs only may rely on alternatives to satisfy the public information test for asset-backed securities.

826 See infra note 849 and accompanying text.

827 See generally Asset-Backed Securities, 75 FR 23328 (May 3, 2010).

and insider trading prohibitions with respect to the index components or the securities of the reference entities.

As noted above, if an index is not narrow-based under the number and concentration criteria, it will be narrow-based if one of the reference entities or securities included in the index fails to meet at least one of the criteria in the public information availability test. However, even if one or more of the reference entities or securities included in the index fail the public information availability test, the final rules provide that the index will not be considered "issuers of securities in a narrow-based security index" or a "narrow-based security index," so long as the applicable reference entity or security that fails the test represents less than five percent of the index's weighting, and so long as reference entities or securities comprising at least 80 percent of the index's weighting satisfy the public information availability test.

An index that includes a very small proportion of reference entities or securities that do not satisfy the public information availability test will be treated as a broad-based security index if the other elements of the definition, including the five percent and 80 percent thresholds, are satisfied prior to execution, but no later than when the parties offer to enter into the index CDS.[828] The five-percent weighting threshold is designed to provide that reference entities or securities not satisfying the public information availability test comprise only a very small portion of the index, and the 80-percent weighting threshold is designed to provide that a predominant percentage of the reference entities or securities in the index satisfy the public information availability test. As a result, these thresholds provide market participants with flexibility in constructing an index. The Commissions believe that these thresholds are appropriate and that providing such flexibility is not likely to increase the likelihood that an

[828] See supra note 625 and accompanying text.

index that satisfies these provisions or the component securities or issuers of securities in that index would be readily susceptible to manipulation or that there would be misuse of material non-public information about the component securities or issuers of securities in that index through the use of CDS based on such indexes.

The final rules also provide that, for index CDS entered into solely between ECPs, there are alternative means to satisfy the public information availability test. Under the final rules, solely for index CDS entered into between ECPs, an index will be considered narrow-based if a reference entity or security included in the index does not meet (i) any of the criteria enumerated above or (ii) any of the following criteria:[829]

- the reference entity or the issuer of the security included in the index (other than a reference entity or issuer included in the index that is an issuing entity of an asset-backed security) makes available to the public or otherwise makes available to such ECP information about such reference entity or issuer pursuant to rule 144A(d)(4) under the Securities Act;[830]
- financial information about the reference entity or the issuer of the security included in the index (other than a reference entity or issuer included in the index that is an issuing entity of an asset-backed security) is otherwise publicly available; or
- in the case of an asset-backed security included in the index, or a reference entity included in the index that is an issuing entity of an asset-backed security, information of the type and level included in public distribution reports for similar asset-backed

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829 See paragraph (a)(1)(iv)(H) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

830 17 CFR 230.144A(d)(4).

securities is publicly available about both the reference entity or issuing entity and the asset-backed security.

As more fully described below, for purposes of satisfying either the rule 144A information criterion or the financial information otherwise publicly available criterion, the final rules provide that a reference entity or an issuer of securities included in an index may look to an affiliated entity to determine whether it satisfies one of these criterion, regardless of whether such affiliated entity itself or its securities are included in the index.[831]

In response to commenters,[832] the Commissions are revising the rule 144A information criterion of the public information availability test applicable to index CDS entered into solely between ECPs to clarify that the rule 144A information must either be made publicly available or otherwise made available to the ECP. In addition, the Commissions are clarifying that financial information about the reference entity or the issuer of the security may otherwise be publicly available through an issuer's website, through public filings with other regulators or exchanges, or through other electronic means. This method of satisfying the public information availability test does not specify the precise method by which financial information must be available.

As with other index CDS, with respect to index CDS entered into solely with ECPs, if the percentage of the effective notional amounts allocated to reference entities or securities satisfying this expanded public information availability test comprise at least 80 percent of the index's weighting, then a reference entity or security included in the index that fails to satisfy the alternative public information test criteria will be disregarded so long as the effective notional

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831 See infra part III.G.3(b)(iv), for a discussion regarding the affiliation definition applicable to the public information availability test applicable to index CDS entered into solely between ECPs. As noted above, the Commissions are modifying the method of calculating affiliation for purposes of this test.

832 See infra note 847 and accompanying text.

amount allocated to that reference entity or security comprises less than five percent of the index's weighting.

Comments

The Commissions received a number of general and specific comments regarding the public information availability test.

A number of commenters believed that the public information availability test should not be included in the final rules for various reasons, including the potential disparate treatment between products based on indexes due to changes in index components,[833] the impact of the migration of indexes from narrow-based to broad-based and vice-versa,[834] and assertions that the test was not needed due to the types of participants engaged in swap and security-based swap transactions.[835] One commenter suggested replacing the public information availability test with a volume trading test.[836]

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833 See SIFMA Letter. This commenter expressed its concern that transactions on the same or similar indexes may result in differing regulatory treatment due to changes in index components as a result of component adjustments or as the availability of information relating to a component issuer changes over time. Id.

834 See Markit Letter. According to this commenter, determining whether an index of loans or borrowers meets the public information availability test would be more difficult and more costly than making the same determination for an index of securities, which "are generally subject to national or exchange-based reporting and disclosure regimes" and could create regulatory uncertainty. Id. This commenter also expressed its belief that the public information availability test would cause indexes to switch between a narrow-based and broad-based classification, which could result in unnecessary cost, confusion, and market disruption. Id.

835 See ISDA Letter. This commenter expressed its belief that the public information availability test is not needed given the largely institutional nature of the existing over-the-counter market. Id. See also July LSTA Letter.

836 See Markit Letter. This commenter expressed its belief that a volume-based classification process would be preferable to the public information availability test for several reasons. First, the statutory definition of "narrow-based security index" includes a volume-based factor. Second, a volume-based factor could be applied easily and transparently because the outstanding notional volume of CDS referencing each index constituent is captured by the Trade Information Warehouse. Third, an index classification based on outstanding notional amount as opposed to the public information availability test would result in less indices migrating from broad- to

The Commissions are adopting the public information availability test as proposed with certain modifications described above. As discussed above, the public information availability test is intended as the substitute for the ADTV provision in the statutory narrow-based security index definition, which the Dodd-Frank Act included as the method for determining whether index CDS are swaps or security-based swaps. Based on the reasons discussed above, the Commissions have retained the public information availability test as the underlying rationale of such provision, that there is sufficient trading in the securities and therefore public information and market following of the issuer of the securities, applies to index CDS. Accordingly, the Commissions believe that there should be public information available about a predominant percentage of the reference entities or issuers of securities underlying the index in order to prevent circumvention of other provisions of the federal securities laws through the use of CDS based on such indexes, to reduce the likelihood that the index, the component securities, or the named issuers of securities in the index could be readily susceptible to manipulation, and to prevent the misuse of material non-public information about such an index, the component securities, or the reference entities.

The Commissions understand that the characterization of an index underlying a CDS as broad-based or narrow-based may change because of changes to the index, such as addition or removal of components, or changes regarding the specific components of the index, such as a decrease in the amount of outstanding common equity for a component. However, these types of changes are contemplated by the statutory narrow-based security index definition, which the

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narrow-based classifications, and vice versa. This commenter also expressed its belief that a volume-based test would ensure that broad-based indices are not readily susceptible to manipulation because indexes based on constituents with high volumes are likely to have significant public information available. Id.

Dodd-Frank Act used to establish whether index CDS are swaps or security-based swaps.[837] Moreover, the Commissions have provided that the determination of whether a Title VII instrument is a swap, security-based swap or mixed swap is made prior to execution, but no later than when the parties offer to enter into the Title VII instrument,[838] and does not change if a security index underlying such instrument subsequently migrates from broad to narrow (or vice versa) during its life. Accordingly, even if the public information availability test would cause indexes underlying index CDS to migrate as suggested by a commenter, that will not affect the classification of outstanding index CDS entered into prior to such migration. However, if an amendment or change is made to such outstanding index CDS that would cause it to be a new purchase or sale of such index CDS, that could affect the classification of such outstanding index CDS. Further, as is true for other products using the narrow-based security index definition, the Commissions also believe that the effects of changes to an index underlying a CDS traded on an organized platform are addressed through the tolerance period and grace period rules the Commissions are adopting, which rules are based on tolerance period and grace period rules for security futures to which the statutory narrow-based security index definition applies.[839]

The Commissions are not adopting a volume-based test based on the trading of the CDS or the trading of the index, either as a replacement for the public information availability test or as an alternative means of satisfying it, as one commenter suggested.[840] The Commissions

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837 The index migration issue exists for all products in which the "narrow-based security index" definition is used. Thus, as is true for security futures, the migration issue exists for debt security indexes and the statutory definition of the term "narrow-based security index," under which an index's characterization may be affected by a change to the index itself or to the components of the index.

838 See supra note 625 and accompanying text.

839 See infra part III.G.6.

840 See supra note 836 and accompanying text.

believe that using a volume-based test based on the trading of the CDS or the trading of the index would not work in the index CDS context because the character of the index CDS would have to be determined before any trading volume could exist and, therefore, the index CDS would fail a volume-based test. The Commissions also believe that a volume-based test based either on the CDS components of the index or the index itself would not be an appropriate substitute for or an alternative to a public information availability test with respect to the referenced entity, issuer of securities, or underlying security because such a volume-based test would not provide transparency on such underlying entities, issuers of securities or securities.[841]

The Commissions believe that the public information availability test in the index CDS rules allows more flexibility with respect to the types of components included in indexes underlying index CDS. For many indexes, such as bespoke indexes, trading volume for CDS on individual components may not be significant even though the index component would otherwise have no trouble satisfying one of the criteria of the public information availability test. The public information availability test in the index CDS rules also is very similar to the test in the rules for debt security indexes, which, as noted above, apply in the context of Title VII instruments, thus providing a consistent set of rules under which index compilers and market participants can analyze the characterization of CDS.

One commenter also had concerns regarding specific types of indexes and specific types of index components, including the applicability of the public information availability test to

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[841] In the context of equity securities indexes to which the ADTV test applies, there likely is information regarding the underlying entities, issuers of securities or securities because, as noted above, Exchange Act registration of the security being traded is a listing standard for equity securities and, therefore, the issuer of the security being traded must be subject to the reporting requirements under the Exchange Act. However, in the context of index CDS, there are no comparable listing standards that would be applicable to provide transparency on the underlying entities, issuers of securities or securities.

indexes of loans or borrowers.[842] As discussed above, however, the Commissions believe that index CDS based on indexes of loans or borrowers should be analyzed under the third prong of the statutory security-based swap definition in the same manner as any other index CDS. Although this commenter noted such indexes may include a higher proportion of "private" borrowers (those borrowers who are not public reporting companies or that do not register offerings of their securities) and thus may themselves not satisfy any of the criteria for the public information availability test,[843] the Commissions believe that the information tests of the rule as modified will address these concerns. The modified rule will add loans to the categories of instruments to be aggregated for purposes of the outstanding indebtedness criterion and, as discussed below, will aggregate outstanding indebtedness of affiliates.[844] As a result of these modifications, the Commissions believe that the indexes the commenter was concerned about may be more likely to satisfy the public information availability test.

One commenter agreed with including an outstanding debt threshold as a criterion in the public information availability test, but requested that the Commissions change this criterion to include loans that are not within the definition of security, as well as affiliate debt guaranteed by the issuer of securities or reference entity, and to reduce the required outstanding debt threshold from $1 billion to $100 million.[845] As discussed above, the Commissions are revising the rules

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842 See July LSTA Letter.

843 Id.

844 As noted above, the Commissions are modifying the method of calculating affiliation for purposes of certain criteria of the public information availability test. See infra part III.G.3(b)(iv).

845 See Markit Letter. This commenter suggested that the debt threshold should be reduced to $100 million because debt issuances in some debt markets, such as the high yield markets, tend to be relatively small. This commenter also suggested that the debt threshold should include debt guaranteed by the issuer of the securities or reference entity because in many cases the issuer of the securities or reference entity is merely guaranteeing debt of its affiliates and not issuing the

to expand the types of debt that are counted toward the $1 billion debt threshold to include any indebtedness, including loans, so long as such indebtedness is not a revolving credit facility. The Commissions have made no other changes to the $1 billion debt threshold.

The Commissions believe that the fact that an entity has guaranteed the obligations of another entity will not affect the likelihood that public information is available about either the borrower on the guaranteed obligation or on the guarantor entity. However, the Commissions note that they are providing an additional interpretation on the affiliation definition of the index CDS rules, including modifying the method of calculating affiliation, that should address this commenter's concerns regarding guaranteed affiliate debt.[846] The Commissions also believe that the $1 billion debt threshold, which is the same amount as the outstanding debt threshold in the rules for debt security indexes, is set at the appropriate level to achieve the objective that such entities are likely to have public information available about them.

One commenter suggested that the proposed rule 144A information criterion of the public information availability test applicable to index CDS entered into solely between ECPs should be satisfied if the issuer made the rule 144A information available upon request to the public or to the ECP in question, rather than being required to provide the information.[847] In response to this commenter, the Commissions are revising the rule 144A information criterion of the public information availability test applicable to index CDS entered into solely between ECPs to clarify that the rule 144A information must be made publicly available or otherwise made available to the ECP.

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debt. Finally, this commenter requested clarification as to whether the debt threshold included loans and leveraged loans.

[846] See infra part III.G.3(b)(iv).

[847] See SIFMA Letter.

The Commissions received one comment regarding the criteria of the public information availability test that relate specifically to asset-backed securities.[848] The commenter was concerned that the test for asset-backed securities underlying an index may be difficult to apply because all asset-backed securities underlying an index are not always registered under the Securities Act.[849] This commenter also was concerned that the term "distribution reports" may not be the same as monthly service reports, which this commenter indicated are available through the deal trustee and/or the SEC website.[850] This commenter also believed that it was unclear whether these monthly service reports would qualify as "distribution reports" for purposes of the public information availability test and whether information regarding Agency MBS pools, which are available on Agency websites, would be sufficient to satisfy the public information availability test.[851] In addition, this commenter requested that the Commissions clarify that not all tranches of a transaction need to be registered under the Securities Act to satisfy the publicly available distribution report requirement.[852]

The Commissions are adopting as proposed the provisions of the public information availability test applicable to indexes based on asset-backed securities. The Commissions note that there are two possible ways to satisfy the public information availability test for index CDS based on asset-backed securities or asset-backed issuers. For index CDS available to non-ECPs, all asset-backed securities in the index or of the issuer in the index must have been sold in registered offerings under the Securities Act and have publicly available distribution reports.

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848 See Markit Letter.

849 Id.

850 Id.

851 Id.

852 Id.

The Commissions are clarifying that monthly service reports filed with the SEC will satisfy the requirement for publicly available distribution reports.[853] However, for index CDS being sold only to ECPs, the public information availability test with respect to the index components is satisfied, regardless of whether the asset-backed securities have been sold in registered offerings under the Securities Act, if information of the type and level included in public distribution reports for similar asset-backed securities is publicly available about both the issuing entity and such asset-backed securities. The Commissions believe that requiring such information about the asset-backed securities and the assets in the pools underlying such asset-backed securities is consistent with existing disclosure requirements for asset-backed securities and existing practices of ABS issuers.

iv) Affiliation of Reference Entities and Issuers of Securities With Respect to Certain Criteria of the Public Information Availability Test

The Commissions are adopting the affiliation definition that applies to certain criteria of the public information availability test with certain modifications from the proposals to address commenters' concerns.[854] The Commissions are making modifications to this affiliation definition that are the same as the modifications the Commissions are making to the affiliation definition that applies when calculating the number and concentration criteria.[855]

This affiliation definition applies for purposes of determining whether a reference entity or issuer of securities included in an index satisfies one of the following four criteria of the public information availability test: (i) the reference entity or issuer of the security included in

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853 Distribution reports, which sometimes are referred to as servicer reports, delivered to the trustee or security holders, as the case may be, are filed with the SEC on Form 10-D.

854 See infra note 867 and accompanying text.

855 See supra part III.G.3(b)(ii).

the index is required to file reports pursuant to the Exchange Act or the regulations thereunder;[856] (ii) the reference entity or issuer of the security included in the index is eligible to rely on the exemption provided in rule 12g3-2(b) under the Exchange Act for foreign private issuers;[857] (iii) the reference entity or issuer of the security included in the index has a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more;[858] and (iv) the reference entity or issuer of the security included in the index has outstanding notes, bonds, debentures, loans, or evidences of indebtedness (other than revolving credit facilities) having a total remaining principal amount of at least $1 billion.[859] This affiliation definition also applies for purposes of determining whether a reference entity or issuer of securities included in an index satisfies one of the following two criteria of the alternative public information availability test applicable to index CDS entered into solely between ECPs: (i) the reference entity or issuer of the security included in the index makes available rule 144A information;[860] and (ii) financial information about the reference entity or issuer of the security included in the index is otherwise publicly available.[861]

The final rules provide that the terms "reference entity included in the index" and "issuer of the security included in the index" include a single reference entity or issuer of securities

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856 See paragraph (a)(1)(iv)(A) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

857 See paragraph (a)(1)(iv)(B) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

858 See paragraph (a)(1)(iv)(C) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

859 See paragraph (a)(1)(iv)(D) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

860 See paragraph (a)(1)(iv)(H)(1) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

861 See paragraph (a)(1)(iv)(H)(2) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

included in an index, respectively, or a group of affiliated entities.[862] For purposes of the rules, a reference entity or issuer of securities included in an index may rely upon an affiliated entity to satisfy certain criteria of the public information availability test. However, with respect to asset-backed securities, the final rules provide that each reference entity or issuer of securities included in an index that is an issuing entity of an asset-backed security is considered a separate reference entity or issuer, as applicable, and will not be considered affiliated with any other entities.

The final rules provide that a reference entity or issuer of securities included in an index is affiliated with another entity if it controls, is controlled by, or is under common control with, that other entity.[863] The final rules define control, solely for purposes of this affiliation definition, to mean ownership of more than 50 percent of a reference entity's or issuer's equity or the ability to direct the voting of more than 50 percent of a reference entity's or issuer's voting equity.[864] This revision is the same as the modification the Commissions are making to the affiliation definition that applies when calculating the number and concentration criteria, which is discussed above.[865]

As the Commissions noted above, this change is based on the Commissions' consideration of comments received. By using a more than 50 percent (i.e., majority ownership) test rather than a 20 percent ownership test for the control threshold, there is a greater likelihood that there will be information available about the reference entity or issuer of securities included

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862 See paragraph (c)(4) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

863 See paragraph (c)(1) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

864 See paragraph (c)(2) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

865 See supra part III.G.3(b)(ii).

in the index because the market likely will view the affiliated entity and the reference entity or issuer of securities included in the index as a single company or economic entity.[866] Accordingly, to the extent information regarding the affiliated entity is publicly available, there may be information regarding the reference entity or issuer of securities included in the index that also is publicly available. This modified control threshold will permit such reference entity or issuer of securities to rely upon an affiliated entity to satisfy one of the criteria of the public information availability test. Further, unlike the affiliation definition that applies when calculating the number and concentration criteria, the affiliation definition that applies to certain criteria of the public information availability test does not require that the affiliated entity or its securities be included in the index.

As the affiliation definition applies to the Exchange Act reporting company and foreign private issuer criteria of the public information availability test, a reference entity or an issuer of securities included in an index that itself is not required to file reports pursuant to the Exchange Act or the regulations thereunder or is not eligible to rely on the exemption provided in rule 12g3-2(b) under the Exchange Act for foreign private issuers may rely upon the status of an affiliated entity as an Exchange Act reporting company or foreign private issuer, regardless of whether that affiliated entity itself or its securities are included in the index, to satisfy one of these criteria. For example, a majority-owned subsidiary included in an index may rely upon the

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[866] The more than 50 percent (i.e., majority ownership) test is generally consistent with consolidation under U.S. generally accepted accounting principles. See FASB ASC section 810-10-25, Consolidation – Overall – Recognition (stating that consolidation is appropriate if a reporting entity has a controlling financial interest in another entity and a specific scope exception does not apply). Accordingly, using a more than 50 percent (i.e., majority ownership) test will make it more likely that the reference entity or issuer of securities included in the index and the affiliated entity will be consolidated with each other in financial statements. Consolidated financial statements present the financial position and results of operations for a parent (controlling entity) and one or more subsidiaries (controlled entities) as if the individual entities actually were a single company or economic entity.

status of its parent, which may or may not be included in the index, to satisfy the issuer eligibility criteria if the parent is required to file reports under the Exchange Act or is a foreign private issuer.

Similarly, as the affiliation definition applies to the worldwide equity market capitalization and outstanding indebtedness criteria of the public information availability test, a reference entity or an issuer of securities included in an index that itself does not have a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more or outstanding notes, bonds, debentures, loans, or evidences of indebtedness (other than revolving credit facilities) having a total remaining principal amount of at least $1 billion, may aggregate the worldwide equity market capitalization or outstanding indebtedness of an affiliated entity, regardless of whether that affiliated entity itself or its securities are included in the index, to satisfy one of these criteria. For example, a majority-owned subsidiary included in an index may aggregate the worldwide equity market capitalization or outstanding indebtedness of its parent and/or other affiliated entities, such as other majority-owned subsidiaries of the parent, to satisfy one of these criteria.

Finally, as the affiliation definition applies to the rule 144A information and financial information otherwise publicly available criteria of the alternative public information availability test applicable to index CDS entered into solely between ECPs, a reference entity or an issuer of securities included in an index that itself does not make available rule 144A information or does not have financial information otherwise publicly available may rely upon an affiliated entity, regardless of whether that affiliated entity itself or its securities are included in the index, to satisfy one of these criteria.

Comments

One commenter requested that the Commissions revise the affiliation definition that applies for purposes of the public information availability test to increase the threshold from 20 percent ownership to majority ownership.[867] This commenter noted that majority ownership is consistent with current market practice, including the definition of affiliate included in the 2003 ISDA Credit Derivatives Definitions.[868] This commenter also noted that the current approach with respect to the inclusion of affiliated entities in the same index uses majority ownership rather than 20 percent ownership to determine affiliation.[869] This commenter also requested that the Commissions clarify the application of the affiliation definition to the public information availability test.[870] Further, this commenter requested that the worldwide equity market capitalization criterion should include all affiliated entities because the reference entity included in the index may not be the member of a corporate group that issues public equity.[871] Finally, this commenter was concerned that the outstanding indebtedness criterion would not include affiliate debt guaranteed by the reference entity or issuer of securities included in the index.[872] Further, as noted above,[873] another commenter was concerned that index CDS may include a higher proportion of "private" borrowers (those borrowers that are not public reporting

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867 See Markit Letter (requesting a threshold of at least 50 percent).

868 Id.

869 Id.

870 Id.

871 Id. This commenter provided Kinder Morgan Kansas Inc. (CDS) and Kinder Morgan Inc. (equity) as an example of where the reference entity and issuer of equity among a corporate group are not the same. Id.

872 Id.

873 See supra note 842 and accompanying text.

companies or that do not register offerings of their securities) and thus may themselves not satisfy each of the criteria for the public information availability test.[874]

The Commissions note the commenters' concerns. The Commissions are modifying the method of determining affiliation that applies for purposes of satisfying certain criteria of the public information availability test. The final rules provide that a reference entity or issuer of securities included in an index may rely upon an affiliated entity (meeting the more than 50 percent control threshold) to satisfy one of the criterion of the public information availability test. This modification is similar to the one the Commissions are making to the affiliation definition that applies for purposes of calculating the number and concentration criteria. As noted above, based on commenters' letters, the Commissions understand that the current standard CDS documentation and the current approach with respect to the inclusion of affiliated entities in the same index use majority ownership rather than 20 percent ownership to determine affiliation. The Commissions agree with commenters that in the case of index CDS only it is more appropriate to use a more than 50 percent (i.e., majority ownership) test rather than a 20 percent ownership test. The Commissions believe that because reference entities or issuers of securities included in an index may rely on an affiliated entity to help satisfy the public information availability test a threshold of majority ownership rather than 20 percent ownership will increase the likelihood that there is information available about the reference entity or issuer of securities included in the index. The Commissions believe that determining affiliation in this manner for purposes of the public availability of information test responds to the commenter's concerns.

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[874] See July LSTA Letter.

Further, the Commissions are providing several illustrative examples of the way in which the affiliation definition works in the context of the public availability of information criteria to address the commenter's concerns regarding the application of the affiliation definition in that context. The Commissions also note that the final rules respond to the commenter's concerns regarding the applicability of the affiliation definition to the worldwide equity market capitalization criterion by providing that the worldwide market capitalization of an affiliate can be counted in determining whether the reference entity or issuer of securities included in the index meets the worldwide equity market capitalization criterion. Moreover, the Commissions note that the final rules respond to the commenter's concerns regarding affiliate debt by providing that indebtedness of an affiliate can be counted in determining whether the reference entity or issuer of securities included in the index meets the outstanding indebtedness criterion. Finally, the Commissions note that the affiliation definition as modified responds to the commenter's concerns regarding "private" borrowers because the modified affiliation definition will allow a reference entity or issuer of securities included in an index to consider the indebtedness, the outstanding equity, and the reporting status of an affiliate in determining whether the public information availability test is satisfied.

As noted above, the Commissions also believe that the modified affiliation definition responds to commenters' concerns noted above that the rules further defining the terms "issuers of securities in a narrow-based security index" and "narrow-based security index" should be simplified. The modified affiliation definition enables market participants to make an affiliation determination for purposes of the public information availability test criteria by measuring the more than 50 percent (i.e., majority ownership) control threshold.

v) Application of the Public Information Availability Requirements to Indexes Compiled by a Third-Party Index Provider

The Commissions requested comment in the Proposing Release as to whether the public information availability test should apply to an index compiled by an index provider that is not a party to an index CDS ("third-party index provider") that makes publicly available general information about the construction of the index, index rules, identity of components, and predetermined adjustments, and which index is referenced by an index CDS that is offered on or subject to the rules of a DCM or SEF, or by direct access in the U.S. from an FBOT that is registered with the CFTC.[875] Two commenters stated that the presence of a third-party index provider would assure that sufficient information is available regarding the index CDS itself.[876] Neither commenter provided any analysis to explain how or whether a third-party index provider would be able to provide information about the underlying securities or issuers of securities in the index. The Commissions are not revising the rules to exclude from the public information availability test any index compiled by a third-party index provider.

vi) Treatment of Indexes Including Reference Entities That Are Issuers of Exempted Securities or Including Exempted Securities

The Commissions are adopting the rules regarding the treatment of indexes that include exempted securities or reference entities that are issuers of exempted securities as proposed without modification.[877] The Commissions believe such treatment is consistent with the

875 See Proposing Release at 29851-52.

876 See ISDA Letter and SIFMA Letter.

877 See rules 1.3(zzz)(1)(i) and 1.3(aaaa)(1)(i) under the CEA and rules 3a68-1a(a)(2) and 3a68-1b(a)(2) under the Exchange Act; and July 2006 Debt Index Rules. The Commissions did not receive any comments on the proposed rules regarding the treatment of indexes that include exempted securities or reference entities that are issuers of exempted securities.

objective and intent of the statutory definition of the term "security-based swap," as well as the approach taken in the context of security futures.[878] Accordingly, paragraph (1)(ii) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and paragraph (a)(2) of rules 3a68-1a and 3a68-1b under the Exchange Act provide that, in the case of an index that includes exempted securities, or reference entities that are issuers of exempted securities, in each case as defined as of the date of enactment of the Futures Trading Act of 1982 (other than municipal securities), such securities or reference entities are excluded from the index when determining whether the securities or reference entities in the index constitute a "narrow-based security index" or "issuers of securities in a narrow-based security index" under the rules.

Under paragraph (1)(ii) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and paragraph (a)(2) of rules 3a68-1a and 3a68-1b) under the Exchange Act, an index composed solely of securities that are, or reference entities that are issuers of, exempted securities (other than municipal securities) will not be a "narrow-based security index" or an index composed of "issuers of securities in a narrow-based security index." In the case of an index where some, but not all, of the securities or reference entities are exempted securities (other than municipal securities) or issuers of exempted securities (other than municipal securities), the index will be a "narrow-based security index" or an index composed of "issuers of securities in a narrow-based security index" only if the index is narrow-based when the securities that are, or reference

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878 See section 3(a)(68)(C) of the Exchange Act, 15 U.S.C. 78c(a)(68)(C) (providing that "[t]he term 'security-based swap' does not include any agreement, contract, or transaction that meets the definition of a security-based swap only because such agreement, contract, or transaction references, is based upon, or settles through the transfer, delivery, or receipt of an exempted security under paragraph (12) [of the Exchange Act], as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in paragraph (29) [of the Exchange Act] as in effect on the date of enactment of the Futures Trading Act of 1982), unless such agreement, contract, or transaction is of the character of, or is commonly known in the trade as, a put, call, or other option").

entities that are issuers of, exempted securities (other than municipal securities) are disregarded. The Commissions believe this approach should result in consistent treatment for indexes regardless of whether they include securities that are, or issuers of securities that are, exempted securities (other than municipal securities) while helping to ensure that exempted securities (other than municipal securities) and issuers of exempted securities (other than municipal securities) are not included in an index merely to make the index either broad-based or narrow-based under the rules.

4. Security Indexes

The Dodd-Frank Act defines the term "index" as "an index or group of securities, including any interest therein or based on the value thereof."[879] The Commissions provided an interpretation in the Proposing Release regarding how to determine when a portfolio of securities is a narrow-based or broad-based security index, and the circumstances in which changes to the composition of a security index (including a portfolio of securities)[880] underlying a Title VII instrument would affect the characterization of such Title VII instrument.[881] The Commissions are restating the interpretation set forth in the Proposing Release with one clarification in response to a commenter.[882] Specifically, the Commissions are clarifying what is meant by "predetermined" for purposes of whether criteria or a self-executing formula for adjusting the

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879 See section 3(a)(68)(E) of the Exchange Act, 15 U.S.C. 78c(a)(68)(E).

880 The Commissions noted in the Proposing Release that a "portfolio" of securities could be a group of securities and therefore an "index" for purposes of the Dodd-Frank Act. See Proposing Release at 29854. To the extent that changes are made to the securities underlying the Title VII instrument and each such change is individually confirmed, then those substituted securities are not part of a security index as defined in the Dodd-Frank Act, and therefore a Title VII instrument on each of those substituted securities is a security-based swap.

881 Solely for purposes of the discussion in this section, the terms "security index" and "security portfolio" are intended to include either securities or the issuers of securities.

882 See infra note 891 and accompanying text.

security index underlying a Title VII instrument qualify under the interpretation. The Commissions find that this interpretation is an appropriate way to address how to determine when a portfolio of securities is a narrow-based or broad-based security index, and the circumstances in which changes to the composition of a security index (including a portfolio of securities) underlying a Title VII instrument would affect the characterization of such Title VII instrument, and is designed to reduce costs associated with making such a determination.[883]

A security index in most cases is designed to reflect the performance of a market or sector by reference to representative securities or interests in securities. There are several well-known security indexes established and maintained by recognized index providers currently in the market.[884] However, instead of using these established indexes, market participants may enter into a Title VII instrument where the underlying reference of the Title VII instrument is a portfolio of securities selected by the counterparties or created by a third-party index provider at the behest of one or both counterparties. In some cases, the Title VII instrument may give one or both of the counterparties, either directly or indirectly (e.g., through an investment adviser or through the third-party index provider), discretionary authority to change the composition of the security portfolio, including, for example, by adding or removing securities in the security portfolio on an "at-will" basis during the term of the Title VII instrument.[885] Where the counterparties, either directly or indirectly (e.g., through an investment adviser or through the

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883 See supra part I, under "Overall Economic Considerations".

884 One example is the S&P 500® Index, an index that gauges the large cap U.S. equities market.

885 Alternatively, counterparties may enter into Title VII instruments where a third-party investment manager selects an initial portfolio of securities and has discretionary authority to change the composition of the security portfolio in accordance with guidelines agreed upon with the counterparties. Under the final guidance the Commissions are issuing today, such security portfolios are treated as narrow-based security indexes, and Title VII instruments on those security portfolios are security-based swaps.

third-party index provider), have this discretionary authority to change the composition or weighting of securities in a security portfolio, that security portfolio will be treated as a narrow-based security index, and therefore a Title VII instrument on that security portfolio is a security-based swap.[886]

However, not all changes that occur to the composition or weighting of a security index underlying a Title VII instrument will always result in that security index being treated as a narrow-based security index. Many security indexes are constructed and maintained by an index provider pursuant to a published methodology.[887] For instance, the various Standard & Poor's security indexes are reconstituted and rebalanced as needed and on a periodic basis pursuant to published index criteria.[888] Such indexes underlying a Title VII instrument would be broad-based or narrow-based depending on the composition and weighting of the underlying security index.

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886 The Commissions understand that a security portfolio could be labeled as such or could just be an aggregate of individual Title VII instruments documented, for example, under a master agreement or by amending an annex of securities attached to a master trade confirmation. If the security portfolio were created by aggregating individual Title VII instruments, each Title VII instrument must be evaluated in accordance with the guidance to determine whether it is a swap or a security-based swap. For the avoidance of doubt, if the counterparties to a Title VII instrument exchanged payments under that Title VII instrument based on a security index that was itself created by aggregating individual security-based swaps, such Title VII instrument would be a security-based swap. See supra part III.D.

887 See, e.g., NASDAQ, "NASDAQ-100 Index" ("The NASDAQ-100 Index is calculated under a modified capitalization-weighted methodology. The methodology generally is expected to retain the economic attributes of capitalization-weighting while providing enhanced diversification. To accomplish this, NASDAQ will review the composition of the NASDAQ-100 Index on a quarterly basis and adjust the weightings of Index components using a proprietary algorithm, if certain pre-established weight distribution requirements are not met."), available at http://dynamic.nasdaq.com/dynamic/nasdaq100_activity.stm.

888 Information regarding security indexes and their related methodologies may be widely available to the general public or restricted to licensees in the case of proprietary or "private label" security indexes. Both public and private label security indexes frequently are subject to intellectual property protection.

In addition, counterparties to a Title VII instrument frequently agree to use as the underlying reference of a Title VII instrument a security index based on predetermined criteria where the security index composition or weighting may change as a result of the occurrence of certain events specified in the Title VII instrument at execution, such as "succession events." Counterparties to a Title VII instrument also may use a predetermined self-executing formula to make other changes to the composition or weighting of a security index underlying a Title VII instrument. In either of these situations, the composition of a security index may change pursuant to predetermined criteria or predetermined self-executing formulas without the Title VII instrument counterparties, their agents, or third-party index providers having any direct or indirect discretionary authority to change the security index.

In general, and by contrast to Title VII instruments in which the counterparties, either directly or indirectly (e.g., through an investment adviser or through the third-party index provider), have the discretion to change the composition or weighting of the referenced security index, where there is an underlying security index for which there are predetermined criteria or a predetermined self-executing formula for adjusting the security index that are not subject to change or modification through the life of the Title VII instrument and that are set forth in the Title VII instrument at execution (regardless of who establishes the criteria or formula), a Title VII instrument on such underlying security index is based on a broad-based or narrow-based security index, depending on the composition and weighting of the underlying security index. Subject to the interpretation discussed below regarding security indexes that may shift from being a narrow-based security index or broad-based security index during the life of an existing Title VII instrument, the characterization of a Title VII instrument based on a security index as

either a swap or a security-based swap will depend on the characterization of the security index using the above interpretation.[889]

The Commissions are clarifying in response to a commenter that, for purposes of this interpretation, criteria or a self-executing formula regarding composition of a security index underlying a Title VII instrument shall be considered "predetermined" if it is bilaterally agreed upon pre-trade by the parties to a transaction.[890] In order to qualify under this interpretation, however, the Commissions reiterate that the "predetermined" criteria or self-executing formula, as described above, must not be subject to change or modification through the life of the Title VII instrument and must be set forth in the Title VII instrument at execution (regardless of who establishes the criteria or formula).

Comments

The Commissions requested comment on a number of issues regarding the interpretation contained in this section as it was proposed, including whether the terms "predetermined criteria" and "predetermined self-executing formula" are clear, and whether additional interpretations should be provided with respect to these terms. The Commissions received one comment on the interpretation provided in the Proposing Release, in which the commenter requested clarification that criteria affecting the composition of an index, when such criteria are agreed bilaterally, pre-trade, by the counterparties to a bespoke index trade, are "predetermined" for purposes of determining whether the index is treated as narrow-based or broad-based.[891]

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889 See supra note 886, regarding the aggregation of separate trades.

890 See infra note 891 and accompanying text.

891 See ISDA Letter. While this commenter agrees with the guidance that the predetermined changes described in this section should not alter the character of an index (or the classification of a Title VII instrument based thereon), this commenter disagrees that the ability to make discretionary changes should cause an otherwise broad-based security index to be a narrow-based security

The Commissions are restating the interpretation set forth in the Proposing Release with one clarification in response to the commenter's concerns. As discussed above, the Commissions are providing that not all changes that occur to the composition or weighting of a security index underlying a Title VII instrument will result in that security index being treated as a narrow-based security index. Foremost among these examples is a security index that is constructed and maintained by an index provider pursuant to a published methodology.[892] Changes to such an index pursuant to such a methodology are not the type of discretionary changes that will render an otherwise broad-based security index a narrow-based security index. The Commissions believe this clarification addresses the commenter's concerns.

5. Evaluation of Title VII Instruments on Security Indexes That Move from Broad-Based to Narrow-Based or Narrow-Based to Broad-Based

a) In General

The determination of whether a Title VII instrument is a swap, a security-based swap, or both (i.e., a mixed swap), is made prior to execution, but no later than when the parties offer to enter into the Title VII instrument.[893] If the security index underlying a Title VII instrument migrates from being broad-based to being narrow-based, or vice versa, during the life of a Title VII instrument, the characterization of that Title VII instrument will not change from its initial

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index. This commenter requested that the Commissions classify transactions "at inception and upon actual change in respect of any classification-related characteristic, be that change the product of a renegotiation or a unilateral exercise of discretion." Id. The Commissions note that if material terms of a Title VII instrument are amended or modified during its life based on an exercise of discretion and not through predetermined criteria or a predetermined self-executing formula, the Commissions view the amended or modified Title VII instrument as a new Title VII instrument. See infra part III.G.5.

892 Indeed, the Commissions specifically mentioned in this regard, and have included in the final guidance above, the various Standard & Poor's security indexes--some of which may be described as "common equity indices" as alluded to in ISDA's comment--that are reconstituted and rebalanced as needed and on a periodic basis pursuant to published index criteria.

893 See supra note 625 and accompanying text.

characterization regardless of whether the Title VII instrument was entered into bilaterally or was executed through a trade on or subject to the rules of a DCM, SEF, FBOT, security-based SEF, or NSE. For 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.

If the material terms of a Title VII instrument are amended or modified during its life based on an exercise of discretion and not through predetermined criteria or a predetermined self-executing formula, the Commissions view the amended or modified Title VII instrument as a new Title VII instrument.[894] As a result, the characteristics of the underlying security index must be reassessed at the time of such an amendment or modification to determine whether the security index has migrated from broad-based to narrow-based, or vice versa. If the security index has migrated, then the characterization of the amended or modified Title VII instrument will be determined by evaluating the underlying security index at the time the Title VII instrument is amended or modified. Similarly, if a security index has migrated from broad-based to narrow-based, or vice versa, any new Title VII instrument based on that security index will be

[894] For example, if, on its effective date, a Title VII instrument tracks the performance of an index of 12 securities but is amended during its term to track the performance of only 8 of those 12 securities, the Commissions would view the amended or modified Title VII instrument as a new Title VII instrument. Because it is a new Title VII instrument, any regulatory requirements regarding new Title VII instruments apply. Conversely, if, on its effective date, a Title VII instrument tracks the performance of an index of 12 securities but is amended during its term to reflect the replacement of a departing "key person" of a hedge fund that is a counterparty to the Title VII instrument with a new "key person," the Commissions would not view the amended or modified Title VII instrument as a new Title VII instrument because the amendment or modification is not to a material term of the Title VII instrument.

characterized pursuant to an evaluation of the underlying security index at the execution of that new Title VII instrument.

The Commissions provided an interpretation in the Proposing Release regarding circumstances in which the character of a security index on which a Title VII instrument is based changes according to predetermined criteria or a predetermined self-executing formula set forth in the Title VII instrument (or in a related or other agreement entered into by the counterparties or a third-party index provider to the Title VII instrument) at execution. The Commissions are restating this interpretation with one clarification in response to a commenter.[895]

Where at the time of execution such criteria or such formula would cause the underlying broad-based security index to become or assume the characteristics of a narrow-based security index or vice versa during the duration of the instrument,[896] then the Title VII instrument based on such security index is a mixed swap during the entire life of the Title VII instrument.[897] Although at certain points during the life of the Title VII instrument, the underlying security index would be broad-based and at other points the underlying security index would be narrow-based, regulating such a Title VII instrument as a mixed swap from the execution of the Title VII instrument and throughout its life reflects the appropriate characterization of a Title VII

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895 See infra note 898 and accompanying text.

896 Thus, for example, if a predetermined self-executing formula agreed to by the counterparties of a Title VII instrument at or prior to the execution of the Title VII instrument provided that the security index underlying the Title VII instrument would decrease from 20 to 5 securities after six months, such that the security index would become narrow-based as a result of the reduced number of securities, then the Title VII instrument is a mixed swap at its execution. The characterization of the Title VII instrument as a mixed swap will not change during the life of the Title VII instrument.

897 As discussed in section III.G.4., supra, to the extent a Title VII instrument permits "at-will" substitution of an underlying security index, however, as opposed to the use of predetermined criteria or a predetermined self-executing formula, the Title VII instrument is a security-based swap at its execution and throughout its life regardless of whether the underlying security index was narrow-based at the execution of the Title VII instrument.

instrument based on a security index that migrates pursuant to predetermined criteria or a predetermined self-executing formula.

The Commissions are clarifying what is meant by whether the pre-determined criteria or pre-determined self-executing formula "would cause" the underlying broad-based security index to become or assume the characteristics of a narrow-based security index, or vice versa, as noted above in the interpretation. The Commissions believe that, unless the criteria or formula were intentionally designed to change the index from narrow to broad, or vice versa, Title VII instruments based on indexes that may, but will not necessarily, change from broad to narrow (or vice versa) under such criteria or formula should be considered swaps or security-based swaps, as appropriate, at execution and for the term thereof, and not mixed swaps. In such circumstances, it is not the case that the criteria or formula "would cause" the change within the meaning of the Commission's interpretation.

The Commissions believe that this interpretation regarding the use of predetermined criteria or a predetermined self-executing formula will prevent potential gaming of the Commissions' interpretation regarding security indexes, and prevent potential regulatory arbitrage based on the migration of a security index from broad-based to narrow-based, or vice versa. In particular, predetermined criteria and predetermined self-executing formulas can be constructed in ways that take into account the characteristics of a narrow-based security index and prevent a narrow-based security index from becoming broad-based, and vice versa.

Comments

The Commissions received two comments on the proposed interpretation in this section regarding the classification of Title VII Instruments based on security indexes that change from narrow-based to broad-based, or vice versa, under predetermined criteria or a predetermined self-

executing formula, as mixed swaps. One commenter requested that the Commissions clarify that a Title VII instrument based on a security index that may, but will not necessarily, change from narrow-based to broad-based, or vice versa, under predetermined criteria or a predetermined self-executing formula should be characterized at execution as a swap or security-based swap, as applicable, and not as a mixed swap.[898] This commenter believed that the Commissions' interpretation should capture as mixed swaps only those Title VII instruments on indexes that will change with certainty, and not those that might change given specific market circumstances.[899] Moreover, this commenter believed that the Commissions' statement that a Title VII instrument on a security index governed by a pre-determined self-executing formula that "would cause" a change from broad to narrow, or narrow to broad, means that the change in character must be a certainty for the instrument to be classified as a mixed swap.[900] The Commissions have clarified their interpretation in response to this commenter's concerns as discussed above.

Another commenter disagreed with the Commissions' proposed interpretation that transactions on indexes under predetermined criteria or a predetermined self-executing formula that would change from broad to narrow, or narrow to broad, should be classified as mixed swaps at inception.[901] This commenter does not believe that regulatory arbitrage is such a significant concern in this context that would justify the challenges to market participants if these

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898 See SIFMA Letter.

899 Id.

900 Id.

901 See ISDA Letter.

transactions were treated as mixed swaps subject to the dual regulatory authority of the Commissions.[902]

The Commissions believe that regulatory arbitrage is a sufficient concern to justify mixed swap status and dual regulatory oversight for Title VII instruments where the index would change from broad to narrow, or narrow to broad, under the pre-determined criteria or predetermined self-executing formula. Counterparties that are concerned about regulatory burdens associated with mixed swap status can redesign their formula to avoid the result, or enter into another swap or security-based swap that is structured to achieve the same economic result without mixed swap status.

b) Title VII Instruments on Security Indexes Traded on Designated Contract Markets, Swap Execution Facilities, Foreign Boards of Trade, Security-Based Swap Execution Facilities, and National Securities Exchanges

As was recognized in the Proposing Release, security indexes underlying Title VII instruments that are traded on DCMs, SEFs, FBOTs, security-based SEFs, or NSEs raise particular issues if an underlying security index migrates from broad-based to narrow-based, or vice versa.[903] The Commissions are adopting as proposed their interpretation clarifying that the characterization of an exchange-traded Title VII instrument based on a security index at its execution will not change through the life of the Title VII instrument, regardless of whether the underlying security index migrates from broad-based to narrow-based, or vice versa. Accordingly, a market participant who enters into a swap on a broad-based security index traded on or subject to the rules of a DCM, SEF or FBOT that migrates from broad-based to narrow-based may hold that position until the swap's expiration without any change in regulatory

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902 Id.

903 See Proposing Release at 29856.

responsibilities, requirements, or obligations; similarly, a market participant who enters into a security-based swap on a narrow-based security index traded on a security-based SEF or NSE that migrates from narrow-based to broad-based may hold that position until the security-based swap's expiration without any change in regulatory responsibilities, requirements, or obligations.

In addition, the Commissions are adopting, as proposed, final rules providing for tolerance and grace periods for Title VII instruments on security indexes that are traded on DCMs, SEFs, FBOTs, security-based SEFs and NSEs.[904] As was noted in the Proposing Release,[905] in the absence of any action by the Commissions, if a market participant wants to offset a swap or enter into a new swap on a DCM, SEF or FBOT where the underlying security index has migrated from broad-based to narrow-based, or to offset a security-based swap or enter into a new security-based swap on a security-based SEF or NSE where the underlying security index has migrated from narrow-based to broad-based, the participant would be prohibited from doing so. That is because swaps may trade only on DCMs, SEFs, and FBOTs, and security-based swaps may trade only on registered NSEs and security-based SEFs.[906] The rules being adopted by the Commissions address how to treat Title VII instruments traded on trading platforms where the underlying security index migrates from broad-based to narrow-based or narrow-based to broad-based, so that market participants will know where such Title VII

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904 See paragraphs (2), (3) and (4) of rule 1.3(yyy) under the CEA and paragraphs (b), (c) and (d) of rule 3a68-3 under the Exchange Act.

905 See Proposing Release at 29857.

906 If a swap were based on a security index that migrated from broad-based to narrow-based, a DCM, SEF, or FBOT could no longer offer the Title VII instrument because it is now a security-based swap. Similarly, if a security-based swap were based on a security index that migrated from narrow-based to broad-based, a security-based SEF or NSE could no longer offer the Title VII instrument because it is now a swap.

instruments may be traded and can avoid potential disruption of their ability to offset or enter into new Title VII instruments on trading platforms when such migration occurs.[907]

As was noted in the Proposing Release,[908] Congress and the Commissions addressed a similar issue in the context of security futures, where the security index on which a future is based may migrate from broad-based to narrow-based or vice versa. Congress provided in the definition of the term "narrow-based security index" in both the CEA and the Exchange Act[909] for a tolerance period ensuring that, under certain conditions, a futures contract on a broad-based security index traded on a DCM may continue to trade, even when the index temporarily assumes characteristics that would render it a narrow-based security index under the statutory definition.[910] In general, an index is subject to this tolerance period, and therefore is not a narrow-based security index, if: (i) a futures contract on the index traded on a DCM for at least 30 days as a futures contract on a broad-based security index before the index assumed the characteristics of a narrow-based security index; and (ii) the index does not retain the characteristics of a narrow-based security index for more than 45 business days over 3

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907 The rules apply only to the particular Title VII instrument that is traded on or subject to the rules of a DCM, SEF, FBOT, security-based SEF, or NSE. As the Commissions noted in the Proposing Release, to the extent that a particular Title VII instrument is not traded on such a trading platform (even if another Title VII instrument of the same class or type is traded on such a trading platform), the rules do not apply to that particular Title VII instrument. See Proposing Release at 29857 n. 259.

908 See Proposing Release at 29857.

909 CEA section 1a(35)(B)(iii), 7 U.S.C. 1a(35)(B)(iii); section 3(a)(55)(C)(iii) of the Exchange Act, 15 U.S.C. 78c(a)(55)(C)(iii).

910 By joint rules, the Commissions have provided that "[w]hen a contract of sale for future delivery on a security index is traded on or subject to the rules of a foreign board of trade, such index shall not be a narrow-based security index if it would not be a narrow-based security index if a futures contract on such index were traded on a designated contract market . . . ." See rule 41.13 under the CEA, 17 CFR 41.13, and rule 3a55-3 under the Exchange Act, 17 CFR 240.3a55-3. Accordingly, the statutory tolerance period applicable to futures on security indexes traded on DCMs applies to futures traded on FBOTs as well.

consecutive calendar months. Pursuant to these statutory provisions, if the index becomes narrow-based for more than 45 business days over 3 consecutive calendar months, the index is excluded from the definition of the term "narrow-based security index" for the following 3 calendar months as a grace period.

The Commissions believe that a similar tolerance period should apply to swaps traded on DCMs, SEFs, and FBOTs and security-based swaps traded on security-based SEFs and NSEs. Accordingly, the Commissions are adopting the rules, as proposed, providing for tolerance periods for swaps that are traded on DCMs, SEFs, or FBOTs[911] and for security-based swaps traded on security-based SEFs and NSEs.[912]

The final rules provide that to be subject to the tolerance period, a security index underlying a swap executed on or subject to the rules of a DCM, SEF, or FBOT must not have been a narrow-based security index[913] during the first 30 days of trading.[914] If the index becomes narrow-based during the first 30 days of trading, the index must not have been a narrow-based security index during every trading day of the 6 full calendar months preceding a date no earlier than 30 days prior to the commencement of trading of a swap on such index.[915] If either of these alternatives is met, the index will not be a narrow-based security index if it has been a narrow-

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911 See paragraph (2) of rule 1.3(yyy) under the CEA and paragraph (b) of rule 3a68-3 under the Exchange Act.

912 See paragraph (3) of rule 1.3(yyy) under the CEA and paragraph (c) of rule 3a68-3 under the Exchange Act.

913 For purposes of these rules, the term "narrow-based security index" shall also mean "issuers of securities in a narrow-based security index." See supra part III.G.3(b), (discussing the rules defining "issuers of securities in a narrow-based security index").

914 This provision is consistent with the provisions of the CEA and the Exchange Act applicable to futures contracts on security indexes. CEA section 1a(35)(B)(iii)(I), 7 U.S.C. 1a(35)(B)(iii)(I); section 3(a)(55)(C)(iii)(I) of the Exchange Act, 15 U.S.C. 78c(a)(55)(C)(iii)(I).

915 This alternative test is the same as the alternative test applicable to futures contracts in CEA rule 41.12, 17 CFR 41.12, and rule 3a55-2 under the Exchange Act, 17 CFR 240.3a55-2.

based security index for no more than 45 business days over 3 consecutive calendar months.[916] These provisions apply solely for purposes of swaps traded on or subject to the rules of a DCM, SEF, or FBOT.

Similarly, the rules provide a tolerance period for security-based swaps traded on security-based SEFs or NSEs. To be subject to the tolerance period, a security index underlying a security-based swap executed on a security-based SEF or NSE must have been a narrow-based security index during the first 30 days of trading. If the index becomes broad-based during the first 30 days of trading, paragraph (3)(i)(B) of rule 1.3(yyy) under the CEA and paragraph (c)(1)(ii) of rule 3a68-3 under the Exchange Act provide that the index must have been a non-narrow-based (i.e., a broad-based) security index during every trading day of the 6 full calendar months preceding a date no earlier than 30 days prior to the commencement of trading of a security-based swap on such index. If either of these alternatives is met, the index will be a narrow-based security index if it has been a security index that is not narrow-based for no more than 45 business days over 3 consecutive calendar months.[917] These provisions apply solely for purposes of security-based swaps traded on security-based SEFs or NSEs.

In addition, the Commissions are adopting rules as proposed that, once the tolerance period under the rules has ended, there will be a grace period during which a Title VII instrument based on a security index that has migrated from broad-based to narrow-based, or vice versa, will

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[916] These provisions are consistent with the parallel provisions in the CEA and Exchange Act applicable to futures contracts on security indexes traded on DCMs. See CEA section 1a(35)(B)(iii)(II), 7 U.S.C. 1a(35)(B)(iii)(II), and section 3(a)(55)(C)(iii)(II) of the Exchange Act, 15 U.S.C. 78c(a)(55)(C)(iii)(II).

[917] These provisions are consistent with the parallel provisions in the CEA and the Exchange Act applicable to futures contracts on security indexes traded on DCMs. See CEA section 1a(35)(B)(iii), 7 U.S.C. 1a(35)(B)(iii); section 3(a)(55)(C)(iii) of the Exchange Act, 15 U.S.C. 78c(a)(55)(C)(iii).

be able to trade on the platform on which Title VII instruments based on such security index were trading before the security index migrated and can also, during such period, be cleared.[918] The final rules provide for an additional three-month grace period applicable to a security index that becomes narrow-based for more than 45 business days over three consecutive calendar months, solely with respect to swaps that are traded on or subject to the rules of DCMs, SEFs, or FBOTs. During the grace period, such an index will not be considered a narrow-based security index. The rules apply the same grace period to a security-based swap on a security index that becomes broad-based for more than 45 business days over 3 consecutive calendar months, solely with respect to security-based swaps that are traded on a security-based SEF or NSE. During the grace period, such an index will not be considered a broad-based security index.[919] As a result, this rule provides sufficient time for a Title VII instrument based on a migrated security index to satisfy listing and clearing requirements applicable to swaps or security-based swaps, as appropriate.

As was noted in the Proposing Release,[920] there will be no overlap between the tolerance and the grace periods under the rules and no "re-triggering" of the tolerance period. For example, if a security index becomes narrow-based for more than 45 business days over 3 consecutive calendar months, solely with respect to swaps that are traded on or subject to the rules of DCMs, SEFs, or FBOTs, but as a result of the rules is not considered a narrow-based security index during the grace period, the tolerance period provisions will not apply, even if the

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918 See paragraph (4) of rule 1.3(yyy) under the CEA and paragraph (d) of rule 3a68-3 under the Exchange Act.

919 These provisions are consistent with the parallel provisions in the CEA and the Exchange Act applicable to futures contracts on security indexes traded on DCMs. See CEA section 1a(35)(D), 7 U.S.C. 1a(35)(D); section 3(a)(55)(E) of the Exchange Act, 15 U.S.C. 78c(a)(55)(E).

920 See Proposing Release at 29858.

security-index migrated temporarily during the grace period. After the grace period has ended, a security index will need to satisfy anew the requirements under the rules regarding the tolerance period in order to trigger a new tolerance period.

The rules will not result in the re-characterization of any outstanding Title VII instruments. In addition, the tolerance and grace periods as adopted will apply only to Title VII instruments that are traded on or subject to the rules of DCMs, SEFs, FBOTs, security-based SEFs, and NSEs.

Comments

The Commissions received one comment on the proposed rules described in this section.[921] This commenter stated its view that extending the "grace period" from three months to six months would ease any disruption or dislocation associated with the delisting process with respect to an index that has migrated from broad to narrow, or narrow to broad, and that has failed the tolerance period.[922] This commenter also stated its view that where an index CDS migrates, for entities operating both a SEF and a security-based SEF, such entities should be permitted to move the index from one platform to the other simply by providing a notice to the SEC and CFTC.[923]

As discussed above, the Commissions are adopting the proposed rules without modification. The Commissions note that the three-month grace period applicable to security futures was mandated by Congress in that context,[924] and the commenter has provided no data or

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921 See MarketAxess Letter.

922 Id.

923 Id.

924 See July 2006 Debt Index Rules. The Commissions are not aware of any disruptions caused by the three-month grace period in the context of security futures.

evidence for its request that the Commissions diverge from that grace period and provide for a longer grace period with respect to swaps and security-based swaps. The Commissions believe that the three-month grace period is similarly appropriate to apply in the context of a Title VII instrument based on an index that has migrated to provide sufficient time to execute off-setting positions. With respect to the commenter's other suggestion that entities operating both a SEF and a security-based SEF should be able to move the index from one platform to another where an index CDS migrates simply by filing a notice with the SEC and CFTC, the Commissions do not believe that this proposal is within the scope of this rulemaking.

H. Method of Settlement of Index CDS

The method that the parties have chosen or use to settle an index CDS following the occurrence of a credit event under such index CDS also can affect whether such index CDS would be a swap, a security-based swap, or both (i.e., a mixed swap). The Commissions provided an interpretation in the Proposing Release regarding the method of settlement of index CDS and are restating the interpretation without modification. The Commissions find that this interpretation is an appropriate way to address index CDS with different settlement methods and is designed to reduce the cost associated with determining whether such an index CDS is a swap or a security-based swap.[925]

If an index CDS that is not based on a narrow-based security index under the Commissions' rules includes a mandatory physical settlement provision that would require the delivery of, and therefore the purchase and sale of, a non-exempted security[926] or a loan in the

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925 See supra part I, under "Overall Economic Considerations".

926 The Commissions note that section 3(a)(68)(C) of the Exchange Act, 15 U.S.C. 78c(a)(68)(C), provides that "[t]he term "security-based swap" does not include any agreement, contract, or transaction that meets the definition of a security-based swap only because such agreement, contract, or transaction references, is based upon, or settles through the transfer, delivery, or

event of a credit event, such an index CDS is a mixed swap.[927] Conversely, if an index CDS that is not based on a narrow-based security index under the Commissions' rules includes a mandatory cash settlement[928] provision, such index CDS is a swap, and not a security-based swap or a mixed swap, even if the cash settlement were based on the value of a non-exempted security or a loan.

An index CDS that is not based on a narrow-based security index under the Commissions' rules and that provides for cash settlement in accordance with the 2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement Supplement to the 2003 Definitions (the "Auction Supplement") or with the 2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement CDS Protocol ("Big Bang Protocol")[929] is a swap, and will not be considered a security-based swap or a mixed swap solely because the determination of the cash price to be paid is established through a securities or loan auction.[930]

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receipt of an exempted security under paragraph (12) [of the Exchange Act], as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in paragraph (29) [of the Exchange Act] as in effect on the date of enactment of the Futures Trading Act of 1982), unless such agreement, contract, or transaction is of the character of, or is commonly known in the trade as, a put, call, or other option."

927 The SEC also notes that there must either be an effective registration statement covering the transaction or an exemption under the Securities Act would need to be available for such physical delivery of securities and compliance issues under the Exchange Act would also need to be considered.

928 The Commissions are aware that the 2003 Definitions include "Cash Settlement" as a defined term and that such "Settlement Method" (also a defined term in the 2003 Definitions) works differently than auction settlement pursuant to the "Big Bang Protocol" or "Auction Supplement" (each as defined below). The Commissions' use of the term "cash settlement" in this section includes "Cash Settlement," as defined in the 2003 Definitions, and auction settlement, as described in the "Big Bang Protocol" or "Auction Supplement." See infra note 929 and accompanying text.

929 See ISDA, "2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement CDS Protocol," available at http://www.isda.org/bigbangprot/docs/Big-Bang-Protocol.pdf.

930 The possibility that such index CDS may, in fact, be physically settled if an auction is not held or if the auction fails would not affect the characterization of the index CDS.

In 2009, auction settlement, rather than physical settlement, became the default method of settlement for, among other types of CDS, index CDS on corporate issuers of securities.[931] The amount of the cash settlement is determined through an auction triggered by the occurrence of a credit event.[932] The Auction Supplement "hard wired" the mechanics of credit event auctions into the 2003 Definitions.[933] The Commissions understand that the credit event auction process that is part of the ISDA terms works as follows.

Following the occurrence of a credit event under a CDS, a determinations committee ("DC") established by ISDA, following a request by any party to a credit derivatives transaction that is subject to the Big Bang Protocol or Auction Supplement, will determine, among other matters: (i) whether and when a credit event occurred; (ii) whether or not to hold an auction to enable market participants to settle those of their credit derivatives transactions covered by the auction; (iii) the list of deliverable obligations of the relevant reference entity; and (iv) the necessary auction specific terms. The credit event auction takes place in two parts. In the first part of the auction, dealers submit physical settlement requests, which are requests to buy or sell any of the deliverable obligations (based on the dealer's needs and those of its counterparties), and an initial market midpoint price is created based on dealers' initial bids and offers. Following the establishment of the initial market midpoint, the physical settlement requests are then calculated to determine the amount of open interest.

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931 The Commissions understand that the Big Bang Protocol is followed for index CDS involving corporate debt obligations but is not followed for index CDS based on asset-backed securities, loan-only CDS, and certain other types of CDS contracts. To the extent that such other index CDS contain auction procedures similar to the auction procedures for corporate debt to establish the cash price to be paid, the Commissions also would not consider such other index CDS that are not based on narrow-based security indexes under the Commissions' rules to be mixed swaps.

932 The Commissions understand that other conditions may need to be satisfied as well for an auction to be held.

933 See supra note 48.

The aggregate amount of open interest is the basis for the second part of the auction. In the second part of the auction, dealers and investors can determine whether to submit limit orders and the levels of such limit orders. The limit orders, which are irrevocable, have a firm price in addition to size and whether it is a buy or sell order. The auction is conducted as a "dutch" auction, in which the open buy interests and open sell interests are matched.[934] The final price of the auction is the last limit order used to match against the open interest. The final price in the auction is the cash price used for purposes of calculating the settlement payments in respect of the orders to buy and sell the deliverable obligations and it is also used to determine the cash settlement payment under the CDS.

Comments

One commenter believed that a mandatory physical settlement provision in an index CDS based on a broad-based security index should not transform a swap into a mixed swap because (i) the SEC would retain jurisdiction over a transfer of securities as part of such settlement and (ii) application of the interpretation would be difficult since many instruments contemplate physical settlement but have a cash settlement option, or vice versa.[935]

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934 The second part of the credit event auction process involves offers and sales of securities that must be made in compliance with the provisions of the Securities Act and the Exchange Act. First, the submission of a physical settlement request constitutes an offer by the counterparty to either buy or sell any one of the deliverable obligations in the auction. Second, the submission of the irrevocable limit orders by dealers or investors are sales or purchases by such persons at the time of submission of the irrevocable limit order. Through the auction mechanism, where the open interest (which represents physical settlement requests) is matched with limit orders, buyers and sellers are matched. Finally, following the auction and determination of the final price, the counterparty who has submitted the physical delivery request decides which of the deliverable obligations will be delivered to satisfy the limit order in exchange for the final price. The sale of the securities in the auction occurs at the time the limit order is submitted, even though the identification of the specific deliverable obligation does not occur until the auction is completed.

935 See ISDA Letter.

As discussed above, the Commissions are restating the interpretation regarding mandatory physical settlement as provided in the Proposing Release. The Commissions' interpretation assures that the federal securities laws apply to the offer and sale of the underlying securities at the time the index CDS is sold.[936] The Commissions note the commenter's concerns but believe that as a result of the Commissions' understanding of the auction settlement process for index CDS, which is the primary method by which index CDS are settled and which addresses circumstances in which securities may be tendered in the auction process separate from the CDS settlement payment, it is not clear that there is in fact any significant number of circumstances in which such index CDS may be optionally physically settled. The Commissions note that this commenter did not elaborate on the circumstances in which the auction process would not apply.

I. Security-Based Swaps as Securities under the Exchange Act and Securities Act

Pursuant to the Dodd-Frank Act, a security-based swap is defined as a "security" under the Exchange Act[937] and Securities Act.[938] As a result, security-based swaps are subject to the Exchange Act and the Securities Act and the rules and regulations promulgated thereunder.[939]

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936 With respect to the applicability of the federal securities laws, the Commissions are concerned about the use of index CDS to effect distributions of securities without compliance with the requirements of the Securities Act. The Commissions recognize that with respect to transactions in security-based swaps by an issuer of an underlying security, an affiliate of the issuer, or an underwriter the offer and sale of the underlying security (in this case the security to be delivered) occur at the time that the security-based swap is offered and sold, not at the time of settlement. Further, the Commissions note the restrictions on offers and sales of security-based swaps to non-ECPs without compliance with the registration requirements of the Securities Act. See section 5(e) of the Securities Act, 15 U.S.C. 77e(d).

937 See section 761(a)(2) of the Dodd-Frank Act (inserting the term "security-based swap" into the definition of "security" in section 3a(10) of the Exchange Act, 15 U.S.C. 78c(a)(10)).

938 See section 768(a)(1) of the Dodd-Frank Act (inserting the term "security-based swap" into the definition of "security" in section 2(a)(1) of the Securities Act, 15 U.S.C. 77b(a)(1)).

The SEC did not provide interpretations in the Proposing Release on the application of the Exchange Act and the Securities Act, and the rules and regulations thereunder, to security-based swaps. However, the SEC solicited comment on whether additional interpretations may be necessary regarding the application of certain provisions of the Exchange Act and the Securities Act, and the rules and regulations promulgated thereunder, to security-based swaps. The SEC did not receive any comments with respect to this issue in the context of this rulemaking and is not providing any interpretations in this release.

IV. Mixed Swaps

A. Scope of the Category of Mixed Swap

The category of mixed swap is described, in both the definition of the term "security-based swap" in the Exchange Act and the definition of the term "swap" in the CEA, as a security-based swap that is also:

> based on the value of 1 or more interest or other rates, currencies, commodities, instruments of indebtedness, indices, quantitative measures, other financial or economic interest or property of any kind (other than a single security or a narrow-based security index), or the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence (other than an event described in subparagraph (A)(ii)(III) [of section 3(a)(68) of the Exchange Act]).[940]

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[939] Sections 761(a)(3) and (4) of the Dodd-Frank Act amend sections 3(a)(13) and (14) of the Exchange Act, 15 U.S.C. 78c(a)(13) and (14), and section 768(a)(3) of the Dodd-Frank Act adds section 2(a)(18) to the Securities Act, 15 U.S.C. 77b(a)(18), to provide that the terms "purchase" and "sale" of a security-based swap shall mean the "the execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing of rights or obligations under, a security-based swap, as the context may require."

[940] Section 3(a)(68)(D) of the Exchange Act, 15 U.S.C. 78c(a)(68)(D); section 1a(47)(D) of the CEA, 7 U.S.C. 1a(47)(D).

A mixed swap, therefore, is both a security-based swap and a swap.[941] As stated in the Proposing Release, the Commissions believe that the scope of mixed swaps is, and is intended to be, narrow.[942] Title VII establishes robust and largely parallel regulatory regimes for both swaps and security-based swaps and directs the Commissions to jointly prescribe such regulations regarding mixed swaps as may be necessary to carry out the purposes of the Dodd-Frank Act.[943] More generally, the Commissions believe the category of mixed swap was designed so that there would be no gaps in the regulation of swaps and security-based swaps. Therefore, in light of the statutory scheme created by the Dodd-Frank Act for swaps and security-based swaps, the Commissions believe the category of mixed swap covers only a small subset of Title VII instruments.

For example, a Title VII instrument in which the underlying references are the value of an oil corporation stock and the price of oil would be a mixed swap. Similarly, a Title VII instrument in which the underlying reference is a portfolio of both securities (assuming the portfolio is not an index or, if it is an index, that the index is narrow-based) and commodities would be a mixed swap. Mixed swaps also would include certain Title VII instruments called "best of" or "out performance" swaps that require a payment based on the higher of the performance of a security and a commodity (other than a security). As discussed elsewhere in this release, the Commissions also believe that certain Title VII instruments may be mixed swaps if they meet specified conditions.

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941 Id. The exclusion from the definition of the term "swap" for security-based swaps does not include security-based swaps that are mixed swaps. See section 1a(47)(B)(x) of the CEA, 7 U.S.C. 1a(47)(B)(x).

942 See Proposing Release at 29860.

943 See section 712(a)(8) of the Dodd-Frank Act.

The Commissions also believe that the use of certain market standard agreements in the documentation of Title VII instruments should not in and of itself transform a Title VII instrument into a mixed swap. For example, many instruments are documented by incorporating by reference market standard agreements. Such agreements typically set out the basis of establishing a trading relationship with another party but are not, taken separately, a swap or security-based swap. These agreements also include termination and default events relating to one or both of the counterparties; such counterparties may or may not be entities that issue securities.[944] The Commissions believe that the term "any agreement . . . based on . . . the occurrence of an event relating to a single issuer of a security," as provided in the definition of the term "security-based swap," was not intended to include such termination and default events relating to counterparties included in standard agreements that are incorporated by reference into a Title VII instrument.[945] Therefore, an instrument would not be simultaneously a swap and a security-based swap (and thus not a mixed swap) simply by virtue of having incorporated by reference a standard agreement, including default and termination events relating to counterparties to the Title VII instrument.

Comments

While the Commissions did not receive any comments on the interpretation regarding the scope of the category of mixed swaps, one commenter recommended that the Commissions require that market participants disaggregate mixed swaps and enter into separate simultaneous transactions so that they cannot employ mixed swaps to obscure the underlying substance of

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944 Those standard events include inter alia bankruptcy, breach of agreement, cross default to other indebtedness, and misrepresentations.

945 See section 3(a)(68)(A)(ii)(III) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(III).

transactions.[946] The Commissions are not adopting any rules or interpretations to require disaggregation of mixed swaps into their separate components, as the Dodd-Frank Act specifically contemplated that there would be mixed swaps comprised of both swaps and security-based swaps.

B. Regulation of Mixed Swaps

1. Introduction

The Commissions are adopting as proposed paragraph (a) of rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act to define a "mixed swap" in the same manner as the term is defined in both the CEA and the Exchange Act. The Commissions also are adopting as proposed two rules to address the regulation of mixed swaps. First, paragraph (b) of rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act will provide a regulatory framework with which parties to bilateral uncleared mixed swaps (i.e., mixed swaps that are neither executed on or subject to the rules of a DCM, NSE, SEF, security-based SEF, or FBOT nor cleared through a DCO or clearing agency), as to which at least one of the parties is dually registered with both Commissions, will need to comply. Second, paragraph (c) of rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act establishes a process for persons to request that the Commissions issue a joint order permitting such persons (and any other person or persons that subsequently lists, trades, or clears that class of mixed swap)[947] to comply, as to parallel provisions[948] only,

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946 See Better Markets Letter.

947 All references to Title VII instruments in parts IV and VI shall include a class of such Title VII instruments as well. For example, a "class" of Title VII instrument would include instruments that are of similar character and provide substantially similar rights and privileges.

948 As stated in paragraph (c) of proposed rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act, "parallel provisions" means comparable provisions of the CEA and the Exchange Act that were added or amended by Title VII with respect to security-based swaps and swaps, and the rules and regulations thereunder.

with specified parallel provisions of either the CEA or the Exchange Act, and related rules and regulations (collectively "specified parallel provisions"), instead of being required to comply with parallel provisions of both the CEA and the Exchange Act.

2. Bilateral Uncleared Mixed Swaps Entered Into by Dually-Registered Dealers or Major Participants

Swap dealers and major swap participants will be comprehensively regulated by the CFTC, and security-based swap dealers and major security-based swap participants will be comprehensively regulated by the SEC.[949] The Commissions recognize that there may be differences in the requirements applicable to swap dealers and security-based swap dealers, or major swap participants and major security-based swap participants, such that dually-registered market participants may be subject to potentially conflicting or duplicative regulatory requirements when they engage in mixed swap transactions. In order to assist market participants in addressing such potentially conflicting or duplicative requirements, the Commissions are adopting, as proposed with one modification explained below, rules that will permit dually-registered swap dealers and security-based swap dealers and dually-registered major swap participants and major security-based swap participants to comply with an alternative regulatory regime when they enter into certain mixed swaps under specified circumstances. The Commissions received no comments on the proposed rules.

Accordingly, as adopted, paragraph (b) of rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act provide that a bilateral uncleared mixed swap,[950] where at least one party is

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[949] Section 712(a)(7)(A) of the Dodd-Frank Act requires the Commissions to treat functionally or economically similar entities in a similar manner.

[950] Under paragraph (b) of rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act, a "bilateral uncleared mixed swap" will be a mixed swap that: i) is neither executed on nor subject to the rules of a DCM, NSE, SEF, security-based SEF, or FBOT; and ii) will not be submitted to a DCO or registered or exempt clearing agency to be cleared. To the extent that a mixed swap 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 SEC rules and regulations promulgated thereunder). The rules as adopted also provide that such mixed swaps will be subject to only the following provisions of the CEA (and CFTC rules and regulations promulgated thereunder):

- Examinations and information sharing: CEA sections 4s(f) and 8;[951]
- Enforcement: CEA sections 2(a)(1)(B), 4(b), 4b, 4c, 4s(h)(1)(A), 4s(h)(4)(A), 6(c), 6(d), 6c, 6d, 9, 13(a), 13(b) and 23;[952]
- Reporting to an SDR: CEA section 4r;[953]
- Real-time reporting: CEA section 2(a)(13);[954]
- Capital: CEA section 4s(e);[955] and
- Position Limits: CEA section 4a.[956]

The Commissions are modifying proposed rule 1.9(b)(3)(i) under the CEA and Rule 3a68-4(b)(3)(i) to include additional "enforcement" authority. Specifically, as adopted, the rules provide that such swaps will be subject to the anti-fraud, anti-manipulation, and other provisions

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subject to the mandatory clearing requirement (see section 2(h)(1)(A) of the CEA, 7 U.S.C. 2(h)(1)(A), and section 3C(a)(1) of the Exchange Act) (and where a counterparty is not eligible to rely on the end-user exclusion from the mandatory clearing requirement (see section 2(h)(7) of the CEA, 7 U.S.C. 2(h)(7), and section 3C(g) of the Exchange Act)), this alternative regulatory treatment will not be available.

951 7 U.S.C. 6s(f) and 12, respectively.

952 7 U.S.C. 2(a)(1)(B), 6(b), 6b, 6c, 6s(h)(1)(A), 6s(h)(4)(A), 9 and 15, 13b, 13a-1, 13a-2, 13, 13c(a), 13c(b), and 26, respectively.

953 7 U.S.C. 6r.

954 7 U.S.C. 2(a)(13).

955 7 U.S.C. 6s(e).

956 7 U.S.C. 6a.

of the business conduct standards in CEA sections 4s(h)(1)(A) and 4s(h)(4)(A) and the rules promulgated thereunder for mixed swaps.[957] Rule 23.410 under the CEA,[958] adopted under CEA section 4s(h)(1)(A), applies to swap dealers and major swap participants and prohibits fraud, manipulation, and other abusive practices and also imposes requirements regarding the confidential treatment of counterparty information, which will apply to mixed swaps.[959]

As discussed in the Proposing Release, the Commissions believe that paragraph (b) of rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act will address potentially conflicting or duplicative regulatory requirements for dually-registered dealers and major participants that are subject to regulation by both the CFTC and the SEC, while requiring dual registrants to comply with the regulatory requirements the Commissions believe are necessary to provide sufficient regulatory oversight for mixed swap transactions entered into by such dual registrants. The CFTC also believe that paragraph (b) of rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act will provide clarity to dually-registered dealers and major participants, who are subject to regulation by both the CFTC and the SEC, as to the requirements of each Commission that will apply to their bilateral uncleared mixed swaps.

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957 7 U.S.C. 6s(h)(1)(A) and 6s(h)(4)(A).

958 17 CFR 23.410.

959 Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 FR 9734, 9751-9755 (Feb. 17, 2012). The Commissions note that, while the introductory text of rule 1.9(b)(3)(i)(A) through (F) under the CEA and rule 3a68-4(b)(3)(i)(A) through (F) under the Exchange Act characterizes the cited CEA sections (e.g., "enforcement", "capital," etc.), such characterization is meant as guidance only. For example, final rule 1.9(b)(3)(i)(B) uses the word "enforcement" to characterize certain of the cited CEA sections and the rules and regulations promulgated thereunder that prohibit fraud, manipulation, or abusive practices. Other cited provisions, such as the Whistleblower protections under CEA section 23, or the related rules and regulations, such as requirements to keep counterparty information confidential under rule 23.410(c) under the CEA, 17 CFR 23.410(c), are similarly enforcement provisions in that they protect market participants from fraudulent or other abusive practices.

3. Regulatory Treatment for Other Mixed Swaps

Because mixed swaps are both security-based swaps and swaps,[960] absent a joint rule or order by the Commissions permitting an alternative regulatory approach, persons who desire or intend to list, trade, or clear a mixed swap (or class thereof) will be required to comply with all the statutory provisions in the CEA and the Exchange Act (including all the rules and regulations thereunder) that were added or amended by Title VII with respect to swaps or security-based swaps.[961] Such dual regulation may not be appropriate in every instance and may result in potentially conflicting or duplicative regulatory requirements. However, before the Commissions can determine the appropriate regulatory treatment for mixed swaps (other than the treatment discussed above), the Commissions will need to understand better the nature of the mixed swaps that parties want to trade. As a result, the Commissions proposed paragraph (c) of rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act to establish a process pursuant to which any person who desires or intends to list, trade, or clear a mixed swap (or class thereof) that is not subject to the provisions of paragraph (b) of the rules (i.e., bilateral uncleared mixed swaps entered into by at least one dual registrant) may request the Commissions to publicly issue a joint order permitting such person (and any other person or persons that subsequently lists, trades, or clears that class of mixed swap) to comply, as to parallel provisions only, with the specified parallel provisions, instead of being required to comply with parallel provisions of both

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960 See supra note 10.

961 Because security-based swaps are also securities, compliance with the federal securities laws and rules and regulations thereunder (in addition to the provisions of the Dodd-Frank Act and the rules and regulations thereunder) will also be required. To the extent one of the Commissions has exemptive authority with respect to other provisions of the CEA or the federal securities laws and the rules and regulations thereunder, persons may submit separate exemptive requests or rulemaking petitions regarding those provisions to the relevant Commission.

the CEA and the Exchange Act.[962] The Commissions received no comments on the proposed rules and are adopting the rules as proposed.

As adopted, paragraph (c) of rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act further provide that a person submitting such a request to the Commissions must provide the Commissions with:

i) all material information regarding the terms of the specified, or specified class of, mixed swap;

ii) the economic characteristics and purpose of the specified, or specified class of, mixed swap;

iii) the specified parallel provisions, and the reasons the person believes such specified parallel provisions would be appropriate for the mixed swap (or class thereof);

iv) an analysis of (1) the nature and purposes of the parallel provisions that are the subject of the request; (2) the comparability of such parallel provisions; and (3) the extent of any conflicts or differences between such parallel provisions; and

v) such other information as may be requested by either of the Commissions.

This provision is intended to provide the Commissions with sufficient information regarding the mixed swap (or class thereof) and the proposed regulatory approach to make an informed determination regarding the appropriate regulatory treatment of the mixed swap (or class thereof).

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[962] Other than with respect to the specified parallel provisions with which such persons may be permitted to comply instead of complying with parallel provisions of both the CEA and the Exchange Act, any other provision of either the CEA or the federal securities laws that applies to swaps or security-based swaps will continue to apply.

As adopted, paragraph (c) of rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act also will allow a person to withdraw a request regarding the regulation of a mixed swap at any time prior to the issuance of a joint order by the Commissions. This provision is intended to permit persons to withdraw requests that they no longer need. This, in turn, will save the Commissions time and staff resources.

As adopted, paragraph (c) of rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act further provide that in response to a request pursuant to the rules, the Commissions may jointly issue an order, after public notice and opportunity for comment, permitting the requesting person (and any other person or persons that subsequently lists, trades, or clears that class of mixed swap) to comply, as to parallel provisions only, with the specified parallel provisions (or another subset of the parallel provisions that are the subject of the request, as the Commissions determine is appropriate), instead of being required to comply with parallel provisions of both the CEA and the Exchange Act. In determining the contents of such a joint order, the Commissions can consider, among other things:

i) the nature and purposes of the parallel provisions that are the subject of the request;

ii) the comparability of such parallel provisions; and

iii) the extent of any conflicts or differences between such parallel provisions.

Finally, as adopted, paragraph (c) of rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act require the Commissions, if they determine to issue a joint order pursuant to these rules, to do so within 120 days of receipt of a complete request (with such 120-day period being tolled during the pendency of a request for public comment on the proposed interpretation). If the Commissions do not issue a joint order within the prescribed time period, the rules require that each Commission publicly provide the reasons for not having done so. Paragraph (c) of rule

1.9 under the CEA and rule 3a68-4 under the Exchange Act makes clear that nothing in the rules requires either Commission to issue a requested joint order regarding the regulation of a particular mixed swap (or class thereof).

These provisions are intended to provide market participants with a prompt review of requests for a joint order regarding the regulation of a particular mixed swap (or class thereof). The rules also will provide transparency and accountability by requiring that at the end of the review period, the Commissions issue the requested order or publicly state the reasons for not doing so.

V. Security-Based Swap Agreements

A. Introduction

SBSAs are swaps over which the CFTC has regulatory and enforcement authority but for which the SEC also has antifraud and certain other authority.[963] The term "security-based swap agreement" is defined as a "swap agreement" (as defined in section 206A of the GLBA[964]) of which "a material term is based on the price, yield, value, or volatility of any security or any

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963 See section 3(a)(78) of the Exchange Act, 15 U.S.C. 78c(a)(78); CEA section 1a(47)(A)(v), 7 U.S.C. 1a(47)(A)(v). The Dodd-Frank Act provides that certain CFTC registrants, such as DCOs and SEFs, will keep records regarding SBSAs open to inspection and examination by the SEC upon request. See, e.g., sections 725(e) and 733 of the Dodd-Frank Act. The Commissions are committed to working cooperatively together regarding their dual enforcement authority over SBSAs.

964 15 U.S.C. 78c note. The Dodd-Frank Act amended the definition of "swap agreement" in section 206A of the GLBA to eliminate the requirements that a swap agreement be between ECPs, as defined in section 1a(18)(C) of the CEA, 7 U.S.C. 1a(18)(C), and subject to individual negotiation. See section 762(b) of the Dodd-Frank Act. Sections 762(c) and (d) of the Dodd-Frank Act also made conforming amendments to the Exchange Act and the Securities Act to reflect the changes to the regulation of "swap agreements" that are either "security-based swaps" or "security-based swap agreements" under the Dodd-Frank Act.

group or index of securities, including any interest therein" but does not include a security-based swap.[965]

B. Swaps that are Security-Based Swap Agreements

Although the Commissions believe it is not possible to provide a bright line test to define an SBSA, the Commissions believe that it is possible to clarify that certain types of swaps clearly fall within the definition of SBSA. For example, as the Commissions noted in the Proposing Release, a swap based on an index of securities that is not a narrow-based security index (i.e., a broad-based security index) would fall within the definition of an SBSA under the Dodd-Frank Act.[966] Similarly, an index CDS that is not based on a narrow-based security index or on the "issuers of securities in a narrow-based security index," as defined in rule 1.3(zzz) under the CEA and rule 3a68-1a under the Exchange Act, would be an SBSA. In addition, a swap based

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965 See section 3(a)(78) of the Exchange Act, 15 U.S.C. 78c(a)(78). The CFMA amended the Exchange Act and the Securities Act to exclude swap agreements from the definitions of security in those statutes but subjected "security-based swap agreements," as defined in section 206B of the GLBA, 15 U.S.C. 78c note, to the antifraud, anti-manipulation, and anti-insider trading provisions of the Exchange Act and Securities Act. See CFMA, supra note 697, title III.

The CEA does not contain a stand-alone definition of "security-based swap agreement," but includes the definition instead in subparagraph (A)(v) of the swap definition in CEA section 1a(47), 7 U.S.C. 1a(47). The only difference between these definitions is that the definition of SBSA in the Exchange Act specifically excludes security-based swaps (see section 3(a)(78)(B) of the Exchange Act, 15 U.S.C. 78c(a)(78)(B)), while the definition of SBSA in the CEA does not contain a similar exclusion. Instead, the exclusion for security-based swaps is placed in the general exclusions from the swap definition in the CEA (see CEA section 1a(47)(B)(x), 7 U.S.C. 1a(47)(B)(x)).

966 See Proposing Release at 29863. Swaps based on indexes that are not narrow-based security indexes are not included within the definition of the term security-based swap under the Dodd-Frank Act. See section 3(a)(68)(A)(ii)(I) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(I), and discussion supra part 0. However, such swaps have a material term that is "based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein," and therefore such swaps fall within the SBSA definition.

on a U.S. Treasury security or on certain other exempted securities other than municipal securities would fall within the definition of an SBSA under the Dodd-Frank Act.[967]

The Commissions received no comments on the examples provided in the Proposing Release regarding SBSAs. Accordingly, the Commissions are not further defining SBSA beyond restating the examples above.[968]

C. Books and Records Requirements for Security-Based Swap Agreements

The Commissions are adopting rule 1.7 under the CEA and rule 3a68-3 under the Exchange Act, as proposed, to clarify that there will not be additional books and records requirements regarding SBSAs other than those that are required for swaps. The Dodd-Frank Act provides that the Commissions shall adopt rules regarding the books and records required to be kept for SBSAs.[969] As discussed above, SBSAs are swaps over which the CFTC has

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967 Swaps on U.S. Treasury securities that do not have any other underlying references involving securities are expressly excluded from the definition of the term "security-based swap" under the Dodd-Frank Act. See section 3(a)(68)(C) of the Exchange Act, 15 U.S.C. 78c(a)(68)(C) (providing that an agreement, contract, or transaction that would be a security-based swap solely because it references, is based on, or settles through the delivery of one or more U.S. Treasury securities (or certain other exempted securities) is excluded from the security-based swap definition). However, swaps on U.S. Treasury securities or on other exempted securities covered by subparagraph (C) of the security-based swap definition have a material term that is "based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein," and therefore fall within the SBSA definition.

968 The Commissions noted that certain transactions that were not "security-based swap agreements" under the CFMA are nevertheless included in the definition of security-based swap under the Dodd-Frank Act – including, for example, a CDS on a single loan. Accordingly, although such transactions were not subject to insider trading restrictions under the CFMA, under the Dodd-Frank Act they are subject to the federal securities laws, including insider trading restrictions.

969 Specifically, section 712(d)(2)(B) of the Dodd-Frank Act requires the Commissions, in consultation with the Board, to jointly adopt rules governing books and records requirements for SBSAs by persons registered as SDRs under the CEA, including uniform rules that specify the data elements that shall be collected and maintained by each SDR. Similarly, section 712(d)(2)(C) of the Dodd-Frank Act requires the Commissions, in consultation with the Board, to jointly adopt rules governing books and records for SBSAs, including daily trading records, for swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants.

regulatory authority, but for which the SEC has antifraud, anti-manipulation, and certain other authority. In the Proposing Release, the Commissions noted that the CFTC had proposed rules governing books and records for swaps, which would apply to swaps that also are SBSAs.[970] The Commissions further stated their belief that those proposed rules would provide sufficient books and records regarding SBSAs, and that additional books and records requirements were not necessary for SBSAs.[971] The Commissions received no comments on the proposed rules.

Accordingly, rule 1.7 under the CEA and rule 3a68-3 under the Exchange Act provide that persons registered as SDRs under the CEA and the rules and regulations thereunder are not required to i) keep and maintain additional books and records regarding SBSAs other than the books and records regarding swaps that SDRs would be required to keep and maintain pursuant to the CEA and rules and regulations thereunder; and ii) collect and maintain additional data regarding SBSAs other than the data regarding swaps that SDRs are required to collect and maintain pursuant to the CEA and rules and regulations thereunder. In addition, rule 1.7 under the CEA and rule 3a68-3 under the Exchange Act provide that persons registered as swap dealers

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970 See Swap Data Recordkeeping and Reporting Requirements, 75 FR 76573 (Dec. 8, 2010) (proposed rules regarding swap data recordkeeping and reporting requirements for SDRs, DCOs, DCMs, SEFs, swap dealers, major swap participants, and swap counterparties who are neither swap dealers nor major swap participants); See Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants, 75 FR 76666 (Dec. 9, 2010) (proposed rules regarding reporting and recordkeeping requirements and daily trading records requirements for swap dealers and major swap participants). These rules have been adopted by the CFTC. See Swap Data Recordkeeping and Reporting Requirements, 77 FR 2136 (Jan. 13, 2012) (final rules regarding swap data recordkeeping and reporting requirements for SDRs, DCOs, DCMs, SEFs, swap dealers, major swap participants, and swap counterparties who are neither swap dealers or major swap participants); See Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants, 77 FR 20128 (Apr. 3, 2012) (final rules regarding reporting and recordkeeping requirements and daily trading records requirements for swap dealers and major swap participants).

971 See Proposing Release at 29863.

or major swap participants under the CEA and the rules and regulations thereunder, or registered as security-based swap dealers or major security-based swap participants under the Exchange Act and the rules and regulations thereunder, are not required to keep and maintain additional books and records, including daily trading records, regarding SBSAs other than the books and records regarding swaps that those persons are required to keep and maintain pursuant to the CEA and the rules and regulations thereunder.[972]

VI. Process for Requesting Interpretations of the Characterization of a Title VII Instrument

The Commissions recognize that there may be Title VII instruments (or classes of Title VII instruments) that may be difficult to categorize definitively as swaps or security-based swaps. Further, because mixed swaps are both swaps and security-based swaps, identifying a mixed swap may not always be straightforward.

Section 712(d)(4) of the Dodd-Frank Act provides that any interpretation of, or guidance by, either the CFTC or SEC regarding a provision of Title VII shall be effective only if issued jointly by the Commissions (after consultation with the Board) on issues where Title VII requires the CFTC and SEC to issue joint regulations to implement the provision. The Commissions believe that any interpretation or guidance regarding whether a Title VII instrument is a swap, a security-based swap, or both (i.e., a mixed swap), must be issued jointly pursuant to this requirement.

The Commissions proposed rules in the Proposing Release to establish a process for interested persons to request a joint interpretation by the Commissions regarding whether a

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[972] Rule 1.7 under the CEA and Rule 3a69-3 under the Exchange Act provide that the term "security-based swap agreement" has the meaning set forth in CEA section 1a(47)(A)(v), 7 U.S.C. 1a(47)(A)(v), and section 3(a)(78) of the Exchange Act, 15 U.S.C. 78c(a)(78), respectively.

particular Title VII instrument (or class of Title VII instruments) is a swap, a security-based swap, or both (i.e., a mixed swap).[973] The Commissions are adopting the rules as proposed.

Section 718 of the Dodd-Frank Act establishes a process for determining the status of "novel derivative products" that may have elements of both securities and futures contracts. Section 718 of the Dodd-Frank Act provides a useful model for a joint Commission review process to appropriately categorize Title VII instruments. As a result, the final rules include various attributes of the process established in section 718 of the Dodd-Frank Act. In particular, to permit an appropriate review period that provides sufficient time to ensure federal regulatory interests are satisfied that also does not unduly delay the introduction of new financial products, the adopted process, like the process established in section 718, includes a deadline for responding to a request for a joint interpretation.[974]

The Commissions are adopting rule 1.8 under the CEA and rule 3a68-2 under the Exchange Act that establish a process for parties to request a joint interpretation regarding the characterization of a particular Title VII instrument (or class thereof). Specifically, the final rules provide that any person may submit a request to the Commissions to provide a public joint interpretation of whether a particular Title VII instrument is a swap, a security-based swap, or both (i.e., a mixed swap).[975]

The final rules afford market participants with the opportunity to obtain greater certainty from the Commissions regarding the regulatory status of particular Title VII instruments under

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973 See Proposing Release at 29864-65.

974 The Commissions note that section 718 of the Dodd-Frank Act is a separate process from the process the Commissions are adopting, and that any future interpretation involving the process under section 718 would not affect the process being adopted here, nor will any future interpretation involving the process adopted here affect the process under section 718.

975 See paragraph (a) of rule 1.8 under the CEA and rule 3a68-2 under the Exchange Act.

the Dodd-Frank Act. This provision should decrease the possibility that market participants inadvertently might fail to meet the regulatory requirements applicable to a particular Title VII instrument.

The final rules provide that a person requesting an interpretation as to the characterization of a Title VII instrument as a swap, a security-based swap, or both (i.e., a mixed swap), must provide the Commissions with the person's determination of the characterization of the instrument and supporting analysis, along with certain other documentation.[976] Specifically, the person must provide the Commissions with the following information:

- All material information regarding the terms of the Title VII instrument;
- A statement of the economic characteristics and purpose of the Title VII instrument;
- The requesting person's determination as to whether the Title VII instrument should be characterized as a swap, a security-based swap, or both (i.e., a mixed swap), including the basis for such determination; and
- Such other information as may be requested by either Commission.

This provision should provide the Commissions with sufficient information regarding the Title VII instrument at issue so that the Commissions can appropriately evaluate whether it is a swap, a security-based swap, or both (i.e., a mixed swap).[977] By requiring that requesting persons furnish a determination regarding whether they believe the Title VII instrument is a swap, a security-based swap, or both (i.e., a mixed swap), including the basis for such

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976 See paragraph (b) of rule 1.8 under the CEA and rule 3a68-2 under the Exchange Act.

977 The Commissions also may use this information to issue (within the timeframe for issuing a joint interpretation) a joint notice of proposed rulemaking to further define one or more of the terms "swap," "security-based swap," or "mixed swap." See paragraph (f) of rule 1.8 under the CEA and rule 3a68-2 under the Exchange Act, which are discussed below.

determination, this provision also will assist the Commissions in more quickly identifying and addressing the relevant issues involved in arriving at a joint interpretation of the characterization of the instrument.

The final rules provide that a person may withdraw a request at any time prior to the issuance of a joint interpretation or joint notice of proposed rulemaking by the Commissions.[978] Notwithstanding any such withdrawal, the Commissions may provide an interpretation regarding the characterization of the Title VII instrument that was the subject of a withdrawn request.

This provision will permit parties to withdraw requests for which the party no longer needs an interpretation. This, in turn, should save the Commissions time and staff resources. If the Commissions believe such an interpretation is necessary regardless of a particular request for interpretation, however, the Commissions may provide such a joint interpretation of their own accord.

The final rules provide that if either Commission receives a proposal to list, trade, or clear an agreement, contract, or transaction (or class thereof) that raises questions as to the appropriate characterization of such agreement, contract, or transaction (or class thereof) as a swap, security-based swap, or both (i.e., a mixed swap), the receiving Commission promptly shall notify the other.[979] This provision of the final rules further provides that either Commission, or their Chairmen jointly, may submit a request for a joint interpretation to the Commissions as to the characterization of the Title VII instrument where no external request has been received.

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978 See paragraph (c) of rule 1.8 under the CEA and rule 3a68-2 under the Exchange Act.

979 See paragraph (d) of rule 1.8 under the CEA and rule 3a68-2 under the Exchange Act.

This provision is intended to ensure that Title VII instruments do not fall into regulatory gaps and will help the Commissions to fulfill their responsibility to oversee the regulatory regime established by Title VII of the Dodd-Frank Act by making sure that Title VII instruments are appropriately characterized, and thus appropriately regulated. An agency, or their Chairmen jointly, submitting a request for an interpretation as to the characterization of a Title VII instrument under this paragraph will be required to submit the same information as, and could withdraw a request in the same manner as, a person submitting a request to the Commissions. The bases for these provisions are set forth above with respect to paragraphs (b) and (c) of the final rules.

The final rules require that the Commissions, if they determine to issue a joint interpretation as to the characterization of a Title VII instrument, do so within 120 days of receipt of the complete external or agency submission (unless such 120-day period is tolled during the pendency of a request for public comment on the proposed interpretation).[980] If the Commissions do not issue a joint interpretation within the prescribed time period, the final rules require that each Commission publicly provide the reasons for not having done so within such prescribed time period. This provision of the final rules also incorporates the mandate of the Dodd-Frank Act that any joint interpretation by the Commissions be issued only after consultation with the Board of Governors of the Federal Reserve System.[981] Finally, the rules make clear that nothing requires either Commission to issue a requested joint interpretation regarding the characterization of a particular instrument.

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980 See paragraph (e) of rule 1.8 under the CEA and rule 3a68-2 under the Exchange Act. This 120-day period is based on the timeframe set forth in section 718(a)(3) of the Dodd-Frank Act.

981 See section 712(d)(4) of the Dodd-Frank Act.

These provisions are intended to assure market participants a prompt review of submissions requesting a joint interpretation of whether a Title VII instrument is a swap, a security-based swap, or both (i.e., a mixed swap). The final rules also provide transparency and accountability by requiring that at the end of the review period, the Commissions issue the requested interpretation or publicly state the reasons for not doing so.

The final rules permit the Commissions, in lieu of issuing a requested interpretation, to issue (within the timeframe for issuing a joint interpretation) a joint notice of proposed rulemaking to further define one or more of the terms "swap," "security-based swap," or "mixed swap."[982] Under the final rules, the 120-day period to provide a response will be tolled during the pendency of a request for public comment on any such proposed interpretation. Such a rulemaking, as required by Title VII, would be required to be done in consultation with the Board of Governors of the Federal Reserve System. This provision is intended to provide the Commissions with needed flexibility to address issues that may be of broader applicability than the particular Title VII instrument that is the subject of a request for a joint interpretation.

Comments

Three commenters discussed the proposed process for requesting interpretations of the characterization of a Title VII instrument,[983] and while supporting such joint interpretive process, suggested certain changes, including extending it to SBSAs,[984] mandating that the Commissions

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982 See paragraph (f) of rule 1.8 under the CEA and rule 3a68-2 under the Exchange Act.

983 See Better Markets Letter; CME Letter; and SIFMA Letter.

984 See Better Markets Letter.

issue a response to a request,[985] and suggesting that the Commissions should seek expedited judicial review in the event the Commissions do not agree on the interpretation.[986]

The Commissions are adopting the final rules as proposed and are not including SBSAs in the process. The joint interpretive process is intended to decrease the possibility that market participants inadvertently might fail to meet regulatory requirements that are applicable to swaps, security-based swaps, or mixed swaps and, as such, provides a mechanism for market participants to request whether an instrument will be regulated by the CFTC, the SEC, or both. However, the Commissions do not believe it is appropriate to predetermine whether particular swaps also are SBSAs as SBSAs are already swaps over which the CFTC has regulatory and enforcement authority and as to which the SEC has antifraud and certain other related authorities.[987] Predetermining whether particular swaps may be SBSAs under this process is not needed to provide certainty as to the applicable regulatory treatment of these instruments.

The Commissions also are retaining in the final rules the framework for providing or not providing joint interpretations. As noted above, section 718 of the Dodd-Frank Act contains a framework for evaluating novel derivative products that may have elements of both securities and futures contracts (other than swaps, security-based swaps or mixed swaps). The Commissions believe that establishing a joint interpretive process for swaps, security-based

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985 See CME Letter and SIFMA Letter. These commenters suggested that the Commissions should be required to issue a joint interpretation for all joint interpretive requests that are not withdrawn. Id.

986 See CME Letter. This commenter suggested that the Commissions should seek expedited judicial review to determine the characterization of a Title VII instrument if the Commissions cannot agree on a joint interpretation. Id.

987 See section 3(a)(78) of the Exchange Act, 15 U.S.C. 78c(a)(78), and section 1a(47)(A)(v) of the CEA, 7 U.S.C. 1a(47)(A)(v). The Dodd-Frank Act provides that certain CFTC registrants, such as DCOs and SEFs, will keep records regarding security-based swap agreements open to inspection and examination by the SEC upon request. See, e.g., sections 725(e) and 733 of the Dodd-Frank Act.

swaps and mixed swaps that is modeled in part on this statutory framework should facilitate providing interpretations to market participants in a timely manner, if the Commissions determine to do so. Establishing a process by rule will provide market participants with an understandable method by which they can request an interpretation from the Commissions. As the Commissions have the authority, but not the obligation, under the Dodd-Frank Act to further define the terms "swap," "security-based swap," and "mixed swap," the Commissions are retaining the flexibility in the interpretive process rules to decide whether or not to issue joint interpretations. The Commissions believe, however, that it is appropriate to advise market participants of the reasons why such interpretation is not being issued and the final rules retain the requirement that the Commissions publicly explain the reasons for not issuing a joint interpretation.

Further, the Commissions are not revising the final rules to provide for expedited judicial review. The Dodd-Frank Act does not contain any provision that provides for expedited judicial review if the Commissions do not issue a joint interpretation with respect to a Title VII instrument. Although the Commissions note that section 718 of the Dodd-Frank Act contains a statutorily mandated expedited judicial review of one of the Commission's actions (if sought by the other Commission) regarding novel derivative products that may have elements of both securities and futures contracts, such statutory provision does not apply to Title VII instruments.[988] Further, Title VII provides flexibility to the Commissions to determine the

[988] The Commissions note that judicial review provisions in section 718 relating to the status of novel derivative products only provide that either Commission (either the SEC or the CFTC) has the right to petition for review of a final order of the other Commission with respect to novel derivative products that may have elements of both securities and futures that affects jurisdictional issues. Nothing in section 718 requires that the Commissions issue exemptions or interpretations pursuant to such section or provides any person other than the Commissions the right to petition for Court review of a Commission order issued pursuant to section 718.

methods by which joint interpretations are provided. Title VII does not contain any required expedited judicial review of Commission actions, and the Commissions do not have the authority to require expedited judicial review under Title VII, with respect to a Title VII instrument. Accordingly, the Commissions do not believe that including such a provision is appropriate in the context of providing interpretations to market participants regarding the definitions of swap, security-based swap, or mixed swap.

Two commenters were concerned about the length of the review period and believed that the Commissions should shorten such time period.[989] The Commissions are not modifying the final rules from those proposed with respect to the length of the review period. The 120-day review period is based on a timeframe established by Congress with respect to determining the status of novel derivative products.[990] The Commissions believe that this length of the review period also is appropriate for other derivative products such as swaps, security-based swaps, and mixed swaps. Further, the Commissions believe the 120-day review period is necessary to enable the Commissions to obtain the necessary information regarding a Title VII instrument,

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989 See CME Letter and Markit Letter. One of these commenters suggested that the Commissions should reduce the 120-day review period to 30 days because the value of receiving a joint interpretation would be negated if a market participant had to wait 120 days. This commenter also suggested that foreign competitors will gain a competitive advantage to U.S. market participants because they will not need to wait for a joint interpretation before trading similar or identical products. See CME Letter. The Commissions note that to the extent foreign competitors are engaging in swap and security-based swap transactions subject to either Commission's jurisdiction, they will be subject to the same process for requesting interpretations of the characterization of Title VII instruments as U.S. market participants. The other commenter requested that the Commissions issue a joint interpretation for each "widely-utilized index," at the time of the index series' launch, within a two-week period rather than the proposed 120-day period for novel derivative products under section 718 of the Dodd-Frank Act. This commenter did not recognize that the joint interpretive process would be available in this case, and that it may be initiated by an index provider. See paragraph (a) of rule 1.8 under the CEA and rule 3a68-2 under the Exchange Act (providing that "[a]ny person" may submit a request for a joint interpretation). See Markit Letter.

990 See section 718(a)(3) of the Dodd-Frank Act.

thoroughly analyze the instrument, and formulate any joint interpretation regarding the instrument. In a related comment, one commenter suggested that the Commissions allow a requesting party, while awaiting a joint interpretation, to make a good faith characterization of a particular Title VII instrument and engage in transactions based on such characterization.[991] The Commissions believe that it is essential that the characterization of an instrument be established prior to any party engaging in the transactions so that the appropriate regulatory schemes apply. The Commissions do not believe that allowing market participants to make such a determination as to the status of a product is either appropriate or consistent with the statutory provisions providing for the Commissions to further define the terms "swap," "security-based swap" and "mixed swap." Further, allowing market participants to determine the status of a product could give rise to regulatory arbitrage and inconsistent treatment of similar products.

Finally, some commenters expressed concern about the public availability of information regarding the joint interpretive process and asked that the parties be able to seek confidential treatment of their submissions.[992] The Commissions note that under existing rules of both Commissions, requesting parties may seek confidential treatment for joint interpretive requests from the SEC and the CFTC in accordance with the applicable existing rules relating to

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991 See SIFMA Letter. This commenter also suggested that while the requesting party, and all other market participants, would be bound by the joint interpretation when issued, they should not face retroactive re-characterization of a transaction executed during the review period and prior to the issuance of the joint interpretation. Id.

992 One commenter suggested that the Commissions should permit the parties seeking a joint interpretation to request confidential treatment from the Commissions during the course of the review period in order to protect proprietary information and deal structures. See SIFMA Letter. Another commenter suggested that the Commissions should make public all requests for joint interpretations, any guidance actually provided in response to such requests, and any decisions not to provide guidance in response to such requests (along with an explanation of the grounds for any such decision). See Better Markets Letter.

confidential treatment of information.[993] The Commissions also note that even if confidential treatment has been requested, all joint interpretive requests, as well all joint interpretations and any decisions not to issue a joint interpretation (along with the explanation of the grounds for such decision), will be made publicly available at the conclusion of the review period.[994]

VII. Anti-Evasion

A. CFTC Anti-Evasion Rules

1. CFTC's Anti-Evasion Authority

a) Statutory Basis for the Anti-Evasion Rules

Pursuant to the authority in sections 721(c) and 725(g)(2) of the Dodd-Frank Act and CEA sections 1a(47)(E) and 2(i),[995] the CFTC is promulgating the anti-evasion rules as they were proposed and restating the accompanying interpretation with modifications in response to

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993 See 17 CFR 200.81 and 17 CFR 140.98. The Commissions note that the joint interpretive process is intended to provide, among other things, notification to all market participants as to the regulatory classification of a particular Title VII instrument. In this regard, the Commissions do not believe it is appropriate to provide a joint interpretation only to the market participants requesting the interpretation, while delaying publication of the same joint interpretation to market participants generally. Therefore, CFTC staff will not exercise its discretion under 17 CFR 140.98(b) to delay publication of a joint interpretation. SEC staff does not have discretion under 17 CFR 200.81(b) to delay publication of a joint interpretation.

994 The CFTC's publication of any joint interpretative request and the joint interpretation itself will be subject to the restrictions of section 8 of the CEA. See 7 U.S.C. 12. Subject to limited exceptions, CEA section 8 generally restricts the CFTC from publishing "data and information that would separately disclose the business transactions or market positions of any person and trade secrets or names of customers…" Id. The CFTC and its staff have a long history of providing interpretive guidance with respect to the regulatory status of specific proposed transactions in compliance with CEA section 8. However, market participants making a joint interpretive request should be aware that the SEC is not subject to CEA section 8 and, therefore, is not subject to the restrictions of CEA section 8. The CFTC anticipates that most joint interpretive requests will not contain CEA Section 8 information. However, given that the SEC is not subject to the restrictions of CEA section 8, the CFTC intends to work with requesting parties to assure that joint interpretive requests do not include CEA section 8 information. Nevertheless, given the foregoing, market participants should not submit CEA section 8 information in their joint interpretive requests.

995 7 U.S.C. 1a(47)(E) and 2(i).

commenters. The CFTC also is providing an additional interpretation regarding rules 1.3(xxx)(6) and 1.6 under the CEA.

Section 721(c) of the Dodd-Frank Act requires the CFTC to further define the terms "swap," "swap dealer," "major swap participant," and "eligible contract participant," in order "[t]o include transactions and entities that have been structured to evade" subtitle A of Title VII (or an amendment made by subtitle A of the CEA). Moreover, as the CFTC noted in the Proposing Release,[996] several other provisions of Title VII reference the promulgation of anti-evasion rules, including:

- Subparagraph (E) of the definition of "swap" provides that foreign exchange swaps and foreign exchange forwards shall be considered swaps unless the Secretary of the Treasury makes a written determination that either foreign exchange swaps or foreign exchange forwards, or both, among other things, "are not structured to evade the [Dodd-Frank Act] in violation of any rule promulgated by the [CFTC] pursuant to section 721(c) of that Act;"[997]
- Section 722(d) of the Dodd-Frank Act provides that the provisions of the CEA relating to swaps shall not apply to activities outside the United States unless those activities, among other things, "contravene such rules or regulations as the [CFTC] may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of [the CEA] that was enacted by the [Title VII];"[998] and

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996 Proposing Release at 29866.

997 CEA section 1a(47)(E), 7 U.S.C. 1a(47)(E).

998 CEA section 2(i), 7 U.S.C. 2(i). New CEA section 2(i), as added by section 722(d) of the Dodd-Frank Act, also provides that the provisions of Title VII relating to swaps shall not apply to activities outside the United States unless those activities "have a direct and significant connection with activities in, or effect on, commerce of the United States."

- Section 725(g) of the Dodd-Frank Act amends the Legal Certainty for Bank Products Act of 2000 to provide that, although identified banking products generally are excluded from the CEA, that exclusion shall not apply to an identified banking product that is a product of a bank that is not under the regulatory jurisdiction of an appropriate Federal banking agency,[999] meets the definition of the terms "swap" or "security-based swap," and "has been structured as an identified banking product for the purpose of evading the provisions of the [CEA], the [Securities Act], or the [Exchange Act]."[1000]

Comments

One commenter asserted the CFTC has no statutory basis to promulgate the anti-evasion rules, as proposed.[1001] Specifically, this commenter stated that neither CEA sections 2(h)(4)(A) nor 6(e) grant the CFTC authority to prescribe an anti-evasion rule and interpretation as described in the Proposing Release.[1002] Moreover, this commenter argued that CEA section 2(i) limits the CFTC to prescribing anti-evasion rules related only to activities occurring outside of the United States.[1003] The CFTC finds these comments misplaced because CEA sections

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999 The term "identified banking product" is defined in section 402 of the Legal Certainty for Bank Products Act of 2000, 7 U.S.C. 27. The term "appropriate Federal banking agency" is defined in CEA section 1a(2), 7 U.S.C. 1a(2), and section 3(a)(72) of the Exchange Act, 15 U.S.C. 78c(a)(72), which were added by sections 721(a) and 761(a) of the Dodd-Frank Act, respectively.

1000 Section 741(b) of the Dodd-Frank Act amends section 6(e) of the CEA, 7 U.S.C. 9a, to provide that any DCO, swap dealer, or major swap participant "that knowingly or recklessly evades or participates in or facilitates an evasion of the requirements of section 2(h) [of the CEA] shall be liable for a civil monetary penalty in twice the amount otherwise available for a violation of section 2(h) [of the CEA]." This anti-evasion provision is not dependent upon the promulgation of a rule under section 721(c) of the Dodd Frank Act, and hence the proposed rule and interpretive guidance is not meant to apply to CEA section 6(e).

1001 See IECA Letter.

1002 Id.; 7 U.S.C. 2(h)(4)(A) and 9a.

1003 See IECA Letter; 7 U.S.C. 2(i).

2(h)(4)(A) and 6(e) provide the CFTC with additional authority to prescribe anti-evasion rules for specific purposes above and beyond the authority provided by sections 721(c) and 725(g) of the Dodd-Frank Act and CEA sections 1a(47)(E) and 2(i), upon which the CFTC is relying in this rulemaking.[1004] In addition, section 2(i) of the CEA provides that activities conducted outside the United States, including entering into agreements, contracts and transactions or structuring entities, which willfully evade or attempt to evade any provision of the CEA, shall be subject to the provisions of Subtitle A of Title VII of the Dodd-Frank Act; it does not limit the CFTC's other authorities cited above. Accordingly, nothing in CEA sections 2(h)(4)(A), 2(i) or 6(e) prevent the CFTC from prescribing rules 1.3(xxx)(6) and 1.6.

Two commenters supported the proposal's "principles-based" approach to anti-evasion,[1005] while several others suggested modifications.[1006] Two commenters believed that the Proposing Release is overly broad and that, if the CFTC does finalize anti-evasion rules, such rules should be narrower in scope.[1007] Similarly, one other commenter asserted that the CFTC erred in the Proposing Release by placing too great an emphasis on the flexibility of the rules as

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1004 CEA section 2(h)(4)(A), 7 U.S.C. 2(h)(4)(A), provides: The Commission shall prescribe rules under this subsection (and issue interpretations of rules prescribed under this subsection) as determined by the Commission to be necessary to prevent evasions of the mandatory clearing requirements under this Act.

CEA section 6(e), 7 U.S.C. 9a, in relevant part, provides: (4) Any designated clearing organization that knowingly or recklessly evades or participates in or facilitates an evasion of the requirements of section 2(h) shall be liable for a civil money penalty in twice the amount otherwise available for a violation of section 2(h). (5) Any swap dealer or major swap participant that knowingly or recklessly evades or participates in or facilitates an evasion of the requirements of section 2(h) shall be liable for a civil money penalty in twice the amount otherwise available for a violation of section 2(h).

1005 See Barnard Letter and Better Markets Letter.

1006 See CME Letter; ISDA Letter; and SIFMA Letter.

1007 See ISDA Letter and SIFMA Letter.

opposed to providing clarity for market participants.[1008] The CFTC continues to believe a "principles-based" approach to its anti-evasion rules is appropriate. The CFTC is not adopting an alternative approach, whereby it provides a bright-line test of non-evasive conduct, because such an approach may provide potential wrongdoers with a roadmap for structuring evasive transactions. Notwithstanding this concern, as described below, the CFTC is providing an additional interpretation and examples of evasion in order to provide clarity to market participants.[1009]

One commenter suggested an alternative standard for a finding of evasion should be "whether the transaction is lawful or not" under the CEA, CFTC rules and regulations, orders, or other applicable federal, state or other laws.[1010] The CFTC is not adopting this suggested alternative standard for evasion because to adopt this standard would blur the distinction between whether a transaction (or entity) is lawful and whether it is structured in a way to evade the Dodd-Frank Act and the CEA. The anti-evasion rules provided herein are concerned with the latter conduct, not the former.[1011] Thus, the CFTC does not believe it is appropriate to limit the enforcement of its anti-evasion authority to only unlawful transactions.

1008 See CME Letter.

1009 Examples described in the guidance are illustrative and not exhaustive of the transactions, instruments or entities that could be considered evasive. In considering whether a transaction, instrument or entity is evasive, the CFTC will consider the facts and circumstances of each situation.

1010 See WGCEF Letter.

1011 If a transaction is unlawful, the CFTC (or another authority) may be able to bring an action alleging a violation of the applicable rule, regulation, order or law.

2. Final Rules

a) Rule 1.3(xxx)(6)

The CFTC is adopting the Rule 1.3(xxx)(6) as proposed. As adopted, Rule 1.3(xxx)(6)(i) under the CEA generally defines as swaps those transactions that are willfully structured to evade the provisions of Title VII governing the regulation of swaps. Furthermore, rules 1.3(xxx)(6)(ii) and (iii) effectuate CEA section 1a(47)(E)(i) and section 725(g) of the Dodd-Frank Act, respectively, and will be applied in a similar fashion as rule 1.3(xxx)(6)(i). Rule 1.3(xxx)(6)(ii) applies to currency and interest rate swaps that are willfully structured as foreign exchange forwards or foreign exchange swaps to evade the new regulatory regime for swaps enacted in Title VII. Rule 1.3(xxx)(6)(iii) applies to transactions of a bank that are not under the regulatory jurisdiction of an appropriate Federal banking agency and where the transaction is willfully structured as an identified banking product to evade the new regulatory regime for swaps enacted in Title VII.

Rule 1.3(xxx)(6)(iv) provides that in determining whether a transaction has been willfully structured to evade rules 1.3(xxx)(6)(i) through (iii), the CFTC will not consider the form, label, or written documentation dispositive.[1012] This approach is intended to prevent evasion through clever draftsmanship of a form, label, or other written documentation.

Rule 1.3(xxx)(6)(v) further provides that transactions, other than transactions structured as securities, willfully structured to evade (as provided in rules 1.3(xxx)(6)(i) through (iii)) will be considered in determining whether a person is a swap dealer or major swap participant.

[1012] See supra part II.D.1.

Lastly, rule 1.3(xxx)(6)(vi) provides that rule 1.3(xxx)(6) will not apply to any agreement, contract or transaction structured as a security (including a security-based swap) under the securities laws as defined in section 3(a)(47) of the Exchange Act.[1013]

b) Rule 1.6

The CFTC is adopting rule 1.6 as proposed. Section 2(i) of the CEA states that the provisions of the CEA relating to swaps that were enacted by Title VII (including any rule prescribed or regulation promulgated thereunder) shall not apply to activities outside the United States unless, among other things, those activities "contravene such rules or regulations as the [CFTC] may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of [the CEA] that was enacted by [Title VII]."

Pursuant to this authority, rule 1.6(a), as adopted, makes it unlawful to conduct activities outside the United States, including entering into transactions and structuring entities, to willfully evade or attempt to evade any provision of the CEA as enacted under Title VII or the rules and regulations promulgated thereunder.

In addition, rule 1.6(b) provides that in determining whether a transaction or entity has been entered into or structured willfully to evade, as provided in rule 1.6(a), the CFTC will not consider the form, label, or written documentation as dispositive.

Rule 1.6(c) provides that an activity conducted outside the United States to evade, as described in proposed rule 1.6(a), shall be subject to the provisions of Subtitle A of Title VII of the Dodd-Frank Act. As the CFTC explained in the Proposing Release,[1014] such provisions are necessary to fully prevent those who seek to willfully evade the regulatory requirements

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[1013] 15 U.S.C. 78c(a)(47).

[1014] Proposing Release at 29866.

established by Congress in Title VII relating to swaps from enjoying any benefits from their efforts to evade.

Lastly, rule 1.6(d) provides that no agreement, contract or transaction structured as a security (including a security-based swap) under the securities laws shall be deemed a swap pursuant to rule 1.6.

c) Interpretation of the Final Rules

The CFTC is providing an interpretation of the final rules in response to commenters, addressing (i) the applicability of the anti-evasion rules to transactions that qualify for the forward exclusion, (ii) the applicability of the anti-evasion rules to transactions executed on a SEF, (iii) the treatment of evasive transactions after they are discovered, and (iv) documentation considerations.[1015]

With regard to the forward exclusion, the CFTC is clarifying, in response to a commenter,[1016] that entering into transactions that qualify for the forward exclusion from the swap definition shall not be considered evasive. However, in circumstances where a transaction does not, in fact, qualify for the forward exclusion, the transaction may or may not be evasive depending on an analysis of all relevant facts and circumstances.[1017]

1015 The CFTC also is adopting the interpretive guidance from the Proposing Release, as proposed, but with certain clarifications. See infra part VII.A.3.

1016 See COPE Letter (requesting clarification that transacting in the physical markets (e.g., entering into nonfinancial commodity forward contracts), as opposed to executing a swap, would not be considered evasion).

1017 The CFTC is aware that there are circumstances where a forward contract can perform the same or a substantially similar economic function as a swap through alternative delivery procedures. Further, there are circumstances where a person who deals in both forwards and swaps may make decisions regarding financial risk assessment that will involve the consideration of regulatory obligations. The CFTC will carefully scrutinize the facts and circumstances associated with forward contracts.

Concerning the applicability of the anti-evasion rules to transactions executed on a SEF, the CFTC is clarifying, in response to comments,[1018] that a transaction that has been self-certified by a SEF (or a DCM), or that has received prior approval from the CFTC, will not be considered evasive.[1019]

With respect to the treatment of evasive transactions after they are discovered, the CFTC is clarifying, in response to comments,[1020] that in instances where one party willfully structures a transaction to evade but the counterparty does not, the transaction, which meets the swap definition under rule 1.3(xxx)(6), or is subject to the provisions of Subtitle A of Title VII pursuant to rule 1.6, will be subject to all CEA provisions and the regulations thereunder (as applied to the party who willfully structures a transaction to evade). In rare situations where there is a true "innocent party,"[1021] it will likely be due to fraud or misrepresentation by the evading party and the business consequences and remedies will be the same as for any such victim.[1022] The CFTC will impose appropriate sanctions only on the willful evader for violations

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1018 See MarketAxess Letter (commenting that the anti-evasion rules should not apply to transactions executed on, or subject to the rules of, a SEF, because before a SEF may list a swap, it must self-certify or voluntarily obtain CFTC approval to list the product).

1019 Pursuant to part 40 of the CFTC's regulations, 17 CFR Part 40, registered SEFs and DCMs must self-certify with the CFTC that any products that they list "[comply] with the [CEA] and regulations thereunder" and are liable for any false self-certifications. Therefore, market participants that have entered into such transactions will not be considered to be engaging in evasion, while a SEF or DCM could be found to have falsely self-certified.

1020 See WGCEF Letter (generally expressing concern that the penalty for anti-evasion is "draconian") and IECA Letter (commenting that the non-evading party should not become a party to an evasive "swap" transaction, and thus subject to the regulatory requirements of the Dodd-Frank Act.) .

1021 The analysis of whether a party is "innocent" is based on the facts and circumstances of a particular transaction as well as a course of dealing by each of the parties.

1022 This is not dissimilar to an enforcement action for trading illegal off-exchange futures contracts in violation of CEA section 4(a), 7 U.S.C. 6(a). The CFTC regularly seeks restitution for victims in enforcement actions where applicable. Additionally, victims retain their private rights of action for breach of contract and any related equitable remedies.

of the relevant provisions of the CEA and CFTC regulations since the individual agreement, contract or transaction was (and always should have been) subject to them.[1023] Further, on a prospective basis for future transactions or instruments similar to those of the particular evasive swap, the CFTC will consider these transactions or instruments to be swaps within the meaning of the Dodd-Frank Act (as applied to both the party who willfully structures a transaction to evade and the "innocent party").

Moreover, evasive transactions will count toward determining whether each evading party with the requisite intent is a swap dealer or major swap participant.[1024] In response to a commenter's suggestion that, as proposed, rule 1.3(xxx)(6)(v) should require a pattern of transactions,[1025] the CFTC is not requiring a pattern of evasive transactions as a prerequisite to prove evasion, although such a pattern may be one factor in analyzing whether evasion has occurred under rules 1.3(xxx)(6) or 1.6. Further, in determining whether such a transaction is a swap, the CFTC will consider whether the transaction meets the definition of the term "swap" as defined by statute and as it is further defined in this rulemaking.[1026]

1023 In considering which provisions of the CEA and CFTC regulations are relevant, the CFTC will evaluate which CEA provisions and CFTC regulations the evasive swap would have had to comply with had it not evaded the definition of swap (e.g., reporting, recordkeeping, clearing, etc.). However, where both parties have willfully structured to evade or attempted to evade the requirements of the Dodd-Frank Act, the CFTC may subject the agreement, contract, instrument, or transaction itself to the full regulatory regime and the willful evaders to applicable sanctions.

1024 In other words, the evasive transaction would count toward the relevant thresholds (e.g., de minimis (with respect to determining swap dealer status, if the evasive transaction constituted dealing activity) and substantial position (with respect to determining major swap participant status)).

1025 See IECA Letter. This same commenter suggested that rule 1.3(xxx)(6)(v) should be applied only to the authorities regarding evasion provided by Congress and refer to the entity structuring the evading transaction have been addressed above.

1026 Thus, for example, if a person, in seeking to evade Title VII, structures a product that is a privilege on a certificate of deposit, the CFTC's anti-evasion rules would not be implicated because CEA section 1a(47)(B)(iii), 7 U.S.C. 1a(47)(B)(iii), excludes such a product from the swap definition.

As an illustration of some of the foregoing concepts, if the market for foreign exchange forwards on a particular currency settles on a T+ 4 basis, but two counterparties agree to expedite the settlement of an foreign exchange forward on such currency to characterize the transaction falsely as a spot transaction in order to avoid reporting the transaction, rule 1.3(xxx)(6)(i) would define the transaction as a swap. In this example, both parties may be subject to sanctions if they both have the requisite intent (i.e., willfully evaded). However, had the counterparty with the reporting obligation in this example convinced the other counterparty, by using a false rationale unrelated to avoiding reporting, to expedite the foreign exchange forward settlement in order to avoid reporting, then the only party that would be at risk for sanctions (i.e., the only party with the requisite intent) would be the counterparty with the reporting obligation who deceived the other counterparty.

With regard to documentation considerations, as discussed above, the CFTC is adopting rules 1.3(xxx)(6)(iv) and 1.6(b), as proposed,[1027] but is providing the following interpretation. As stated in the Proposing Release,[1028] the structuring of instruments, transactions, or entities to evade the requirements of the Dodd- Frank Act may be "limited only by the ingenuity of man."[1029] Therefore, the CFTC will look beyond manner in which an instrument, transaction, or entity is documented to examine its actual substance and purpose to prevent any evasion through clever draftsmanship--an approach consistent with the CFTC's case law in the context of determining whether a contract is a futures contract and the CFTC's interpretations in this

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[1027] Rules 1.3(xxx)(6)(iv) and 1.6(b) provide that "in determining whether a transaction has been willfully structured to evade, neither the form, label, nor written documentation of the transaction shall be dispositive."

[1028] Proposing Release at 29866.

[1029] Cargill v. Hardin, 452 F.2d 1154, 1163 (8th Cir. 1971).

release regarding swaps.[1030] The documentation of an instrument, transaction, or entity (like its form or label) is a relevant, but not dispositive, factor in determining whether evasion has occurred.

Comments

The CFTC received a number of comments on various aspects of proposed rules 1.3(xxx)(6) and 1.6.

Several commenters requested clarity as to what types of transactions might be considered evasive under proposed rule 1.3(xxx)(6) and 1.6.[1031] One commenter requested that the CFTC clarify that transacting in the physical markets (e.g., entering into nonfinancial commodity forward contracts), as opposed to executing a swap, would not be considered evasion.[1032] As discussed above, the CFTC has provided an interpretation regarding the applicability of the anti-evasion rules to transactions that qualify for the forward exclusion. Another commenter requested that the CFTC clarify that the anti-evasion rules would not apply to transactions executed on a SEF because, before a SEF may list a swap, it must self-certify or voluntarily obtain CFTC permission to list that product.[1033] The CFTC has provided an interpretation discussed above to address this comment.

Two commenters expressed concern regarding the penalty to the counterparties to a transaction that is deemed to violate the CFTC's anti-evasion provisions.[1034] Pursuant to the final rule, when a transaction violates the anti-evasion rules, the CFTC will consider the

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1030 See supra part II.D.1.

1031 See CME Letter; COPE Letter; IECA Letter; MarketAxess Letter; and WGCEF Letter.

1032 See COPE Letter.

1033 See MarketAxess Letter.

1034 See IECA Letter and WGCEF Letter.

transaction a swap. One of these commenters said that the non-evading party should not unilaterally become a party to a swap, and thus be subject to the regulatory requirements of the Dodd-Frank Act.[1035] This commenter believed the rule should be clear that only the "evading" party would become a party to a swap, but the "non-evading" party would not.[1036] The other comments believed that a transaction that is determined to have violated the CFTC's anti-evasion rules should be considered a swap only if it meets all other aspects of the statutory definition of the term "swap."[1037] The CFTC agrees that the anti-evasion rules are not meant to "punish the innocent," but rather to appropriately address the evading counterparty's or counterparties' failure to meet the requirements of the Dodd-Frank Act. Therefore, the CFTC has provided an interpretation described above about how a transaction, discovered to have evaded the CEA or the Dodd-Frank Act (and therefore, a swap under rule 1.3(xxx)(6) or subject to the provisions of Subtitle A under rule 1.6) will be treated after the evasion is discovered.

Furthermore, the CFTC agrees that a transaction that is determined to have violated the CFTC's anti-evasion rules will be considered a swap only if it meets the definition of the term "swap," and has provided an interpretation to address this comment. In response to both comments, the CFTC also has provided an example to illustrate the concepts in the interpretation.

The CFTC received one comment regarding rules 1.3(xxx)(6)(iv) and 1.6(b). This commenter believed that a difference exists between "documentation," which contains terms,

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1035 See IECA Letter.

1036 Id.

1037 See WGCEF Letter.

conditions, etc. of an agreement, and the "form or label."[1038] Thus, because a form or label may be duplicitously assigned to a transaction, this commenter agreed that neither the form nor the label should be dispositive.[1039] However, because documentation contains the substance of an agreement, this commenter believed that documentation should be dispositive in determining whether a given contract has been entered to willfully evade because the substance of a contract is derived from its documentation.[1040] Alternatively, this commenter requested that if the CFTC does not amend its proposal, the CFTC clarify what evidence or subject matter would be dispositive of willful evasion.[1041] The CFTC disagrees with these comments and has provided an interpretation discussed above that the documentation of an instrument, transaction, or entity is a relevant, but not dispositive, factor. This view not only is consistent with CFTC case law, and the CFTC's interpretations herein, but reduces the possibility of providing a potential roadmap for evasion.

Two commenters raised issues applicable to proposed rule 1.6 alone. One commenter believed that proposed rule 1.6 should not be adopted until the cross-border application of the swap provisions of Title VII is addressed.[1042] The CFTC disagrees and believes that the rule provides sufficient clarity to market participants even though the CFTC has not yet finalized guidance regarding the cross-border application of the swap provisions of the Dodd-Frank Act. The other commenters believed that the proposed rule text and interpretation does not fully explain how the CFTC would apply proposed rule 1.6 in determining whether a swap subject to

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1038 See CME Letter.

1039 Id.

1040 Id.

1041 Id.

1042 See ISDA Letter.

foreign jurisdiction and regulated by a foreign regulator is evasive.[1043] As stated above, an agreement, contract, instrument or transaction that is found to have been willfully structured to evade will be subject to CEA provisions and the regulations thereunder pursuant to rule 1.6(c).

3. Interpretation Contained in the Proposing Release

The CFTC is restating the interpretation contained in the Proposing Release,[1044] but is providing additional clarification regarding certain types of circumstances that may (or may not) constitute an evasion of the requirements of Title VII. However, the CFTC notes that each activity will be evaluated on a case-by-case basis with consideration given to all relevant facts and circumstances.

In developing its interpretation, the CFTC considered legislative, administrative, and judicial precedent with respect to the anti-evasion provisions in other Federal statutes. For example, the CFTC examined the anti-evasion provisions in the Truth in Lending Act,[1045] the Bank Secrecy Act,[1046] and the Internal Revenue Code.[1047]

1043 See CME Letter.

1044 See Proposing Release at 29865.

1045 15 U.S.C. 1604(a) provides, in relevant part, that the Federal Reserve Board: shall prescribe regulations to carry out the purposes of this subchapter . . . . [T]hese regulations may contain such classifications, differentiations, or other provisions, and may provide for such adjustments and exceptions for any class of transactions, as in the judgment of the Board are necessary or proper to effectuate the purposes of this subchapter, to prevent circumvention or evasion thereof, or to facilitate compliance therewith.

In affirming the Board's promulgation of Regulation Z, the Supreme Court noted that anti-evasion provisions such as section 1604(a) evince Congress's intent to "stress[] the agency's power to counteract attempts to evade the purposes of a statute." Mourning v. Family Publ'ns Serv., Inc., 411 U.S. 356, 370 (1973) (citing Gemsco v. Walling, 324 U.S. 244 (1945) (giving great deference to a regulation promulgated under similar prevention-of-evasion rulemaking authority in the Fair Labor Standards Act)).

1046 31 U.S.C. 5324 (stating, in pertinent part, that "[n]o person shall, for the purpose of evading the reporting requirements of [the Bank Secrecy Act (BSA) or any regulation prescribed thereunder]. . . . structure or assist in structuring, or attempt to structure or assist in structuring, any transaction with one or more domestic financial institutions"). The Federal Deposit

The CFTC will not consider transactions, entities, or instruments structured in a manner solely motivated by a legitimate business purpose to constitute willful evasion ("Business Purpose Test"). Additionally, relying on Internal Revenue Service ("IRS") concepts, when determining whether particular conduct is an evasion of the Dodd-Frank Act, the CFTC will consider the extent to which the conduct involves deceit, deception, or other unlawful or illegitimate activity.

a) Business Purpose Test

Interpretation

Consistent with the Proposing Release,[1048] the CFTC recognizes that transactions may be structured, and entities may be formed, in particular ways for legitimate business purposes, without any intention of circumventing the requirements of the Dodd-Frank Act with respect to swaps. Thus, in evaluating whether a person is evading or attempting to evade the swap requirements with respect to a particular instrument, entity, or transaction, the CFTC will consider the extent to which the person has a legitimate business purpose for structuring the instrument or entity or entering into the transaction in that particular manner. Although different means of structuring a transaction or entity may have differing regulatory implications and attendant requirements, absent other indicia of evasion, the CFTC will not consider transactions, entities, or instruments structured in a manner solely motivated by a legitimate business purpose

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Insurance Corporation regulations implementing the BSA require banks to report transactions that "the bank knows, suspects, or has reason to suspect" are "designed to evade any regulations promulgated under the Bank Secrecy Act." 12 CFR 353.3 (2010).

1047 The Internal Revenue Code makes it unlawful for any person willfully to attempt "in any manner to evade or defeat any tax . . . ." 26 U.S.C. 7201. While a considerable body of case law has developed under the tax evasion provision, the statute itself does not define the term, but generally prohibits willful attempts to evade tax.

1048 Proposing Release at 29867.

to constitute evasion. However, to the extent a purpose in structuring an entity or instrument or entering into a transaction is to evade the requirements of Title VII with respect to swaps, the structuring of such instrument, entity, or transaction may be found to constitute willful evasion.[1049]

Although some commenters suggest that the determination that there is a legitimate business purpose, and the use of that concept as a relevant fact in the determination of the possibility of evasion, will not provide appropriate clarity, it is a recognized analytical method and would be useful in the overall analysis of potentially willful evasive conduct.

The CFTC fully expects that a person acting for legitimate business purposes within its respective industry will naturally weigh a multitude of costs and benefits associated with different types of financial transactions, entities, or instruments, including the applicable regulatory obligations. In that regard, and in response to commenters, the CFTC is clarifying that a person's specific consideration of regulatory burdens, including the avoidance thereof, is not dispositive that the person is acting without a legitimate business purpose in a particular case. The CFTC will view legitimate business purpose considerations on a case-by-case basis in conjunction with all other relevant facts and circumstances.

[1049] As the CFTC observed in the Proposing Release, a similar concept applies with respect to tax evasion. See Proposing Release at 29867 n. 324. A transaction that is structured to avoid the payment of taxes but that lacks a valid business purpose may be found to constitute tax evasion. See, e.g., Gregory v. Helvering, 293 U.S. 465, 469 (1935) (favorable tax treatment disallowed because transaction lacked any business or corporate purpose). Under the "sham-transaction" doctrine, "a transaction is not entitled to tax respect if it lacks economic effects or substance other than the generation of tax benefits, or if the transaction serves no business purpose." Winn-Dixie Stores, Inc. v. Comm'r, 254 F.3d 1313, 1316 (11th Cir. 2001) (citing Knetsch v. United States, 364 U.S. 361 (1960)). "The doctrine has few bright lines, but 'it is clear that transactions whose sole function is to produce tax deductions are substantive shams.'" Id. (quoting United Parcel Serv. of Am., Inc. v. Comm'r, 254 F.3d 1014, 1018 (11th Cir. 2001)). To be clear, though, while the Proposing Release references the use of the business purpose test in tax law, the CFTC is not using the legitimate business purpose consideration in the same manner as the IRS.

Moreover, the CFTC recognizes that it is possible that a person intending to willfully evade Dodd-Frank may attempt to justify its actions by claiming that they are legitimate business practices in its industry; therefore, the CFTC will retain the flexibility, via an analysis of all relevant facts and circumstances, to confirm not only the legitimacy of the business purpose of those actions but whether the actions could still be determined to be willfully evasive. For example, a person may attempt to disguise a product that may be a swap by employing accounting practices that are not appropriate for swaps. Whether or not the method of accounting or employed accounting practices are determined to be for legitimate business purposes, that alone will not be dispositive in determining whether it is willfully evasive according to either rule 1.3(xxx)(6) or 1.6.

Because transactions and instruments are regularly structured, and entities regularly formed, in a particular way for various, and often times multiple, reasons, it is essential that all relevant facts and circumstances be considered. Where a transaction, instrument, or entity is structured solely for legitimate business purposes, it is not willfully evasive. By contrast, where a consideration of all relevant facts and circumstances reveals the presence of a purpose that is not a legitimate business purpose, evasion may exist.

Comments

Two commenters believed the proposed business purpose test is inappropriate for determining if a transaction is structured to evade Title VII.[1050] One of these commenters stated that the CFTC misunderstood how the "business purpose" test is applied by the IRS in the tax evasion context resulting in misguided proposed interpretive guidance.[1051] As stated above, the

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[1050] See CME Letter and WGCEF Letter.

[1051] See CME Letter.

CFTC believes that it is appropriate to consider legitimate business purposes in determining if a transaction is structured to evade Title VII. In response to this comment, although the interpretation references the use of legitimate business purpose in tax law, the CFTC is not bound to use the legitimate business purpose consideration in the same manner as the IRS and, accordingly, is not adopting the IRS's interpretation.

Two commenters urged the CFTC to clarify that considering the costs of regulation is a legitimate business purpose when structuring a transaction. Accordingly, they request that the CFTC clarify that entering into a transaction to avoid costly regulations, even though that transaction could otherwise be structured as a swap, will not be considered *per se* evasion/evasive.[1052] Finally, one commenter took issue with the statement that "absent other indicia of evasion, [the CFTC] would not consider transactions, entities, or instruments in a manner solely motivated by a legitimate business purpose to constitute evasion."[1053] Because "transactions, entities, or instruments" are rarely structured a certain way solely for one purpose, this commenter believed such a statement does not give market participants any relief or guidance.[1054] The CFTC has addressed these comments received on the business purpose test through the clarifications to its interpretation discussed above and reiterates that the CFTC will consider all relevant facts and circumstances in determining whether an action is willfully evasive.

1052 See ISDA Letter and WGCEF Letter.

1053 See SIFMA Letter.

1054 Id.

b) Fraud, Deceit or Unlawful Activity

Interpretation

When determining whether a particular activity constitutes willful evasion of the CEA or the Dodd-Frank Act, the CFTC will consider the extent to which the activity involves deceit, deception, or other unlawful or illegitimate activity. This concept was derived from the IRS's delineation of what constitutes tax evasion, as elaborated upon by the courts. The IRS distinguishes between tax evasion and legitimate means for citizens to minimize, reduce, avoid or alleviate the tax that they pay under the Internal Revenue Code.[1055] Similarly, persons that craft derivatives transactions, structure entities, or conduct themselves in a deceptive or other illegitimate manner in order to avoid regulatory requirements should not be permitted to enjoy the fruits of their deceptive or illegitimate conduct.

Although it is likely that fraud, deceit, or unlawful activity will be present where willful evasion has occurred, the CFTC does not believe that these factors are prerequisites to an evasion

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[1055] Whereas permissible means of reducing tax (or "tax avoidance," as the IRS refers to the practice) is associated with full disclosure and explanation of why the tax should be reduced under law, tax evasion consists of the willful attempt to evade tax liability, and generally involves "deceit, subterfuge, camouflage, concealment, or some attempt to color or obscure events or to make things seem other than they are." The IRS explains:

> Avoidance of taxes is not a criminal offense. Any attempt to reduce, avoid, minimize, or alleviate taxes by legitimate means is permissible. The distinction between avoidance and evasion is fine, yet definite. One who avoids tax does not conceal or misrepresent. He/she shapes events to reduce or eliminate tax liability and, upon the happening of the events, makes a complete disclosure. Evasion, on the other hand, involves deceit, subterfuge, camouflage, concealment, some attempt to color or obscure events or to make things seem other than they are. For example, the creation of a bona fide partnership to reduce the tax liability of a business by dividing the income among several individual partners is tax avoidance. However, the facts of a particular investigation may show that an alleged partnership was not, in fact, established and that one or more of the alleged partners secretly returned his/her share of the profits to the real owner of the business, who, in turn, did not report this income. This would be an instance of attempted evasion.

IRS, Internal Revenue Manual, part 9.1.3.3.2.1, available at http://www.irs.gov/irm/part9/irm_09-001-003.html#d0e169.

finding. As stated throughout this release, the presence or absence of fraud, deceit, or unlawful activity is one fact (or circumstance) the CFTC will consider when evaluating a person's activity. That said, the anti-evasion rules do require willfulness, i.e. "scienter." In response to the commenter who requests the CFTC define "willful conduct," the CFTC will interpret "willful" consistent with how the CFTC has in the past, that a person acts "willfully" when they act either intentionally or with reckless disregard.[1056]

Comments

One commenter, although generally supportive of the use of the IRS "tax evasion" concept as a guidepost for this criterion, requested the CFTC provide examples of legitimate versus evasive conduct in a manner similar to what is contained in the Internal Revenue Manual.[1057] The CFTC does not believe it is appropriate to provide an example because such an example may provide a guidepost for evasion.

Two commenters suggested that a finding of fraud, deceit, or unlawful activity should be a prerequisite to any finding of evasion.[1058] As noted above, the CFTC disagrees that such activity should be a prerequisite to a finding of evasion, but its presence or absence is one relevant fact and circumstance the CFTC will consider. Finally, one commenter requested further guidance defining willful conduct in the context of deliberate and knowing wrongdoing.[1059] As noted above, the CFTC has considered the suggestion that the CFTC

1056 See In re Squadrito, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,262 (CFTC Mar. 27, 1992) (adopting definition of "willful" in McLaughlin v. Richland Shoe Co., 486 U.S. 128 (1987)).

1057 See CME Letter.

1058 See ISDA Letter and SIFMA Letter.

1059 See ISDA Letter (citing U.S. v. Tarallo, 380 F.3d 1174, 1187 (9th Cir. 2004), and Merck & Co. v. Reynolds, 130 S. Ct. 1784, 1796 (2010)).

provide guidance on what defines "willful behavior," with some commenters submitting that some definitional guidance should be offered or that the standard should be whether or not a transaction is "lawful."[1060] The CFTC agrees with the need for legal clarity and believes that the concept of willfulness is a well-recognized legal concept of which there is substantial case law and legal commentary familiar to the financial industry.[1061]

B. SEC Position Regarding Anti-Evasion Rules

Section 761(b)(3) of the Dodd-Frank Act grants discretionary authority to the SEC to define the terms "security-based swap," "security-based swap dealer," "major security-based swap participant," and "eligible contract participant," with regard to security-based swaps, "for the purpose of including transactions and entities that have been structured to evade" subtitle B of Title VII (or amendments made by subtitle B).

The SEC did not propose rules under section 761(b)(3) regarding anti-evasion but requested comment on whether SEC rules or interpretive guidance addressing anti-evasion with respect to security-based swaps, security-based swap dealers, major security-based swap participants, or ECPs were necessary. Two commenters responded to the request for comment and recommended that the SEC adopt anti-evasion rules and interpretive guidance.[1062] One commenter suggested that the SEC model its anti-evasion rules and interpretive guidance on the CFTC's anti-evasion rules.[1063]

The SEC is not adopting anti-evasion rules under section 761(b)(3) at this time. The SEC notes that since security-based swaps are "securities" for purposes of the federal securities laws,

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1060 See CME Letter; ISDA Letter; and WGCEF Letter.

1061 See supra note 1056.

1062 See Barnard Letter and Better Markets Letter.

1063 See Barnard Letter.

unless the SEC grants a specific exemption,[1064] all of the SEC's existing regulatory authority will apply to security-based swaps. Since existing regulations, including antifraud and anti-manipulation provisions, will apply to security-based swaps, the SEC believes that it is unnecessary to adopt additional anti-evasion rules for security-based swaps under section 761(b)(3) at this time.

VIII. Miscellaneous Issues

A. Distinguishing Futures and Options from Swaps

The Commissions did not propose rules or interpretations in the Proposing Release regarding distinguishing futures from swaps. One commenter requested that the CFTC clarify that nothing in the release was intended to limit a DCM's ability to list for trading a futures contract regardless of whether it could be viewed as a swap if traded over-the-counter or on a SEF, since futures and swaps are indistinguishable in material economic effects.[1065] This commenter further recommended that the CFTC adopt a final rule that further interprets the statutory "swap" definition.[1066]

The CFTC declines to provide the requested clarification or adopt a rule. Prior distinctions that the CFTC relied upon (such as the presence or absence of clearing) to

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1064 See Effective Date and Implementation infra part IX.

1065 See CME Letter.

1066 Id. CME suggested that the CFTC modify the futures contract exclusion in CEA Section 1a(47)(B)(i) so that the modified language would read as follows: (B) EXCLUSIONS.—The term 'swap' does not include— (i) any contract for the sale of a commodity for future delivery listed for trading by a designated contract market (or option on such contract) . . . CME believes that such a rule would clarify the scope of Section 4(a) of the CEA, which makes it illegal to trade a futures contract except on or subject to the rules of a DCM.

CME believed that such a modification would clarify the scope of Section 4(a) of the CEA, 7 U.S.C. 6(a), which makes it unlawful to trade a futures contract except on or subject to the rules of a DCM.

distinguish between futures and swaps may no longer be relevant.[1067] As a result, it is difficult to distinguish between futures and swaps on a blanket basis as the commenter suggested. However, a case-by-case approach for distinguishing these products may lead to more informed decision-making by the CFTC. Moreover, the CFTC notes that a DCM may self-certify its contracts pursuant to Part 40 of the CFTC's rules,[1068] subject to the CFTC's oversight authority. If a DCM has a view that a particular product is a futures contract, it may self-certify the contract consistent with that view. The DCM also has a number of other options, including seeking prior approval from the CFTC, requesting an interpretation, or requesting a rulemaking if it is in doubt about whether a particular agreement, contract or transaction should be classified as a futures contract or a swap.

B. Transactions Entered Into by Foreign Central Banks, Foreign Sovereigns, International Financial Institutions, and Similar Entities

The swap definition excludes "any agreement, contract, or transaction a counterparty of which is a Federal Reserve bank, the Federal Government, or a Federal agency that is expressly backed by the full faith and credit of the United States."[1069] Some commenters to the ANPR suggested that the Commissions should exercise their authority to further define the terms "swap" to similarly exclude transactions in which a counterparty is a foreign central bank, a foreign sovereign, an international financial institution ("IFI"),[1070] or similar organization.

1067 See, e.g., Swap Policy Statement, supra note 214.

1068 17 CFR Part 40.

1069 CEA section 1a(47)(B)(ix), 7 U.S.C. 1a(47)(B)(ix).

1070 For this purpose, we consider the "international financial institutions" to be those institutions defined as such in 22 U.S.C. 262r(c)(2) and the institutions defined as "multilateral development banks" in the Proposal for the Regulation of the European Parliament and of the Council on OTC Derivative Transactions, Central Counterparties and Trade Repositories, Council of the European Union Final Compromise Text, Article 1(4a(a)) (March 19, 2012). There is overlap between the two definitions, but together they include the following institutions: the International Monetary

ANPR commenters advanced international comity, national treatment, limited regulatory resources, limits on the Commissions' respective extraterritorial jurisdiction, and international harmonization as rationales for such an approach. The Proposing Release was silent on this issue.[1071]

Comments

Several commenters asserted that swaps transactions to which an IFI is a counterparty should be excluded from the swap and security-based swap definitions.[1072] In addition to the arguments noted above, commenters asserted that certain IFIs have been granted certain statutory immunities by the United States, and that regulation under the Dodd-Frank Act of their activities would be inconsistent with the grant of these immunities.

Fund, International Bank for Reconstruction and Development, European Bank for Reconstruction and Development, International Development Association, International Finance Corporation, Multilateral Investment Guarantee Agency, African Development Bank, African Development Fund, Asian Development Bank, Inter-American Development Bank, Bank for Economic Cooperation and Development in the Middle East and North Africa, Inter-American Investment Corporation, Council of Europe Development Bank, Nordic Investment Bank, Caribbean Development Bank, European Investment Bank and European Investment Fund. (The term international financial institution includes entities referred to as multilateral development banks. The International Bank for Reconstruction and Development, the International Finance Corporation and the Multilateral Investment Guarantee Agency are parts of the World Bank Group.) The Bank for International Settlements, which also submitted a comment, is a bank in which the Federal Reserve and foreign central banks are members. Another commenter, KfW, is a corporation owned by the government of the Federal Republic of Germany and the German State governments and backed by the "full faith and credit" of the Federal Republic of Germany.

1071 But see Dissent of Commissioner Sommers, Proposing Release at 29899.

1072 See Letter from Günter Pleines and Diego Devos, Bank for International Settlements, dated July 20, 2011; Letter from Jacques Mirante-Péré and Jan De Bel, Council of Europe Development Bank, dated July 22, 2011; Letter from Isabelle Laurant, European Bank for Reconstruction and Development, dated July 22, 2011; Letter from A. Querejeta and B. de Mazières, European Investment Bank, dated July 22, 2011; Letter from J. James Spinner and Søren Elbech, Inter-American Development Bank, dated July 22, 2011; Letter from Lutze-Christian Funke and Frank Czichowski, KfW, dated August 12, 2011; Letter from Heikki Cantell and Lars Eibeholm, Nordic Investment Bank, dated August 2, 2011; and Letter from Vicenzo La Via, World Bank Group, dated July 22, 2011.

The CFTC declines to provide an exclusion from the swap definition along the lines suggested by these commenters.[1073] An exclusion from the swap definition for swap transactions entered into by foreign sovereigns, foreign central banks, IFIs and similar entities, would mean that swaps entered into by such entities would be completely excluded from Dodd-Frank regulation. Their counterparties, who may be swap dealers or major swap participants, or security-based swap dealers or major security-based swap participants, would have no regulatory obligations with respect to such swaps. These regulated counterparties could develop significant exposures to the foreign sovereigns, foreign central banks, IFIs and similar entities, without the knowledge of the Commissions.

In addition, swaps entered into by foreign sovereigns, foreign central banks, IFIs and similar entities undeniably are swaps. To be sure, the Commissions have adopted rules and interpretations to further define the term "swap" to exclude certain transactions, which prior to the enactment of the Dodd-Frank Act generally would not have been considered swaps. However, the CFTC is not using its authority to further define the term "swap" to effectively exempt transactions that are, in fact, swaps. While, as noted above, Congress included a counterparty-specific exclusion for swaps entered into by the Federal Reserve Board, the Federal government and certain government agencies, Congress did not provide a similar exemption for foreign central banks, foreign sovereigns, IFIs, or similar organizations.

[1073] The commenters' suggested exclusion from the swap definition would also exclude their transactions from the security-based swap definition, which is based on the definition of swap.

C. Definition of the Terms "Swap" and "Security-Based Swap" as used in the Securities Act

The SEC is adopting a technical rule that provides that the terms "swap" and "security-based swap" as used in the Securities Act[1074] have the same meanings as in the Exchange Act[1075] and the rules and regulations thereunder.[1076] The SEC is adopting such technical rule to assure consistent definitions of these terms under the Securities Act and the Exchange Act.

IX. Effective Date and Implementation

Consistent with sections 754 and 774 of the Dodd-Frank Act, the final rules and interpretations will be effective [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. The compliance date for the final rules and interpretations also will be [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]; with the following exceptions:

- The compliance date for the interpretation regarding guarantees of swaps will be the effective date of the rules proposed in the separate CFTC release when such rules are adopted by the CFTC.
- Solely for the purposes of the Order Granting Temporary Exemptions under the Securities Exchange Act of 1934 in Connection with the Pending Revision of the Definition of "Security" to Encompass Security-Based Swaps[1077] and the

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1074 See section 2(a)(17) of the Securities Act, 15 U.S.C. 77b(a)(17).

1075 See sections 3(a)(69) of the Exchange Act, 15 U.S.C. 78c(a)(69), and 3(a)(68) of the Exchange Act, 15 U.S.C. 78c(a)(68). The definitions of the terms "swap" and "security-based swap" in the Exchange Act are the same as the definitions of these terms in the CEA. See section 1a of the CEA, 7 U.S.C. 1a.

1076 See rule 194 under the Securities Act.

1077 76 FR 39927 (Jul. 7, 2011) ("Exchange Act Exemptive Order"). The Exchange Act Exemptive Order grants temporary relief and provides interpretive guidance to make it clear that a substantial number of the requirements of the Exchange Act do not apply to security-based swaps as a result

Exemptions for Security-Based Swaps,[1078] the compliance date for the final rules further defining the term "security-based swap" will be [INSERT DATE 180 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

The CFTC believes that it is appropriate to make the compliance date for the interpretation regarding guarantees of swaps the same as the effective date of the rules proposed in the separate CFTC release when such rules are adopted by the CFTC in order to relieve market participants from compliance obligations that would arise as a result of the interpretation. As described in the Exchange Act Exemptive Order and as provided in the SB Swaps Interim Final Rules, the exemptions granted pursuant to the Exchange Act Exemptive Order and the SB Swaps Interim Final Rules will expire upon the compliance date of the final rules further defining the terms "security-based swap" and "eligible contract participant." The final rules further defining the term "eligible contract participant," adopted in the Entity Definitions Release,[1079] were published in the Federal Register on May 23, 2012. The compliance date and the effective date for such final rules is the same, July 23, 2012. The SEC believes that

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of the revised definition of "security" going into effect on July 16, 2011. The Exchange Act Exemptive Order also provided temporary relief from provisions of the Exchange Act that allow the voiding of contracts made in violation of those laws.

1078 Rule 240 under the Securities Act, 17 CFR 230.240, rules 12a-11 and 12h-1(i) under the Exchange Act 1934, 17 CFR 240.12a-11 and 240.12h-1(i), and Rule 4d-12 under the Trust Indenture Act of 1939, 17 CFR 260.4d-12 ("SB Swaps Interim Final Rules"). See also 76 FR 40605 (Jul. 11, 2011). The SB Swaps Interim Final Rules provide exemptions under the Securities Act, the Exchange Act, and the Trust Indenture Act of 1939 for those security-based swaps that prior to July 16, 2011, were security-based swap agreements and are defined as "securities" under the Securities Act and the Exchange Act as of July 16, 2011, due solely to the provisions of the Dodd-Frank Act. The SB Swaps Interim Final Rules exempt offers and sales of these security-based swaps from all provisions of the Securities Act, other than the Section 17(a) anti-fraud provisions, as well as exempt these security-based swaps from Exchange Act registration requirements and from the provisions of the Trust Indenture Act of 1939, provided certain conditions are met.

1079 See supra note 12.

establishing a compliance date for the definition of "security-based swap" solely for purposes of the Exchange Act Exemptive Order and the SB Swaps Interim Final Rules that is [INSERT DATE 180 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER] (i.e. 120 days after the effective date) is appropriate because doing so will leave in place the exemptions granted by the Exchange Act Exemptive Order and the SB Swaps Interim Final Rules for a period of time that is sufficient to facilitate consideration of that order and rule. Specifically, the SEC will consider the appropriate treatment of security-based swaps under the provisions of the Exchange Act not amended by the Dodd-Frank Act before expiration of the exemptions set forth in the Exchange Act Exemptive Order, and will consider the appropriate treatment of security-based swaps for purposes of the registration provisions of the Securities Act, the registration provisions of the Exchange Act, and the indenture qualification provisions of the Trust Indenture Act of 1939 before the expiration of the exemptions set forth in the SB Swaps Interim Final Rules.[1080]

If any provision of these final rules or interpretations, or the application thereof to any person or circumstance, is held to be invalid, such invalidity shall not affect other provisions or application of such provisions to other persons or circumstances that can be given effect without the invalid provision or application.

[1080] The SEC has received a request for certain permanent exemptions upon the expiration of the exemptions contained in the Exchange Act Exemptive Order. See SIFMA SBS Exemptive Relief Request (Dec. 5, 2011), which is available at http://www.sec.gov/comments/s7-27-11/s72711-10.pdf. The SEC also has received comments regarding the exemptions under the Securities Act, the Exchange Act, and the Trust Indenture Act of 1939. See Letter from Kenneth E. Bentsen, Jr., Executive Vice President, Public Policy and Advocacy, SIFMA, and Robert Pickel, Chief Executive Officer, ISDA, dated Apr. 20, 2012, which is available at http://www.sec.gov/comments/s7-26-11/s72611-5.pdf. The SEC is reviewing the request for exemptive relief and each related comment and will consider any appropriate actions regarding such request.

X. Administrative Law Matters – CEA Revisions

A. Paperwork Reduction Act

1. Introduction

The Paperwork Reduction Act of 1995 ("PRA") imposes certain requirements on Federal agencies in connection with their conducting or sponsoring any collection of information as defined by the PRA.[1081] An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. Certain provisions of this rule will result in new collection of information requirements within the meaning of the PRA. With the exception of the new "book-out" confirmation requirement discussed below, the CFTC believes that the burdens that will be imposed on market participants under rules 1.8 and 1.9 already have been accounted for within the SEC's calculations regarding the impact of this collection of information under the PRA and the request for a control number submitted by the SEC to OMB for rule 3a68-2 ("Interpretation of Swaps, Security-Based Swaps, and Mixed Swaps") and rule 3a68-4 ("Regulation of Mixed Swaps: Process for Determining Regulatory Treatment for Mixed Swaps"). In response to this submission, OMB issued control number 3235-0685. The responses to these collections of information will be mandatory.[1082] The CFTC will protect proprietary information according to the Freedom of Information Act and 17 CFR part 145, headed "Commission Records and Information." In addition, the CFTC emphasizes that section 8(a)(1) of the CEA[1083] strictly prohibits the Commission, unless specifically authorized by the CEA, from making public "data and information that would

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[1081] 44 U.S.C. 3501 et seq.

[1082] As discussed below, the "collection of information" related to the new "book out" confirmation requirement was not included in the SEC's submission and will be the subject of a request for a control number by the CFTC to OMB.

[1083] 7 U.S.C. 12(a)(1).

separately disclose the business transactions or market positions of any person and trade secrets or names of customers." The CFTC also is required to protect certain information contained in a government system of records pursuant to the Privacy Act of 1974.

2. Rules 1.8 and 1.9

As discussed in the proposal, Rules 1.8 and 1.9 under the CEA will result in new "collection of information" requirements within the meaning of the PRA. Rule 1.8 under the CEA will allow persons to submit a request for a joint interpretation from the Commissions regarding whether an agreement, contract or transaction (or a class thereof) is a swap, security-based swap, or mixed swap. Rule 1.8 provides that a person requesting an interpretation as to the nature of an agreement, contract, or transaction as a swap, security-based swap, or mixed swap must provide the Commissions with the person's determination of the nature of the instrument and supporting analysis, along with certain other documentation, including a statement of the economic purpose for, and a copy of all material information regarding the terms of, each relevant agreement, contract, or transaction (or class thereof). The Commissions also may request the submitting person to provide additional information. In response to the submission, the Commissions may issue a joint interpretation regarding the status of that agreement, contract, or transaction (or class of agreements, contracts, or transactions) as a swap, security-based swap, or mixed swap.

Rule 1.9 of the CEA enables persons to submit requests to the Commissions for joint orders providing an alternative regulatory treatment for particular mixed swaps. Under rule 1.9, a person will provide to the Commissions a statement of the economic purpose for, and a copy of all material information regarding, the relevant mixed swap. In addition, the person will provide the specific alternative provisions that the person believes should apply to the mixed swap, the reasons the person believes it would be appropriate to request an alternative regulatory treatment,

and an analysis of: i) the nature and purposes of the specified provisions; ii) the comparability of the specified provisions to other statutory provisions of Title VII of the Dodd-Frank Act and the rules and regulations thereunder; and iii) the extent of any conflicting or incompatible requirements of the specified provisions and other statutory provisions of Title VII and the rules and regulations thereunder. The Commissions also may request the submitting person to provide additional information.

a) Information Provided by Reporting Entities

The burdens imposed by rules 1.8 and 1.9 under the CEA are the same as the burdens imposed by the SEC's rules 3a68-2 and 3a68-4. Therefore, the burdens that will be imposed on market participants under rules 1.8 and 1.9 already have been accounted for within the SEC's calculations regarding the impact of this collection of information under the PRA and the request for a control number submitted by the SEC to OMB.[1084]

b) Information Collection Comments

In the Proposing Release, the CFTC invited public comment on the reporting and recordkeeping burdens discussed above with regard to rules 1.8 and 1.9. Pursuant to 44 U.S.C. 3506(c)(2)(B), the CFTC solicited comments in order to: i) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the CFTC, including whether the information will have practical utility; ii) evaluate the accuracy of the CFTC's estimate of the burden of the proposed collections of information; iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and iv) minimize the burden of the collections of information on those who are to

[1084] 44 U.S.C. 3501-3521. See also 44 U.S.C. 3509 and 3510.

respond, including through the use of automated collection techniques or other forms of information technology.

No comments were received with respect to the reporting and recordkeeping burdens discussed in the proposing release. In response to the request for a control number by the SEC, OMB issued control number 3235-0685.

3. Book-Out Confirmation

As noted above, the CFTC believes that its interpretation which clarifies that oral book-out agreements must be followed in a commercially reasonable timeframe by a confirmation in some type of written or electronic form would result in a new "collection of information" requirement within the meaning of the PRA. Therefore, the CFTC is submitting the new "book-out" information collection to OMB for review in accordance with 44 U.S.C. 3506(c)(2)(A) and 5 CFR 1320.8(d). The CFTC will, by separate action, publish in the Federal Register a notice on the paperwork burden associated with the interpretation's requirement that oral book-outs be followed in a commercially reasonable timeframe by confirmation in some type of written or electronic form in accordance with 5 CFR 1320.8 and 1320.10. If approved, this new collection of information will be mandatory.

B. Regulatory Flexibility Act

The Regulatory Flexibility Act ("RFA") requires that agencies consider whether the rules they propose will have a significant economic impact on a substantial number of small entities and, if so, provide a regulatory flexibility analysis respecting the impact.[1085] A regulatory flexibility analysis or certification typically is required for "any rule for which the agency

[1085] 5 U.S.C. 601 et seq.

publishes a general notice of proposed rulemaking pursuant to" the notice-and-comment provisions of the Administrative Procedure Act, 5 U.S.C. 553(b).

With respect to the proposed release, while the CFTC provided an RFA statement that the proposed rule would have a direct effect on numerous entities, specifically DCMs, SDRs, SEFs, SDs, MSPs, ECPs, FBOTs, DCOs, and certain "appropriate persons" who relied on the Energy Exemption,[1086] the Chairman, on behalf of the CFTC, certified that the rulemaking would not have a significant economic effect on a substantial number of small entities. Comments on that certification were sought.

In the Proposing Release, the CFTC provided that it previously had established that certain entities subject to the CFTC's jurisdiction – namely, DCMs, DCOs and ECPs – are not small entities for purposes of the RFA.[1087] As the CFTC previously explained, because of the central role they play in the regulatory scheme concerning futures trading, the importance of futures trading in the national economy, and the financial requirements needed to comply with the regulatory requirements imposed on them under the CEA, DCMs and DCOs have long been determined not to be small entities.[1088] Based on the definition of ECP in the Commodity Futures Modernization Act of 2000 ("CFMA") and the legislative history underlying that definition, the CFTC determined that ECPs were not small entities.[1089] In light of its past

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1086 See 76 FR 29868 – 89.

1087 See respectively, Policy Statement and Establishment of Definitions of "Small Entities" for Purposes of the Regulatory Flexibility Act, supra note 331, at 18619 (DCMs); A New Regulatory Framework for Clearing Organizations, 66 FR 45604, 45609 (Aug. 29, 2001) (DCOs); Opting Out of Segregation, 66 FR 20740, 20743 (Apr. 25, 2001) (ECPs).

1088 See respectively, Policy Statement and Establishment of Definitions of "Small Entities" for Purposes of the Regulatory Flexibility Act, supra note 331, at 18619 (DCMs); A New Regulatory Framework for Clearing Organizations, 66 FR 45604, 45609, Aug. 29, 2001 (DCOs).

1089 See Opting Out of Segregation. 66 FR 20740, 20743, Apr. 25, 2001 (ECPs).

determination, and the increased thresholds on ECPs added by the Dodd-Frank Act making it more difficult for entities to qualify as an ECP, the CFTC determined in its proposed rulemakings that ECPs are not small entities.

Furthermore, the CFTC provided that certain entities that would be subject to the proposed rule – namely SDs, MSPs, SDRs, SEFs, and FBOTs – are entities for which the CFTC had not previously made a size determination for RFA purposes. The CFTC determined that these entities should not be considered small entities based on their size and characteristics analogous to non-small entities that pre-dated the adoption of Dodd-Frank,[1090] and certified in rulemakings that would have an economic impact on these entities that these entities are not small entities for RFA purposes.[1091]

Finally, the CFTC recognized that, in light of the CFTC's proposed withdrawal of the Energy Exemption, the proposed rule could have an economic impact on certain "appropriate persons" who relied on the Energy Exemption. The Energy Exemption listed certain "appropriate persons" that could rely on the exemption and also required that, to be eligible for this exemption, an "appropriate person must have demonstrable capacity or ability to make or take delivery. The Energy Exemption stated: "in light of the general nature of the current participants in the market, the CFTC believes that smaller commercial firms, which cannot meet [certain] financial criteria, should not be included."[1092] Therefore, the CFTC did not believe that

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1090 See 76 FR 29868 – 89.

1091 See respectively, Registration of Swap Dealers and Major Swap Participants, 77 FR 2613, 2620, Jan. 19, 2012 (swap dealers and major swap participants); Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 FR 63732, 63745, Oct. 18, 2010 (SEFs); Swap Data Repositories, 76 FR 54538, 54575, Sept. 1, 2011; Registration of Foreign Boards of Trade, 76 FR 80674, 80698, Dec. 23, 2011 (FBOTs).

1092 Energy Exemption, supra note 207.

the "appropriate persons" eligible for the Energy Exemption, and who may be affected by its withdrawal, are "small entities" for purposes of RFA. Moreover, as previously discussed, the CFTC is expanding the Brent Interpretation to all nonfinancial commodities for both swaps and future delivery definitions and is clarifying that certain alternative delivery procedures discussed in the Energy Exemption will not disqualify a transaction from the forward contract exclusion under the Brent Interpretation.[1093] Thus, to the extent any entities, small or otherwise, relied on the Energy Exemption, such entities can now rely on the expanded Brent Interpretation to qualify for the forward contract exclusion. Accordingly, the withdrawal of the Energy Exemption will not result in a significant economic impact on any entities.

With respect to this rulemaking, which includes interpretations, as well as general rules of construction and definitions that will largely be used in other rulemakings, the CFTC received one comment respecting its RFA certification. The commenter, an association that represents producers, generators, processors, refiners, merchandisers and commercial end users of nonfinancial energy commodities, including energy and natural gas, contended that the CFTC's overall new jurisdiction under the Dodd-Frank Act over "swaps" and the burdens that the CFTC's rules place on nonfinancial entities, including small entities such as its members[1094] that execute such swaps, can only be determined after the rules and interpretations in the product definitions rulemaking are finalized. Moreover, the commenter asserted that its small entity members seek to continue their use of nonfinancial commodity "swaps" only to hedge the

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1093 See supra part II.B.2.a)i)(C).

1094 See ETA Letter. In general, ETA states that the Small Business Administration ("SBA") has determined that many of its members are "small entities" for purposes of the RFA. Id. (references the comment letter filed by the NRECA, APPA and LLPC as the "Not-for-Profit Electric Coalition" in response to the Commodity Option NOPR's (76 FR 6095) assertion that there are no ECPs that are "small entities" for RFA purposes).

commercial risks of their not-for profit public service activities. The commenter concluded that the CFTC should conduct a regulatory flexibility analysis for the entire mosaic of its rulemakings under the Dodd-Frank Act, taking into consideration the products definition rulemaking.

The commenter did not provide specific information on how the further defining of the terms swap, security-based swap and security-based swap agreement, providing regulations regarding mixed swaps, and providing regulations governing books and records requirements for security-based swap agreements would have a significant impact on a substantial number of small entities. Nonetheless, the CFTC has reevaluated this rulemaking in light of the commenter's statements. Upon consideration, the CFTC declines to consider the economic impacts of the entire mosaic of rules under the Dodd-Frank Act, since an agency is only required to consider the impact of how it exercises its discretion to implement the statute through a particular rule. In all rulemakings, the CFTC performs an RFA analysis for that particular rule.

Moreover, as the commenter mentioned, most of the transactions into which its members enter are based on nonfinancial commodities. The CFTC has provided interpretations in this release clarifying the forward exclusion in nonfinancial commodities from the swap definition (and the forward exclusion from the definition of "future delivery"), including forwards with embedded volumetric options, and separately, has provided for a trade option exemption.[1095] The CFTC also has provided an interpretation that certain customary commercial transactions are excluded from the swap definition.[1096]

1095 See Commodity Options, 77 FR 25320, Apr. 27, 2012.

1096 To the extent the transactions entered into by ETA members are traded or executed on Regional Transmission Organizations and Independent System Operators, or entered into between entities described in section 201(f) of the Federal Power Act, they may be addressed through the public interest waiver process described in CEA section 4(c)(6).

Accordingly, for the reasons stated in the proposal and the foregoing discussion in response to the comment received, the CFTC continues to believe that the rulemaking will not have a significant impact on a substantial number of small entities. Therefore, the Chairman, on behalf of the CFTC, hereby certifies pursuant to 5 U.S.C. 605(b) that the rules will not have a significant impact on a substantial number of small entities.

C. Costs and Benefits Considerations

Section 15(a) of the CEA requires the CFTC to consider the costs and benefits of its actions before promulgating a regulation or issuing certain orders under the CEA.[1097] Section 15(a) further specifies that the costs and benefits shall be evaluated in light of the following five broad areas of market and public concern: (1) protection of market participants and the public; (2) efficiency, competitiveness, and financial integrity of markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. The CFTC considers the costs and benefits resulting from its discretionary determinations with respect to the Section 15(a) factors. The CFTC also considers, qualitatively, costs and benefits relative to the status quo, that is, the pre-Dodd Frank Act regulatory regime, for historical context to help inform the reader.

In the Proposing Release, the CFTC assessed the costs and benefits of the proposed rules in general, followed by assessments of the costs and benefits of each of the rules, taking into account the considerations described above. The CFTC also requested comment on these assessments, and a number of comments were received. In this Adopting Release, the CFTC will again assess the costs and benefits of the rules in general followed by the individual rules in this rulemaking, for each case taking into account the above considerations and the comments

[1097] 7 U.S.C. 19(a).

received. These costs and benefits, to the extent identified and, where possible, quantified have helped to inform the decisions of and the actions taken by the CFTC that are described throughout this release.

1. Introduction

Prior to the adoption of Title VII, swaps and security-based swaps were by and large unregulated. The Commodity Futures Modernization Act of 2000 ("CFMA") excluded financial over-the-counter swaps from regulation under the CEA, provided that trading occurred only among "eligible contract participants."[1098] Swaps based on exempt commodities -- including energy and metals – could be traded among ECPs without CFTC regulation, but certain CEA provisions against fraud and manipulation continued to apply to these markets. No statutory exclusions were provided for swaps on agricultural commodities by the CFMA, although they could be traded under certain regulatory exemptions provided by the CFTC prior to its enactment. Swaps based on securities were subject to certain SEC enforcement authorities, but the SEC was prohibited from prophylactic regulation of such swaps.

In the fall of 2008, an economic crisis threatened to freeze U.S. and global credit markets. The federal government intervened to buttress the stability of the U.S. financial system.[1099] The crisis revealed the vulnerability of the U.S. financial system and economy to wide-spread systemic risk resulting from, among other things, poor risk management practices of certain

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[1098] See 7 U.S.C. 1a(12) (2006).

[1099] On October 3, 2008, President Bush signed the Emergency Economic Stabilization Act of 2008, which was principally designed to allow the U.S. Treasury and other government agencies to take action to help to restore liquidity and stability to the U.S. financial system (e.g., the Trouble Asset Relief Program—also known as TARP—under which the U.S. Treasury was authorized to purchase up to $700 billion of troubled assets that weighed down the balance sheets of U.S. financial institutions). See Pub. L. 110-343, 122 Stat. 3765 (2008).

financial firms and the lack of supervisory oversight for financial institutions as a whole.[1100] More specifically, the crisis demonstrated the need for regulation of the over-the-counter derivatives markets.[1101]

On July 21, 2010, President Obama signed the Dodd-Frank Act into law. Title VII of the Dodd-Frank Act established a comprehensive new regulatory framework for swaps and security-based swaps. As discussed above, the legislation was enacted, among other reasons, to reduce risk, increase transparency, and promote market integrity within the financial system, including by: (i) providing for the registration and comprehensive regulation of swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants; (ii) imposing clearing and trade execution requirements on swaps and security-based swaps, subject to certain exceptions; (iii) creating rigorous recordkeeping and real-time reporting regimes; and (iv) enhancing the rulemaking and enforcement authorities of the Commissions with respect to,

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1100 See Financial Crisis Inquiry Commission, "The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States," Jan. 2011, at xxvii, available at http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

1101 Id. at 25 (concluding that "enactment of . . . [the Commodity Futures Modernization Act of 2000 ("CFMA")] to ban the regulation by both the federal and state governments of over-the-counter (OTC) derivatives was a key turning point in the march toward the financial crisis."). See also id. at 343 ("Lehman, like other large OTC derivatives dealers, experienced runs on its derivatives operations that played a role in its failure. Its massive derivatives positions greatly complicated its bankruptcy, and the impact of its bankruptcy through interconnections with derivatives counterparties and other financial institutions contributed significantly to the severity and depth of the financial crisis.") and id. at 353 ("AIG's failure was possible because of the sweeping deregulation of [OTC] derivatives, […] including capital and margin requirements that would have lessened the likelihood of AIG's failure. The OTC derivatives market's lack of transparency and of effective price discovery exacerbated the collateral disputes of AIG and Goldman Sachs and similar disputes between other derivatives counterparties.").

among others, all registered entities and intermediaries subject to the Commissions' oversight.[1102]

Section 721 of the Dodd-Frank Act amends the Commodity Exchange Act ("CEA") by adding definitions of the terms "swap," "security-based swap," and "security-based swap agreement." Section 712(d)(1) provides that the CFTC and the SEC, in consultation with the Federal Reserve Board, shall jointly further define those terms. Section 712(a)(8) provides further that the Commissions shall jointly prescribe such regulations regarding "mixed swaps" as may be necessary to carry out the purposes of Title VII of the Dodd-Frank Act ("Title VII"). Section 712(d)(2) requires the Commissions, in consultation with the Federal Reserve Board, to jointly adopt rules governing books and records requirements for security-based swap agreements.

Under the comprehensive framework for regulating swaps and security-based swaps established in Title VII, the CFTC is given regulatory authority over swaps, the SEC is given regulatory authority over security-based swaps, and the Commissions jointly are to prescribe such regulations regarding mixed swaps as may be necessary to carry out the purposes of Title VII. In addition, the SEC is given antifraud authority over, and access to information from, certain CFTC-regulated entities regarding security-based swap agreements, which are a type of swap related to securities over which the CFTC is given regulatory and enforcement authority.

[1102] The CFTC has provided a table in the Appendix that cross-references the costs and benefits considerations of the final rules effectuated by the Product Definitions in order to provide more transparency with respect to this qualitative assessment of the programmatic costs. See Appendix, "Rules Effectuated by Product Definitions." The CFTC is not providing a quantitative estimate of total programmatic costs, because it cannot be reliably estimated at this time. Many rules have not been finalized, including capital and margin which may have significant costs. Any estimate made of the programmatic costs of the Product Definitions would be unreliable and therefore may be misleading.

The statutory definitions of "swap" and "security-based swap" in Title VII are detailed and comprehensive. The Dodd-Frank Act directs the Commissions, among other things, to "further define" these terms; it does not direct the Commissions to provide definitions for them, which are already provided for in the statute. Thus, even in the absence of these rules, the Dodd-Frank Act would require regulating products that meet the statutory definitions of these terms as swaps and security-based swaps. Consequently, a large part of the costs and benefits resulting from the regulation of swaps and security-based swaps derives from the Dodd-Frank Act itself and not from these rules that further define swaps.

Several commenters to the ANPR issued by the Commissions regarding the definitions expressed a concern that the product definitions could be read broadly to include certain types of transactions that previously had never been considered swaps or security-based swaps. In response to those comments, the rules and interpretations clarify that certain traditional insurance products, consumer and commercial agreements, and loan participations are not swaps or security-based swaps, which will increase legal certainty and lower the costs of assessing whether a product is a swap or security-based swap for market participants. In this regard, the rules and interpretations are intended to reduce unnecessary burdens on persons using such agreements, contracts, or transactions, the regulation of which under Title VII may not be necessary or appropriate to further the purposes of Title VII.

In addition, the CFTC is clarifying the scope of the forward contract exclusion[1103] for nonfinancial commodities from the statutory swap definition to provide legal certainty for market participants as to which transactions will qualify for the exclusion. In this regard, the CFTC is clarifying the circumstances under which market participants may rely on past CFTC guidance

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[1103] See supra part II.B.2.a).

regarding the forward exclusion from the definition of "future delivery," and in particular the Brent Interpretation for booked-out transactions, [1104] with respect to the forward exclusion from the swap definition. The CFTC is extending the Brent Interpretation to all nonfinancial commodities, and is withdrawing the Energy Exemption as proposed, [1105] with certain clarifications. The final interpretation with clarifications in response to comments should enhance legal certainty regarding the forward exclusions.

While the statutory definitions of swap and security-based swap are detailed and comprehensive, the rules further clarify whether particular types of transactions are swaps or security-based swaps. For example, foreign exchange forwards and swaps are defined as swaps, subject to the Treasury Secretary's determination to exempt them from the swap definition. The statute provides that certain provisions of the CEA apply to foreign exchange forwards and swaps, even if the Treasury Secretary determines to exempt them, and the rules reflect this. Specifically, these transactions still would be subject to certain requirements for reporting swaps, and swap dealers and major swap participants engaging in such transactions still would be subject to certain business conduct standards. The rules also clarify that, because certain foreign exchange products do not fall within the definitions of foreign exchange swap and forward, such products are not subject to the Treasury Secretary's determination to exempt. Outside of the foreign exchange suite of products, the rules and interpretations clarify that certain transactions are swaps or security-based swaps. These products include forward rate agreements, certain contracts for differences, swaptions and forward swaps. The rules and the interpretations are

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[1104] See supra part II.B.2.a)i)(B).

[1105] See supra part II.B.2.a)i)(C).

intended to increase clarity and legal certainty for market participants with respect to these products.

Next this release addresses the relationship between swaps and security-based swaps and how to distinguish them. The Commissions are clarifying whether particular agreements, contracts or transactions that are subject to Title VII of the Dodd-Frank Act (which are referred to as "Title VII Instruments" in this release) are swaps, security-based swaps or both (i.e., mixed swaps). In addition, the Commissions are clarifying the use of the term "narrow-based security index" in the security-based swap definition. In general, the CFTC has jurisdiction over Title VII instruments on broad-based security indexes, while the SEC has jurisdiction over Title VII instruments on narrow-based security indexes. This release clarifies that the existing criteria for determining whether a security index is narrow-based, and the past guidance of the Commissions regarding those criteria in the context of security futures, apply to Title VII instruments. Credit default swaps ("CDS") also are subject to this same jurisdictional division – CDS on broad-based security indexes are regulated by the CFTC, while CDS on narrow-based security indexes (as well as CDS on single name securities or loans) generally are regulated by the SEC. This release provides new criteria tailored to CDS for determining whether a CDS is based on an index that is a narrow-based security index. Also, it explains the term "index" and adopts a final rule governing tolerance and grace periods for Title VII instruments on security indexes traded on trading platforms. These rules and interpretations generally are designed to provide clarity and enhanced legal certainty regarding the appropriate classification of Title VII instruments as swaps, security-based swaps or mixed swaps, so that market participants may ascertain the applicable regulatory requirements more easily.

This release anticipates that mixed swaps, which are both swaps and security-based swaps, will be a narrow category, but lists a few examples of mixed swaps and interprets how to distinguish one type of TRS that is a mixed swap from another that is not. This release addresses the regulatory treatment of bilateral, uncleared mixed swaps where one counterparty is a dual registrant with the CFTC and SEC. It also establishes a process for requesting a joint order from the Commissions to determine the appropriate regulatory treatment of mixed swaps that do not fall into the category of mixed swaps where one counterparty is a dual registrant. Concerning "security-based swap agreements" (or SBSAs), this release explains what types of transactions are SBSAs and includes rules that provide that there will not be additional books and records requirements regarding SBSAs other than those that have been proposed by the CFTC for swaps in order to avoid duplicative regulation and costs.

This release also includes rules establishing a process for members of the public to request a joint interpretation from the Commissions regarding whether a Title VII instrument is a swap, security-based swap or a mixed swap. The process includes a deadline for a decision, as well as a requirement that if the Commissions do not issue a joint interpretation within the prescribed time period, each Commission must publicly provide the reasons for not having done so.

Finally, this release includes anti-evasion rules and related interpretations adopted by the CFTC, which in general would apply to agreements, contracts, transactions and entities that are willfully structured to evade Dodd-Frank requirements.

2. Costs and Benefits of the Definitions--In General

The rules and interpretations in this Adopting Release: further define the terms "swap," "security-based swap," and "security-based swap agreement;" provide for the regulation of "mixed swaps;" and address books and records requirements for security-based swap

agreements. In the discussion that follows, the CFTC considers the costs and benefits resulting from its own discretionary determinations with respect to the section 15(a) factors.

There are "programmatic" costs and benefits as well as "assessment" costs of the Product Definitions. Programmatic costs result from subjecting certain agreements, contracts, or transactions to the regulatory regime of Title VII.[1106] Effectiveness of the Products Definitions will trigger effectiveness of any statutory provision or regulation that depends, in whole or in part, on the effectiveness of this final rulemaking. By fulfilling the statutory mandate, many of the programmatic benefits of Title VII and the CFTC's implementing regulations are triggered, including risk reduction, increasing transparency, and promoting market integrity and, by extension, the increased possibility of preventing or reducing the severity of another global financial crisis such as occurred in 2008. Delimiting the scope of the terms "swap," "security-based swap," "security-based swap agreement," and "mixed swaps" also helps to determine the scope of activities and entities that will be subject to the various Title VII regulatory requirements. Requirements for clearing and trade execution, capital and margin, business conduct, and reporting and recordkeeping, all of which have been or will be implemented in other CFTC rules, will lead to programmatic costs that have been or will be addressed in the CFTC's rules to implement those requirements. When considering the programmatic costs and benefits of the Product Definitions, the CFTC recognizes the scope of activities and entities affected by the further Product Definitions by reference to the other final rulemakings under Title VII accomplished to date. The costs that parties will incur to assess whether certain agreements, contracts, or transactions are "swaps," "security-based swaps," "security-based swap agreements," or "mixed swaps" that are subject to the Title VII regulatory regime, and, if so,

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[1106] See Appendix, "Rules Effectuated by Product Definitions."

costs to assess whether such Title VII instrument is subject to the regulatory regime of the SEC or the CFTC are referred to herein as assessment costs.

In general, many commenters have suggested that the statutory definitions of swap and security-based swap are overbroad in that they could be viewed to include agreements, contract, and transactions that the market had not considered to be swaps or security-based swaps prior to the enactment of the Dodd-Frank Act, are (or could be) swaps or security-based swaps. Thus, in response to these comments, the CFTC has engaged in a qualitative analysis of various agreements, contracts, and transactions of which the CFTC is aware and that commenters have brought to its attention. Based on this analysis, the CFTC has established rules and interpretations to identify agreements, contracts, and transactions that are swaps or security-based swaps where the statutory definition may be inadequate or ambiguous. In developing the further definitions, the CFTC has endeavored to narrow the scope of the terms "swap" and "security-based swap" without excluding agreements, contracts and transactions that the CFTC has determined should be regulated as swaps and security-based swaps. Narrowing the scope of the statutory definitions should reduce the overall programmatic costs of Title VII because fewer agreements, contracts, and transactions will be subject to the full panoply of Title VII regulation. Narrowing the scope of the statutory definitions should also increase the net programmatic benefits of the CFTC's Title VII regulations because the CFTC is targeting in the Product Definitions rulemaking agreements, contracts and transactions that the CFTC has determined, after considering comments received and undertaking a qualitative analysis, are swaps or security-based swaps. The CFTC anticipates that applying the full panoply of Title VII regulation to only those agreements, contracts or transactions that the CFTC has determined are

swaps or security-based swaps will be most effective in achieving the net benefits of Title VII regulation under the Dodd-Frank Act.

a) Costs

The scope of the terms "swap," "security-based swap," "security-based swap agreement," and "mixed swap" is an important factor in determining the range of activities and entities that will be subject to various requirements set forth in the Dodd-Frank Act, such as trade execution, clearing, reporting, registration, business conduct, and capital requirements. Complying with these requirements, which will be implemented in other rules by the CFTC, are programmatic costs, which also have been or will be addressed in the CFTC's rules to implement those requirements.[1107]

The CFTC believes that the rulemaking to further define the terms "swap," "security-based swap," "security-based swap agreement," and "mixed swap" is consistent with how market participants understand these products. The further definitions increase legal certainty and thereby reduce assessment costs by clarifying that certain products that meet the requirements of the applicable rules and interpretations, such as traditional insurance products, are not swaps.

b) Benefits

Many of the benefits of Title VII and the CFTC's implementing regulations, including risk reduction, increasing transparency, and promoting market integrity are programmatic benefits of the Products Definitions since they are effectuated by Product Definitions. These programmatic benefits are difficult to quantify and measure. Moreover, these benefits can be expected to manifest themselves over the long run and be distributed over the market as a whole.

[1107] See Appendix, "Rules Effectuated by Product Definitions."

The CFTC believes that the final rules and interpretations can be consistently applied by substantially all market participants to determine which agreements, contracts, or transactions are, and which are not, swaps, security-based swaps, security-based swap agreements, or mixed swaps. The benefits of the individual rules and interpretations are discussed in their respective sections below.

c) Comments and Consideration of Alternatives

The CFTC requested comment on the costs and benefits of the proposed rules and interpretations regarding the definitions in general for market participants, markets and the public. Further, the CFTC requested comment as to whether there are any aspects of the proposed rules and interpretive guidance regarding the definitions that are both burdensome to apply and not helpful to achieving clarity as to the scope of the defined terms, and whether there are less burdensome means of providing clarity as to the scope of the defined terms.

A commenter[1108] argued that a proper cost-benefit analysis can only be performed once an integrated and complete mosaic of rules is available for analysis and doubted that the definitions impose no independent costs. The CFTC has considered, qualitatively, the costs and benefits of the entire mosaic of CFTC rules under the Dodd-Frank Act in this rulemaking. Due to data limitations and other uncertainty, the CFTC cannot perform a meaningful quantitative analysis, yet. The CFTC considers in this rulemaking the costs and benefits of how the Commissions are exercising their discretion in further defining the Product Definitions because Congress included in the Dodd-Frank Act statutory definitions of these terms, over which the CFTC has no discretion. Moreover, the CFTC has considered the independent costs (i.e. costs

[1108] See ETA Letter. See also IECA Letter II (requesting a comprehensive costs benefits analysis on all of Title VII).

imposed through exercising its discretion) that the Products Definitions may impose through its determinations as discussed below.

Another commenter[1109] contended that the costs and benefits considerations in the Proposing Release were not based on any empirical data and are not consistent with the expected costs of compliance anticipated by market participants. However, the CFTC cannot do a comprehensive empirical analysis regarding costs and benefits of the Products Definitions before actual data is available when the swap regulatory regime has been implemented in full. Moreover, the CFTC did use some empirical estimates in its costs and benefits considerations in the Proposing Release, namely in assessment costs for the process to seek an interpretation of whether a product is a swap, security-based swap, or mixed swap, as well as in the process to determine regulatory treatment for mixed swaps. [1110] Commenters did not submit data or other information to support an argument that the CFTC's estimates were inaccurate.

Commenters[1111] expressed concern about costs from regulatory uncertainty imposed on swaps market participants resulting from other Title VII rulemakings not yet being final. The consideration of thousands of letters and the process of due deliberation and reasoned decision-making by the CFTC has caused delays. Nevertheless, the CFTC is working with deliberate speed to complete the rulemakings, and eventually this particular type of legal uncertainty will be eliminated.

1109 See WGCEF Letter.

1110 See Proposing Release at 29874.

1111 See FIA Letter; IIB Letter; and ISDA Letter.

A commenter[1112] requested that inter-affiliate swaps be exempt from the swap definition, arguing that regulating such swaps may increase costs to consumers and undermine efficiencies from the use of centralized hedging affiliates. The CFTC anticipates that it will address inter-affiliate swaps in a subsequent rulemaking.

Several commenters[1113] argued that foreign central banks, foreign sovereigns, international financial institutions, such as multilateral development banks, and similar organizations should be exempt from swap regulations, since regulations would impose costs on these entities. Specifically, a commenter[1114] asserted that multilateral development banks should not have to register or be subject to clearing and margin requirements and requested that multilateral development banks' transactions be exempted from the definition of a swap. As explained above, these transactions are swaps. In addition, the proposed exclusion is overbroad because it would mean that swaps and security-based swaps entered into by foreign central banks, foreign sovereigns, international financial institutions, and similar organizations would be completely excluded from Dodd-Frank regulation. Their counterparties, who may be swap dealers and other regulated entities, would have no regulatory obligations with respect to such swaps, and could develop significant exposures without the knowledge of the CFTC, other regulators and market participants. If these transactions were not swaps, then no market participant would be obligated to report them to a U.S.-registered swap data repository or real-time report them. This lack of transparency might distort swap pricing and impede proper risk

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1112 See Shell Trading Letter.

1113 See CEB Letter; EIB Letter; and World Bank Letter.

1114 See World Bank Letter.

management in as much as the market may not be aware of the risk entailed in these opaque transactions and might thwart price discovery.

The Commissions did not propose rules or interpretations on how to distinguish futures from swaps. A commenter requested that the CFTC clarify that nothing in the release was intended to limit a DCM's ability to list for trading a futures contract regardless of whether it could be viewed as a swap if traded over-the-counter or on a SEF, since futures and swaps are "indistinguishable in material economic effects."[1115] The commenter further recommended that the CFTC adopt a final rule that amends the statutory definition of the term "swap" by adding to the futures contract exclusion in CEA Section 1a(47)(B)(i) the following language after the word "delivery": "listed for trading by a designated contract market." The same commenter believed that such a rule would clarify the scope of Section 4(a) of the CEA,[1116] which makes it illegal to trade a futures contract except on or subject to the rules of a DCM.[1117]

Although it is potentially more costly to a DCM in terms of providing additional analysis to support listing a futures contract on its exchange, the CFTC is not adopting the distinction the commenter advocates. Prior distinctions that the CFTC relied upon (such as the presence or absence of clearing) to distinguish between futures and swaps may no longer be relevant.[1118] As a result, it is difficult to distinguish between futures and swaps on a blanket basis as the commenter suggested. However, a case-by-case approach for distinguishing these products may lead to more informed decision-making by the CFTC.

1115 See CME Letter.

1116 7 U.S.C. 6(a).

1117 See CME Letter.

1118 See, e.g., Swap Policy Statement, supra note 214

The CFTC notes that a DCM may self-certify its contracts pursuant to Part 40 of the CFTC's rules,[1119] subject to the CFTC's oversight authority. If a DCM has a view that a particular product is a futures contract, it may self-certify the contract consistent with that view. The DCM also has a number of other options, including seeking prior approval from the CFTC, requesting an interpretation, or requesting a rulemaking if it is in doubt about whether a particular agreement, contract or transaction should be classified as a futures contract or a swap.

3. Costs and Benefits of Rules and Interpretations Regarding Insurance

Rule 1.3(xxx)(4)(i) under the CEA clarifies that agreements, contracts or transactions that satisfy its provisions will not be swaps or security-based swaps. Specifically, the term "swap" and "security-based swap" does not include an agreement, contract, or transaction under rule 1.3(xxx)(4)(i)(A) that, by its terms or by law, as a condition of performance on the agreement, contract, or transaction: i) requires the beneficiary of the agreement, contract, or transaction to have an insurable interest that is the subject of the agreement, contract, or transaction and thereby carry the risk of loss with respect to that interest continuously throughout the duration of the agreement, contract, or transaction; ii) requires that loss to occur and be proved, and that any payment or indemnification therefor be limited to the value of the insurable interest; iii) is not traded, separately from the insured interest, on an organized market or over-the-counter; and iv) with respect to financial guaranty insurance only, in the event of payment default or insolvency of the obligor, any acceleration of payments under the policy is at the sole discretion of the insurer (the "Product Test").

Rule 1.3(xxx)(4)(i)(B) under the CEA provides that for an agreement, contract, or transaction that meets the Product Test to be excluded from the swap and security-based swap

[1119] 17 CFR Part 40.

definitions as insurance, it must be provided: i) by a person that is subject to supervision by the insurance commissioner (or similar official or agency) of any State or by the United States or an agency or instrumentality thereof, and such agreement, contract, or transaction is regulated as insurance applicable State law or the laws of the United States (the "first prong"); ii) directly or indirectly by the United States, any State, or any of their respective agencies or instrumentalities, or pursuant to a statutorily authorized program thereof (the "second prong"); iii) in the case of reinsurance only, by a person to another person that satisfies the Provider Test, provided that: such person is not prohibited by applicable State law or the laws of the United States from offering such agreement, contract, or transaction to such person that satisfies the Provider Test; the agreement, contract, or transaction to be reinsured satisfies the Product Test or is one of the Enumerated Products; and except as otherwise permitted under applicable State law, the total amount reimbursable by all reinsurers for such agreement, contract, or transaction may not exceed the claims or losses paid by the cedant; or iv) in the case of non-admitted insurance by a person who: 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 under applicable State law (the "Provider Test").

In response to commenters' requests that the Commissions codify the proposed interpretation regarding certain enumerated types of insurance products in the final rules, the interpretation is being codified in paragraph (i)(C) of rule 1.3(xxx)(4) under the CEA. In addition, in response to comments, the Commissions are expanding and revising the list of traditional insurance products. As adopted, the rule provides that the terms "swap" and "security-based swap" will not include an agreement, contract, or transaction that is provided in

accordance with the conditions set forth in the Provider Test and is one of the following types of products (collectively, "Enumerated Products"): surety bonds; fidelity bonds; life insurance; health insurance; long-term care insurance; title insurance; property and casualty insurance; annuities; disability insurance; insurance against default on individual residential mortgages (commonly known as private mortgage insurance, as distinguished from financial guaranty of mortgage pools); and reinsurance (including retrocession) of any of the foregoing. Based on comments received, the Commissions are adding three products to the list of products as proposed, adding reinsurance (including retrocession) of any of the traditional insurance products included in the list, and deleting a requirement applicable to annuities that they must be subject to tax treatment under section 72 of the Internal Revenue Code.

The Commissions are also clarifying that the Product Test, the Provider Test and the Enumerated Products in the rules are a non-exclusive safe harbor (the "Insurance Safe Harbor"), such that if a product fails the Insurance Safe Harbor, that does not necessarily mean that the product is a swap or security-based swap—further analysis may be required in order to make that determination.

Rule 1.3(xxx)(4)(ii) provides a "grandfather" for insurance transactions (as opposed to insurance products), pursuant to which transactions that are entered into on or before the effective date of the Product Definitions will not fall within the definition of swap or security-based swap, provided that, at such time that it was entered into, the transaction was provided in accordance with the Provider Test.

The CFTC is interpreting the term "swap" (that is not a security-based swap or mixed swap) to include a guarantee of such swap, to the extent that a counterparty to a swap position would have recourse to the guarantor in connection with the position. The CFTC is persuaded

that when a swap has the benefit of a guarantee, the guarantee is an integral part of that swap. The CFTC finds that a guarantee of a swap (that is not a security-based swap or mixed swap) is a term of that swap that affects the price or pricing attributes of that swap. When a swap counterparty typically provides a guarantee as credit support for its swap obligations, the market will not trade with that counterparty at the same price, on the same terms, or at all without the guarantee. The guarantor's resources are added to the analysis of the swap; if the guarantor is financially more capable than the swap counterparty, the analysis of the swap becomes more dependent on the creditworthiness of the guarantor. The CFTC anticipates that a "full recourse" guarantee would have a greater effect on the price of a swap than a "limited" or "partial recourse" guarantee; nevertheless, the CFTC is determining that the presence of any guarantee with recourse, no matter how robust, is price forming and an integral part of a guaranteed swap. The CFTC's interpretation of the term "swap" to include guarantees of swap does not limit or otherwise affect in any way the relief provided by the Insurance Grandfather. In a separate release, the CFTC will address the practical implications of interpreting the term "swap" to include guarantees of swaps (the "separate CFTC release").

a) Costs

A market participant will need to ascertain whether an agreement, contract, or transaction satisfies the criteria set forth in rule 1.3(xxx)(4). This analysis will have to be performed prior to entering into the agreement, contract, or transaction to ensure that the relief provided by the Insurance Safe Harbor is available. The CFTC expects that potential costs associated with any possible uncertainty cited by commenters as to whether an agreement, contract, or transaction that the participants consider to be insurance could instead be regulated as a swap would be greater without the Insurance Safe Harbor than the cost of the analysis under the final rule herein.

Although the Insurance Safe Harbor is designed to mitigate costs associated with legal uncertainty and misclassification of products, to the extent that it inadvertently fails to exclude certain types of insurance products from the definitions, these failures could lead to costs for market participants entering into agreements, contracts, or transactions. Some insurance products might inadvertently be subjection to regulation as swaps. To the extent that the Insurance Safe Harbor leads to the inadvertent misclassification of some swaps as insurance, costs for market participants entering into agreements, contracts, or transactions that are inadvertently regulated as insurance products, and not as swaps, may increase.[1120] Similarly, insurance products inadvertently mischaracterized as swaps could impose additional costs on market participants, who could be required to meet certain regulatory requirements applicable to swaps.

Assessment costs should be minimal or non-existent for traditional insurance products,[1121] but for a new and novel insurance product that is more complex, the costs of analysis may be greater. Nevertheless, it is anticipated that such cases will be infrequent. Moreover, it may be difficult to assess whether products that do not fall within the Insurance Safe Harbor are swaps or security-based swaps rather than insurance. Market participants may need to request an interpretation from the Commissions regarding such products, or obtain an opinion of counsel, which will involve certain costs.[1122] However, the CFTC expects such cases

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1120 Improperly characterizing swaps as insurance may theoretically cause market participants that are not licensed insurance companies to become licensed insurance companies, if applicable, thus imposing costs of complying with state insurance regulation.

1121 The CFTC anticipates that traditional insurance products will either be easy to identify from the list of Enumerated Products or will unambiguously satisfy the Products Test.

1122 The CFTC believes that $27,000 represents a reasonable estimate of the upper end of the range of the costs to undertake the legal analysis of the status of an agreement, contract, or transaction as a swap or security-based swap. The average cost incurred by market participants in connection with

will arise less frequently in light of the increased clarity provided by the rule. An alternative to a safe harbor approach under the rule—that failure to meet the rule and interpretation would automatically mean that the product is a swap and not insurance—would likely impose greater costs on market participants and result in more frequent misclassification of products.

The CFTC is interpreting the term "swap" (that is not a security-based swap or mixed swap) to include a guarantee of such swap, to the extent that a counterparty to a swap position would have recourse to the guarantor in connection with the position. The CFTC anticipates minimal or no assessment costs from the interpretation with respect to guarantees of swaps.[1123] The CFTC does, however, anticipate that there will be some programmatic costs associated with the requirements that it will propose for guarantees of swaps in the separate CFTC release.[1124] The CFTC will carefully consider those costs in that rulemaking.

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assessing whether an agreement, contract, or transaction is a swap or security-based swap is based upon the estimated amount of time that staff believes will be required for both in-house counsel and outside counsel to apply the definition. Staff estimates that some agreements, contracts, or transactions will clearly satisfy the Insurance Safe Harbor, Insurance Grandfather and an in-house attorney, without the assistance of outside counsel, will be able to make a determination in less than one hour. Based upon data from SIFMA's *Management & Professional Earnings in the Securities Industry 2011* (modified by SEC staff to account for an 1800-hour-work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead), staff estimates that the average national hourly rate for an in-house counsel is $378. If an agreement, contract, or transaction is more complex, the CFTC estimates the analysis will require approximately 30 hours of in-house counsel time and 40 hours of outside counsel time. The CFTC estimates the costs for outside legal services to be $400 per hour. This is based on an estimated $400 per hour cost for outside legal services. This is the same estimate used by the SEC for these services in the release involving Exemptions for Security-Based Swaps Issued By Certain Clearing Agencies, Release No. 33-9308 (Mar. 30, 2012), 77 FR 20536 (Apr. 5, 2012). Accordingly, on the high end of the range the CFTC estimates the cost to be $27,340 ($11,340 (based on 30 hours of in-house counsel time x $378) + $16,000 (based on 40 hours of outside counsel x $400). The estimate is rounded to two significant digits to avoid the impression of false precision of the estimate.

[1123] Because a guarantee is a common and well-understood product, that has been used in commerce since long before the existence of swaps markets, the CFTC anticipates that whether a guarantee is present or not will be obvious.

[1124] As a result of interpreting the term "swap" (that is not a security-based swap or mixed swap) to include a guarantee of such swap, to the extent that a counterparty to a swap position would have

b) Benefits

Subjecting traditional insurance products to Title VII could, absent exception, prevent individuals who are not ECPs from obtaining insurance to protect their properties or families against accidental hazards or risks,[1125] or require insurance sold to individuals who are not ECPs to be traded on exchanges and be cleared. The Commissions have found no evidence that Congress intended them to be regulated as swaps or security-based swaps. In light of the above considerations, the Commissions have determined to provide the Insurance Safe Harbor and Insurance Grandfather in the final rules in order to assure market participants that those agreements, contracts, or transactions that meet their conditions will not fall within the swap or security-based swap definitions. Limiting the number of unexpected product classification outcomes for market participants provides the benefit of predictability when entering into their transactions

The business of insurance is already subject to established pre-Dodd-Frank Act regulatory regimes. Requirements that may work well for swaps and security-based swaps may not be appropriate for traditional insurance products. To the extent that the final rules distinguish insurance from swaps and security-based swaps, the CFTC should be able to tailor rules for specific products that are swaps or security-based swaps to achieve Title VII regulatory

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recourse to the guarantor in connection with the position, and based on the reasoning set forth in the Entity Definitions Release in connection with major swap participants, the CFTC will not deem holding companies to be swap dealers as a result of guarantees to certain U.S. entities that are already subject to capital regulation. This interpretation mitigates the programmatic costs imposed on potential swap dealers by not attributing to a guarantor swap positions of a guaranteed entity that is already subject to capital regulation.

[1125] An individual is considered an ECP if the individual "has amounts invested on a discretionary basis, the aggregate of which is in excess of – (i) $10,000,000; or (ii) $5,000,000 and who enters into the agreement, contract, or transaction in order to manage the risk associated with an asset owned or liability incurred, or reasonable likely to be owned or incurred, by the individual." Section 1a(18)(A)(xi) of the CEA, 7 U.S.C. 1a(18)(A)(xi).

objectives. In adopting the Insurance Safe Harbor, the CFTC has sought to achieve those net benefits that may be obtained from not supplanting existing insurance regulation that are consistent with the regulatory objectives of Title VII.

Without the Insurance Safe Harbor, market participants might be more uncertain about whether an agreement, contract, or transaction is an insurance product rather than a swap. Rule 1.3(xxx)(4) is intended to reduce the potential uncertainty of what constitutes a swap by setting forth clear and objective criteria for distinguishing an agreement, contract, or transaction that is insurance from a swap. Providing such an objective rule and explanation mitigates the potential additional costs of petitioning the Commissions, or obtaining an opinion of counsel, about whether an agreement, contract, or transaction is insurance or a swap.

The objective criteria provided by the rule also will aid sound risk management practices because it will be easier for market participants to decide whether a particular agreement, contract, or transaction is insurance or a swap.

Further, the CFTC anticipates that the interpretation of the term "swap" to include guarantees of swaps and the separate CFTC release will provide programmatic benefits by enabling the CFTC and market participants to receive more price-forming data about swaps, which may help improve price discovery for swaps. The CFTC will carefully consider these and other benefits in the separate CFTC release.

c) Comments and Consideration of Alternatives

The CFTC requested comment on the costs and benefits of proposed rule 1.3(xxx)(4) and interpretive guidance to distinguish between insurance products and swaps for market participants, markets, and the public. Several commenters[1126] argued that any additional

[1126] See AFGI Letter; AIA Letter; and ISDA Letter.

requirement beyond the requirement of the rules that a product is a regulated insurance product creates legal uncertainty and imposes costs. Specifically, a commenter[1127] asserted that it is a burden to introduce conditions that are neither universal nor fundamental, such as showing a continuing risk of loss for some insurance contracts. Another commenter[1128] argued that legal uncertainty may result in conflicting interpretations, which can be a significant burden for financial guaranty transactions that typically require the delivery of a legal opinion.

The Commissions have expanded the list of insurance products excluded from the swap definition to cover certain traditional insurance products that commenters have brought to their attention and that the Commissions have determined are not swaps. The Commissions are also clarifying that the Insurance Safe Harbor does not imply or presume that an agreement, contract or transaction that does not meet its requirements is a swap or security-based swap, but will require further analysis of the applicable facts and circumstances, including the form and substance of the agreement, contract, or transaction, to determine whether it is insurance, and thus not a swap or security-based swap. With regard to financial guaranty in particular, the acceleration of payment criterion is designed to reflect market practice and aid appropriate product classification. The Commissions are stating that they intend to interpret concepts upon which the Product Test relies that are derived from state law consistently with the existing and developing laws of the relevant state(s) governing the agreement, contract, or transaction in question. However, the Commissions note their authority to diverge from state law if the Commissions become aware of evasive conduct. While the CFTC cannot anticipate under what circumstances or how often the Commissions might diverge from state law, the CFTC believes

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[1127] See ISDA Letter.

[1128] See AFGI Letter.

that there will be more consistent than inconsistent interpretations. Accordingly, the rules do not present the increased burden or legal uncertainty that these commenters suggested.

Several commenters also requested that the Commissions codify the proposed interpretive guidance regarding enumerated insurance products in rule text on the basis that codification would enhance legal certainty, and thereby reduce costs.[1129] The Commissions have decided to include a list of products in rule text in response to these commenters concerns.

A commenter proposed that the sole test for determining whether an agreement, contract or transaction is insurance should be whether it is subject to regulation as insurance by the insurance commissioner of the applicable state(s).[1130] While the commenter's test is potentially easier and thus may be less costly to apply than the Commissions' test, it would be inadequate because, as explained in section II.B.1.(d) above, it would essentially delete the product prong of the insurance safe harbor, and thus begging the question of how to distinguish insurance from swaps and security-based swaps and allowing state insurance regulators to supplant the Commissions' role in further defining, or determining what is, a swap. Further, market participants might misconstrue the commenter's test in close cases to mean that any activity permitted by the insurance commissioner of the relevant state(s) may not be regulated as swaps or security-based swaps. However, insurance companies are in many circumstances permitted by state insurance regulators to enter into swaps or security-based swaps, illustrating that the fact that while an insurance company may enter into an agreement, contract or transaction, it does not necessarily mean that such agreement, contract or transaction is insurance. Further, the domain

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1129 See ACLI Letter; NAIC Letter; and RAA Letter.

1130 See MetLife Letter.

of insurance regulation may change and then this commenter's test would induce an evolving boundary between state and CFTC regulation.

Several commenters suggested an approach in which insurance products that qualify for the exclusion contained in section 3(a)(8) of the Securities Act of 1933 would be excluded from the swap definition.[1131] One commenter argued that "Section 3(a)(8) has long been recognized as the definitive provision as to where Congress intends to separate securities products that are subject to SEC regulation from 'insurance' and 'annuity' products that are to be left to state insurance regulation" and that the section 3(a)(8) criteria are well understood and have a long history of interpretation by the SEC and the courts.[1132] Other commenters suggest that because section 3(a)(8) includes both a product and a provider requirement, if the Commissions include it in their final rules, it should be a requirement separate from the Product Test and the Provider Test, and should extend to insurance products that are securities.[1133]

While the Commissions agree that the section 3(a)(8) criteria have a long history of interpretations by the SEC and the courts, the Commissions find that it is inappropriate to apply the section 3(a)(8) criteria in this context. Although section 3(a)(8) contains some conditions applicable to insurance providers that are similar to the prongs of the Provider Test, it does not contain any conditions that are similar to the prongs of the Product Test. Moreover, section 3(a)(8) provides an exclusion from the Securities Act and the CFTC has no jurisdiction under the federal securities laws. Congress directed both agencies to further define the terms "swap" and "security-based swap." As such, the Commissions find that it is more appropriate to have a

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1131 See supra note 162

1132 See supra note 163.

1133 See supra note 164.

standalone rule that incorporates features that distinguish insurance products from swaps and security-based swaps and over which both Commissions will have joint interpretative authority.

Another commenter proposed the following test for an agreement, contract, or transaction to be insurance:

> [It] [e]xists for a specified period of time;
>
> Where the one party to the contract promises to make one or more payments such as money, goods or services;
>
> In exchange for another party's promise to provide a benefit of pecuniary value for the loss, damage, injury, or impairment of an identified interest of the insured as a result of the occurrence of a specified event or contingency outside of the parties' control; and
>
> Where such payment is related to a loss occurring as a result of a contingency or specified event.[1134]

This test may not represent a less costly alternative to the Commissions' test in light of its complexity, and in any event would not distinguish swaps and security-based swaps from insurance more effectively than the Commissions' test for two reasons. The requirements of a specified term and the payment of premiums are present in both insurance products and in agreements, contracts, or transactions that are swaps or security-based swaps, and therefore such requirements do not help to distinguish between them. A test based solely on these requirements, then, would be over-inclusive and exclude from the Dodd-Frank regulatory regime agreements, contacts, and transactions that have not traditionally been considered insurance. Also, the third and fourth requirements of the commenter's test collapse into the Product Prong's requirement that the loss must occur and be proved, and any payment or indemnification therefor must be limited to the value of the insurable interest.

Another commenter offered a 3-part test[1135] in lieu of the Commissions' test:

[1134] See NAIC Letter.

1) The insurance contract must be issued by an insurance company and subject to state insurance regulation;

2) The insurance contract must be the type of contract issued by insurance companies; and

3) The insurance contract must not be of a type that the CFTC and SEC determine to regulate.[1136]

The commenter stated that its approach does not contain a definition of insurance, and for that reason believes that is preferable to the Commissions' approach, which it believes creates legal uncertainty because any attempted definition of insurance has the potential to be over- or under- inclusive.[1137]

While the commenter's test may appear simpler on its face, the CFTC does not believe that it represents a less costly alternative. The first two requirements of the commenter's test do not help to distinguish swaps from insurance; the third provides no greater certainty than the Commissions' facts and circumstances approach. Moreover, as discussed in section II.B.1(d) above, the Commissions' rules and related interpretations are not intended to define insurance. Rather, they provide a safe harbor for certain types of traditional insurance products by reference to factors that may be used to distinguish insurance from swaps and security-based swaps. Agreements, contracts, and transactions that do not qualify for the Insurance Safe Harbor may or may not be swaps, depending upon the facts and circumstances. Thus, the Commissions' test

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1135 See also CAI Letter and Nationwide Letter.

1136 See ACLI ANPR Letter.

1137 See ACLI Letter.

neither creates legal uncertainty as suggested by the commenter, nor the costs associated with such uncertainty.

Another commenter proposed different approaches for existing products and new products. According to the commenter, if an existing type of agreement, contract or transaction is currently reportable as insurance in the provider's regulatory and financial reports under a state or foreign jurisdiction's insurance laws, then that agreement, contract or transaction would be insurance rather than a swap or security-based swap. On the other hand, for new products, if this approach is inconclusive, the commenter recommended that the Commissions use the product prong of the Commissions' test only.[1138]

The commenter's proposal may represent a less costly alternative than the Commissions' test. However, rather than treating existing products and new products differently, the Commissions as discussed above are providing "grandfather" protection for agreements, contracts, and transactions entered into on or before the effective date of the Products Definitions. Moreover, the commenter's test would eliminate the provider test for new products, which the Commissions believe is important to help prevent products that are swaps or security-based swaps from being characterized as insurance.

In sum, the CFTC finds that, while some of the alternatives proposed by commenters may appear less costly to apply than the Commissions' test, in all cases they would sweep out of the Dodd-Frank Act regulatory regime for swaps agreements, contracts, and transactions that have not historically been considered insurance, and that should, in appropriate circumstances, be regulated as swaps or security-based swaps. Accordingly, the CFTC does not find these alternative tests proposed by commenters to be better tools than the Insurance Safe Harbor for

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[1138] See AIA Letter.

limiting the scope of the statutory definitions of swap and security-based swap. Excluding agreements, contracts, and transactions that are, in fact, swaps from the further definition of the term "swap" is inconsistent with the CFTC's regulatory objectives and could increase risk to the U.S. financial system.

Three commenters provided comments regarding the treatment of guarantees of swaps. Two commenters[1139] opposed treating insurance or guarantees of swaps as swaps. Suggesting that the products are not economically similar, one commenter argued that insurance wraps of swaps do not "necessarily replicate the economics of the underlying swap, and only following default could the wrap provider end up with the same payment obligations as a wrapped defaulting swap counterparty."[1140] This commenter also stated that the non-insurance guarantees are not swaps because the result of most guarantees is that the guarantor is responsible for monetary claims against the defaulting party, which in this commenter's view is a different obligation than the arrangement provided by the underlying swap itself.[1141]

One commenter supported treating financial guaranty insurance of a swap or security-based swap as itself a swap or a security-based swap. This commenter argued that financial guaranty insurance of a swap or security-based swap transfers the risk of counterparty non-performance to the guarantor, making it an embedded and essential feature of the insured swap or security-based swap. This commenter further argued that the value of such swap or security-based swap is largely determined by the likelihood that the proceeds from the financial guaranty

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1139 See AFGI Letter, ISDA Letter.

1140 ISDA Letter.

1141 Id.

insurance policy will be available if the counterparty does not meet its obligations.[1142] This commenter maintained that financial guaranty insurance of swaps and security-based swaps serves a similar function to credit default swaps in hedging counterparty default risk.[1143]

While the CFTC is not further defining guarantees of swaps to be swaps, the CFTC is persuaded that when a swap (that is not a security-based swap or mixed swap) has the benefit of a guarantee, the guarantee and related guaranteed swap should be analyzed together. The events surrounding the failure of AIG Financial Products ("AIGFP") highlight how guarantees can cause major risks to flow to the guarantor.[1144] The CFTC finds that the regulation of swaps and the risk exposures associated with them, which is an essential concern of the Dodd-Frank Act, would be less effective if the CFTC did not interpret the term "swap" to include a guarantee of a swap.

Two commenters cautioned against unnecessary and duplicative regulation. One commented that, because the underlying swap, and the parties to it, will be regulated and reported to the extent required by Title VII, there is no need for regulation of non-insurance guarantees.[1145] The other commented that an insurance policy on a swap would be subject to state regulation; without addressing non-insurance guarantees, this commenter stated that additional federal regulation would be duplicative.[1146] The CFTC disagrees with these

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1142 See Better Markets Letter.

1143 See Better Markets Letter.

1144 "AIGFP's obligations were guaranteed by its highly rated parent company . . . an arrangement that facilitated easy money via much lower interest rates from the public markets, but ultimately made it difficult to isolate AIGFP from its parent, with disastrous consequences." Congressional Oversight Panel, The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy 20 (2010).

1145 See ISDA Letter.

1146 See AFGI Letter.

arguments. As stated above, the CFTC is treating financial guaranty insurance of swaps and all other guarantees of swaps in a similar manner because they are functionally or economically similar products. If a guarantee of a swap is not treated as an integral part of the underlying swap, price forming terms of swaps and the risk exposures associated with the guarantees may remain hidden from regulators and may not be regulated appropriately. Moreover, treating guarantees of swaps as part of the underlying swaps ensures that the CFTC will be able to take appropriate action if, after evaluating information collected with respect to the guarantees and the underlying swaps, such guarantees of swaps are revealed to pose particular problems in connection with the swaps markets. The separate CFTC release clarifies the limited practical effects of the CFTC's interpretation, which should address industry concerns regarding duplicative regulation.

One commenter also argued that regulating financial guaranty of swaps as swaps would cause monoline insurers to withdraw from the market, which could adversely affect the U.S. and international public finance, infrastructure and structured finance markets, given that insuring a related swap often is integral to the insurance of municipal bonds and other securities.[1147] The CFTC finds this argument unpersuasive. The CFTC understands that the 2008 global financial crisis severely affected most monolines and only one remains active in U.S. municipal markets. Thus, it appears that the monolines have, for the most part, already exited these markets. In addition, as stated above, the separate CFTC release clarifies the limited practical effects of the CFTC's interpretation, which should address industry concerns.

[1147] See AFGI Letter. Of the members of AFGI, only Assured Guaranty (or its affiliates) is currently writing financial guaranty insurance policies on U.S. municipal obligations.

4. Costs and Benefits of the Withdrawing the Energy Exemption and Interpretation Regarding the Forward Contract Exclusion from the Swap Definition

The CFTC is clarifying that the forward contract exclusion from the swap definition for nonfinancial commodities should be read consistently with the forward contract exclusion from the CEA definition of the term "future delivery." In that regard, the CFTC is retaining the Brent Interpretation and extending it to apply to all nonfinancial commodities, and withdrawing the Energy Exemption, which had extended the Brent Interpretation regarding the forward contract exclusion from the term "future delivery" to energy commodities other than oil, as it is no longer necessary. Although the CFTC is withdrawing the Energy Exemption, the CFTC is providing that certain alternative delivery procedures, such as physical netting agreements, that are mentioned in the Energy Exemption, are consistent with the intent of the book out provision in the Brent Interpretation--provided that the parties had a bona fide intent, when entering into the transactions, to make or take (as applicable) delivery of the commodity covered by those transactions. The CFTC also is providing an interpretation regarding documentation of orally booked-out transactions.

In addition, the CFTC is clarifying that its prior guidance regarding commodity options embedded in forward contracts should be applied as well to the treatment of forward contracts in nonfinancial commodities that contain embedded options under the Dodd-Frank Act. The final interpretation also explains the CFTC's position with regard to forwards with embedded volumetric optionality, including an explanation of how it would treat some of the specific contracts described by commenters, such as full requirements contracts. It also explains the CFTC's view with respect to certain contractual provisions, such as liquidated damages and renewable/evergreen provisions that do not disqualify the transactions in which they are contained from the forward exclusions. The CFTC has also provided an interpretation regarding

nonfinancial commodities, including environmental commodities, and interpretations concerning physical exchange transactions, fuel delivery agreements, certain physical commercial agreements, and energy management agreements.

a) Costs

The CFTC's statement that it will construe the forward contract exclusion consistently with respect to the definitions of the terms "swap" and "future delivery," as discussed herein, will not impose any new material costs on market participants. It also will establish a uniform interpretation of the forward contract exclusion from the definitions of both statutory terms, which will avoid the significant costs that some commenters state would result if the forward contract exclusion were construed differently in these two contexts.[1148] In addition, the CFTC's clarification regarding the continued viability of the alternative delivery procedures in the Energy Exemption should reduce costs to the industry by conferring legal certainty that their transactions may continue to have these procedures without losing their eligibility for the forward exclusions.

As noted in section II.B.2.(a)(ii) above, the CFTC has explained its position regarding nonfinancial commodities. This should help the industry to determine whether their transactions are eligible for the forward exclusions, and consequently reduce costs to the industry for transactions involving non-financial commodities such as renewable energy credits that may be eligible for the forward exclusions. The final interpretation regarding forwards with embedded volumetric optionality should reduce costs to the industry, because these transactions may

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[1148] See EEI Letter ("Without legal certainty as to the regulatory treatment of their forward contracts, EEI's members and other end users who rely on the forward contract exclusion likely will face higher transaction costs due to greater uncertainty. These increased transaction costs may include: (i) more volatile or higher commodity prices; and (ii) increased credit costs, in each case caused by changes in market liquidity as end users change the way they transact in the commodity markets. A single regulatory approach that uses the same criteria to confirm that a forward contract is excluded from the Commission's jurisdiction over swaps and futures will reduce this uncertainty and the associated costs to end users." (footnote omitted)).

qualify for the forward exclusions from the swap and "future delivery" definitions. The explanation of how the CFTC will view specific contracts mentioned by commenters under this interpretation should enhance legal certainty and thereby reduce costs.

The clarification that certain contractual provisions do not disqualify transactions from the forward exclusion also should reduce costs to the industry by providing increased legal certainty that these provisions will not render their transactions subject to Dodd-Frank Act regulation. Similar cost reductions should be achieved through enhanced legal certainty provided by the CFTC's interpretations of physical exchange transactions, fuel delivery agreements, and certain physical commercial agreements, all of which may qualify for the forward exclusions under these interpretations. The interpretation regarding energy management agreements, which provides that the fact that a particular transaction is done under the auspices of such agreements does not alter the nature of that transaction, should likewise enhance legal certainty and reduce costs. While the CFTC's interpretation regarding documentation of oral book-outs—that an oral book-out be followed by a confirmation in a commercially reasonable time in written or electronic form—may impose costs for industries that do not document their orally booked out transactions, the CFTC believes that this requirement is consistent with prudent business practices and is necessary to prevent abuse of the Brent safe harbor.

Market participants will need to assess whether products are forward contracts that qualify for the forward exclusions from the swap and future delivery definitions, and may need to request an interpretation regarding such products, or obtain an opinion of counsel, which will involve certain costs. [1149]

[1149] The CFTC believes that $20,000 represents a reasonable estimate of the upper end of the range of the costs to undertake the legal analysis of the status of an agreement, contract, or transaction as a forward contract that qualifies for the forward exclusions. The average cost incurred by market

b) Benefits

The CFTC's interpretations regarding the forward exclusions should provide market participants with greater legal certainty regarding whether their transactions qualify for the forward exclusion from the swap definition, which should facilitate commercial merchandising activity. For example, the interpretation regarding forwards with embedded volumetric options should facilitate commercial merchandising activity of the electricity, natural gas, and other industries that employ these contracts where delivery quantities are flexible, while the conditions in the interpretations should help to assure that these contracts are bona fide forwards.

In addition, the interpretation should result in the appropriate classification of transactions as commercial merchandising transactions (and thus forward contracts) that are not subject to Title VII regulation. This will enhance market participants' efficient use of the swaps markets and, as described above, reduce costs on industry. Documenting oral book-outs should promote good business practices and aid the CFTC in preventing evasion through abuse of the forward exclusion. Finally, the CFTC's interpretation regarding commercial market participants

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participants in connection with assessing whether an agreement, contract, or transaction is a forward contract is based upon the estimated amount of time that staff believes will be required for both in-house counsel and outside counsel to apply the definition. The staff estimates that costs associated with determining whether an agreement, contract, or transaction is a forward contract will range up to $20,000 after rounding to two significant digits. Staff estimates that some agreements, contracts, or transactions will clearly fall within the Brent safe harbor, and an internal attorney, without the assistance of outside counsel, will be able to make a determination in less than one hour. Based upon data from SIFMA's *Management & Professional Earnings in the Securities Industry 2011* (modified by CFTC staff to account for an 1800-hour-work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead), staff estimates that the average national hourly rate for an internal attorney is $378. If an agreement, contract, or transaction is more complex, the CFTC estimates the analysis will require approximately 20 hours of in-house counsel time and 30 hours of outside counsel time. The CFTC estimates the costs for outside legal services to be $400 per hour. Accordingly, on the high end of the range the CFTC estimates the cost to be $19,560 ($7,560 (based on 20 hours of in-house counsel time x $378) + $12,000 (based on 30 hours of outside counsel x $400) which is then rounded to two significant digits to $20,000.

should ensure that the forward exclusions may only be used for commercial merchandising activity and not for speculative purposes. [1150]

The CFTC's position regarding nonfinancial commodities should help the industry to determine whether their transactions are eligible for the forward exclusions, which should facilitate commercial merchandising activity for transactions involving non-financial commodities such as renewable energy credits that may be eligible for the forward exclusions.

c) Comments and Consideration of Alternatives

The CFTC requested comment in the Proposing Release on the costs and benefits of the proposed interpretive guidance regarding the forward contract exclusion and the withdrawal of the Energy Exemption for market participants, markets and the public.

Several commenters requested that the CFTC codify its proposed guidance regarding the forward contract exclusion in rule text to provide greater legal certainty, which they argued may mitigate costs.[1151] However, upon consideration, the CFTC is not codifying its interpretation in rule text. As discussed in section II.B.2.(a)(i), above, the CFTC has never codified its prior interpretations of the forward contract exclusion with respect to the future delivery definition as a rule or regulation. Publishing an interpretation in this release is consistent with the manner in which the CFTC has interpreted the forward exclusion in the past. The additional research costs associated with an interpretation as opposed to codification in the Code of Federal Regulations will be small, because the CFTC has placed this interpretation, and all other product interpretations, in this adopting release for the convenience of practitioners. Moreover, courts

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[1150] If contracts are being used for speculative purposes they are probably swaps and should be subject regulation under Title VII.

[1151] See BGA Letter; COPE Letter; ETA Letter; FERC Staff Letter; and Just Energy Letter.

may rely upon agency interpretations; thus, the CFTC believes that codification would not mitigate costs much.

Some commenters[1152] argued that physical options should be considered forward contracts excluded from the definition of a swap, because increased regulation would cause harm to physical commodity markets without providing significant benefits. The statutory definition of "swap" provides that options – including physical options – are swaps. Accordingly, the CFTC may not exclude such options from the swap definition. Further, treating physical options as forward contracts would be inconsistent with longstanding CFTC precedent. Nonetheless, the CFTC has provided relief using its plenary authority under CEA Section 4c(b)[1153] over commodity options through the trade option exemption. While certain capacity contracts on RTOs and ISOs and certain contracts entered into by section 201(f) entities may be considered options and therefore would be swaps, regulation of these contracts may be addressed through the public interest waiver process in CEA section 4(c)(6).

Several commenters[1154] argued that renewable energy credits should not be swaps; rather, renewable energy credits should be considered nonfinancial commodities eligible for the forward exclusion from the swap definition. They asserted that swap regulations would raise transaction costs making it more difficult and expensive to support renewable energy. The CFTC is clarifying that renewable energy credits are nonfinancial commodities and that transactions therein are eligible for the forward exclusion if they satisfy the terms thereof. So if these transactions meet the forward exclusion, they will bear no increased costs.

1152 See Just Energy Letter; NEMA Letter; NGSA/NCGA Letter; ONEOK Letter; and WGCEF Letter.

1153 7 U.S.C. 6c(b).

1154 See 3Degrees Letter; AWEA Letter; CERP Letter; EMA Letter; GreenX Letter; PMAA/NEFI Letter; REMA Letter; and WGCEF Letter.

A commenter[1155] requested that tolling contracts be considered forwards and not swaps, seeking to avoid unnecessary cost of regulatory uncertainty and unintended conflict between the CFTC and other regulators. The CFTC has not provided blanket interpretations regarding particular products in the rulemaking, but has provided an interpretation regarding the forward contract exclusions provided above in section II.B.2. To the extent a commenter still is uncertain about the treatment of a specific type of transaction, the commenter may request an interpretation from the CFTC.

Another commenter argued more generally that any embedded option (for example, price, quantity, delivery point, delivery date, contract term) that does not permit a unilateral election of financial settlement based upon the value change in an underlying cash market should not render the contract a swap.[1156] While the commenter's approach with respect to "any" embedded option may result in lower costs for market participants because more contracts likely would be excluded as forwards from the swap definition and thus not be subject to regulation under the Dodd-Frank Act, such an expansive approach may inappropriately classify contracts as forwards. The CFTC is providing an interpretation with respect to forwards with embedded volumetric options to address commenters' concerns. The CFTC is also explaining its position above regarding price optionality, optionality with respect to delivery points and delivery dates specifically in response to the commenter's letter, and optionality as to certain contract terms (such as evergreen and renewal provisions) to address particular concerns raised by commenters.

Another commenter suggested that an option to purchase or sell a physical commodity, whether embedded in a forward contract or stand alone, should either (i) fall within the statutory

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1155 See California Utilities Letter.

1156 See COPE Letter, Appendix.

forward exclusion from the swap definition, or (ii) alternatively, if deemed by the CFTC to be a swap, should be exempt from the swap definition pursuant to a modified trade option exemption pursuant to CEA Section 4c(b).[1157] Although this proposal may on its face appear to be simpler than the CFTC's, it is substantively similar to the one the CFTC is adopting. The CFTC has modified the proposed interpretive guidance regarding forwards with embedded options as discussed in section II.B.2.(b)(ii) above; contracts with embedded options that are swaps under the final interpretation may nevertheless qualify for the modified trade option exemption recently adopted by the CFTC.[1158] The CFTC is not adopting an approach that forwards with any type of embedded option should fall within the statutory forward exclusion from the swap definition. Such an approach would be overbroad because it would exclude contracts that are not appropriately classified as forwards. The commenter also requested that trade option exemptions be granted for physical commodities. The costs and benefits of the trade option exemption are addressed in that rulemaking.

Another commenter urged the CFTC to broadly exempt commercial forward contracting from swap regulation by generally excluding from the swap definition any forward contract with embedded optionality between end users "whose primary purpose is consistent with that of an 'end user', and in which any embedded option is directly related to 'end use.'"[1159]

1157 See WGCEF Letter; 7 U.S.C. 6c(b).

1158 See Commodity Options, 77 FR 25320, April 27, 2012. 17 CFR 32.3. Encana Marketing (USA) Inc. ("Encana") believes that the guidance on forwards with embedded options should include embedded physical delivery options because it asserts that many of the contracts currently used by participants in the wholesale natural gas market contain an option for the physical delivery of natural gas. See Encana Letter. To the extent that Encana's comment goes beyond volumetric optionality, commodity options are discussed above in section II.B.2.(b)(i).

1159 See NMPF Letter.

While this alternative may appear to be less costly than the CFTC's interpretation, its vagueness may create significant legal uncertainty about the scope of the forward exclusion, which may increase costs on market participants. Even if this approach does represent a lower cost alternative, however, it is overbroad and likely would result in the inappropriate classification of transactions as forward contracts, and thus would not achieve the CFTC's objective of appropriately classifying transactions that should qualify for the forward exclusions.

Another commenter believed that the CFTC's "facts and circumstances" approach to forwards with embedded options does not provide the legal certainty required by nonfinancial entities engaging in commercial contracts in the normal course of business.[1160] The commenter further argued that many option-like contract terms could be determined to "target the delivery term" under a facts and circumstances analysis. Accordingly, the commenter believed that the CFTC should provide in its rules that an embedded option or embedded optionality will not result in a nonfinancial forward being a swap unless: (1) delivery is optional; (2) financial settlement is allowed; and (3) transfer and trading of the option separately from the forward is permitted.[1161]

The CFTC has long applied a facts and circumstances approach to the forward exclusion, including with respect to forwards with embedded options, an approach with which market

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[1160] See ETA Letter at 19 n.47. Similarly, COPE comments that a nonfinancial commodity forward contract that, "by its terms," is intended to settle physically should be permitted to contain optionality without being transformed into a swap unless such optionality negates the physical settlement element of the contract. That is, if one party can exercise an option to settle the contract financially based upon the value change in an underlying cash market, then the intent for physical settlement is not contained in "the four corners of the contract" and may render the contract a swap. COPE Letter. While COPE's approach may impose less costs on market participants (as more transactions likely would qualify for the forward exclusion, as discussed in section II.B.2.(b)(ii), above, the CFTC has eschewed approaches to the forward exclusion that rely on the "four corners of the contract," which can provide a roadmap to evasion of statutory requirements.

[1161] See ETA Letter.

participants are familiar. That approach balances the need for legal certainty against protecting market participants, market integrity and the risk of providing opportunities for evasion.[1162] By contrast, the commenter's bright-line approach may be simpler to apply, but could undermine market integrity and creates greater evasion opportunities. Moreover, the CFTC's additional interpretation noted above, including clarification about the meaning of the phrase "target the delivery term," and forwards with embedded volumetric optionality, provides enhanced legal certainty in response to the commenter's concerns, which should mitigate the costs of the CFTC's approach to market participants.[1163]

Another commenter[1164] stated its view that the full costs of applying the Dodd-Frank regulatory apparatus to physical energy transactions, or of energy companies being forced to abandon full-requirements bilateral contracting will significantly increase the costs to be paid by U.S. consumers. The CFTC is sensitive to these concerns. The CFTC is providing relief for full-requirements contracts so long as they satisfy the conditions set forth in the interpretation.

The CFTC is also providing relief for other types of physical energy contracts that may qualify for the forward exclusions. Separately, the CFTC has provided relief for trade options in another rulemaking.[1165]

1162 See also NCFC Letter (supporting the CFTC's guidance because it provides legal certainty).

1163 See also Commodity Options, 77 FR 25320, 25324 n. 25, April 27, 2012 (discussing the CFTC's conclusion that an "option[] to redeem" under the USDA Commodity Credit Corporation's marketing loan program constitutes a cotton producer's contractual right to repay its marketing loan and "redeem" the collateral (cotton) to sell in the open market).

1164 See IECA II Letter.

1165 See Commodity Options, 77 FR 25320, April 27, 2012.

5. Loan Participations

In the Proposing Release, the Commissions proposed guidance that they do not interpret the swap and security-based swap definitions to include loan participations in which: i) the purchaser is acquiring a current or future direct or indirect ownership interest in the related loan; and ii) the loan participations are "true participations" (the participant acquires a beneficial ownership interest in the underlying loans). One commenter expressed concern with the second prong of the proposed guidance. Specifically, the commenter said that the "true participation" requirement may result in the improper classification of loan participations as swaps, because LMA-style loan participations may not qualify. Moreover, because of legal uncertainty associated with the "true participation" terminology derived from U.S. bankruptcy law, LSTA-style loan participations may be subject to improper classification as well. The commenter proposed an alternative test described in section II.B.3., above.

The Commissions largely are adopting the recommendation from the commenter regarding the Commissions' proposed guidance concerning loan participations as not swaps or security-based swaps, with certain modifications. This reduces costs for market participants because the Commissions' test for loan participations from the proposal included a "true participation" requirement that commenters suggested is subject to legal uncertainty. Benefits of the rule include enhanced legal certainty that loan participations that meet the requirements of the interpretation are not swaps, which should facilitate loan participation market activity.

6. Interpretation Regarding Commercial/Consumer Transactions

The Commissions are stating that certain customary consumer and commercial transactions that have not previously been considered swaps or security-based swaps do not fall within the statutory definitions of those terms. Specifically with regard to consumer transactions, the Commissions are adopting as proposed the interpretation that certain

transactions entered into by consumers (natural persons) as principals or their agents primarily for personal, family or household purposes would not be considered swaps or security-based swaps. The Commissions have added to the list of consumer transactions certain residential fuel storage contracts; service contracts; consumer options to buy, sell or lease real or personal property; and certain consumer guarantees of loans (credit cards, automobile, and mortgage). The Commissions have also clarified that consumer transactions used to purchase nonfinancial energy commodities are not swaps or security-based swaps. With respect to commercial transactions, the Commissions are adopting as proposed the interpretation that certain commercial transactions involving customary business arrangements (whether or not involving a for-profit entity) would not be considered swaps or security-based swaps. The Commissions also are clarifying that commercial loans by the Federal Home Loan Banks and Farm Credit Institutions are not swaps. Finally, the Commissions are explaining the factors characteristic of consumer and commercial transactions that the Commissions will consider in determining whether other consumer and commercial transactions that are not specifically listed in the interpretation should be considered swaps or security-based swaps.

a) Costs

The CFTC believes that the forgoing interpretation should mitigate costs because it increases legal certainty that specific customary consumer and commercial transactions are not swaps or security-based swaps subject to Dodd-Frank regulation. As a result of this interpretation, consumers and industry participants will not have to seek legal advice regarding whether these transactions are swaps or security-based swaps. The interpretation regarding commercial loans made by the Federal Home Loan Banks and Farm Credit Institutions also reduces costs by not subjecting these transactions to additional Dodd-Frank Act regulation. To the extent a customary consumer or commercial transaction is not included in the interpretation,

consumers and market participants may incur costs in seeking an interpretation from the Commissions regarding the status of their transactions or an opinion of counsel. However, the CFTC has emphasized that the lists are not exclusive, and has provided the factors it will consider for determining whether other consumer and commercial transactions that are not specifically listed in the interpretation should be considered swaps or security-based swaps, which should assist consumers and market participants in deciding whether to seek an interpretation and thus mitigate these costs.

b) Benefits

The foregoing interpretation provides increased legal certainty benefits for market participants and should ensure that customary consumer and commercial transactions, which have never been considered swaps or security-based swaps, will not be subject to Dodd-Frank Act regulation, and may facilitate consumer and commercial activity. As discussed above, the interpretation regarding the factors that the Commissions will consider in determining whether transactions that are not listed in the interpretation are swaps or security-based swaps should assist market participants in determining whether to seek an interpretation regarding such transactions. Therefore, this interpretation helps to mitigate costs of legal uncertainty.

c) Comments and Consideration of Alternatives

Several commenters believed that the proposed interpretive guidance regarding consumer/commercial transactions does not provide sufficient legal certainty and request that the Commissions codify such guidance in regulations in order to provide greater legal certainty, which may mitigate costs.[1166] The Commissions decline to codify the interpretation into rule text. The interpretation is intended to provide guidance to assist consumers and commercial and

[1166] See ETA Letter; ICEA Letter; and Just Energy Letter.

non-profit entities in evaluating whether certain arrangements that they enter into will be regulated as swaps or security-based swaps. The interpretation is intended to allow the flexibility necessary, including the consideration of the applicable facts and circumstances by the Commissions, in evaluating consumer and commercial arrangements to ascertain whether they may be swaps or security-based swaps. The representative characteristics and factors taken together are indicators that a consumer or commercial arrangement is not a swap or security-based swap, and the Commissions have provided specific examples demonstrating how these characteristics and factors apply to some common types of consumer and commercial arrangements. However, as the interpretation is not intended to be a bright-line test for determining whether a particular consumer or commercial arrangement is a swap or security-based swap, if the particular arrangement does not meet all of the identified characteristics and factors, the arrangement will be evaluated based on its particular facts and circumstances. Also, the courts may rely on the interpretation and as such, the CFTC does not believe that the adoption of rule text as opposed to an interpretation will mitigate costs associated with perceived legal uncertainty.[1167]

A commenter[1168] asserted that federal courts will have to hear more disputes, because proposed CFTC jurisdiction would pre-empt significant aspects of state and federal law concerning the purchase and sale of goods and services. This rulemaking includes safe-harbors from the definition of a swap for customary consumer and commercial transactions. The Commissions have expanded the list of consumer transactions that are excluded from the swap

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[1167] The additional research costs associated with an interpretation as opposed to codification in the Code of Federal Regulations will be small, because the CFTC has placed this interpretation, and all other products interpretations, in this adopting release for the convenience of practitioners.

[1168] See IECA Letter.

definition. While it may be possible that federal courts will nevertheless hear more disputes, that would be a result of the statutory swap definition and not from the interpretation being adopted by the Commissions (which should reduce the number of such disputes).

Another commenter[1169] agreed with the general factors proposed for identifying agreements, contracts, or transactions that are not swaps, but requested additional clarity with respect to particular transactions. Specifically, the commenter requested that commercial loans and financing facilities with embedded interest rate options should not be considered swaps. To clarify, interest rate options are swaps. As discussed in section II.B.3. above, plain vanilla interest rate options embedded in a loan, such as rate locks, rate caps and rate collars, are not swaps. If a product is more complex, it may be appropriate for the CFTC to consider it in response to a specific request for interpretation.

7. Residential Exchange Program ("REP")

The REP[1170] was established by Congress "[t]o extend the benefits of low cost Federal System hydro power to residential and small farm electric power consumers throughout the Pacific Northwest Region."[1171] A commenter requests that the CFTC further define the term "swap" to exclude consumer benefits under the Pacific Northwest Electric Power Planning and Conservation Act of 1980 ("Northwest Power Act")[1172] and transactions under the REP[1173] to allow a subsidy to continue to be received by residential and small farm utilities.

1169 See FCC Letter.

1170 The BPA refers to the implementation of Section 5(c) of the Northwest Power Act, 16 U.S.C. 839c(c), as the "Residential Exchange Program."

1171 Id. at 3.

1172 16 U.S.C. Chapter 12H.

1173 See Bonneville Letter.

The Commissions do not consider the REP transactions described by the commenter to be swaps or security-based swaps. Consequently, this rulemaking clarifies that Dodd-Frank regulatory costs will not be imposed on REPs and allows the subsidy to continue to be provided to residential and small farm utilities.

8. Costs and Benefits of Rule Regarding Foreign Exchange Products and Forward Rate Agreements

CFTC rule 1.3(xxx)(2) under the CEA explicitly defines the term "swap" to include an agreement, contract, or transaction that is a cross-currency swap, currency option, foreign currency option, foreign exchange option, foreign exchange rate option, foreign exchange forward, foreign exchange swap, forward rate agreement, and non-deliverable forward involving foreign exchange, unless such agreement, contract, or transaction is otherwise excluded by section 1a(47)(B) of the CEA. Rule 1.3(xxx)(3) provides that: i) a foreign exchange forward or a foreign exchange swap shall not be considered a swap if the Secretary of the Treasury makes the determination described in CEA section 1a(47)(E)(i); and ii) notwithstanding any such determination, certain provisions of the CEA will apply to such a foreign exchange forward or foreign exchange swap (specifically, the reporting requirements in section 4r of the CEA[1174] and regulations thereunder and, in the case of a swap dealer or major swap participant that is a party to a foreign exchange swap or foreign exchange forward, the business conduct standards in section 4s of the CEA[1175] and regulations thereunder). Rule 1.3(xxx)(3) further clarifies that a currency swap, cross-currency swap, currency option, foreign currency option, foreign exchange option, foreign exchange rate option, or non-deliverable forward involving foreign exchange is

[1174] 7 U.S.C. 6r.

[1175] 7 U.S.C. 6s.

not a foreign exchange forward or foreign exchange swap subject to a determination by the Secretary of the Treasury as described in the preamble.

The Commissions are also clarifying that a bona fide foreign exchange spot transaction, i.e., a foreign exchange transaction that is settled on the customary timeline[1176] of the relevant spot market, is not within the definition of the term "swap." In addition, the interpretation clarifies that retail foreign currency options described in CEA Section 2(c)(2)(B) are not swaps. This clarification allows market participants to engage in these transactions with non-ECP customers who would otherwise have to engage in on-exchange transactions.

a) Costs

In complying with rule 1.3(xxx)(2), a market participant will need to ascertain whether an agreement, contract, or transaction is a swap under the definition. This analysis will have to be performed upon entering into the agreement, contract, or transaction. However, any costs associated with this analysis are expected to be less than the costs of doing the same analysis absent the rule, particularly given potential confusion in the event of a determination by the Secretary of the Treasury that foreign exchange forwards and/or foreign exchange swaps not be considered swaps. To the extent that rule 1.3(xxx)(2) improperly includes certain types of agreements, contracts, and transactions in the swap definition, and therefore the imposition of additional requirements and obligations, these requirements and obligations could lead to costs for market participants entering into such agreements, contracts, or transactions. However, the

[1176] As discussed in section II.C.2.(c) above, in general, a foreign exchange transaction will be considered a bona fide spot transaction if it settles via an actual delivery of the relevant currencies within two business days. However a foreign exchange transaction with a longer settlement period concluding with the actual delivery of the relevant currencies may be considered a bona fide spot transaction depending on the customary timeline of the relevant market. In particular, a foreign exchange transaction that is entered into solely to effect the purchase or sale of a foreign security is a bona fide spot transaction where certain conditions are met.

CFTC has carefully considered each of the agreements, contracts and transactions described above that it is further defining as swaps under rule 1.3(xxx)(2) and believe that they are appropriately classified as such, subject to the statutory exclusions.

b) Benefits

Because the statutory definition of the term "swap" includes a process by which the Secretary of the Treasury may determine that certain agreements, contracts, and transactions that meet the statutory definition of a "foreign exchange forward" or "foreign exchange swap," respectively,[1177] shall not be considered swaps, the CFTC is concerned that application of the definition, without further clarification, may cause uncertainty about whether, if the Secretary of the Treasury makes such a determination, certain agreements, contracts, or transactions would be swaps. Rule 1.3(xxx)(3) increases legal certainty that a currency swap, cross-currency swap, currency option, foreign currency option, foreign exchange option, foreign exchange rate option, or non-deliverable forward involving foreign exchange, is a swap (unless it is otherwise excluded by the statutory definition of the term "swap"). The rule also increases legal certainty that reporting requirements, and business conduct requirements for swap dealers and major swap participants, are applicable to foreign exchange forwards and foreign exchange swaps even if the Secretary of the Treasury determines that they should not be considered swaps, and is consistent with the statute. The CFTC also is concerned that confusion could be generated by the "forward" label of non-deliverable forwards involving foreign exchange, and forward rate agreements. Rule 1.3(xxx)(2) increases legal certainty that these types of agreements, contracts, and transactions are swaps.

[1177] CEA section 1a(24), 7 U.S.C. 1a(24)(definition of a "foreign exchange forward"); CEA section 1a(25), 7 U.S.C. 1a(25)(definition of a "foreign exchange swap").

Providing such a rule to market participants to determine whether certain types of agreements, contracts, or transactions are swaps alleviates additional costs to persons of inquiring with the Commissions, or obtaining an opinion of counsel, about whether such agreements, contracts, or transactions are swaps. In addition, such a rule regarding the requirements that apply to foreign exchange forwards and foreign exchange swaps that are subject to a determination by the Secretary of the Treasury similarly alleviates additional costs to persons of inquiring with the Commissions, or obtaining an opinion of counsel, to determine the requirements that are applicable to such foreign exchange forwards and foreign exchange swaps. As with the other rules comprising the Product Definitions, enhanced legal certainty will help market participants to engage in sound risk management practices, which will benefit both market participants and the public.

The interpretation concerning bona fide foreign exchange spot transactions should result in the appropriate classification of such transactions as not subject to Dodd-Frank Act regulation. The interpretation regarding retail foreign currency options subject to CEA Section 2(c)(2)(B) as not swaps provides clarity and reduces costs for market participants, who could not offer the product to non-ECP customers off-exchange in accordance with the provisions of CEA Section 2(c)(2)(B).

In addition, including certain FX transactions, forward rate agreements and certain other transactions in the swap definition protects the public by explicitly subjecting these transactions to Dodd-Frank regulation.

c) Comments and Consideration of Alternatives

The CFTC requested comment as to the costs and benefits of proposed rules 1.3(xxx)(2) and (3). As discussed in the preamble, some commenters[1178] argued that non-deliverable foreign exchange forward transactions should be regulated as foreign exchange forwards, because regulating them as swaps would increase the cost of hedging foreign currency exposures in emerging markets.

Non-deliverable forward transactions do not satisfy the statutory definition of foreign exchange forwards, as explained in section II.C.2.(b)(ii), supra. They do satisfy the swap definition, however. Accordingly, the CFTC lacks discretion not to define them as swaps.

9. Costs and Benefits of Rule Regarding Title VII Instruments on Futures on Foreign Sovereign Debt under Exchange Act Rule 3a12-8

Rule 1.3(bbbb) provides that a Title VII instrument that is based on or references a qualifying foreign futures contract on the debt securities of one or more of the 21 enumerated foreign governments is a swap and not a security-based swap if the Title VII instrument satisfies the following conditions:

- The futures contract on which the Title VII instrument is based or that is referenced must be a qualifying foreign futures contract (as defined in rule 3a12-8) on the debt securities of any one or more of the 21 enumerated foreign governments that satisfies the conditions of rule 3a12-8;
- The Title VII instrument is traded on or through a board of trade (as defined in section 1a(6) of the CEA);

[1178] See CEIBA Letter; Covington Letter; ISDA Letter; and MFA Letter.

- The debt securities on which the qualifying foreign futures contract is based or referenced and any security used to determine the cash settlement amount pursuant to the fourth condition below are not registered under the Securities Act or the subject of any American depositary receipt registered under the Securities Act;
- The Title VII instrument may only be cash settled; and
- The Title VII instrument is not entered into by the issuer of the securities upon which the qualifying foreign futures contract is based or referenced (including any security used to determine the cash payment due on settlement of such Title VII instrument), an affiliate (as defined in the Securities Act and the rules and regulations thereunder)[1179] of the issuer, or an underwriter with respect to such securities.

Only those Title VII instruments that are based on qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments and that satisfy these five conditions will be swaps. The final rules are intended to provide consistent treatment (other than with respect to method of settlement) of qualifying foreign futures contracts and Title VII instruments based on qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments.[1180] The Commissions understand that many of the qualifying

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1179 See, e.g., rule 405 under the Securities Act, 17 CFR 230.405.

1180 The Commissions note that the final rules provide consistent treatment of qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments and Title VII instruments based on qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments unless the Title VII instrument is entered into by the issuer of the securities upon which the qualifying foreign futures contract is based or referenced (including any security used to determine the cash payment due on settlement of such Title VII instrument), an affiliate of the issuer, or an underwriter with respect to such securities.

foreign futures contracts on the debt securities of the 21 enumerated foreign governments trade with substantial volume through foreign trading venues under the conditions set forth in rule 3a12-8[1181] and permitting swaps on such futures contracts subject to similar conditions would not raise concerns that such swaps could be used to circumvent the conditions of rule 3a12-8 and the federal securities laws concerns that such conditions are intended to protect.[1182] Further, providing consistent treatment for qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments and Title VII instruments based on futures contracts on the debt securities of the 21 enumerated foreign governments will allow trading of these instruments through DCMs on which such futures are listed. There may also be cross-margining benefits when different contracts are margined at the same derivatives clearing organization, such as may be the case if a swap on a futures contract and a corresponding futures contract trade on the same DCM. This cross-margining would enhance sound risk management practices.

The CFTC believes that the assessment cost associated with determining whether a swap on certain futures contracts on foreign government securities constitute a swap or security-based swap under rule 1.3(bbbb) should be minimal. Currently, qualifying foreign futures contracts on debt securities of the 21 enumerated foreign governments are traded on exchanges or boards of trade. Market participants may look at the exchange or board of trade listing to determine what they are. Therefore, the assessment, in accordance with the rule, would primarily focus on whether such swap itself is traded on or through a board of trade; whether the swap is cash-settled; whether the futures is traded on a board of trade; whether any security used to determine the cash settlement amount are not registered under the Securities Act or the subject of any

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1181 See supra note 716 and accompanying text.

1182 See supra note 712 and accompanying text.

American depositary receipt registered under the Securities Act; and whether the swap is entered into by the foreign government issuing the debt securities upon which the qualifying futures contract is based or referenced, an affiliate of such foreign government or an underwriter of such foreign government securities. All of these determinations may be readily and quickly ascertained by the parties entering into the agreement, contract, or transaction. Therefore, the assessment costs associated with rule 1.3(bbbb) should be nominal because parties should be able to make assessments in less than an hour.

10. Costs and Benefits of Rules and Interpretations Regarding Title VII Instruments where the Underlying Reference is a Security Index

Historically, the market for index CDS did not divide along jurisdictional divisions between the CFTC and SEC;[1183] however, the Dodd-Frank Act created a jurisdictional divide between swaps and security-based swaps. Under the jurisdictional division, the CFTC has jurisdiction over Title VII instruments based on non-narrow-based security indexes while the SEC has jurisdiction over Title VII instruments based on narrow-based security indexes. The SEC also has jurisdiction over Title VII instruments based on a single security or loan, and certain events related to an issuer of securities or issuers of securities in a narrow-based security index.

Rule 1.3(yyy)(1) under the CEA provides that, for purposes of the security-based swap definition, the term "narrow-based security index" would have the same meaning as the statutory definition set forth in CEA section 1a(35), and the rules, regulations, and orders issued by the Commissions relating to such definition. As a result, except where the new rules the

[1183] For example, index CDS and single name CDS have typically been traded on the same trading desk, and customers have typically held their positions in a single account. The CFTC notes that the jurisdictional divide will impact among other things portfolio margining.

Commissions are adopting provide for other treatment, market participants generally will be able to use the Commissions' past guidance in determining whether certain Title VII instruments based on a security index are swaps or security-based swaps.

The Commissions are promulgating additional rules and providing interpretations regarding Title VII instruments based on a security index. The interpretations and additional rules set forth new narrow-based security index criteria with respect to indexes composed of securities, loans, or issuers of securities referenced by an index CDS. The interpretations and rules also address the definition of an "index" and the treatment of broad-based security indexes that become narrow-based and narrow-based indexes that become broad-based, including rule provisions regarding tolerance and grace periods for swaps on security indexes that are traded on CFTC-regulated and SEC-regulated trading platforms.

a) Costs

In complying with the rules and interpretations, a market participant will need to ascertain whether a Title VII instrument is a swap or a security-based swap according to the criteria set forth in the definitions of the terms "issuers of securities in a narrow-based security index" and "narrow-based security index" as used in the security-based swap definition. This analysis will have to be performed prior to the execution of, but no later than an offer to enter into, a Title VII instrument, and when the material terms of a Title VII instrument are amended or modified, to ensure compliance with rules 1.3(yyy), 1.3(zzz) or 1.3(aaaa).

However, any such costs are expected to be less than the costs of doing the same analysis absent the rules, which the CFTC believes would be more difficult and lead to greater uncertainty. In particular, rule 1.3(yyy) allows market participants to reduce the costs of determining whether a Title VII instrument based on a security index, other than an index CDS, is a swap or security-based swap by clarifying that they will be able to use the Commissions'

past guidance regarding narrow-based security index in making that determination. In the context of index CDS, the Commissions' past guidance regarding narrow-based security indexes does not establish criteria on whether index CDS is a swap or a security-based swap. Accordingly, without further explanation, it would not be clear on which side of the CFTC/SEC jurisdictional divide index CDS would fall. CFTC rules 1.3(zzz) and 1.3(aaaa) allow market participants to reduce the costs of determining whether an index CDS is a swap or a security-based swap by providing a test with objective criteria that is similar to a test with which they already are familiar in the security futures context, yet tailored to index CDS in particular.

Additionally, absent rule 1.3(yyy), which applies the tolerance period rules, if a security index underlying a Title VII instrument traded on a trading platform migrated from being broad-based to being narrow-based, market participants may suffer disruption of their ability to offset or enter into new Title VII instruments, and incur additional costs as a result.

DCMs and SEFs will incur costs in assessing whether an index underlying a Title VII instrument is broad-based, in monitoring the index for migration from broad to narrow-based. There will also be other costs resulting from the migration such as delisting costs. Such migration costs are mitigated by the tolerance period of 45 business days over three calendar months which should reduce the incidence of migration. Similarly, the three-month grace period following an indexes failure of the tolerance period should mitigate delisting and other costs. There will be a range of assessment costs depending on how customized the index underlying an index CDS is.[1184]

[1184] Additionally, the number of components in an index may impact the assessment costs based on having to determine whether the indexes components satisfy the various tests within the rule.

In determining whether a Title VII instrument is a swap or a security-based swap, market participants will need to apply the criteria found in CFTC rules 1.3(yyy), 1.3(zzz) and 1.3(aaaa). Market participants may conduct such analysis in-house or employ outside third-party service providers to conduct such analysis. The costs associated with obtaining such outside professional services would vary depending on the relevant facts and circumstances, particularly the composition of the index. The CFTC believes, however, that $20,000 represents a reasonable estimate of the upper end of the range of the costs of obtaining the services of outside professional in undertaking the analysis.[1185] The CFTC believes that some index CDS based on an established index would not need the assistance of outside counsel, and a determination can be made in less than one hour. If an agreement, contract, or transaction is more complex, the CFTC estimates the analysis will require up to approximately 20 hours of in-house counsel time and 30 hours of outside counsel time.

b) Benefits

Rules 1.3(zzz) and 1.3(aaaa) clarify the treatment of an index CDS as either a swap or a security-based swap by setting forth objective criteria for meeting the definition of the terms

[1185] The average cost incurred by market participants in connection with assessing whether an agreement, contract, or transaction is a swap or security-based swap is based upon the estimated amount of time that staff believes will be required for both in-house counsel and outside counsel to apply the definition. The staff estimates that costs associated with determining whether an agreement, contract, or transaction is a swap or security-based swap will range up to$20,000 after rounding to two significant digits. Staff estimates that some index CDS will be standard and an internal attorney, without the assistance of outside counsel will be able to make a determination in less than one hour. Based upon data from SIFMA's *Management & Professional Earnings in the Securities Industry 2011* (modified by CFTC staff to account for an 1800-hour-work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead), staff estimates that the average national hourly rate for an internal attorney is $378. If an agreement, contract, or transaction is more complex, the CFTC estimates the analysis will require approximately 20 hours of in-house counsel time and 30 hours of outside counsel time. The CFTC estimates the costs for outside legal services to be $400 per hour. Accordingly, on the high end of the range the CFTC estimates the cost to be $19,560 ($7,560 (based on 20 hours of in-house counsel time x $378) + $12,000 (based on 30 hours of outside counsel x $400) which is then rounded to two significant digits to $20,000.

"issuers of securities in a narrow-based security index" and "narrow-based security index," respectively. These objective rules alleviate additional costs to persons trading index CDS of inquiring with the Commissions, or obtaining an opinion of counsel, to make complex determinations regarding whether an index is broad- or narrow-based, and whether an index CDS based on such an underlying index is a swap or security-based swap.

Also, rules 1.3(zzz) and 1.3(aaaa) should reduce the potential for market participants to use an index CDS to evade regulations, because they set objective requirements relating to the concentration of the notional amount allocated to each reference entity or security included in the index, as well as the eligibility conditions for reference entities and securities. Finally, these rules benefit the public by requiring that the providers of index CDS make publicly available sufficient information regarding the reference entities in an index underlying the index CDS. By requiring that such information be made publicly available, rules 1.3(zzz) and 1.3(aaaa) seek to assure the transparency of the index components that will be beneficial to market participants who trade such instruments and to the public.

Separately, rule 1.3(yyy) addresses exchange-traded swaps based on security indexes where the underlying index migrates from broad-based to narrow-based. The rule includes provisions that many market participants are familiar with from security futures trading. The CFTC believes that by using a familiar regulatory scheme, market participants will be able to more readily understand the rule as compared to a wholly new regulatory scheme. Also, the use of a "tolerance period" for swaps on security indexes that migrate from broad-based to narrow-based also creates greater clarity by establishing a 45-day timeframe (and subsequent grace period) on which market participants may rely. This tolerance period results in cost savings when compared to the alternative scenario where no tolerance period is provided and a migration

of an index from broad-based to narrow-based would result in potential impediments to the ability of market participants to offset their swap positions.

Finally, the Commissions are stating that the determination of whether a Title VII instrument is a swap, a security-based swap, or both (i.e., a mixed swap), is made prior to the execution of, but no later than an offer to enter into, the Title VII instrument. If the security index underlying a Title VII instrument migrates from being broad-based to being narrow-based, or vice versa, during the life of a Title VII instrument, the characterization of that Title VII instrument would not change from its initial characterization regardless of whether the Title VII instrument was entered into bilaterally or was executed through a trade on or subject to the rules of a DCM, SEF, FBOT, security-based SEF, or NSE. Absent this interpretation, market participants potentially would need to expend additional resources to continually monitor their swaps to see if the indexes on which they are based have migrated from broad-based to narrow-based. Since the rule provides that the initial determination prevails regardless of whether the underlying index migrates from broad-based to narrow-based, market participants do not need to expend these monitoring costs.

c) Comments and Consideration of Alternatives

A commenter asserted that the regulatory complexity for index CDS is not worth the high compliance costs.[1186] The statute provides that the CFTC has jurisdiction over swaps on broad-based security indices, and the SEC has jurisdiction over swaps on narrow-based security indices, single securities or loans, and certain events related to the issuers of securities. The Commissions need to establish criteria for index CDS, because their past guidance regarding narrow-based security indices does not address them. Without further explanation, it would not

[1186] See ISDA Letter.

be clear on which side of the CFTC/SEC jurisdictional division certain products would fall. The number and concentration limits are derived from criteria that Congress has imposed in the security futures context. The public information availability test does not require that index constituents satisfy all of its requirements; rather, the constituents may satisfy any one of them for the index to be broad-based, and there is a de minimis level for noncompliance.

Another commenter[1187] stated that the proposed interpretation needs to be clearer on loan-based swap transactions and that it is costly to determine whether a particular set of loans or borrowers meets the Commissions' public information availability requirement. The Commissions are clarifying that a TRS on two or more loans is not subject to the broad-based/narrow-based jurisdictional divide, but is a swap under the CFTC's jurisdiction. With respect to loan index CDS, the Commissions believe that the index CDS rules, including the public information availability requirement, should apply to indexes of loans underlying index CDS. However, the Commissions are amending the proposed rules to include loans within the categories of instruments to be aggregated for the total principal amount of debt outstanding threshold of the public information availability requirement, and will aggregate outstanding debt of affiliates for purposes of the test, which the CFTC believes should address the commenter's concerns.

A commenter[1188] pointed out that there may be costs to relist index-based CDS when the index stops being, or becomes, broad-based. Another commenter[1189] believed that the public

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1187 See LSTA Letter.

1188 See MarketAxess Letter.

1189 See Markit Letter.

information availability test will cause indices to switch between narrow-based and broad-based classification, which could result in unnecessary cost, confusion, and market disruption.

The statutory framework requires delisting and relisting. These costs are mitigated by the tolerance period for migration, which may help to prevent frequent migration of indices from broad-based to narrow-based or vice versa. Moreover, it is the case for both on and off-exchange Title VII instruments that the Commissions are stating that the determination of whether a Title VII instrument on a security index is a swap or security-based swap is made prior to execution, but no later than the offer to enter into the instrument, and remains the same throughout the life of the instrument. Accordingly, even if the public information availability test would cause indexes underlying index CDS to migrate as suggested by a commenter, that will not affect the classification of outstanding index CDS entered into prior to such migration. However, if an amendment or change is made to such outstanding index CDS that would cause it to be a new purchase or sale of such index CDS, that could affect the classification of such outstanding index CDS.

A commenter asserted that extending the "grace period" from three months to six months would ease any disruption or dislocation associated with the delisting process with respect to an index that has migrated from broad to narrow, or narrow to broad, and that has failed the tolerance period.[1190] The commenter further suggested that where an index CDS migrates, for entities operating both a SEF and a security-based SEF, such entities should be permitted to move the index from one platform to the other simply by providing a notice to the SEC and CFTC.

[1190] See MarketAxess Letter.

The Commissions are adopting the proposed rules without modification. As discussed in Section III.G.5(b) above, the Commissions note that the three-month grace period applicable to security futures was mandated by Congress in that context,[1191] and the commenter has provided no data or evidence for its request that the Commissions diverge from that grace period and provide for a longer grace period with respect to swaps and security-based swaps. The Commissions believe that the three-month grace period is similarly appropriate to apply in the context of an index that has migrated to provide sufficient time to execute off-setting positions. With respect to the commenter's other suggestion that entities operating both a SEF and a security-based SEF should be able to move the index from one platform to another where an index CDS migrates simply by filing a notice with the SEC and CFTC, the Commissions do not believe that this proposal is within the scope of this rulemaking.

Many commenters offered alternatives to the various tests in proposed rules 1.3(zzz) and 1.3(aaaa).[1192] As discussed more fully above in Section III.G.3.(b), the Commissions have incorporated many of the suggested alternatives into the final rules and interpretations and rejected, after careful consideration, other suggested alternatives. For example, three commenters requested that the Commissions revise the affiliation definition that applies when calculating the number and concentration criteria to require a majority control affiliation threshold, rather than the 20 percent threshold in the proposed rules.[1193] As discussed in section III.G.3.(b) above, the Commissions are modifying the affiliation definition that applies when calculating the number and concentration criteria in response to commenters to use an affiliation

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1191 See July 2006 Debt Index Rules. The Commissions are not aware of any disruptions caused by the three-month grace period in the context of security futures.

1192 See section III.G.3.(b).

1193 See ISDA Letter; Markit Letter; and SIFMA Letter.

test based on majority ownership. Based on commenters' letters, the Commissions understand that the current standard CDS documentation and the current approach used by certain index providers for index CDS with respect to the inclusion of affiliated entities in the same index use majority ownership rather than 20 percent ownership to determine affiliation. The Commissions are persuaded by commenters that in the case of index CDS only it is more appropriate to use majority ownership because majority-owned entities are more likely to have their economic interests aligned and be viewed by the market as part of a group. The Commissions believe that revising the affiliation definition in this manner for purposes of calculating the number and concentration criteria responds to commenters' concerns that the percentage control threshold may inadvertently include entities that are not viewed as part of a group. Thus, as revised, the affiliation definition will include only those reference entities or issuers included in an index that satisfy the more than 50 percent (i.e., majority ownership) control threshold.

Due to the high compliance costs resulting from the public information availability test in particular, a commenter[1194] argued that the Commissions should abandon that test. The final rules retain the public information availability test, which does not present significant compliance costs because it does not require that constituents satisfy all of the requirements and permits a de minimis level of noncompliance.

One commenter offered an alternative to the public information availability test based on the volume of trading.[1195] After careful consideration and as described more fully above in section II.G.3.(b), above, the Commissions are not adopting a volume based test either as a replacement or alternative for the public information availability test. A volume based test

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1194 See SIFMA Letter.

1195 See Markit Letter.

would not be readily ascertainable with respect to certain underlying components which are not exchange traded or do not satisfy listing standards. The public information availability test allows for more flexibility with respect to the components included in indexes underlying index CDS than a volume-based test. Individual components in an index CDS may not satisfy a volume-based test but could otherwise satisfy one of the criteria of the public information availability test. The public information availability test is similar to the test in the rules for debt security indexes, which, as noted above, apply in the context of Title VII Instruments. The public information availability test, accordingly, provides a consistent set of rules under which index compilers and market participants can analyze the characterization of index CDS.

In the public information availability test, one commenter proposed moving the outstanding debt threshold from $1 billion to $100 million.[1196] As stated above, the CFTC believes that the $1 billion debt threshold, which is the same amount as the outstanding debt threshold in the rules for debt security indexes, is set at the appropriate level to achieve the objective that such entities are likely to have public information available about them.[1197] However, the adopted rules expand on the types of debt that are counted toward the $1 billion debt threshold to include any indebtedness, including loans, so long as such indebtedness in not a revolving credit facility.

In response to a request for comment by the Commissions, two commenters believed that the presence of a third-party index provider would assure that sufficient information is available regarding the index CDS itself, but neither commenter provided an analysis to explain how or

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1196 Id.

1197 See supra part III.G.3(b)(iii); See Securities Offering Reform, Release No. 33-8591 (Jul. 19, 2005), 70 FR 44722 (Aug. 3, 2005) (discussing economic analysis involved in determining the $1 billion threshold for non-convertible securities in the context of well-known seasoned issuers).

whether a third-party index provider would be able to provide information about the underlying securities or issuers of securities in the index.[1198] Accordingly, the Commissions are not adopting this alternative.

A commenter[1199] argued that legal uncertainty would present a burden to market participants absent the Commissions clarifying the status of swaps on shares of exchange traded funds that reference broad-based security indices. However, market participants can request a clarification through the interpretation process established herein by the Commissions.

11. Costs and Benefits of Processes to Determine Whether a Title VII Instrument is a Swap, Security-Based Swap, or Mixed Swap, and to Determine Regulatory Treatment for Mixed Swaps

a) Costs

Rule 1.8 under the CEA allows persons to submit a request for a joint interpretation from the Commissions regarding whether an agreement, contract or transaction (or a class of agreements, contracts, or transactions) is a swap, security-based swap, or mixed swap. The CFTC estimates the cost of submitting a request for a joint interpretation pursuant to rule 1.8 would be a cost of about $7,700 for internal company or individual time and associated costs of $12,000 for the services of outside professionals.[1200] Once such a joint interpretation is made,

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1198 See ISDA Letter and SIFMA Letter.

1199 See Anon. Letter.

1200 This estimate is based on information indicating that the average costs associated with preparing and submitting a no-action request to the SEC staff in connection with the identification of whether certain products are securities, which the CFTC believes is a process similar to the process under rule 1.8. The staff estimates that costs associated with such a request will cost approximately $20,000. The CFTC estimates the analysis will require approximately 20 hours of in-house counsel time and 30 hours of outside counsel time. Based upon data from SIFMA's *Management & Professional Earnings in the Securities Industry 2011* (modified by CFTC staff to account for an 1800-hour-work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead), staff estimates that the average national hourly rate for an internal attorney is $378. The CFTC estimates the costs for outside legal services to be $400 per hour. Accordingly, the CFTC estimates the cost to be $20,000 ($7,560 (based on 20 hours of in-

however, other market participants that seek to transact in the same agreement, contract, or transaction (or class thereof) would have regulatory clarity about whether it is a swap, security-based swap, or mixed swap, so the CFTC expects the aggregate costs of submitting joint interpretations to decrease over time as joint interpretations are issued and the number of new requests decrease as a result.

Separately, CFTC rule 1.9 under the CEA allows persons to submit a request for a joint order from the Commissions regarding an alternative regulatory treatment for particular mixed swaps. This process applies except with respect to bilateral, uncleared mixed swaps where one of the parties to the mixed swap 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. With respect to bilateral uncleared mixed swaps where one of the parties is a dual registrant, the rule provides that such mixed swaps would be subject to the regulatory scheme set forth in rule 1.9 in order to provide clarity as to the regulatory treatment of such mixed swaps.

The CFTC estimates that the cost of submitting a request for a joint order seeking an alternative regulatory treatment for a particular mixed swap would be approximately $31,000.[1201]

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house counsel time x $378) + $12,000 (based on 30 hours of outside counsel x $400) rounded to two significant digits to $20,000 to submit a joint request for interpretation.

[1201] This estimate is based on information indicating that the average costs associated with preparing and submitting a no-action request to the SEC staff in connection with the identification of whether certain products are securities, which the CFTC believes is a process similar to the process under rule 3a68-4(c). The staff estimates that costs associated with such a request will cost approximately $31,000. The CFTC estimates the analysis will require approximately 30 hours of in-house counsel time and 50 hours of outside counsel time. Based upon data from SIFMA's *Management & Professional Earnings in the Securities Industry 2011* (modified by CFTC staff to account for an 1800-hour-work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead), staff estimates that the average national hourly rate for an internal attorney is $378. The CFTC estimates the costs for outside legal services to be $400 per hour. Accordingly, the CFTC estimates the cost to be $31,000 ($11,340 (based on 30 hours of in-house counsel time x $378) + $20,000 (based on 50 hours of outside counsel x $400) rounded to two significant digits to submit a joint request for interpretation.

Absent such a process, though, market participants that desire or intend to enter into such a mixed swap (or class thereof) would be required pursuant to Title VII of the Dodd-Frank Act to comply with all regulatory requirements applicable to both swaps and security-based swaps. The CFTC believes that the cost of such dual regulation would likely be at least as great, if not greater, than the costs of the process set forth in rule 1.9 to request an alternative regulatory treatment for such the mixed swap. The rule regarding bilateral uncleared mixed swaps where at least one party is a dual registrant does not entail any additional costs, and may reduce costs for dual registrants that enter into such mixed swaps by eliminating potentially duplicative or inconsistent regulation.

b) Benefits

The CFTC believes that the rules that enable market participants to submit requests for joint interpretations regarding the nature of various agreements, contracts, or transactions, and requests for joint orders regarding the regulatory treatment of mixed swaps will help to create a more level playing field (since the joint interpretations and joint orders will be available to all market participants) regarding which agreements, contracts, or transactions constitute swaps, security-based swaps, or mixed swaps, and the regulatory treatment applicable to particular mixed swaps. The joint interpretations and joint orders will be available to all market participants. The availability of such joint interpretations and joint orders regarding the scope of the definitions and the regulatory treatment of mixed swaps will reduce transaction costs and thereby promote the use of Title VII instruments for risk management and other purposes.

The product interpretation process established by the Commissions has a 120-day deadline. This deadline will facilitate new products coming to market relatively quickly. Further, the process holds the Commissions accountable because they will have to state why they are not providing an interpretation when they decline to do so.

c) Comments and Consideration of Alternatives

A commenter[1202] recommended that the Commissions require that market participants disaggregate mixed swaps and enter into separate simultaneous transactions so that they cannot employ mixed swaps to obscure the underlying substance of transactions.[1203] The Commissions are not adopting any rules or interpretations to require disaggregation of mixed swaps into their separate components, as the Dodd-Frank Act specifically contemplated that there would be mixed swaps comprised of both swaps and security-based swaps. Moreover, the CFTC believes that requiring market participants to disaggregate their agreements, contracts, or transactions into swaps and security-based swaps may limit the freedom of contract or discourage innovation of financial products and potentially increase transaction costs for swap market participants.

12. Costs and Benefits of SBSA Books and Records, and Data, Requirements

CFTC rule 1.7 under the CEA would clarify that there would not be books and records or data requirements regarding SBSAs other than those that would exist for swaps. The rule alleviates any additional books and records or information costs to persons who are required to keep and maintain books and records regarding, or collect and maintain data regarding, SBSAs because the rule does not require such persons to keep or maintain any books and records, or collect and maintain any data, regarding SBSAs that differs from the books, records, and data required regarding swaps.

Specifically, rule 1.7 would require persons registered as SDRs to: i) keep and maintain books and records regarding SBSAs only to the extent that SDRs are required to keep and maintain books and records regarding swaps; and ii) collect and maintain data regarding SBSAs

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1202 See Better Markets Letter.

1203 Id.

only to the extent that SDRs are required to collect and maintain data regarding swaps. In addition, rule 1.7 would require persons registered as swap dealers or major swap participants to keep and maintain books and records, including daily trading records, regarding SBSAs only to the extent that those persons would be required to keep and maintain books and records regarding swaps.

Because rule 1.7 imposes no requirements with respect to SBSAs other than those that exist for swaps, rule 1.7 would impose no costs other than those that are required with respect to swaps in the absence of rule 1.7. Rule 1.7 provides clarity by establishing uniform requirements regarding books and records, and data collection, requirements for swaps and for SBSAs. No comments were received with respect to Rule 1.7.

13. Costs and Benefits of the Anti-Evasion Rules and Interpretation

The CFTC is exercising the anti-evasion rulemaking authority granted to it by the Dodd-Frank Act. Generally, CFTC rule 1.3(xxx)(6) under the CEA defines as a swap any agreement, contract, or transaction that is willfully structured to evade the provisions of Title VII governing the regulation of swaps. Further, CFTC rule 1.6 under the CEA would prohibit activities conducted outside the United States, including entering into agreements, contracts, and transactions and structuring entities, to willfully evade or attempt to evade any provision of the CEA as enacted by Title VII or the rules and regulations promulgated thereunder.

As opposed to providing a bright-line test, rule 1.3(xxx)(6) would apply to agreements, contracts, and transactions that are willfully structured to evade and rule 1.6 would apply to entering into agreements, contracts, or transactions to evade (or as an attempt to evade) and structuring entities to evade (or as an attempt to evade) subtitle A of Title VII governing the regulation of swaps. Although this test does not provide a bright line, it helps ensure that would-be evaders cannot willfully structure their transactions or entities for the purpose of evading the

requirements of subtitle A of Title VII. The CFTC also is explaining some circumstances that may constitute an evasion of the requirements of subtitle A of Title VII, while at the same time preserving the CFTC's ability to determine, on a case-by-case basis, with consideration given to all the facts and circumstances, that other types of transactions or actions constitute an evasion of the requirements of the statute or the regulations promulgated thereunder.

a) Costs

Market participants may incur costs when deciding whether a particular transaction or entity could be construed as being willfully structured to evade subtitle A of Title VII of the Dodd-Frank Act; however, the rules and related interpretations explain what constitutes evasive conduct, which should serve to mitigate such costs.

b) Benefits

Absent the proposed anti-evasion rules and related interpretations, price discovery might be impaired because markets would not be informed about those transactions, since through evasion such transactions would not comply with Dodd-Frank Act regulatory requirements. Additionally, certain risks could increase in a manner that the CFTC would not be able to measure accurately. The anti-evasion rules and related interpretations will bring the appropriate scope of transactions and entities within the regulatory framework established by the Dodd-Frank Act, which will better allow the CFTC to assure transparency and protect the U.S. financial system from certain risks that could go undetected through evasive conduct.

c) Comments and Consideration of Alternatives

A commenter[1204] asserted that a market participant should be able to enter into a transaction or structure an instrument or entity to avoid higher regulatory burdens and attendant

[1204] See CME Letter.

costs as long as the transaction or entity has an overriding business purpose. Another commenter[1205] noted that the CFTC recognized in the Proposing Release that choosing to do a security-based swap over a swap to lessen a regulatory burden does not constitute evasion in itself, but expressed the view that this should not be limited to a choice between structuring a transaction as a swap and security. In this commenter's view, parties must be able to legitimately consider all relevant factors, including the cost and burden of regulation, in making their structuring choices. Another commenter[1206] requested that the CFTC make clear that movements away from swaps towards physical trades that reduce regulatory burdens will not be considered evasion under the final rule. A different commenter[1207] argued that the anti-evasion proposal is overly broad and unnecessarily limits the ability of market participants to choose between legitimate structuring alternatives. Finally, another commenter[1208] believes that the proposed rules will create an "impossible burden" on the innocent (non-evading) party.

Activity conducted solely for a legitimate business purpose, absent other indicia of evasion, does not constitute evasion as described in the CFTC's interpretation. The CFTC has clarified that consideration of regulatory burdens, including evidence of regulatory avoidance, is not dispositive of whether there has been evasion or not, but should be considered along with all other relevant facts and circumstances. For example, activities structured as securities instead of swaps and transactions that meet the forward exclusion are not evasion per se. The CFTC has clarified that it will impose appropriate sanctions on the willful evader for violation of the CEA and CFTC regulations and not on non-evading parties.

1205 See ISDA Letter.

1206 See COPE Letter.

1207 See SIFMA Letter.

1208 See IECA Letter II.

A commenter suggests that an alternative standard for a finding of evasion should be "whether the transaction is lawful or not" under the CEA, CFTC rules and regulations, orders, or other applicable federal, state or other laws.[1209] While the commenter's alternative standard for evasion may impose lower costs on market participants because it is a bright-line test, the CFTC is not adopting it. The commenter's alternative standard would blur the distinction between whether a transaction (or entity) is lawful and whether it is structured in a way to evade Dodd-Frank and the CEA. The anti-evasion rules provided herein are concerned with the latter conduct, not the former.[1210] Thus, the CFTC does not believe it is appropriate to limit the enforcement of its anti-evasion authority to only unlawful transactions.

CEA Section 15(a) Summary:

(1) Protection of market participants and the public

Including certain foreign exchange transactions, forward rate agreements and certain other transactions in the swap definition protects the public by subjecting these transactions to Dodd-Frank regulation. Similarly, the anti-evasion rules protect market participants against evasive conduct that would take away the protection afforded to them under Dodd-Frank regulation.

(2) Efficiency, competitiveness, and the financial integrity of markets

The CFTC believes that the final rules and interpretations can be consistently applied by substantially all market participants to determine which agreements, contracts, or transactions are, and which are not, swaps, security-based swaps, security-based swap agreements, or mixed swaps. This may improve resource allocation efficiency as market participant may not have to

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1209 See WGCEF Letter.

1210 If a transaction is unlawful, the CFTC (or another authority) may be able to bring an action alleging a violation of the applicable rule, regulation, order or law.

incur the cost of petitioning the Commissions or obtaining an opinion of counsel to determine the status of agreements, contracts or transactions as frequently as would be necessary without the rules or interpretations.

Moreover, the Commissions' statement that the determination of whether a Title VII instrument is a swap, a security-based swap, or both (i.e., a mixed swap), is made prior to the execution of, but no later than an offer to enter into, the Title VII instrument , and remains the same throughout the instrument's life (absent amendment of the instrument), improves resource allocation efficiency because, without this interpretation, market participants potentially would need to expend additional resources to continually monitor their swaps to see if the indexes on which they are based have migrated from broad-based to narrow-based. The tolerance and grace periods for index CDS traded on CFTC and SEC-regulated trading platforms should lower the frequency of index migration and attendant costs, also improving resource allocation efficiency.

(3) Price discovery

Not exempting swaps from foreign central banks, foreign sovereigns, international financial institutions, such as multilateral development banks, and similar organizations helps improve transparency and price discovery through disclosure that might otherwise not occur. Market participants will be informed about the prices of these transactions. Furthermore, they will be better informed about the risks that these transactions entail.

The CFTC's interpretation of the term "swap" to include guarantees of swaps that are not security-based swaps or mixed swaps and the separate CFTC release will enable the CFTC and market participants to receive more price-forming data about such swaps, which help improve price discovery for swaps. Without anti-evasion rules, price discovery might be impaired, since

market participants would otherwise not be informed about relevant but evasive swap transactions.

(4) Sound risk management practices

Properly classifying transactions as swaps or not swaps may lead to sound risk management practices, because the added clarity provided by the rules and interpretations herein will enable market participants to consider whether a particular agreement, contract, or transaction is a swap, prior to entering into such agreement, contract or transaction.

The business of insurance is already subject to established pre-Dodd-Frank Act regulatory regimes. Requirements that may work well for swaps and security-based swaps may not be appropriate for traditional insurance products. To the extent that the final rules distinguish insurance from swaps and security-based swaps, the CFTC believes that the Commissions should be able to tailor rules for specific products that are swaps or security-based swaps to achieve Title VII regulatory objectives. In adopting the Insurance Safe Harbor, the CFTC believes that the Commissions seek to achieve those net benefits that may be obtained from not supplanting existing insurance regulation.

Documenting oral book-outs should promote good business practices and aid the CFTC in preventing evasion through abuse of the forward exclusion.

Title VII instruments on qualifying foreign futures contracts on debt securities of one of the 21 enumerated foreign governments is a swap and not a security-based swap if the Title VII instrument satisfies certain conditions. The classification may provide cross-margining benefits when swap contracts and the futures contract are margined at the same derivatives clearing organization, and thus, may enhance sound risk management practices.

Other Public Interest Considerations

Documenting oral book-outs should promote good business practices and aid the CFTC in preventing evasion through abuse of the forward exclusion.

The product interpretation process established by the Commissions has a 120-day deadline. This deadline will facilitate new products coming to market relatively quickly. Further, the process holds the Commissions accountable, because they will have to state why they are not providing an interpretation when they decline to do so.

The rule for books and records requirements for SBSAs does not impose new recordkeeping requirements on SBSAs, but relies on existing recordkeeping requirements for swaps, which avoids unnecessary regulation.

Appendix – Rules Effectuated by the Product Definitions		
Rulemaking	**Description of Rule**	**Citation to Cost Benefit Considerations**
Agricultural Swaps	Makes no distinction between agricultural swaps and other swaps	76 FR 49291, 49297, Aug. 10, 2011
Commodity Options	Exempts subject to conditions certain options on physical commodities where parties are commercials or ECPs. The option results in physical delivery of the underlying.	77 FR 25320, 25331, Apr. 27, 2012
CPO/CTA compliance obligations	Rescinds the exemption from CPO registration; rescinds relief from the certification requirement for annual reports provided to operators of certain pools offered only to qualified eligible persons (QEPs; modifies the criteria for claiming relief); and require the annual filing of notices claiming exemptive relief under several sections of the Commission's regulations. Finally, the adopted amendments include new risk disclosure requirements for CPOs and CTAs.	77 FR 11252, 11275, Feb. 24, 2012
Business Conduct Standards for SDs and MSPs With Counterparties	Applies to SDs and (except where indicated) MSPs and prohibits certain abusive practices, requires disclosures of material information to counterparties and requires SDs/MSPs to undertake certain due diligence relating to their dealings with counterparties. Certain rules do not apply to transactions initiated on a swap execution facility (SEF) or designated contract market (DCM) when the SD/MSP does not know the identity of the counterparty prior to execution.	77 FR 9734, 9805, Feb. 17, 2012
SD and MSP Recordkeeping, Reporting, and Duties Rules; FCMs and IBs Conflicts of Interest Rules; and Chief Compliance Officer Rules for SDs, MSPs, and FCMs	Establishes reporting, recordkeeping, and daily trading records requirements for SDs and MSPs; establishes and governs the duties of SDs and MSPs; establishes conflicts of interest requirements for SDs, MSPs, FCMs, and IBs; establishes the designation, qualifications, and duties of the chief compliance officers (CCOs) of FCMs, SDs, and MSPs and describes the required contents of the annual report detailing a registrant's compliance policies and activities, to be prepared by the chief compliance officer and furnished to the CFTC.	77 FR 20128, 20166, Apr. 3, 2012
Position Limits for Futures and Swaps	Establishes limits on speculative positions in 28 selected physical commodity futures and swaps	76 FR 71626, 71662, Nov. 18, 2011
Real-Time Public Reporting of Swap Transaction Data	Establishes regulations concerning the real-time public reporting of swap transactions and pricing data.	77 FR 1182, 1232, Jan. 9, 2012

Swap Data Recordkeeping and Reporting Requirements	Establishes swap data recordkeeping and reporting requirements for registered entities and counterparties.	77 FR 2136, 2176, Jan. 13, 2012
Swap Data Repositories: Registration Standards, Duties and Core Principles	Establishes regulations concerning the registration and regulation of swap data repositories.	76 FR 54538, 54572, Sept. 1, 2011
Registration of SDs and MSPs	Establishes the process for the registration of SDs and MSPs.	77 FR 2613, 2623, Jan. 19, 2012

XI. Administrative Law Matters – Exchange Act Revisions

A. Economic Analysis

1. Overview

The SEC is sensitive to the costs and benefits of its rules. In adopting the final rules in this release, the SEC has been mindful of the costs and benefits associated with these rules which provide fundamental building blocks for the Title VII regulatory regime established by Congress. In addition, section 3(f) of the Exchange Act requires the SEC, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote competition, efficiency, and capital formation.[1211] Moreover, section 23(a)(2) of the Exchange Act requires the SEC, when adopting rules under the Exchange Act, to consider the impact such rules would have on competition. Section 23(a)(2) also prohibits the SEC from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.[1212] The SEC requested comment on all aspects of the costs and benefits of the proposed rules in the Proposing Release,[1213] and any effect these rules may have on competition, efficiency, and capital formation.

These final rules implement the mandate of Title VII that the CFTC and the SEC, in consultation with the Federal Reserve Board, jointly further define the terms "swap," "security-based swap," and "security-based swap agreement."[1214] The rules adopted in this release may be divided into three categories:

1211 15 U.S.C. 78c(f).

1212 15 U.S.C. 78w(a)(2).

1213 See Proposing Release at 29885.

1214 See section 712(d)(1) of the Dodd-Frank Act.

First, the Commissions are adopting rules that will assist market participants in determining whether particular agreements, contracts, and transactions fall within or outside the swap and security-based swap definitions (i.e., identifying products subject to Title VII). The final rules provide: (1) an Insurance Safe Harbor for those agreements, contracts, and transactions that the Commissions believe Congress does not intend to be Title VII instruments;[1215] (2) a "grandfather" for those insurance agreements, contracts, or transactions (as opposed to insurance product categories) entered into on or before the effective date of the Product Definitions provided that, when the parties entered into such agreement, contract, or transaction, when the parties entered into such agreement, contract, or transaction, it was provided in accordance with the Provider Test;[1216] and (3) further definition of the term "swap" to specifically list certain enumerated products and not include certain foreign exchange forwards and foreign exchange swaps.[1217]

Second, the Commissions are adopting rules that will assist market participants in determining whether a particular Title VII instrument is a swap subject to CFTC regulation, a security-based swap subject to SEC regulation, or a mixed swap subject to regulation by the CFTC and the SEC (i.e., mapping the jurisdictional divide between the CFTC and the SEC). Specifically, Title VII instruments that are CDS referencing a security index or a group or index of issuers of securities or obligations of issuers of securities may be swaps subject to CFTC regulation or security-based swaps subject to SEC regulation, depending on whether such Title VII instruments are based on events relating to "issuers of securities in a narrow-based security

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1215 See supra part II.B.1.

1216 See supra part II.B.1.c).

1217 See supra part II.C.2.

index" or events relating to securities in a "narrow-based security index".[1218] The final rules further define the terms "issuers of securities in a narrow-based security index" and "narrow-based security index" for purposes of this analysis.[1219] Further, the Commissions are adopting rules that provide tolerance and grace periods for Title VII instruments based on a security index that are traded on certain trading platforms where the security index may temporarily move from being within the "narrow-based security index" definition to being outside (e.g.,. moving from narrow-based to broad-based, or vice versa.)[1220] Additionally, the Commissions are providing clarification that a Title VII instrument based on a qualifying foreign futures contract on the debt securities of one or more of the 21 enumerated foreign governments is a swap and not a security-based swap, if certain conditions are met.[1221]

Third, the Commissions are adopting rules that provide: (1) a regulatory framework for certain mixed swaps and a process for market participants to request that the Commissions issue a joint order determining the appropriate regulatory treatment of certain other mixed swaps[1222] and (2) a process for market participants to request a joint interpretation from the Commissions regarding whether a particular Title VII instrument is a swap, security-based swap, or mixed swap.[1223] The final rules also provide that market participants have no additional books and records requirements for SBSAs other than those for swaps.[1224]

1218 See section 3(a)(68)(A)(ii)(III) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(III).

1219 See supra part 0.

1220 See supra part III.G.5.

1221 See supra part III.E.

1222 See supra part IV.

1223 See supra part VI.

1224 See supra part V.

In considering the economic consequences of the final rules, the SEC acknowledges the regulatory regime that was in place prior to the enactment of Title VII. Prior to the enactment of Title VII, swaps and security-based swaps were by-and-large unregulated. The Commodity Futures Modernization Act of 2000 ("CFMA") created a regulatory regime that prohibited the SEC from regulating security-based swap agreements,[1225] though it provided the SEC with limited enforcement authority over such instruments with respect to fraud, manipulation, and insider trading.[1226] Title VII created an entirely new regulatory regime to regulate swaps, security-based swap agreements and security-based swaps.

[1225] The CFMA added section 206A to the GLBA, 15 U.S.C. 78c note, to define the term "swap agreement" to mean any agreement, contract, or transaction between ECPs, the material terms of which (other than price and quantity) are subject to individual negotiation, that fall within certain categories of transactions. Additionally, the CFMA added section 206B to the GLBA, 15 U.S.C. 78c note, which defined a "security-based swap agreement" to mean a swap agreement (as defined in section 206A of the GLBA) on which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein. Furthermore, the CFMA added section 206C to the GLBA, 15 U.S.C. 78c note, which defined a "non-security-based swap agreement" to mean any swap agreement (as defined in section 206A of the GLBA) that is not a security-based swap agreement (as defined in section 206B of the GLBA). Title VII amended the definition of the term "swap agreement" (discussed in footnote 1284) and repealed the definition of the terms "security-based swap agreement" and "non-security-based agreement." See sections 762(a) and (b) of the Dodd-Frank Act. However, Title VII also added a new definition of the term "security-based swap agreement" in section 3(a)(78) of the Exchange Act, 15 U.S.C. 78c(a)(78), that is generally consistent with the repealed definition, except that the new definition excludes security-based swaps. Accordingly, Title VII provides jurisdiction to the CFTC for security-based swap agreements, such as Title VII Instruments based on broad-based securities indexes, and also retains the SEC's jurisdiction over such instruments in instances of fraud, manipulation, or insider trading.

[1226] The CFMA excluded from the definition of the term "security" the term "security-based swap agreement" as well as the term "non-security based swap agreement" (as those terms are defined in section 206B and 206C (respectively) of the GLBA, 15 U.S.C. 78c note). See sections 2A(a) and (b)(1) of the Securities Act, 15 U.S.C. 77b-1(a) and (b)(1), and sections 3A(a) and (b)(1) of the Exchange Act, 15 U.S.C. 78c-1(a) and (b)(1). Furthermore, the CFMA explicitly prohibited the SEC from registering, or requiring, recommending, or suggesting the registration under the Securities Act and the Exchange Act of any security-based swap agreement (as defined in section 206B of the GLBA). See section 2A(b)(2) of the Securities Act, 15 U.S.C. 77b-1(b)(2), and section 3A(b)(2) of the Exchange Act, 15 U.S.C. 78c-1(b)(2). The CFMA also made explicit that the SEC is prohibited from either (1) promulgating, interpreting, or enforcing rules or (2) issuing orders of general applicability under the Securities Act or Exchange Act in a manner that imposes or specifies reporting or recordkeeping requirements, procedures, or standards as prophylactic

2. Economic Analysis Considerations

The rules adopted in this release implicate different types of potential costs and benefits. First, there are costs, as well as benefits, arising from subjecting certain agreements, contracts, or transactions to the regulatory regime of Title VII. The SEC refers to these costs and benefits as "programmatic" costs and benefits. Additionally, there are costs that parties will incur to assess whether certain agreements, contracts, or transactions are indeed subject to the Title VII regulatory regime, and, if so, costs to assess whether such Title VII instrument is subject to the regulatory regime of the SEC or the CFTC. The SEC refers to these costs as "assessment" costs.[1227]

The programmatic costs and benefits and the assessment costs raise distinct analytic issues. First, the SEC recognizes that the Product Definitions, while integral to the regulatory requirements that will be imposed on the swap and security-based swap markets pursuant to Title VII, do not themselves establish the scope or nature of those substantive requirements or their related costs and benefits. The SEC anticipates that the rules implementing the substantive requirements under Title VII will be subject to their own economic analysis, but final rules have

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measures against fraud, manipulation, or insider trading with respect to any security-based swap agreement (as defined in section 206B of the GLBA). However, the CFMA did provide the SEC with limited enforcement authority under section 10(b) of the Exchange Act, 15 U.S.C. 78j(b), and the rules promulgated thereunder that prohibit fraud, manipulation, or insider trading (but not rules imposing or specifying reporting or record-keeping requirements, procedures, or standards as prophylactic measures against fraud, manipulation, or insider trading). Furthermore, the CFMA applies judicial precedents under sections 9, 10(b), 15, 16, 20, and 21A of the Exchange Act, 15 U.S.C. 78i, 78j(b), 78o, 78p, 78t, and 78u-1, as well as section 17(a) of the Securities Act, 15 U.S.C. 77q(a), to security-based swap agreements (as defined in section 206B of the GLBA) to the same extent as they apply to securities.

[1227] The SEC expects that the benefits resulting from further defining the terms "swap," "security-based swap," and "mixed swap" will likely accrue primarily at the programmatic level. To the extent appropriate, given the purposes of Title VII, the Commissions have sought to mitigate the costs persons will incur in connection with determining whether the instrument is a swap, security-based swap, or mixed swap.

not yet been adopted that would subject agreements, contracts, or transactions, or entities that act as intermediaries (such as security-based swap dealers ("SBS dealers") or major security-based swap participants ("MSBSPs")) or provide market infrastructures (such as clearing agencies, trade repositories and trade execution facilities), to such substantive requirements. The costs and benefits described below are therefore those that may arise in connection with: (1) determining whether certain agreements, contracts, or transactions are Title VII instruments (i.e., the assessment costs) and (2) subjecting those agreements, contracts, or transactions that are Title VII instruments, determined based on the statutory definitional lines that the Commissions are further defining, to a complete and fully effective complement of Title VII statutory and regulatory requirements. In addition, the discussion below addresses the costs and benefits arising from security-based swaps being within the definition of security under the Securities Act and the Exchange Act. Once a Title VII Instrument is determined to be a security-based swap, the security-based swap will be a security subject to the full panoply of the federal securities laws. Such treatment will give rise to costs and benefits, including those that apply to securities generally. Security-based swaps may be subject to additional costs to the extent that there are overlapping regulatory requirements arising from the Title VII regulatory requirements and those federal securities laws requirements that apply to securities generally. The SEC has already taken action to address some of such overlapping or inconsistent requirements[1228] and will continue to evaluate other needed actions, if any, to minimize any such overlapping regulatory implications.

[1228] See Order Pursuant to Sections 15F(b)(6) and 36 of the Securities Exchange Act of 1934 Granting Temporary Exemptions and Other Temporary Relief, Together With Information on Compliance Dates for New Provisions of the Securities Exchange Act of 1934 Applicable to Security-Based Swaps, and Request for Comment, Release No. 34-64678 (June 15, 2011), 76 FR 36287 (June 22, 2011); Exchange Act Exemptive Order; and SB Swaps Interim Final Rules.

Second, in determining the appropriate scope of these rules, the SEC considers the types of agreements, contracts, or transactions that should be regulated as swaps, security-based swaps, or mixed swaps under Title VII in light of the purposes of the Dodd-Frank Act, the overall regulatory framework, the historical treatment of the instruments and other regulatory frameworks, and the data currently available to the SEC. The SEC has sought to further define the terms "swap," "security-based swap," and "mixed swap" to address the status of agreements, contracts, and transactions that are appropriate to regulate as swaps, security-based swaps and mixed swaps within the purposes of Title VII and not to include those agreements, contracts, and transactions that historically have not been considered to be swaps or security-based swaps thereby not imposing unnecessary or inappropriate Title VII costs and burdens on parties engaging in agreements, contracts, and transactions. In addition, the SEC recognizes that these rules may have effects on competition, efficiency, and capital formation as a result of certain agreements, contracts, and transactions being determined to fall under or outside the Title VII regulatory regime, or as a result of the jurisdictional divide between the SEC and CFTC as mandated by the statute.

In the sections below, the SEC begins by recognizing that the Title VII regulatory regime has programmatic benefits and costs, as well as assessment costs. These costs and benefits have informed the decisions and the actions taken that are described throughout the release. Accordingly, the analysis below includes references to the discussions of the decisions and actions taken by the Commissions set forth above in other parts of this release. Finally the SEC discusses the effects of these rules on competition, efficiency, and capital formation.

3. Programmatic Benefits and Costs

By enacting Title VII, Congress created a regulatory regime for swaps and security-based swaps that previously did not exist.[1229] Title VII amendments to the Exchange Act impose, among other requirements, the following: (1) registration and comprehensive oversight of SBS dealers and MSBSPs;[1230] (2) reporting of security-based swaps to a registered security-based swap data repository ("SB SDR"), or to the SEC (if the security-based swap is uncleared and no SB SDR will accept the security-based swap for reporting), and dissemination of the security-based swap market data to the public;[1231] (3) clearing of security-based swaps at a registered clearing agency (or a clearing agency that is exempt from registration) if the SEC makes a determination that such security-based swaps are required to be cleared, unless an exception from the mandatory clearing requirement applies;[1232] and (4) if a security-based swap is subject

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1229 See supra part XI.A.1.

1230 See section 15F of the Exchange Act, 15 U.S.C. 78o-10.

1231 See section 3(a)(75) of the Exchange Act, 15 U.S.C. 78c(a)(75) (defining the term "security-based swap data repository"); section 13(m) of the Exchange Act, 15 U.S.C. 78m(m) (regarding public availability of security-based swap data); section 13(n) of the Exchange Act, 15 U.S.C. 78m(n) (regarding requirements related to SB SDRs); and section 13A of the Exchange Act, 15 U.S.C. 78m-1 (regarding reporting and recordkeeping requirements for certain security-based swaps). See also Security-Based Swap Data Repository Registration, Duties, and Core Principles, Release No. 34-63347 (Nov. 19, 2010), 75 FR 77306 (Dec. 10, 2010); corrected at 75 FR 79320 (Dec. 20, 2010) and 76 FR 2287 (Jan. 13, 2011) ("SDR Proposing Release"); and Regulation SBSR – Reporting and Dissemination of Security-Based Swap Information, Release No. 34-63346 (Nov. 19, 2010), 75 FR 75208 (Dec. 2, 2010) ("Regulation SBSR Proposing Release"). In each proposing release the SEC invited comment with respects to the costs and benefits of each of the proposed rules. The costs associated with these and other substantive rules, along with any comments received by the SEC addressing the costs of the proposed rules, are being addressed in more detail in connection with the applicable rulemakings.

1232 See section 3C(a)(1) of the Exchange Act, 15 U.S.C. 78c-3(a)(1). See also Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations, 75 FR 82490 (Dec. 30, 2010) ("Clearing Procedures Proposing Release"). In the Clearing Procedures Proposing Release the SEC invited comment with respects to the costs and benefits of each of the proposed rules. The costs associated with these and other substantive rules, along with any comments received by the SEC

to the clearing requirement, execution of the security-based swap transaction on an exchange, on a security-based swap execution facility ("SB SEF") registered under the Exchange Act,[1233] or on an SB SEF that has been exempted from registration by the SEC under the Exchange Act,[1234] unless no SB SEF or exchange makes such security-based swap available for trading.[1235] In addition, Title VII amends the Securities Act and the Exchange Act to include security-based swaps in the definition of "security" for the purposes of those statutes.[1236] As a result, security-based swaps are subject to the full panoply of the federal securities laws. Title VII also added specific provisions to the Securities Act and Exchange Act affecting how security-based swaps may be sold. For example, Title VII amended section 5 of the Securities Act to require that a registration statement meeting the requirements of the Securities Act be in effect before there can be an offer to sell, offer to buy, purchase or sale of a security-based swap from or to any person

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addressing the costs of the proposed rules, are being addressed in more detail in connection with the applicable rulemakings.

1233 See section 3D of the Exchange Act, 15 U.S.C. 78c-4.

1234 See section 3D(e) of the Exchange Act, 15 U.S.C. 78c-4(e).

1235 See sections 3C(g) and (h) of the Exchange Act, 15 U.S.C. 78c-3(g) and (h). See also section 3(a)(77) of the Exchange Act, 15 U.S.C. 78c(77) (defining the term "security-based swap execution facility"). See also Registration and Regulation of Security-Based Swap Execution Facilities, Release No. 34-63825 (Feb. 2, 2011), 76 FR 10948 (Feb. 28, 2011) ("SB SEF Proposing Release"). In the SB SEF Proposing Release each proposing release the SEC invited comment with respects to the costs and benefits of each of the proposed rules. The costs associated with these and other substantive rules, along with any comments received by the SEC addressing the costs of the proposed rules, are being addressed in more detail in connection with the applicable rulemakings.

1236 See sections 761(a)(2) and 768(a)(1) of the Dodd-Frank Act (amending sections 3(a)(10) of the Exchange Act, 15 U.S.C. 78c(a)(10), and 2(a)(1) of the Securities Act, 15 U.S.C. 77b(a)(1), respectively). The Dodd-Frank Act also amended the Securities Act to provide that any offer or sale of a security-based swap by or on behalf of the issuer of the securities upon which such security-based swap is based or is referenced, an affiliate of the issuer, or an underwriter, shall constitute a contract for sale of, sale of, offer for sale, or offer to sell such securities. See section 768(a) of the Dodd-Frank Act (amending section 2(a)(3) of the Securities Act, 15 U.S.C. 77b(a)(3)).

who is not an ECP.[1237] In addition, Title VII added section 6(l) to the Exchange Act to require that any security-based swap transaction with or for a person that is not an ECP must be effected on a national securities exchange.[1238]

The creation of regulatory regimes for agreements, contracts, or transactions that are defined as a swap or security-based swap will result in an array of programmatic benefits. However, if an agreement, contract or transaction falls within the swap or security-based swap definition, the parties to the agreement, contract, or transaction also may incur a number of upfront and ongoing costs associated with the regulation of Title VII instruments and transactions. These programmatic benefits and costs, discussed in more detail below, relate to Title VII registration; business conduct standards, compliance, operation and governance; clearing, trade execution, and reporting and processing; investor protection provisions of Title VII and the application of the federal securities laws.[1239]

1237 15 U.S.C. 77e.

1238 See section 6(l) of the Exchange Act, 15 U.S.C. 78f(l).

1239 For example, dealers and major participants will be subject to business conduct requirements of section 15F of the Exchange Act, and thus will be required, among other things, to determine that their counterparty meets certain eligibility standards before entering into security-based swaps with them and to disclose information about material risks and characteristics, material incentives, conflicts of interest, the daily mark, and clearing rights. See Business Conduct Standards for Security-Based Swaps Dealer and Major Security-Based Swap Participants, Release No. 34-64766 (June 29, 2011), 76 FR 42396, 42406, 42410 (July 18, 2011) ("Business Conduct Standards Proposing Release"). Also, for example, in connection with registration requirements the SEC expects security-based swap dealers and major security-based swap participants to incur costs in connection with completing and filing forms, providing related certifications, addressing additional requirements in connection with associated persons, as well as certain additional costs. See Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, Release No. 34-65543 (Oct. 12, 2011), 76 FR 65784, 65813-18 (Oct. 24, 2011) ("SB Swap Participant Registration Proposing Release"). In each proposing release the SEC invited comment with respects to the costs and benefits of each of the proposed rules. The costs associated with these and other substantive rules, along with any comments received by the SEC addressing the costs of the proposed rules, are being addressed in more detail in connection with the applicable rulemakings.

a) Title VII Registration of Entities Involved in Security-Based Swaps

As a result of Title VII imposing a new regulatory regime on security-based swaps, in addition to making such security-based swaps securities under the Securities Act and the Exchange Act, Title VII will require the registration of entirely new types of registrants with the SEC, including SBS dealers and MSBSPs,[1240] SB SEFs,[1241] SB SDRs,[1242] and clearing agencies registered to clear security-based swaps.[1243] The SEC expects that registrants will incur costs in gathering information, accurately completing forms and filing these forms with the SEC.[1244] Registration will provide the SEC with information regarding registrants which will enable the SEC to oversee the SEC's security-based swap registrants.

b) Business Conduct Standards, Compliance, Operation, and Governance

Title VII imposes requirements on registrants that did not exist prior to the adoption of Title VII, including core principles, duties and/or standards that are related to the type of registrant and its function.[1245] For example, Title VII includes core principles for SB SEFs,

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1240 See section 15F(b)(5) of the Exchange Act, 15 U.S.C. 78o-10(b)(5).

1241 See section 3D(a) of the Exchange Act, 15 U.S.C. 78c-4.

1242 See section 13(n)(1) of the Exchange Act, 15 U.S.C. 78m(n)(1).

1243 See section 17A(g) of the Exchange Act, 15 U.S.C. 78q-1(g).

1244 The SEC has proposed rules related to the registration requirements for each of these new registrants. See SB Swap Participant Registration Proposing Release; SB SEF Proposing Release; SDR Proposing Release; and Clearing Agency Standards for Operation and Governance, Release No. 34-64017 (Mar. 3, 2011), 76 FR 14472 (Mar. 16, 2011) ("Clearing Agency Standards Proposing Release"). In each proposing release the SEC invited comment with respects to the costs and benefits of each of the proposed rules. The costs associated with these and other substantive rules, along with any comments received by the SEC addressing the costs of the proposed rules, are being addressed in more detail in connection with the applicable rulemakings.

1245 See sections 3D(d), 13(n)(5) and (7), and 15F(h) and (j) of the Exchange Act, 15 U.S.C. 78c-4(d), 78m(n)(5) and (7), and 78o-10(h) and (j).

many of which require SB SEFs to establish and enforce rules specific to the trading of security-based swaps.[1246] Similarly, Title VII assigns duties (in addition to core principles) that are specific to the nature of SB SDRs, e.g. the acceptance and maintenance of data related to security-based swaps.[1247] The provisions of Title VII related to SB SEFs and SB SDRs are designed to provide transparency in the security-based swap market.

Title VII also imposes a number of requirements on registered SBS dealers and MSBSPs, such as external business conduct requirements.[1248] Specifically, section 15F(h)(3)(B) of the Exchange Act establishes certain disclosure requirements for SBS dealers and MSBSPs,[1249] and section 15F(h)(3)(C) of the Act requires that communications by these entities meet certain standards of fairness and balance.[1250] The level of protection becomes higher for special entities[1251] to whom dealers offer security-based swaps.[1252] For example, an SBS dealer that acts

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1246 See sections 3D(d)(2), (3), (4), (6), and (8) of the Exchange Act, 15 U.S.C. 78c-4(d)(2), (3), (4), (6), and (8). See also SB SEF Proposing Release. In the SB SEF Proposing Release the SEC invited comment with respects to the costs and benefits of each of the proposed rules. The costs associated with these and other substantive rules, along with any comments received by the SEC addressing the costs of the proposed rules, are being addressed in more detail in connection with the applicable rulemakings.

1247 See section 13(n)(5) of the Exchange Act, 15 U.S.C. 78m(n)(5). See also SDR Proposing Release. In the SDR Proposing Release the SEC invited comment with respects to the costs and benefits of each of the proposed rules. The costs associated with these and other substantive rules, along with any comments received by the SEC addressing the costs of the proposed rules, are being addressed in more detail in connection with the applicable rulemakings.

1248 The SEC has proposed rules regarding business conduct standards for security-based swap dealers and major security-based swap participants. See Business Conduct Standards Proposing Release. In the Business Conduct Standards Proposing Release the SEC invited comment regarding the costs and benefits associated with the proposed rules. The costs associated with these and other substantive rules, along with any comments received by the SEC addressing the costs of the proposed rules, are being addressed in more detail in connection with the applicable rulemakings.

1249 See section 15F(h)(3)(B) of the Exchange Act, 15 U.S.C. 78o-10(h)(3)(B).

1250 See section 15F(h)(3)(C) of the Exchange Act, 15 U.S.C. 78o-10(h)(3)(C).

1251 Title VII amends the Exchange Act to define a special entity as: (1) a Federal agency; (2) a State, State agency, city, county, municipality, or other political subdivision of a State; (3) any

as an advisor to a special entity has a duty to act in the best interest of the special entity and is required to make reasonable efforts to obtain such information as is necessary for the SBS dealer to make a reasonable determination that any security-based swap recommended by the SBS dealer is in the best interests of the special entity.[1253] In addition, section 15F(j)(5) of the Exchange Act imposes requirements intended to address potential conflicts of interest that may arise in transactions between a SBS dealer or MSBSP and its counterparty.[1254] Title VII also imposes upon SBS dealers and MSBSPs requirements to implement risk management policies and procedures that are designed to prevent them from taking on excessive risk and to enable them to better deal with market fluctuations that might otherwise endanger their financial health.[1255]

Section 15F(e) of the Exchange Act as added by section 764(a) of the Dodd Frank Act, imposes capital and margin requirements on dealers and major participants,[1256] which are designed to reduce the financial risks of these institutions and contribute to the stability of the security-based swap market in particular and the U.S. financial system more generally.[1257] With

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employee benefit planned, as defined in section 3 of the Employee Retirement Income Security Act of 1974; or (4) any governmental plan, as denied in section 3 of the Employee Retirement Income Security Act of 1974; or any endowment, including an endowment that is an organization in section 501(c)(3) of the Internal Revenue Code of 1986. See section 15F(h)(2)(C) of the Exchange Act, 15 U.S.C. 78o-10(h)(2)(C).

1252 See sections 15F(h)(2), (h)(4), and (h)(5) of the Exchange Act, 15 U.S.C. 78o-10(h)(2), (h)(4), and (h)(5).

1253 See section 15F(h)(4)(B) and (C) of the Exchange Act, 15 U.S.C. 78o-10(h)(4)(B) and (C).

1254 See section 15F(j)(5) of the Exchange Act, 15 U.S.C. 78o-10(j)(5).

1255 See section 15F(j)(2) of the Exchange Act, 15 U.S.C. 78o-10(j)(2).

1256 See section 15F(e) of the Exchange Act, 15 U.S.C. 78o-10(e).

1257 See Entity Definitions Release at 30723, supra note 12.

respect to a security-based swap submitted for clearing, counterparties will be required to post initial margin and maintenance margin to secure its obligations under the trade.

Section 3E of the Exchange Act, among other things, requires registered brokers, dealers and SBS dealers that collect initial and variation margin from counterparties to cleared security-based swap transactions to maintain that collateral in segregated accounts.[1258] With respect to uncleared swaps, section 3E gives a counterparty to a SBS dealer or MSBSP that collects collateral the right to request segregation of initial margins and maintenance of such initial margins in accordance with rules promulgated by the SEC.[1259] These protections provide market participants who enter into transactions with these entities confidence that their collateral accounts will remain separate from the SBS dealer or MSBSP's assets in the event of bankruptcy.[1260]

c) Clearing, Trade Execution, Reporting and Processing

Section 763 of the Dodd-Frank Act adds section 3C to the Exchange Act, which deals with clearing for security-based swaps.[1261] Prior to the enactment of Title VII, swaps which traded on a bilateral basis were subject to counterparty credit risk, which may not have been fully

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1258 See 15 U.S.C. 78c-5.

1259 Id.

1260 Id.

1261 See 15 U.S.C. 78c-3. See also Clearing Procedures Proposing Release; Clearing Agency Standards Proposing Release; End-User Exception of Mandatory Clearing of Security-Based Swaps, Release No. 34-63556 (Dec. 15, 2010), 75 FR 79992 (Dec. 21, 2010) ("End-User Exception Proposing Release"); and Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps under Regulation MC, Release No. 34-63107, (Oct. 14, 2010), 75 FR 65882 (Oct. 26, 2010) ("Proposed Regulation MC"). In each proposing release the SEC invited comment with respects to the costs and benefits of each of the proposed rules. The SEC has received comments on the cost and benefits of these proposed rules. The costs associated with these and other substantive rules are being addressed in more detail in connection with the applicable rulemakings.

mitigated by the posting of collateral.[1262] Section 3C of the Exchange Act requires that security-based swaps, with some exceptions, be cleared through a central counterparty ("CCP") registered with the SEC.[1263] Clearing a security-based swap places a CCP between the parties to a trade and reduces the counterparty risk.

Title VII also requires the execution of clearable security-based swaps on exchanges or SB SEFs if such security-based swaps are available to trade and the reporting of trades to an SB SDR and dissemination of trading data to the public.[1264] Title VII also imposes requirements relating to the operations of the SB SEFs and SDRs.[1265] Section 15F(i) of the Exchange Act establishes regulatory standards for certain [registered security-based swap entities] related to the confirmation, processing, netting, documentation, and valuation of security-based swaps, which should enhance the efficiency of the trade execution and processing of security-based swaps.[1266]

Furthermore, sections 15F(f), (g), and (j)(3) of the Exchange Act impose certain reporting, recordkeeping, and regulatory disclosure requirements on SBS dealers and

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1262 See U.S. Gov't Accountability Office, *Systemic Risk: Regulatory Oversight and Recent Initiatives to Address Risk Posed by Credit Default Swaps*, GAO-09-397T, at 13 (Mar. 5, 2009).

1263 15 U.S.C. 78c-3. Such clearing agencies also are required to register. See section 17A(g) of the Exchange Act, 15 U.S.C. 78q-1(g).

1264 See sections 3C(h) and 13(m) of the Exchange Act, 15 U.S.C. and 13m(m). See also Regulation SBSR Proposing Release; and SDR Proposing Release.

1265 See SDR Proposing Release; and SB SEF Proposing Release. In each proposing release the SEC invited comment with respects to the costs and benefits of each of the proposed rules. The costs associated with these and other substantive rules, along with any comments received by the SEC addressing the costs of the proposed rules, are being addressed in more detail in connection with the applicable rulemakings.

1266 See section 15F(i) of the Exchange Act, 15 U.S.C. 78o-10(i). See also Trade Acknowledgment and Verification on Security-Based Swap Transactions, Release No. 34-63727 (Jan. 14, 2011), 76 FR 3859 (Jan. 21, 2011) ("Trade Documentation Proposing Release"). In the Trade Documentation Proposing Release the SEC invited comment with respects to the costs and benefits of each of the proposed rules. The costs associated with these and other substantive rules, along with any comments received by the SEC addressing the costs of the proposed rules, are being addressed in more detail in connection with the applicable rulemakings.

MSBSPs.[1267] Specifically, Title VII imposes on parties to a security-based swap the responsibility to "report security-based swap transaction information to the appropriate registered entity in a timely manner as may be prescribed by the [SEC]."[1268] Title VII's reporting, recordkeeping, and disclosure requirements should enhance the volume and quality of information available in the market and facilitate effective oversight by the SEC.

d) Investor Protection Provisions of Title VII and the Application of the Federal Securities Laws

Prior to the enactment of Title VII, the SEC had the ability to bring actions based on fraud, manipulation or insider trading relating to security-based swap agreements (as defined in section 206B of the GLBA[1269]) but did not have any other regulatory authority over swaps, security-based swaps or market participants involved in security-based swap transactions.[1270] Title VII provides the SEC with antifraud enforcement authority over SBSAs under Title VII and gives the SEC the authority to regulate security-based swap transactions and the security-based

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1267 See section 15F(f) of the Exchange Act, 15 U.S.C. 78o-10(f) (reporting and recordkeeping requirements); section 15F(g) of the Exchange Act, 15 U.S.C. 78o-10(g) (daily trading records requirements); section 15F(j)(3) of the Exchange Act, 15 U.S.C. 78o-10(j)(3) (requirements related to the disclosure of information to regulators). See also Regulation SBSR Proposing Release. In the Regulation SBSR Proposing Release the SEC invited comment with respects to the costs and benefits of each of the rules proposed in the release. The costs associated with these and other substantive rules, along with any comments received by the SEC addressing the costs of the proposed rules, are being addressed in more detail in connection with the applicable rulemakings.

1268 See section 13(m)(1)(F) of the Exchange Act, 15 U.S.C. 13m(m)(1)(F). See also Regulation SBSR Proposing Release. In the Regulation SBSR Proposing Release the SEC invited comment with respects to the costs and benefits of each of the proposed rules. The costs associated with these and other substantive rules, along with any comments received by the SEC addressing the costs of the proposed rules, are being addressed in more detail in connection with the applicable rulemakings.

1269 15 U.S.C. 78c note.

1270 See supra part XI.A.1, notes 1225 and 1226.

swaps market, including the authority to prevent or deter fraud, manipulation or deceptive conduct and take other actions.[1271]

By including security-based swaps in the definition of security under the Securities Act and the Exchange Act and repealing the restrictions on regulating security-based swap agreements as securities, Title VII extended the investor protections under the federal securities laws to security-based swaps. In particular, Title VII amends the Exchange Act and the Securities Act to include security-based swaps within the definition of the term "security."[1272] Accordingly, security-based swaps are securities and benefit from the investor protections provided by the federal securities laws.[1273] In addition to the antifraud and anti-manipulation provisions, these protections include the registration, disclosure and civil liability provisions of the Securities Act and the disclosure provisions of the Exchange Act. Title VII specifically provides protections to non-ECPs by adding section 5(e) to the Securities Act, which requires that a registration statement must be in effect before a person can offer to sell, offer to purchase from, or otherwise enter into security-based swaps with non-ECPs.[1274] Any security-based swap

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1271 See supra part XI.A.1, notes 1225 and 1226 and part I. See also Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps, Release No. 34-63236 (Nov. 3, 2010), 75 FR 68560 (Nov. 8, 2010) ("SB Swap Antifraud Proposing Release"). In the SB Swap Antifraud Proposing Release the SEC invited comment with respects to the costs and benefits of each of the proposed rules. The costs associated with these and other substantive rules, along with any comments received by the SEC addressing the costs of the proposed rules, are being addressed in more detail in connection with the applicable rulemakings.

1272 See section 2(a)(1) of the Securities Act and section 3(a)(10) of the Exchange Act, 15 U.S.C. 77b(a)(1) and 15 U.S.C. 78c(a)(10).

1273 See, e.g., Order Granting Temporary Exemptions under the Securities Exchange Act of 1934 in Connection with the Pending Revision of the Definition of "Security" to Encompass Security-Based Swaps, and Request for Comment, 76 FR 39927 (July 7, 2011) (discussing the effect of the amendment to the definition of the term "security" to include security-based swaps under the Exchange Act and granting certain temporary relief and providing interpretive guidance).

1274 See section 768(b) of the Dodd Frank act (adding section 5(e) of the Securities Act, 15 U.S.C. 77e(d)).

with or for a person that is not an ECP must be effected on a national securities exchange.[1275] Furthermore, Title VII ensures that a security-based swap cannot be used to avoid registration or investor protection under the Securities Act by providing that if a security-based swap is entered into by an issuer's affiliate or underwriter, the offer and sale of the underlying security must comply with the Securities Act.[1276]

The programmatic benefits related to investor protection under the federal securities laws have corresponding costs including costs associated with compliance with the registration and disclosure regime of the Securities Act if an exemption from such registration provisions is not available.[1277]

The above programmatic benefits and costs that will flow from regulation of the security-based swap market mandated by Title VII will be significant, although very difficult to quantify and measure.[1278] Moreover, the benefits can be expected to manifest themselves over the long

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[1275] See section 6(l) of the Exchange Act, 15 U.S.C. 78f(l).

[1276] See section 768(a) of the Dodd-Frank Act (amending section 2(a)(3) of the Securities Act, 15. U.S.C. 77b(a)(3)).

[1277] For offers and sales to non-ECPs, the statute requires registration of the security-based swap transaction.

[1278] One commenter suggested that the best measure of the benefits of the Dodd-Frank Act is the cost of the 2008 financial crisis. This commenter provided, as an example, an estimate from the Bank of England that the cost of the 2008 financial crisis in terms of lost output was between $60 trillion and $200 trillion. See Letter from Dennis Kelleher, Better Markets to the CFTC, June 3, 2011, regarding the reopening and extension of comment periods for rulemaking implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act. The SEC recognizes that this estimate addresses the aggregate cost of the financial crisis. It is also recognized that others have expressed concern regarding the potential cost of the requirements of Dodd-Frank. See, e.g., letters from SIFMA, the American Bankers Association, the Financial Services Roundtable and the Clearing House Association, dated February 13, 2012 (commenting on Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 FR 68846 (Nov. 7, 2011)) and The Financial Services Roundtable, dated October 17, 2011 (commenting on Further Definition of ''Swap Dealer,'' ''Security-Based Swap Dealer,'' ''Major Swap Participant,'' ''Major Security-Based Swap Participant'' and ''Eligible Contract Participant'', 75 FR 80174 (Dec. 21, 2010)).

run and be distributed over the market as a whole. The programmatic costs and benefits associated with substantive rules applicable to security-based swaps under Title VII are being addressed in more detail in connection with the applicable rulemakings implementing Title VII. There are programmatic costs that may arise from the application of other provisions of the federal securities laws to security-based swaps, security-based swap transactions and market participants involved in such security-based swap transactions, including costs arising from potential overlapping regulatory requirements. The SEC already has taken interim actions to mitigate such overlapping and potentially conflicting regulatory requirements and will be carefully evaluating any future actions that may be necessary and appropriate to address such overlapping or conflicting requirements.

4. Costs and Benefits Associated with Specific Rules

a) Insurance Safe Harbor and Grandfather for Insurance Products (Rules 3a69-1 under the Exchange Act)

i) Programmatic Benefits and Costs

The Commissions are adopting rules that establish an Insurance Safe Harbor and an Insurance Grandfather for certain agreements, contracts, and transactions that meet the conditions and tests set forth in rule 3a69-1 under the Exchange Act.[1279] The agreements, contracts, and transactions that satisfy the Insurance Safe Harbor or Insurance Grandfather under the Exchange Act will fall outside the statutory swap and security-based swap definitions.[1280] The SEC believes that the conditions and tests set forth in the Insurance Safe Harbor represent

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1279 See supra part II.B.1.

1280 Id.

the characteristics of many types of traditional insurance products.[1281] As stated above, the Commissions are not aware of anything in the legislative history or Title VII itself to suggest that Congress intended for traditional insurance products to be regulated as swaps or security-based swaps.[1282]

Typically, insurance has not been regulated under the federal securities laws; although variable life insurance and annuities are securities and are regulated under the federal securities laws.[1283] Although a broad reading of the swap definition could encompass traditional insurance, the SEC does not believe that such a reading is consistent with Congressional intent.[1284] To include products that meet the Insurance Safe Harbor or Insurance Grandfather in the swap or security-based swap definition would subject traditional insurance products to the Title VII regime which the SEC does not believe is intended by Congress. Imposing programmatic costs

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1281 Id.

1282 Id.

1283 See generally section 3(a)(8) of the Securities Act, 15 U.S.C. 77c(a)(8), and section 12(g) of the Exchange Act, 15 U.S.C. 78l(g). The SEC has previously stated its view that Congress intended any insurance contract falling within section 3(a)(8) to be excluded from all provisions of the Securities Act notwithstanding the language of the Securities Act indicating that section 3(a)(8) is an exemption from the registration but not the antifraud provisions. See Definition of "Annuity Contract or Optional Annuity Contract", 49 FR 46750, 46753 (Nov. 28, 1984). See also Tcherepnin v. Knight, 389 U.S. 332, 342 n.30 (1967) (Congress specifically stated that "insurance policies are not to be regarded as securities subject to the provisions of the [Securities] act," (quoting H.R. Rep. 85, 73rd Cong., 1st Sess. 15 (1933)). See also supra note 42.

1284 Section 206A of the GLBA, 15 U.S.C. 78c note defined the term "swap agreement" and the CFMA had two requirements in addition to the definition of "swap" itself: (1) the transaction is between ECPs (as defined prior to enactment of the Dodd-Frank Act); and (2) the material terms of the swap agreement (other than price and quantity) are subject to individual negotiation. Section 762 of the Dodd-Frank Act removed these requirements from the definition of swap agreement. See supra part XI.A.1, notes 1225 and 1226. The definition of swap in Title VII of the Dodd-Frank Act is not conditioned on the existence of either of the two requirements, although swap or security-based swap transactions with non-ECPs are subject to additional restrictions under the federal securities laws and the Commodity Exchange Act. See CEA section 1a(47), 7 U.S.C. 1a(47). Insurance policies are typically not subject to individual negotiation. Additionally, the average insurance purchaser may not qualify as an ECP. See CEA section 1a(18)(A)(xi), 7 U.S.C. 1a(18)(A)(xi).

on the insurance industry, such as those associated with compliance with the registration, compliance, and operation and governance requirements as described above, in addition to the Securities Act and Exchange Act requirements applicable to security-based swap transactions involving non-ECPs, would increase the business costs of insurance providers, which costs could be passed on to the consumers who need such insurance. In addition, because of the above costs as well as the Securities Act and Exchange Act restrictions applicable to offers and sales of security-based swaps to non-ECPs, including products that meet the Insurance Safe Harbor in the swap or security-based swap definition could potentially affect the ability of insurance providers to continue to offer insurance products and disrupt contracts that satisfy the Insurance Grandfather that are used every day in the American economy. For example, if Title VII applied to traditional insurance products, people who purchased insurance to protect their property or families against accidental hazards or risks would need to be qualified as ECPs[1285] or the offer and sale of the insurance products that were security-based swaps would need to be registered with the SEC[1286] and traded on an exchange;[1287] and for swaps that are under the CFTC jurisdiction would only be able to be sold on or subject to the rules of a board of trade. In addition, insurance providers that offer insurance products exceeding the de minimis threshold (as adopted in the Entities Release) applicable to swap dealers and security-based swap dealers

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1285 An individual is considered an ECP if the individual "has amounts invested on a discretionary basis, the aggregate of which is in excess of – (i) $10,000,000; or (ii) $5,000,000 and who enters into the agreement, contract, or transaction in order to manage the risk associated with an asset owned or liability incurred, or reasonable likely to be owned or incurred, by the individual." CEA section 1a(18)(A)(xi), 7 U.S.C. 1a(18)(A)(xi).

1286 See section 5(e) of the Securities Act, 15 U.S.C. 77e(d).

1287 See CEA section 2(e), 7 U.S.C. 2(e), and section 6(l) of the Exchange Act, 15 U.S.C. 78f(l).

would be required to register as swap dealers or SBS dealers[1288] and be subject to the substantive requirements that result from such registration.

The rules adopted in this release provide continuity in the regulatory treatment of agreements, contracts, and transactions that are insurance and fall outside the swap and security-based swap definitions. Market participants will be able to continue to rely on their existing understanding of insurance laws and regulations to engage in business activities relating to the insurance agreements, contracts, and transactions that satisfy the Insurance Safe Harbor or Insurance Grandfather.

ii) Assessment Costs

Market participants will need to assess whether a particular agreement, contract, or transaction satisfies the Insurance Safe Harbor or Insurance Grandfather, prior to execution, but no later than when the parties offer to enter into the agreement, contract, or transaction. If such agreement, contract, or transaction satisfies rules 3a69-1 under the Exchange Act, it would fall outside the swap and security-based swap definitions. If such agreement, contract, or transaction does not satisfy the Insurance Safe Harbor or Insurance Grandfather, it would need to be analyzed based upon its own facts and circumstances in order to determine whether it falls within or outside the swap or security-based swap definition. For agreements, contracts, or transactions entered into subsequent to the effective date of such rule, this analysis will have to be performed prior to execution but no later than when the parties offer to enter into the agreement, contract, or transaction to customers to ensure compliance with Title VII. Incurring these assessment costs

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[1288] See Registration of Swap Dealers and Major Swap Participants, 77 FR 2613, corrected at 77 FR 3590 (regarding swap dealers and major swap participants); SB Swap Participant Proposing Release, supra note 1239, (regarding SBS dealers and MSBSPs).

with respect to these agreements, contracts, or transactions would not have been required in most cases prior to Title VII for two primary reasons. First, as security-based swaps were not regulated prior to Title VII, there was no need to determine whether an agreement, contract or transaction fell within or outside the definition of security-based swap agreement in the CFMA. Second, the need for parties to assess individual types of insurance for purposes of determining whether the federal securities laws apply would be limited because, as previously stated, typically, insurance has not been regulated under the federal securities laws, although variable life insurance and annuities are securities and are regulated under the federal securities laws.[1289]

The SEC believes that rule 3a69-1 under the Exchange Act reduces the assessment costs that would otherwise exist without these rules. Without rule 3a69-1 under the Exchange Act, market participants would still need to assess whether or not the agreement, contract, or transaction they are offering falls within the swap or security-based swap definition. More time and effort would likely be spent on the assessment because of lack of any safe harbor or grandfather to rely on. Without rule 3a69-1 under the Exchange Act, market participants may feel the need to request joint interpretations from the Commissions before they invest resources in insurance business, even with respect to agreements, contracts, or transactions that would otherwise meet the Insurance Safe Harbor or Insurance Grandfather.

The SEC recognizes that the assessment costs associated with rule 3a69-1 under the Exchange Act may include costs related to obtaining legal advice on whether an agreement, contract, or transaction meets the requirements of the Insurance Safe Harbor or Insurance Grandfather. The SEC has sought to minimize the costs of this analysis by adopting an approach

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[1289] See supra note 1283.

that incorporates the characteristics of traditional insurance into the straightforward Product Test and Provider Test, as described in the discussions of relevant rules above.

The SEC believes there will be minimal assessment costs for parties to determine whether an agreement, contract, or transaction is among those specifically enumerated in rule 3a69-1 under the Exchange Act[1290] or that falls within the Insurance Grandfather.[1291]

With respect to rule 3a69-1 under the Exchange Act, the SEC believes that at least some market participants are likely to seek legal counsel for interpretation of various aspects of the rule, particularly when structuring new or novel insurance products. The costs associated with obtaining such legal counsel would vary depending on the relevant facts and circumstances, including the complexity of the agreement, contract, or transaction and whether an interpretation from the Commissions is requested. The SEC believes that the range of costs to undertake the legal analysis required to determine whether the Insurance Safe Harbor or Insurance Grandfather applies to an agreement, contract, or transaction will range from $378 to $27,000, with $27,000 representing a reasonable estimate of the upper end of the range of the costs.[1292]

1290 See supra part II.B.1.

1291 See supra part II.B.1.c).

1292 The average cost incurred by market participants in connection with assessing whether an agreement, contract, or transaction is a swap or security-based swap is based on the estimated amount of time that staff believes will be required for both in-house counsel and outside counsel to apply rule 3a69-1. Staff estimates that some agreements, contracts, or transactions will clearly satisfy the Insurance Safe Harbor, Insurance Grandfather and an in-house attorney, without the assistance of outside counsel, will be able to make a determination in one hour. Based upon data from SIFMA's *Management & Professional Earnings in the Securities Industry 2011* (modified by SEC staff to account for an 1800-hour-work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead), staff estimates that the average national hourly rate for an in-house counsel is $378. If an agreement, contract, or transaction is more complex, the SEC estimates the analysis will require approximately 30 hours of in-house counsel time and 40 hours of outside counsel time. The SEC estimates the costs for outside legal services to be $400 per hour. This is based on an estimated $400 per hour cost for outside legal services. This is the same estimate used by the SEC for these services in the release involving Exemptions for Security-Based Swaps Issued By Certain Clearing Agencies, Release No. 33-9308 (Mar. 30,

iii) Alternatives

The SEC could have determined to not further define the terms "swap" and "security-based swap" to address the status of traditional insurance products. If the Commissions did not further define the terms "swap" and "security-based swap" to address the status of traditional insurance products by adopting the Insurance Safe Harbor or the Insurance Grandfather certain insurance providers would have treated their insurance products as swaps or security-based swap, thereby incurring programmatic costs that would otherwise be avoidable. Other insurance providers could misinterpret the application of the definition of swap to certain agreements, contracts, or transactions to determine that they fall outside such definition of swap or security-based swap, in which case the amount of Title VII programmatic benefits and costs with respect to such products may potentially decrease. As stated above, without rule 3a69-1 under the Exchange Act, there also would be higher assessment costs to determine whether an agreement, contract, or transaction falls within or outside the swap or security-based swap definition.[1293]

The Commissions received several comments in support of alternatives to rule 3a69-1 under the Exchange Act as proposed[1294]. The alternatives suggested by commenters include:

- a test based on whether the agreement, contract, or transaction is subject to regulation as insurance by the insurance commissioner of the applicable state(s).[1295]

2012), 77 FR 20536 (Apr. 5, 2012). Accordingly, on the high end of the range the SEC estimates the cost to be $27,340 ($11,340 (based on 30 hours of in-house counsel time x $378) + $16,000 (based on 40 hours of outside counsel x $400). This estimate is rounded by two significant digits to avoid the impression of false precision of the estimate.

1293 See supra part XI.A.4(a)(ii).

1294 See supra part II.B.1.d), for a discussion of each of the proposed alternatives.

1295 See ACLI Letter; AFGI Letter; AIA Letter; MetLife Letter and Travelers Letter.

- a test based on the application of section 3(a)(8) of the Securities Act[1296] to the agreement, contract, or transaction.[1297]
- various alternative tests that add (or exclude) requirements to the Product Test and the Provider Test.[1298]

The Commissions have considered each of these alternatives proposed by commenters and are adopting the final rule as discussed above.[1299] The Commissions are not adopting the specific alternative tests as proposed by commenters. In considering each of these alternatives, the SEC has taken into account the costs and benefits associated with each alternative.

In the SEC's view, as discussed above,[1300] because these alternative tests do not adequately distinguish traditional insurance products from Title VII instruments, they could result in an over-inclusive Insurance Safe Harbor or Insurance Grandfather and fail to include in the Title VII regulatory regime agreements, contracts, and transactions that Congress intended to be regulated as swaps or security-based swaps.[1301] Therefore, the programmatic benefits of the Title VII regime would not be fully realized if any of the alternatives were adopted.

1296 15 U.S.C. 77c(a)(8).

1297 See ACLI Letter at 7; AFGI Letter at 3; CAI Letter at 21-25 and Nationwide Letter at 4.

1298 See ACLI Letter; AIA Letter; Nationwide Letter and NAIC Letter.

1299 See supra part II.B.1.

1300 See supra part II.B.1.d).

1301 For a more detailed discussion of the comments, including those that suggested alternatives, and the Commissions' response, see supra part II.B.1.d).

b) Narrow-Based Security Index Rules (Rules 3a68-1a, 3a68-1b, and 3a68-3(a) under the Exchange Act)

i) Programmatic Costs and Benefits

As previously stated, Title VII created a jurisdictional division between the CFTC and the SEC. The CFTC has jurisdiction over swaps, whereas the SEC has jurisdiction over security-based swaps. In most instances it is clear based on a plain reading of the statute whether a Title VII instrument is a swap or security-based swap (e.g., a CDS referencing a single security or issuer is a security-based swap).[1302] In other instances, such as index CDS, whether a Title VII instrument is a swap or security-based swap depends on whether such instrument is based on a "narrow-based security index" or events relating to "issuers of securities in a narrow-based security index".[1303] The Commissions are adopting rules 3a68-1a and 3a68-1b under the Exchange Act to further define the terms "issuers of securities in a narrow-based security index" and "narrow-based security index" for purposes of analyzing CDS.[1304] Additionally, the Commissions are adopting rule 3a68-3(a) under the Exchange Act to define narrow-based security index, except as otherwise provided in rules 3a68-1a and 3a68-1b, consistent with the statutory definition set forth in section 3(a)(55) of the Exchange Act and the rules, regulations and orders of the SEC thereunder.

As discussed above, there are programmatic costs and benefits that flow from being a Title VII instrument.[1305] The overall programmatic costs and benefits flowing from an agreement, contract, or transaction being a swap or a security-based swap may be impacted by

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1302 See section 3(a)(68)(A)(II) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(II).

1303 See section 3(a)(68)(A)(I) and (III) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(I) and (III).

1304 See supra part III.G.3.b).

1305 See supra part XI.A.3.

the similarities and differences in the Commissions' regulatory programs for swaps and security-based swaps. Generally, the Title VII regulatory regimes of the CFTC and SEC are expected to be broadly similar and complementary. Title VII requires the SEC and the CFTC to consult and coordinate for the purposes of assuring regulatory consistency and comparability with respect to rules adopted and orders issued pursuant to Title VII to the extent possible.[1306] Title VII provides that the Commissions should treat functionally or economically similar products or entities in a similar manner in such rules or orders, but does not require identical rules.[1307] The Commissions may, therefore, diverge substantively on certain rulemakings. In certain areas, the SEC believes it may be appropriate for Title VII's application to security-based swaps to be different from its application to the swaps that will be regulated by the CFTC, as the relevant products, entities and market themselves are different, or because the relevant statutory provisions are different. The SEC believes, however, that the programmatic costs and benefits (which will be discussed in subsequent releases adopting substantive rules) that will flow from the application of rules under either jurisdiction as a result of applying rules 3a68-1a, 3a68-1b, and 3a68-3(a) under the Exchange Act are expected to be broadly similar and complementary.

In addition, since Title VII specifically provides that security-based swaps are securities and grants the SEC the exclusive authority to regulate security-based swaps (other than as to mixed swaps for which the SEC shares jurisdiction with the CFTC), in adopting rules 3a68-1a, 3a68-1b, and 3a68-3(a) under the Exchange Act to further define the terms "narrow-based security index," and "issuers of securities in a narrow-based security index", the SEC is mindful of the programmatic costs and benefits specifically associated with security-based swaps falling

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1306 See section 712(a)(1) and (a)(2) of the Dodd-Frank Act.

1307 See section 712(a)(7)(A) and (B) of the Dodd-Frank Act.

under the federal securities laws regime and being regulated by the SEC. These programmatic benefits include, for example, the applicability of the Securities Act registration, disclosure, and civil liability scheme, as well as the SEC's authority to take action to protect investors and prevent fraud and market manipulation. These benefits could in some cases have corresponding costs associated with the application of the Securities Act related to registration, disclosure and civil liability scheme and the registration, disclosure and liability provisions of the Exchange Act. For example, if an issuer of an underlying security enters into a security-based swap it will have to comply with the Securities Act registration requirements both for the security-based swap and the underlying security unless an exemption from registration is available. As another example, if market participants wish to sell security-based swaps to non-ECPs they will have to comply with the registration requirements of the Securities Act. Any person that would be required to comply with the registration requirements of the Securities Act with respect to security-based swaps will incur the costs of such registration, including legal and accounting costs. Additionally, such person will become subject to the periodic reporting requirements of the Exchange Act, unless already subject to such requirements, and incur the costs associated with such Exchange Act periodic reporting.

ii) Assessment Costs

Market participants will need to ascertain whether an agreement, contract or transaction based on an index is a swap or a security-based swap, prior to execution, but no later than when the parties offer to enter into it, according to the criteria set forth in the definitions of the terms "narrow-based security index" and "issuers of securities in a narrow-based security index." The SEC expects that this assessment will be made each time an index is considered to be used or created for purposes of transactions based on such index, and each time the material terms of the

index on which the agreement, contract, or transaction is based are amended or modified.[1308] These assessment costs with respect to agreements, contracts, or transactions based on indexes did not arise prior to the enactment of Title VII. The SEC believes that such assessment costs may vary depending on the composition of the index that may underlie agreement, contract, or transaction. For example, the number of components in an index may impact the assessment costs because of the need to determine whether the index's components satisfy the various tests within the rule. However, once such assessment is performed and the narrow-based or broad-based characteristics have been established with respect to an index, unless the characteristic of such index changes, any market participants engaging in agreements, contracts, or transactions referencing such index would not need to incur any material assessment costs, other than to confirm that the index has not changed in a way that would change its classification from narrow-based to broad-based or vice versa.

Although the assessment cost associated with rules 3a68-1a, 3a68-1b, and 3a68-3(a) under the Exchange Act may vary, the SEC estimates that costs associated with undertaking the determination of whether an agreement, contract or transaction based on an index is a swap or security-based swap will range from $378 to $20,000.[1309] The SEC believes that some

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1308 See generally supra part 0.

1309 The average cost incurred by market participants in connection with assessing whether an agreement, contract, or transaction is a swap or security-based swap is based on the estimated amount of time that staff believes will be required for both in-house counsel and outside counsel to apply the definition. Staff estimates that the average national hourly rate for an in-house counsel is $378 based on data from SIFMA's *Management & Professional Earnings in the Securities Industry 2011* (modified by SEC staff to account for an 1800-hour-work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead). The SEC estimates the costs for outside legal services to be $400 per hour. This is the same estimate used by the SEC for these services in the release involving Exemptions for Security-Based Swaps Issued By Certain Clearing Agencies, Release No. 33-9308 (Mar. 30, 2012), 77 FR 20536 (Apr. 5, 2012). Accordingly, on the high end of the range the SEC estimates the cost to be $19,560 ($7,560 (based on 20 hours of in-house counsel time x $378) + $12,000 (based on 30 hours of

agreements, contracts, or transactions based on an established index would not need the assistance of outside counsel, and a determination can be made in one hour. If an agreement, contract, or transaction is more complex, the SEC estimates the analysis will require approximately 20 hours of in-house counsel time and 30 hours of outside counsel time. Accordingly, if an agreement, contract or transaction is based on a newly structured customized index or basket to suit a particular investment or hedging need, the SEC estimates that the assessment may be at or close to the upper end of the estimated range, as part of the structuring of such customized index or basket.[1310]

iii) Alternatives

The Commissions received many comments on proposed rules 3a68-1a and 3a68-1b and have incorporated many of the suggested alternatives into the final rules and rejected, after careful consideration, other suggested alternatives, as fully discussed in section III.G.3.b. The policy choices made with respect to accepting or rejecting the alternatives suggested by the commenters have been informed by the cost and benefit considerations. In particular, as stated above, the SEC is mindful of the programmatic costs and benefits specifically associated with security-based swaps falling under the federal securities laws regime.[1311]

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outside counsel x $400). This estimate is rounded by two significant digits to avoid the impression of false precision of the estimate.

[1310] For example, the legal costs associated with the analysis of whether an index or basket CDS is a swap or security-based swap will include, among other things, analysis of the weighting of each index or basket component, the aggregate weighting of any five non-affiliated reference entities included in the index or basket, whether a predominant percentage (by weighting) of the issuers included in the index or basket satisfy the public information availability test and whether any issuer included in the index or basket with 5% or more weighting satisfies the public information availability test.

[1311] See supra part XI.4.(b)(i).

One alternative to rules 3a68-1a and 3a68-1b is for the Commissions to not further define the terms "issuers of securities in a narrow-based security index" or "narrow-based security index." The SEC believes the assessment cost associated with determining whether an index CDS is a swap or security-based swap would be greater in the absence of rules 3a68-1a and 3a68-1b. Without these rules, market participants would still need to analyze index components and it would be difficult to apply the statutory language of "issuer of securities in a narrow-based security index" in section 3(a)(68)(A)(ii)(III) of the Exchange Act to index CDS, given that the existing statutory definition of "narrow-based security index" and the past guidance are focused on equity security indexes, volatility indexes and debt security indexes, none of which are specifically tailored for index CDS.[1312] Absent rules 3a68-1a and 3a68-1b, it is very likely that market participants would need to request interpretations from the Commissions. Rules 3a68-1a and 3a68-1b provide tailored and objective criteria, similar to the criteria used in the context of futures contracts on volatility indexes and debt security indexes, to assist market participants in determining whether an index CDS is based on issuers of securities in a narrow-based security index.[1313] These rules will allow market participants to make determinations without requesting interpretations from the Commissions and, therefore, should reduce the assessment costs.

Commenters expressed concern associated with the public information availability test and suggested that the public information availability test not be incorporated into the final rule for various reasons.[1314] As discussed above[1315], the Commissions are adopting the public information availability test with some modifications.

1312 See supra part 0.

1313 Id.

1314 See LSTA Letter (with respect to loans), Markit Letter, ISDA Letter and SIFMA Letter.

The SEC believes there are many programmatic benefits associated with the public information availability test. As noted above, the public information availability test is intended as the substitute test for the ADTV provision in the statutory narrow-based security index definition[1316]. The ADTV test is designed to take into account the trading of equity securities and, because the listing standards for equity securities require that the security be registered under the Exchange Act, the issuer of the equity security will be subject to the periodic reporting requirements of the Exchange Act. Due to the specific provisions of the statutory ADTV test, the Commissions have determined that the ADTV test is not a useful test for purposes of determining whether an index of reference entities or debt securities is a "narrow-based security index" because the components of the index are either reference entities, which do not "trade," or debt instruments, which commonly are not listed, and, therefore, do not have a significant trading volume.[1317] Applying the ADTV test in the existing statutory narrow-based security index definition would not serve any purposes. However, the basis for such provision, that there is sufficient trading in the securities, public information about, and therefore market following of, the issuer of the securities, applies to index CDS. As a substitute for such ADTV test, the SEC believes that there should be 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. The SEC believes that this should reduce the likelihood that non-narrow-based indexes referenced in index CDS, or the component securities, or the named issuers of securities in that index would be used as a

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1315 See supra part III.G.3.b)iii)

1316 Id.

1317 Id.

surrogate for the reference entities securities without complying with the federal securities laws. In particular, the SEC believes that the public information availability test should reduce the likelihood that the index CDS could be used to circumvent the registration provisions of the Securities Act and provisions of the Exchange Act through the use of CDS based on such indexes, manipulate the reference entities securities or the securities in the index and reduce the potential for misuse of material non-public information through the use of CDS based on such indexes..[1318] If a CDS is based on an index that does not satisfy the public information availability test,[1319] such index CDS will be a security-based swap and thus subject to the federal securities laws and the SEC's oversight.[1320]

Some commenters indicated that the determinations of public availability of information would be costly but did not quantify such costs or explain the difficulty in making an assessment of whether information was publicly available[1321]. The SEC recognizes that there will be assessment costs associated with application of the public information availability test. The SEC notes that the public information availability test applies only for purposes of determining whether an index is a "narrow-based security index." The SEC would expect that market participants would look to the index provider to make the assessment or, if the index or basket is customized by the market participant that the creator of the index would take into account the

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1318 Id.

1319 So long as the effective notional amounts allocated to reference entities or securities included in the index that satisfy the public information availability test comprise at least 80 percent of the index's weighting, failure by a reference entity or security included in the index to satisfy the public information availability test would be disregarded if the effective notional amounts allocated to that reference entity or security comprise less than 5 percent of the index's weighting. See paragraph (b) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

1320 See id.

1321 See LSTA Letter (with respect to loans); and SIFMA Letter

public information availability of the index components in creating the custom index or basket. As a result, while the SEC recognizes that there will be costs in evaluating whether the index components satisfy the tests, including the public information availability test, the SEC believes that the index provider (or the creator of the custom index or basket) would already be evaluating the index components to determine whether the provider's index criteria were satisfied and, as part of such evaluation, would be able to ascertain whether the public information availability test is satisfied.

One commenter raised a specific concern about the assessment cost relating to applying the public information availability test to indexes of loans or borrowers and stated that unlike index of securities, which are generally subject to national or exchange-based reporting and disclosure regimes, a higher proportion of the components of an index of loans or borrowers may not be registered securities or reporting companies under the Exchange Act and therefore, this commenter stated that it would be more difficult or costly to determine whether an index of loans or borrowers meets the public information availability test.[1322] The SEC has modified the public information availability test to expand the categories of instrument to be aggregated for purposes of the outstanding indebtedness criterion and to change the method of calculating affiliation for purposes of the public information availability test. The SEC believes that these modifications will mitigate the assessment costs that the commenter is concerned about.[1323]

The SEC believes that the overall assessment costs of including a public information availability test are justified in light of its benefits of preventing the index CDS from being used as a surrogate for the underlying securities or securities of the referenced issuer of securities.

[1322] See July LSTA Letter. See also supra part III.G.3(b)(iii).

[1323] See supra part III.G.3.b)iii).

This should, in turn, prevent circumvention of the application of the Securities Act to index CDS transactions, and prevent fraud, manipulation and misuse of material non-public information.

One commenter suggested replacing the public information availability test with a volume trading test.[1324] The Commissions are not adopting a volume-trading test based on the CDS components of the index or on the index itself, either as a replacement for the public information availability test or as an alternative means of satisfying it. A volume trading test based on CDS is not practicable to use to determine the character of such index CDS because the character of the index CDS would have to be determined prior to any transaction in the Title VII Instrument. Given that there would be no trading volume at the time such determination is made, the index CDS would fail a volume-trading test in all cases[1325] and the assessment costs incurred in connection with such test would not serve any purpose. There also would be assessment costs in determining how many transactions in the CDS index or each CDS component of the index existed, and it is not apparent that any such trade information is either publicly available or verifiable at this time. In addition, the SEC also believes that a volume test based either on the CDS components of the index or the CDS index itself would not be an appropriate substitute for or an alternative to a public information availability test with respect to the referenced entity, issuer of securities, or underlying security because such a volume-based test would not provide transparency on such underlying entities, issuers of securities or securities.[1326] The volume of transactions in a particular CDS or the CDS index does not relate to whether there is public information about the reference entity or reference security underlying the CDS or CDS index.

1324 See Markit Letter.

1325 See supra part III.G.3.b)iii).

1326 Id.

Therefore, a volume-trading test would not achieve the programmatic benefits described above with respect to the public information availability test.

Similarly, the Commissions also rejected commenters' suggestion that the presence of a third-party index provider would assure that sufficient information is available regarding the index CDS itself without the need for a public information availability test.[1327] As stated above, the public information availability test is intended to assure the availability of information about the components of the index, the underlying securities and issuers of the securities.[1328] The existence of a third-party index provider does not imply any greater likelihood that such public information is available.[1329] Although the existence of a third-party index provider as a substitute for the public information availability test would reduce assessment costs of the market participants using such an index (other than the index provider who must evaluate compliance with index criteria), the SEC does not believe that the existence of the third party index provider is a substitute for the public information availability test. The SEC believes that the information a third-party index provider makes available about the construction of an index, index rules, components, and predetermined adjustments provides information only about the index and is not a substitute for the public availability of information about the issuers of the securities or the securities in the index.[1330] In addition, the SEC does not believe that the existence of a third-party index provider indicates any likelihood that such public information is available about the components of the index, which the SEC believes is important to reduce the

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1327 See ISDA Letter; and SIFMA Letter. Neither commenter provided any analysis to explain how or whether a third-party index provider would be able to provide information about the underlying securities or issuers of securities in the index.

1328 See supra part III.G.3.b)iii).

1329 Id.

1330 Id.

potential for manipulation of the component securities of an index, or the named issuers of securities in an index, the misuse of non-public information about such an index, the component securities or the reference entities and circumvention of other provisions of the federal securities laws through the use of CDS based on such an index.[1331] Further, the SEC notes that a third-party index provider may create customized indexes at the behest of market participants, including as part of its regular business and be paid by such market participants for its index customization and creation services.[1332] Accordingly, the SEC does not believe that a third party index test is an appropriate alternative for the public information availability test and the costs to market participants is justified by the programmatic benefits such test provides.[1333]

As more fully discussed above in section III.G.3.b.iii, in considering other alternatives, including whether to revise or maintain the public information availability test, the SEC has consistently considered the programmatic benefits described above and the importance of assuring that there is information available with respect to the issuers of securities constituting a predominant percentage of an index on which a CDS is based if such index is not going to be considered a "narrow-based security index."

c) Swaps on Certain Futures Contracts on Foreign Sovereign Debt (Rule 3a68-5 Under the Exchange Act)

i) Programmatic Benefits and Costs

Rule 3a68-5 provides that a Title VII instrument that is based on qualifying foreign futures contracts on debt securities of one of the 21 enumerated foreign governments is a swap

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1331 Id.

1332 Id. See also Proposing Release at 29852.

1333 Id.

and not a security-based swap if the Title VII instrument satisfies certain conditions.[1334] This rule is intended to prevent such Title VII instruments from being used to circumvent both the conditions of rule 3a12-8 and the federal securities laws protections underlying such conditions.[1335] The conditions provided in rule 3a68-5 are intended to address these concerns. As discussed above, certain of the qualifying foreign futures contracts on the debt securities of one of the 21 enumerated foreign governments that satisfy the conditions of rule 3a12-8 trade with significant volume through foreign trading venues.[1336] Treating Title VII Instruments on such qualifying foreign futures contracts, subject to the conditions provided in rule 3a68-5, as swaps and not security-based swaps would not raise the concerns that such swaps could be used to circumvent rule 3a12-8, the federal securities laws concerns that such conditions are intended to protect, or allow circumvention of the provisions of the Securities Act applicable to security-based swaps (including those applicable to security-based swaps entered into by issuer of securities underlie such security-based swaps, their affiliates, or underwriters of their securities).[1337] There are certain programmatic costs associated with the rule that market participants will need to be cognizant of. For example, although rule 3a12-8 allows qualifying foreign futures to be physically settled outside the United States, the conditions of rule 3a68-5 require that the swap be cash settled in order to be a swap and not a security-based swap. This has the potential cost of not permitting settlement on the same terms as the qualifying foreign future. However, the SEC believes that, as with other Title VII Instruments, if the Title VII Instrument can be physically settled with securities, it will be a security-based swap. The other

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1334 See supra part III.E.

1335 See supra note 717 and accompanying text.

1336 Id.

1337 Id.

condition in rule 3a68-5 that may impact the characterization of the Title VII Instrument is that the Title VII Instrument cannot be entered into by the foreign government, its affiliates, or an underwriter of its securities. This condition is intended to preserve the programmatic benefit of the application of the Securities Act to transactions in Title VII Instruments entered into by issuers of securities, their affiliates and underwriters. Moreover, the final rule provides consistent treatment of qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments and Title VII instruments based on such futures contracts on the debt securities of the 21 enumerated foreign governments, which will allow instruments to trade through designated contract markets.

ii) Assessment Costs

The SEC believes that the assessment cost associated with determining whether a swap on certain futures contracts on foreign government securities constitute a swap or security-based swap under rule 3a68-5 should be minimal. Currently, qualifying foreign futures contracts on debt securities of the 21 enumerated foreign governments are traded on exchanges or boards of trade. Market participants may look at the exchange or board of trade listing to determine what they are. Therefore, the assessment, in accordance with the rule, would primarily focus on whether such swap itself is traded on or through a board of trade; whether the swap is cash-settled; whether the futures is traded on a board of trade; whether any security used to determine the cash settlement amount are not registered under the Securities Act or the subject of any American depositary receipt registered under the Securities Act; and whether the swap is entered into by the foreign government issuing the debt securities upon which the qualifying futures contract is based or referenced, an affiliate of such foreign government or an underwriter of such foreign government securities. All of these determinations may be readily ascertained by the

parties entering into the agreement, contract, or transaction. Therefore, the assessment costs associated with rule 3a68-5 under the Exchange Act should be nominal because parties should be able to make assessments under rule 3a68-5 in less than an hour.

d) Tolerance and Grace Period for Swaps and Security-Based Swaps Traded on Regulated Trading Platforms (Rule 3a68-3 under the Exchange Act)

i) Programmatic Benefits and Costs

In addition to defining narrow-based security index consistent with the statutory definition set forth in section 3(a)(55) of the Exchange Act and the rules, regulations and orders of the SEC thereunder, Rule 3a68-3 under the Exchange Act establishes a tolerance and grace period for swaps and security-based swaps to address the treatment of indexes that migrate from broad-based to narrow-based or narrow-based to broad-based, so that market participants will know which regulatory jurisdiction will apply to such Title VII instruments.[1338]

There are programmatic costs and benefits associated with tolerance and grace periods. Because swaps may only trade on designated contract markets ("DCM"), swap execution facilities ("SEF"), and foreign boards of trade ("FBOT"), and security-based swaps may trade only on registered national securities exchanges ("NSE") and SB SEFs, a tolerance and grace period creates the benefit of permitting the index provider to substitute certain index components in order to maintain the characteristic of such index being narrow-based or broad-based and allow market participants to continue to enter into the Title VII instrument on which such index is based.[1339] The associated programmatic costs are primarily related to the monitoring of index migrations performed by various trading platforms. Such monitoring costs would be part of the

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[1338] See supra part III.G.5.

[1339] Id.

operation costs that a trading platform would incur in connection with implementing Title VII regardless of whether rule 3a68-3 under the Exchange Act is adopted. Absent rule 3a68-3 under the Exchange Act, trading platforms still need to have the technology necessary to monitor and conduct surveillance for index migration, as well as create internal policies and procedures relating to such migration. On the other hand, without a tolerance and grace period, if a market participant wishes to offset a security-based swap to hedge its index CDS position on an SEC-regulated trading platform where the underlying security index has migrated from narrow-based to broad-based, the participant would be prohibited from doing so because a Title VII instrument based on the index would be a swap, and is ineligible for trading on an NSE or SB SEF.

ii) Assessment Costs

Rule 3a68-3 under the Exchange Act provides a tolerance and grace period and does not require any determination to be made beyond the programmatic cost to monitor for migration as described above. The SEC believes that the assessment costs associated with rule 3a68-3 under the Exchange Act should be nominal on the parties entering into an agreement, contract, or transaction.

iii) Alternatives

One commenter stated its view that extending the "grace period" from three months to six months would ease any disruption or dislocation associated with the delisting process with respect to an index that has migrated from broad-based to narrow-based, or narrow-based to broad-based, and such migration is not reversed during the tolerance period.[1340] The commenter did not provide any data, evidence, or other justification for its request. The Commissions are adopting the three-month grace period as proposed, which was the time frame used by Congress

[1340] See MarketAxess Letter. See also supra part III.G.5.b).

in the context of migration of indexes underlying security futures to address the same issue caused by index migration.[1341] The SEC believes that the three-month grace period gives parties to a swap or security-based swap on an index that has migrated sufficient time to execute offsetting positions and believes that it is appropriate to maintain the three-month period that is the applicable grace period for security futures.

e) Request for Interpretation Process (Rule 3a68-2 Under the Exchange Act)

i) Programmatic Benefits and Costs

Rule 3a68-2 under the Exchange Act allows persons to submit a request for a joint interpretation from the Commissions regarding whether an agreement, contract or transaction (or a class of agreements, contracts, or transactions) is a swap, security-based swap, or mixed swap. As stated above,[1342] if an agreement, contract, or transaction is a swap or a security-based swap the overall programmatic costs and benefits that may arise from the Commissions' regulatory programs are expected to be broadly similar and complementary.[1343] However, in implementing Title VII the Commissions may diverge on rules and requirements stemming from the Title VII regulatory regime. Accordingly, a party to an agreement, contract, or transaction will need to know the appropriate classification, e.g. whether it is a swap or security-based swap, in order to know which regulatory regime and corresponding requirements is applicable. The Dodd-Frank Act requires that, with respect to the definitions of swaps, security-based swaps, and mixed swaps, the Commissions must jointly interpret such definitions. This rule, by providing a mechanism for the Commissions to provide such joint interpretations, allows parties to

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1341 See section 3(a)(55)(C)(iii)(II) of the Exchange Act, 15 U.S.C. 77c(a)(55)(C)(iii)(II).

1342 See supra part X.4(0(i).

1343 Id.

understand the timing and process for seeing such joint interpretation. Regardless of this rule, the programmatic costs and benefits that flow from being a swap or security-based swap remain the same for parties requesting a joint interpretation. But, the rule allows for parties to the agreement, contract, or transaction to request through a joint interpretation from the Commissions, what regulatory regime would apply or whether the agreement, contract, or transaction is within the definition of swap or security-based swap.

ii) Assessment Costs

The SEC estimates the costs of submitting a request for a joint interpretation pursuant to rule 3a68-2 under the Exchange Act would be approximately $20,000.[1344] The use of inside counsel in lieu of outside counsel would reduce this estimate. Once such a joint interpretation is made, however, other market participants that seek to transact in the same agreement, contract, or transaction (or class thereof) would be able to rely on such interpretation in determining whether their agreement, contract or transaction is a swap, security-based swap or mixed swap. Accordingly, assessment costs may be affected by the number of parties seeing an interpretation

[1344] As stated in the Proposing Release at 29878, n.354, this estimate is based on information indicating that the average costs associated with preparing and submitting a no action request to the SEC staff, which the SEC believes is a process similar to the process under rule 3a68-2 under the Exchange Act. The staff estimates that costs associated with a request pursuant to rule 3a68-2 will cost approximately $19,560. The SEC estimates the analysis will require approximately 20 hours of in-house counsel time and 30 hours of outside counsel time. Based upon data from SIFMA's *Management & Professional Earnings in the Securities Industry 2011* (modified by SEC staff to account for an 1800-hour-work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead), staff estimates that the average national hourly rate for an in-house attorney is $378. The SEC estimates the costs for outside legal services to be $400 per hour. This is the same estimate used by the SEC for these services in the release involving Exemptions for Security-Based Swaps Issued By Certain Clearing Agencies, Release No. 33-9308 (Mar. 30, 2012), 77 FR 20536 (Apr. 5, 2012). Accordingly, the SEC estimates the cost to be $19,560 ($7,560 (based on 20 hours of in-house counsel time x $378) + $12,000 (based on 30 hours of outside counsel x $400) to submit a joint request for interpretation. This estimate is rounded by two significant digits to avoid the impression of false precision of the estimate.

or whether prior interpretations with respect to the same or similar agreements, contracts, or transactions have been sought.

f) Definition of Swap (Rule 3a69-2 Under the Exchange Act)

i) Programmatic Benefits and Costs

Rule 3a69-2(a) under the Exchange Act states that the term swap has the meaning set forth in section 3(a)(69) of the Exchange Act.[1345] Rule 3a69-2(b) under the Exchange Act explicitly defines the term "swap" to include an agreement, contract, or transaction that is a cross-currency swap, currency option, foreign currency option, foreign exchange option, foreign exchange rate option, foreign exchange forward, foreign exchange swap, forward rate agreement, or non-deliverable forward involving foreign exchange, unless such agreement, contract, or transaction is otherwise excluded by section 1a(47)(B) of the CEA.[1346] Rule 3a69-2(c) under the Exchange Act provides that: (1) a foreign exchange forward or a foreign exchange swap shall not be considered a swap if the Secretary of the Treasury makes the determination described in section 1a(47)(E)(i) of the CEA;[1347] and (2) notwithstanding any such determination, certain provisions of the CEA will apply to such a foreign exchange forward or foreign exchange swap (specifically, the reporting requirements in section 4r of the CEA[1348] and regulations thereunder and, in the case of a swap dealer or major swap participant that is a party to a foreign exchange swap or foreign exchange forward, the business conduct standards in section 4s of the CEA[1349] and regulations thereunder). Rule 3a69-2(c) under the Exchange Act further clarifies that a

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[1345] 15 U.S.C. 78c(a)(69).

[1346] 7 U.S.C. 1a(47)(B).

[1347] 7 U.S.C. 1a(47)(E)(i).

[1348] 7 U.S.C. 6r.

[1349] 7 U.S.C. 6s.

currency swap, cross-currency swap, currency option, foreign currency option, foreign exchange option, foreign exchange rate option, or non-deliverable forward involving foreign exchange is not a foreign exchange forward or foreign exchange swap subject to a determination by the Secretary of the Treasury as described in the preamble.

Rule 3a69-2 is parallel to rule 1.3(xxx)(2) under the CEA. In order to determine whether an agreement, contract, or transaction is a "swap" or "security-based swap", it is necessary for the Commissions to adopt parallel rules that will apply to a Title VII instrument. Therefore, rule 3a69-2 is included under the Exchange Act. The definition of swap is the starting point for determining the status of a Title VII Instrument as a swap, security-based swap, or mixed swap. To the extent that the specific agreements, contracts, and transactions listed in section 1a(47)(B) of the CEA are swaps, the programmatic costs and benefits that flow from such agreements, contracts or transactions being a Title VII instrument under rule 3a69-2 will be determined by the substantive rules adopted by the CFTC mandated by Title VII. If any such agreements, contracts, or transactions are security-based swaps, the programmatic costs and benefits will be the same as with other security-based swaps.

ii) Assessment Costs

Since this rule lists some of the types of agreements, contracts or transactions already listed in section 1a(47)(B) of the CEA[1350] and the determination made by the Secretary of the Treasury, the SEC does not believe there would be assessment costs in addition to those incurred by market participants in determining whether an agreement, contract or transaction falls within the definition of swap.

[1350] 7 U.S.C. 1a(47)(B).

g) Mixed Swaps (Rule 3a68-4 under the Exchange Act)

i) Programmatic Benefits and Costs

Rule 3a68-4(a) under the Exchange Act defines a "mixed swap" in the same manner as the term is defined in both the CEA and Exchange Act. Furthermore, rule 3a68-4(b) under the Exchange Act establishes the regulatory framework for mixed swaps with which parties to bilateral uncleared mixed swaps (i.e., mixed swaps that are neither executed on or subject to the rules of a DCM, NSE, SEF, SB SEF, or FBOT nor cleared through a DCO or clearing agency), as to which at least one of the parties is dually registered with both the CFTC and the SEC, will need to comply. The SEC believes that paragraph (b) of rule 3a68-4 under the Exchange Act will augment the programmatic benefits of the Title VII regulatory regime. The rule addresses potentially duplicative regulatory requirements for dually-registered dealers and major participants that are subject to regulation by both the CFTC and the SEC, while requiring dual registrants to comply with the regulatory requirements the Commissions believe are necessary to provide sufficient regulatory oversight for mixed swaps transactions entered into by such dual registrants. It eliminates potentially duplicative regulation and reduces the programmatic costs associated with regulatory implementation and compliance in the context of mixed swaps by providing that a bilateral uncleared mixed swap would be subject to all applicable provisions of the federal securities laws (and the SEC rules and regulations promulgated thereunder) but would be subject only to certain CEA provisions (and the CFTC rules and regulations promulgated thereunder).

Rule 3a68-4(c) under the Exchange Act establishes a process for persons to request that the Commissions issue a joint order, with respect to parallel provisions[1351] applicable to mixed swaps, to permit such persons (and any other person or persons that subsequently lists, trades, or clears that class of mixed swap) to comply with the parallel provisions of either the CEA or the Exchange Act and related rules and regulations (collectively "specified parallel provisions"), instead of being required to comply with parallel provisions in both the CEA and the Exchange Act. This process applies except with respect to bilateral, uncleared mixed swaps where one of the parties to the mixed swap 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, for which the regulatory framework is established under rule 3a68-4(c). The SEC has recognized the programmatic benefits associated with rule 3a68-4(c) and believes that in the mixed swap area, the process established by rule 3a68-4(c) would eliminate potentially duplicative regulatory requirements and reduce the compliance costs associated with mixed swaps.

ii) Assessment Costs

With respect to rule 3a68-4(b) under the Exchange Act, one cost is that parties to a mixed swap would need to determine whether they satisfy the conditions set forth in such rule in order to ascertain the regulatory treatment of the mixed swap. Such assessment includes determining whether the mixed swap is neither executed on nor subject to the rules of a DCM, NSE, SEF, SB SEF or FBOT, whether the mixed swap will not be submitted for clearing, and whether one party

[1351] For purposes of paragraph (c) of rule 3a68-4 under the Exchange Act, "parallel provisions" means comparable provisions of the CEA and the Exchange Act that were added or amended by Title VII with respect to security-based swaps and swaps, and the rules and regulations thereunder.

to the mixed swap is a dually registered dealer or major participant. The SEC believes that the above determinations would be based on readily ascertainable facts and the assessment costs associated with such determinations should be minimal.

With respect to rule 3a68-4(c) under the Exchange Act, parties to mixed swaps have the option to decide whether to submit a request for issuing a joint order, weighing the benefits realized from the joint order against the cost of submitting such request. If parties to mixed swaps decide to submit a request, the SEC estimates the total costs of preparing and submitting a party's request to the Commissions pursuant to rule 3a68-4(c) under the Exchange Act will be $31,000 per request for mixed swaps for which a request for a joint interpretation pursuant to rule 3a68-4(c) was not previously made.[1352] The use of inside counsel in lieu of outside counsel would reduce this estimate. Absent such a process, though, market participants that desire or intend to offer or enter into such a mixed swap (or class thereof) would not have the option to request for the Commissions' joint interpretation and absent a joint interpretation, they would be required pursuant to Title VII to comply with all regulatory requirements applicable to both swaps and security-based swaps.

[1352] As discussed in the Proposing Release at 29878, note 356, this estimate is based on information indicating that the average costs associated with preparing and submitting a no-action request to the SEC staff, which the SEC believes is a process similar to the process under rule 3a68-4(c). The staff estimates that costs associated with such a request will cost approximately $31,340. The SEC estimates the analysis will require approximately 30 hours of in-house counsel time and 50 hours of outside counsel time. Based upon data from SIFMA's *Management & Professional Earnings in the Securities Industry 2011* (modified by SEC staff to account for an 1800-hour-work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead), staff estimates that the average national hourly rate for an in-house attorney is $378. The SEC estimates the costs for outside legal services to be $400 per hour. This is the same estimate used by the SEC for these services in the release involving Exemptions for Security-Based Swaps Issued By Certain Clearing Agencies, Release No. 33-9308 (Mar. 30, 2012), 77 FR 20536 (Apr. 5, 2012). Accordingly, the SEC estimates the cost to be $31,340 ($11,340 (based on 30 hours of in-house counsel time x $378) + $20,000 (based on 50 hours of outside counsel x $400) to submit a joint request for interpretation. This estimate is rounded by two significant digits to avoid the impression of false precision of the estimate.

iii) Alternatives

One commenter recommended that the Commissions require that market participants disaggregate mixed swaps and enter into separate simultaneous transactions so that they cannot employ mixed swaps to obscure the underlying substance of transactions.[1353] This commenter stated that "the regulatory complexity of dealing with a mixed swap far outweighs the legitimate benefits to counterparties from documenting the transactions as mixed swaps."[1354] This commenter asserted that some benefits of requiring disaggregation include more useful price reporting; increased transparency; regulatory reporting and monitoring that will align with the transaction database of the counterparties; and the thwarting of illegitimate motivations, such as obfuscation of prices and fees. Regardless of the benefits of disaggregation raised by the commenter, Title VII specifically contemplates that there would be mixed swaps comprised of both swaps and security-based swaps. The SEC believes that requiring parties to disaggregate mixed swaps into separate components is not consistent with Congressional intent and may result in certain programmatic costs, such as limiting the types of derivatives products and transactions market participants may offer and enter into and increasing transaction costs (such as documentation costs) by disaggregating a mixed swap into multiple separate transactions.

h) Books and Records Requirement for SBSAs (Rule 3a69-3 under the Exchange Act)

i) Programmatic Benefits and Costs

Rule 3a69-3 under the Exchange Act provides that there are no additional books and records, or data, requirements regarding SBSAs beyond those required for swaps. The SEC recognized the following programmatic benefits and costs in adopting this rule.

1353 See Better Markets Letter.

1354 Id.

As discussed above, SBSAs are swaps over which the CFTC has primary regulatory authority, but for which the SEC has antifraud, anti-manipulation, and certain other authority.[1355] There will be programmatic benefits and costs as a result of the SDRs, swap dealers and major swap participants implementing and complying with the books and records requirements provided in sections 21 and 4s of the CEA.[1356] The programmatic benefits and costs will flow from the substantive rules adopted by the CFTC regarding record keeping requirements for swaps. SBSAs are swaps and will be subject to these books and records requirements. The SEC believes that the rules proposed by the CFTC would provide sufficient books and records regarding SBSAs[1357], and that additional books and records requirements for SBSAs may be duplicative and would not produce corresponding benefits warranting such additional costs. Rule 3a69-3 under the Exchange Act avoids any additional programmatic costs, especially the additional compliance and operation costs that would be incurred by SDRs, swap dealers and major swap participants in the area of data maintenance and recordkeeping, beyond those which have already been prescribed by the CFTC's rules.

ii) Assessment Costs

The SEC does not believe that any assessment costs associated with rule 3a69-3 under the Exchange Act would be material.

1355 See supra part V.

1356 7 U.S.C. 24a and 6s. Pursuant to sections 21(b)(2) and 4s(f)(1)(B)(ii) of the CEA, the CFTC has adopted rules with respect to data collection and maintenance by SDR and books and records requirements for swap dealers and major swap participants. See Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants, 77 FR 20128 (April 3, 2012); and Swap Data Recordkeeping and Reporting Requirements, 77 FR 2136 (January 13, 2012).

1357 See Proposing Release at 29863. See also supra part V.

5. Effects on Competition, Efficiency and Capital Formation

Section 3(f) of the Exchange Act requires the SEC, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action would promote efficiency, competition, and capital formation.[1358] In addition, section 23(a)(2) of the Exchange Act[1359] requires the SEC, when adopting rules under the Exchange Act, to consider the impact such rules would have on competition. Section 23(a)(2) of the Exchange Act also prohibits the SEC from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The Commissions are further defining "swap" and "security-based swap" pursuant to section 712(d)(1) of the Dodd-Frank Act.[1360] In the Proposing Release, the SEC stated that the SEC preliminarily believed that the proposed Exchange Act rules would not impose significant burden on competition, that they would create efficient processes, and that they would not have adverse effects on capital formation.[1361] In the Proposing Release, the SEC requested comment on each of these issues,[1362] and no commenters responded to specifically address these issues.

The SEC recognizes that the most significant impact of the swap and security-based swap definitions will derive from these definitions serving as the foundation for implementing the Title VII regulatory regime, particularly given the significant impacts that Title VII will have on the security-based swap market. In adopting these definitional rules, the SEC has sought to

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1358 15 U.S.C. 78c(f).

1359 15 U.S.C. 78w(a)(2).

1360 The SEC is also acting pursuant to its rulemaking authority provided by sections 3 and 23(a) of the Exchange Act.

1361 See Proposing Release at 29885-87.

1362 Id. at 29887.

fairly reflect the statutory definitions and their underlying intent to implement the regulatory framework Congress intended to impose on the derivatives markets by enacting Title VII.

The scope of the definitions will affect the ultimate regulatory effects on competition, efficiency, and capital formation that will accompany the full implementation of Title VII. The SEC anticipates analyzing these effects in the adopting releases for the particular regulations. Below is a general discussion of the impacts on competition, efficiency, and capital formation as a result of the rules being adopted in this release.

The final rules being adopted relate primarily to further defining the terms "swap," "security-based swap," and "mixed swap" to determine (i) the instruments that will be subject to the Title VII regulatory regime and (ii) the jurisdictional line between Title VII instruments regulated by the SEC and those regulated by the CFTC. There also are procedural rules regarding interpretive requests and joint orders from the Commissions, and recordkeeping relating to SBSAs. The SEC believes that these procedural rules are related to the status of a product and the regulatory treatment of a mixed swaps, and therefore, the effects of these rules on competition, efficiency, and capital formation are subsumed in the overall impact of the rules defining the perimeter of the Title VII regulatory regime, and those of the rules relating to the jurisdictional line between the SEC and CFTC.

a) The Status of Products

The status of products as inside the Title VII regulatory perimeter (i.e., swaps and security-based swaps) or outside the regulatory perimeter will have impacts on market participants. These rules will impact the status of certain market participants currently acting as intermediaries in the security-based swap market, subjecting them to regulatory oversight and registration. As the SEC has noted, the market among intermediaries for security-based swaps is highly concentrated. The concentration in large part appears to reflect the fact that larger entities

possess competitive advantages in engaging in over-the-counter security-based swap dealing activities, particularly with respect to having sufficient financial resources to provide potential counterparties with adequate assurances of financial performance.[1363] At the same time, as noted by commenters to the Entities Definition Release, some entities engage in smaller volumes of security-based swap dealing activity.[1364]. Some small and mid-size banks, for example, routinely provide such services involving relatively small notional amounts to their customers.[1365] Although these relatively small dealers in general may not compete directly with the largest dealers (because they service a different segment of the market), they may be expected to play a role in helping certain types of customers (such as customers with a relatively small need for security-based swaps) enter into security-based swaps, thus promoting the availability of these products.[1366] This availability may assist market participants (as end users), as discussed below, in engaging security-based swap activities that may be related to their businesses or financing needs.

As the SEC has noted before, persons who fall within the definitions of "security-based swap dealer" and "major security-based swap participant" will incur a range of programmatic costs by virtue of their status as a registered dealer or major participant and certain assessment costs regarding their security-based swap activities. To the extent the costs associated with these statutorily mandated requirements are relatively fixed or large enough, they may negatively affect competition within the security-based swap market.[1367] This may, for example, lead

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1363 See Entity Definitions Release, at 30740.

1364 Id.

1365 Id.

1366 Id.

1367 Id.

smaller dealers or entities for whom dealing is not a core business to keep their security-based swap dealing activity below the volume threshold required to be registered with the SEC or exit the market if the profit from the security-based swap dealing activity cannot justify the cost incurred to comply with the Title VII requirements; both scenarios could cause customers to have less access to the market or to incur higher costs in accessing the market. Such costs might also deter the entry of new firms into the market. If sufficiently high, these costs of compliance may increase concentration among dealers.[1368]

Certain aspects of the regulation of products defined as security-based swaps may enhance competition in the market for security-based swaps. For example, the proposed business conduct standards, if adopted as proposed, including those for disclosure of material risks and for fair and balanced communications, may reduce information asymmetries between security-based swap dealers, major security based swap participants, and their counterparties. The reduction of information asymmetries should promote price efficiency, promote more informed decision-making, and reduce the incidence of fraudulent or misleading representations.[1369]

In addition, as the SEC noted in the Entity Definitions Release, the current security-based swap market is subject to the potential for risk spillovers and systemic risk, which can occur when the financial sector as a whole (or certain key segments) is exposed to a significant amount of concentrated financial risk, either through direct counterparty relationships or the deterioration of asset values, and such exposure gives rise to the systemic chain effect of one firm's financial distress or losses leading to financial distress or losses of the entire financial sector as a

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1368 Id.

1369 See Business Conduct Standards Proposing Release, 76 FR 42396-42459, at 42452. See also supra part XI.A.3.

whole.[1370] With respect to transactions involving security-based swaps, security-based swap dealers and major security-based swap participants will be regulated and, as noted in the Entity Definitions Release, such regulation and requirements are expected to increase market participants' confidence in the dealers' and major participants' ability to perform their obligations.[1371]

The effect of the definitions on efficiency and capital formation is linked to their effect on competition. Markets that are competitive, with fair and transparent pricing and equal access to security-based swaps, may be expected to promote the efficient allocation of capital. Similarly, definitions that promote, or do not unduly restrict, competition can be accompanied by regulatory benefits that minimize the risk of market failure and thus promote efficiency and capital formation within the market.[1372]

As discussed above, certain Title VII requirements and rules relating to intermediaries, such as internal and external business conduct standards, if adopted as proposed, are expected to reduce information asymmetries and promote price efficiency. These business conduct standards, if adopted as proposed, would also help regulators perform their functions in an effective manner. The resulting increase in market integrity could affect capital formation in U.S. capital markets positively.[1373]

Other entities also will be affected by the scope of the security-based swap definition, including clearing agencies that currently, and in the future will, clear security-based swaps, the security-based swap data repositories that collect security-based swap data, and the SB SEFs and

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1370 See Entity Definitions Release, at 30740.

1371 Id. at 30723 -30724

1372 See Entity Definitions Release, at 30742.

1373 See Business Conduct Standards Proposing Release, at 42452; SDR Proposing Release, at 77365.

exchanges that are transaction venues for security-based swaps, subjecting these entities to regulation and oversight by the SEC.[1374] For example, The SEC has noted that the intent of the proposed rules concerning standards for clearing agency operations and governance standards of clearing agencies is to promote the prompt and accurate clearance and settlement of securities transactions, including security-based swap transactions, by requiring certain minimum standards at clearing agencies.[1375] The SEC stated that it preliminarily believes that these requirements would ensure resilient and cost-effective clearing agency operations as well as promote transparent and effective clearing agency governance that would consequently support confidence among market participants in clearing agencies' ability to serve as efficient mechanisms for clearance and settlement and to facilitate capital formation.[1376]

Similarly, the SEC has previously stated that the core principles, duties, and requirements imposed by Title VII and the proposed rules on SB SEFs will foster innovation in the security-based swap market by allowing entities that seek to become SB SEFs to structure diverse platforms for the trading of security-based swaps,[1377] increase pre-trade price transparency, and establish fair, objective, and not unreasonably discriminatory standards for granting impartial access to trading on the SB SEFs,[1378] thereby furthering higher efficiency, promoting competition, and encouraging capital formation.[1379] The SEC also noted that any resulting increase in market integrity proceeding from the rules intended to support the statutorily-

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1374 See supra part XI.A.3.

1375 See Clearing Agency Standards Proposing Release, at 14535.

1376 Id.

1377 See SB SEF Proposing Release, at 11049.

1378 Id.

1379 Id. at 11049-50.

mandated regulatory obligations of SB SEFs would likely increase market participants' confidence in the soundness and fairness of the security-based swap market.[1380] Such increased confidence likely would stimulate financial investment in SB swaps by corporate entities and others that may find that more transparent venues for the trading of SB swaps would allow them to purchase SB swaps to offset business risks and to meet hedging objectives.[1381] Further, to the extent that market participants utilize SB swaps to better manage portfolio risks with respect to positions in underlying securities, the extent that they are willing to participate in the SB swap market may impact their willingness to participate in the underlying asset's market.[1382] Therefore, the Commission stated its preliminarily belief that the proposed rules would help encourage capital formation.[1383]

Furthermore, in the proposing release regarding SDRs, [1384] the SEC noted that, by allowing multiple SDRs to provide data collection, maintenance, and recordkeeping services, the rules are intended to promote competition among SDRs. The SEC also stated that the proposed rules promote data collection, maintenance, and recordkeeping according to existing best practices that are used in similar capital market institutions and are likely to positively affect transparency in credit markets and would help capital formation in the broader capital markets whose participants rely on security-based swap markets to meet their hedging objectives.[1385]

1380 Id. at 11049.

1381 Id.

1382 Id. at 11050

1383 Id.

1384 See SDR Proposing Release, at 77365.

1385 Id.

Other parties to security-based swap transactions may be affected by the definitions as well. Title VII amends the Exchange Act and the Securities Act to include security-based swap within the definition of the term "security."[1386] End-users will have the benefit and protection of the existing federal securities laws, including the Exchange Act and Securities Act provisions added by Title VII. As a result of the amendment to the Securities Act regarding security-based swap transactions entered into by issuers of the securities underlying the security-based swap, and their affiliates and underwriters,[1387] such issuers, affiliates, and underwriters cannot use security-based swaps without also complying with the Securities Act provisions with respect to the underlying securities. Furthermore, Title VII provides protections to non-ECPs by adding provisions to both the Securities Act and the Exchange Act that require security-based swap transactions with such non-ECPs to be covered by an effective registration statement under the Securities Act and traded on a national securities exchange, and for brokers and dealers engaging in transactions with non-ECPs to be registered as such under section 15 of the Exchange Act. To the extent counterparties, including issuers of the underlying securities, or their affiliates or underwriters, determine to engage in such transactions, other counterparties may have a greater willingness to engage in such transactions because of the protections afforded by the Securities Act registration, disclosure, and civil liability scheme. An increased interest by end-users may create effects on competition.

While other securities-related derivatives have the same limitations on issuers, affiliates, and underwriters using the derivative to avoid the Securities Act application to the underlying securities at the time the transaction is entered into, these other derivatives, such as security

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1386 See section 2(a)(1) of the Securities Act and section 3(a)(10) of the Exchange Act, 15 U.S.C. 77b(a)(1) and 15 U.S.C. 78c(a)(10).

1387 See supra part XI.A.3.

options and security futures, do not contain the same limitation on transactions with non-ECPs. Although security options and security futures must be traded on a national securities exchange as one condition to avail themselves of an exemption from registration under the Securities Act,[1388] other exemptions from registration under the Securities Act may be available for transactions in security options sold to non-ECPs that are not available to security-based swap transactions with non-ECPs.

There also may be effects on efficiency and capital formation by facilitating end-users' use of security-based swaps for investment or hedging of risks relating to investments or business operations, thereby affecting liquidity and costs in connection with the issuance of equity and debt securities. The further definitions may promote capital formation by facilitating these hedging and investment activities. For example, in the context of CDS, as credit risk is correlated, lenders who made loans and investors in debt securities may find it desirable to hedge credit risks on their loan or securities portfolios by purchasing protection through single-name or index CDS.[1389] Although basis risk may exist in this type of trade, it should be effective at reducing counterparty exposure.[1390]

b) Jurisdictional Divide Impacts

There may be competitive impacts that arise due to the jurisdictional divide between the CFTC and the SEC that Congress imposed in Title VII. While the competitive impacts of the substantive rules will be addressed as part of each substantive rulemaking, the SEC acknowledges that such competitive effects may exist as a consequence of the statutory jurisdictional divide. These competitive impacts may arise due to capital and margin treatment,

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1388 See section 3(a)(14) of the Securities Act and Rule 238 under the Securities Act.

1389 See Entity Definitions Release, at 30742.

1390 Id.

for example, which may affect demand for security-based swaps as compared to other types of security instruments. In addition, to the extent there are differences in regulatory treatment between security-based swaps and other securities-based or securities-related instruments, there will be competition across the markets affecting all market participants.

As one example of the possible competitive effects of the jurisdictional divide, section 3E(a) of the Exchange Act provides that only a registered broker, dealer, or security-based swap dealer may accept margin from customers to secure cleared security-based swap transactions,[1391] and that the broker, dealer, or security-based swap dealer shall treat and deal with all margin received from a customer as belonging to the customer.[1392] Similarly, section 4d(f) of the Commodity Exchange Act requires that only a registered futures commission merchant may accept margin from customers to secure cleared swap transactions[1393] and that the futures commissions merchant shall treat and deal with margin received from a customer as belonging to the customer.[1394] The SEC understands that many members of clearing agencies are dually-registered broker-dealers and futures commission merchants and that much of the clearing of security-based swaps may occur through such dually-registered entities.[1395] Because collateral

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1391 See section 3E(a) of the Exchange Act, 15 U.S.C. 78c-5(a).

1392 See section 3E(b)(1) of the Exchange Act, 15 U.S.C. 78c-5(b)(1)

1393 See section 4d(f)(1) of the CEA, 7 U.S.C. 6d(f)(1).

1394 See section 4d(f)(2)(A) of the CEA, 7 U.S.C. 6d(f)(2)(A).

1395 See, e.g., letter to the SEC from ICE Clear Credit LLC, dated November 7, 2011 ("ICE Clear Credit Letter"), available at http://www.sec.gov/rules/petitions/2011/petn4-641.pdf (requesting exemptive relief from the application of section 15(c)(3) of the Exchange Act and Rule 15c3-3 thereunder to allow ICE Clear Credit, and its members that are dually-registered broker-dealers and futures commission merchants, to, among other things: (1) hold customer assets used to margin, secure, or guarantee customer positions consisting of cleared credit default swaps that include swaps and security-based swaps in a commingled customer omnibus account subject to section 4d(f) of the CEA; and (2) calculate margin for this commingled customer account on a portfolio margin basis); see also section 4d(F)(1) of the CEA (making it unlawful for any person

for swaps and security-based swaps are required under applicable statutory requirements to be maintained in two separate accounts under the CEA and Exchange Act, respectively, the derivatives portfolio of a customer will be separated into a swap portfolio and a security-based swap portfolio, with two separate margin accounts and without the benefits of netting swaps against security-based swaps for purposes of calculating margin requirements. Absent the adoption of a margin and segregation approach that would permit a customer to hold both swaps and security-based swaps in a single customer account, a customer who clears swaps and security-based swaps through a clearing member who is dually-registered as a futures commission merchant with the CFTC and a broker-dealer with the SEC may have to deliver collateral to the clearing member with respect to the customer's cleared swap portfolio and also deliver collateral as margin to the clearing member with respect to its security-based swap portfolio even if the positions in the swap portfolio offset the risk arising from the positions in the security-based swap portfolio. This will impact customers' liquidity, as opposed to holding swap and security-based swap positions in one single account,[1396] and increase customers' transaction costs. Such an increase will affect customers' ability to use security-based swaps and may drive them to seek less expensive alternatives. Decrease in demand for security-based swaps may increase dealer competition in the security-based swap market for the remaining business, or result in dealers exiting the market.

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to, among other things, accept money and securities from a swaps customer for a cleared swap unless such person has registered with the CFTC as a futures commission merchant).

1396 See ICE Clear Credit Letter at 6, 13-14. See also Statement of General Policy on the Sequencing of the Compliance Dates for Final Rules Applicable to Security-Based Swaps Adopted Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act, 77 FR 35625 n.138 (June 14, 2012).

In addition, there may be competitive impacts on security-based swap dealers, major security-based swap participants, clearing agencies, security-based swap data repositories and security-based swap execution facilities (or national securities exchanges) if they provide services for both security-based swaps and swaps, as their businesses will be divided based on the jurisdictional line between swaps and security-based swaps. For registered entities whose derivatives activities involve products that reference indexes or baskets, they will incur assessment costs[1397] and, to the extent that SEC and CFTC regulations diverge, they will incur additional regulatory compliance costs[1398] to implement two sets of regulations that would not otherwise be incurred if the jurisdictional divide did not exist. The SEC recognizes that these costs may affect existing market participants' considerations whether to continue to operate their business, and new entrants' desire to enter into new business, across two separate regulatory regimes and if they determine that the incremental costs of operating the derivatives business under two separate regulatory regimes would outweigh potential revenues, they may exit certain products to limit the application of regulatory requirements to solely those of the CFTC or the SEC. This could result in a redistribution of the swaps or security-based swaps dealing activity in the derivatives market and lead to further concentration of security-based swap dealing activity.

The SEC understands that Congress intended to create two parallel regulatory regimes for the derivatives market that complement each other. Each regulatory regime will have the benefit of the regulatory expertise of the respective agency. The rules further defining swap, security-based swap, and mixed swap do not by themselves create negative competitive impacts other

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1397 See the discussion of assessment costs of various rules and interpretations, supra part XI.A.4.

1398 See supra parts XI.A.3and XI.A.4.

than those which potentially could be imposed if the Commissions' substantive requirements differ substantially.

Finally, the rules being adopted may have effects on efficiency and capital formation. For example, the rules defining the terms "issuers of securities in a narrow-based security index" and "narrow-based security index" for purposes of the jurisdictional divide are intended to, among other things, minimize the likelihood that an index on which a CDS is based that is outside of the SEC's jurisdiction can be used as a surrogate or substitute for the underlying security, or with respect to securities of the referenced issuer, or to manipulate the market for such securities. Such provisions will provide greater protection to the reference issuers or the issuers of the securities in the index that the index CDS cannot be used in a manner that will adversely affect such issuers and their ability to raise capital.

In conclusion, the SEC believes the rules and interpretations adopted here would not have overall adverse effects on efficiency, competition, or capital formation.

B. Paperwork Reduction Act

1. Background

Rules 3a68-2 and 3a68-4(c) under the Exchange Act contain new "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995.[1399] The SEC has submitted them to the Office of Management and Budget ("OMB") for review in accordance with the PRA.[1400] The titles for the collections of information are: (1) Interpretation of Swaps, Security-Based Swaps, and Mixed Swaps and (2) Regulation of Mixed Swaps: Process for determining regulatory treatment for mixed swaps (OMB Control No. 3235-0685). An

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[1399] 44 U.S.C. 3501 et seq.

[1400] 44 U.S.C. 3507(d) and 5 CFR 1320.11

agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

The rules containing these two collections of information are being adopted pursuant to the Exchange Act. The rules establish a process through which a person can submit a request to the Commissions that the Commissions provide a joint interpretation of whether an agreement, contract, or transaction (or class thereof) is a swap, security-based swap, or both (i.e., a mixed swap). The rules also establish a process with respect to mixed swaps through which a person can submit a request to the Commissions that the Commissions issue a joint order permitting the requesting person (and any other person or persons that subsequently lists, trades, or clears that class of mixed swap) to comply, as to parallel provisions only, with specified parallel provisions, instead of being required to comply with parallel provisions of both the CEA and the Exchange Act. The hours and costs associated with preparing and sending these requests will constitute reporting and cost burdens imposed by each collection of information.

In the Proposing Release, the SEC requested comment on the collection of information requirements.[1401] As discussed in connection with rules 3a68-2 and 3a68-4(c) under the Exchange Act, under the Exchange Act the final rules require the same information to be collected as proposed.[1402] As noted above, the Commissions received approximately 86 comment letters on the Proposing Release.[1403] The SEC did not receive any comments that directly address its Paperwork Reduction Act analysis or its burden estimates. However, the SEC did receive comments regarding confidentiality of information submitted as a result of the

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1401 See Proposing Release at 29877, 29879.

1402 See discussion of rules 3a68-2 and 3a68-4(c) supra parts VI and 0.

1403 See supra part I.

collection of information requirements. These comments do not directly address the SEC's Paperwork Reduction Act analysis, but they do implicate those aspects of the analysis regarding confidentiality. These comments are discussed below.[1404]

2. Summary of Collection of Information Under Rules 3a68-2and 3a68-4(c) Under the Exchange Act

First, the SEC is adopting new rule 3a68-2 under the Exchange Act, which will allow persons to submit a request for a joint interpretation from the Commissions regarding whether an agreement, contract, or transaction (or a class thereof) is a swap, security-based swap, or both (i.e., a mixed swap). Under rule 3a68-2 under the Exchange Act, a person will provide to the Commissions all material information regarding the terms of, and a statement of the economic characteristics and purpose of, each relevant agreement, contract, or transaction (or class thereof), along with that person's determination as to whether each such agreement, contract, or transaction (or class thereof) should be characterized as a swap, security-based swap, or both (i.e., a mixed swap), including the basis for such a determination. The Commissions also may request the submitting person to provide additional information.

The Commissions may issue in response a joint interpretation or joint notice of proposed rulemaking regarding the status of that agreement, contract, or transaction (or class thereof) as a swap, security-based swap, or both (i.e., a mixed swap). Any joint interpretation, like any joint notice of proposed rulemaking, will be public and may discuss the material information regarding the terms of the relevant agreement, contract, or transaction (or class thereof), as well as any other information the Commissions deem material to the interpretation. Requesting persons also will be permitted to withdraw a request made pursuant to rule 3a68-2 under the

[1404] See infra part XI.B.3.

Exchange Act at any time before the Commissions have issued a joint interpretation or joint notice of proposed rulemaking in response to the request.

Persons will submit requests pursuant to rule 3a68-2 under the Exchange Act on a voluntary basis. However, if a person submits a request, all of the information required under the rule, including any additional information requested by the Commissions, must be submitted to the Commissions, except to the extent a person withdraws the request pursuant to the rule.

Second, the SEC is adopting rule 3a68-4(c) under the Exchange Act, which will allow persons to submit requests to the Commissions for joint orders regarding the regulation of a particular mixed swap (or class thereof). Under rule 3a68-4(c) under the Exchange Act, a person will provide to the Commissions all material information regarding the terms of, and the economic characteristics and purpose of, the specified (or specified class of) mixed swap. In addition, a person will provide the specified parallel provisions, the reasons the person believes such specified parallel provisions are appropriate for the mixed swap (or class thereof), and an analysis of: (1) the nature and purposes of the parallel provisions that are the subject of the request; (2) the comparability of such parallel provisions; and (3) the extent of any conflicts or differences between such parallel provisions. The Commissions also may request the submitting person to provide additional information.

The Commissions may issue in response a joint order, after public notice and opportunity for comment, permitting the requesting person (and any other person or persons that subsequently lists, trades, or clears that class of mixed swap) to comply, as to parallel provisions only, with the specified parallel provisions (or another subset of the parallel provisions that are the subject of the request, as the Commissions determine is appropriate), instead of being required to comply with parallel provisions of both the CEA and the Exchange Act. Any joint

order will be public and may discuss the material information regarding the terms of the relevant agreement, contract, or transaction (or class thereof), as well as any other information the Commissions deem material to the interpretation. Requesting persons also will be permitted to withdraw a request made pursuant to rule 3a68-4(c) under the Exchange Act at any time before the Commissions have issued a joint order in response to the request.

Persons will submit requests pursuant to rule 3a68-4(c) under the Exchange Act on a voluntary basis. However, if a person submits a request, all of the information required under the rule, including any additional information requested by the Commissions, must be submitted to the Commissions, except to the extent a person withdraws the request pursuant to the rule.

3. Reasons for and Use of Information

The SEC will use the information collected pursuant to rule 3a68-2 under the Exchange Act to evaluate agreements, contracts, or transactions (or classes thereof) in order to provide joint interpretations or joint notices of proposed rulemaking with the CFTC regarding whether these agreements, contracts, or transactions (or classes thereof) are swaps, security-based swaps, or both (i.e., mixed swaps) as defined in the Dodd-Frank Act. The SEC will use the information collected pursuant to rule 3a68-4(c) under the Exchange Act to evaluate a specified, or a specified class of, mixed swap in order to provide joint orders or joint notices of proposed rulemaking with the CFTC regarding the regulation of that particular mixed swap or class of mixed swap. The information provided to the SEC pursuant to rules 3a68-2 and 3a68-4(c) under the Exchange Act also will allow the SEC to monitor the development of new OTC derivatives products in the marketplace and determine whether additional rulemaking or interpretive guidance is necessary or appropriate.

As discussed above, some commenters expressed concern about the public availability of information regarding the joint interpretive process and asked that the parties be able to seek

confidential treatment of their submissions.[1405] As stated above, under existing rules of both Commissions, requesting parties may seek confidential treatment for joint interpretive requests from the SEC and the CFTC in accordance with the applicable existing rules relating to confidential treatment of information.[1406] Also as stated above, even if confidential treatment has been requested, all joint interpretive requests, as well all joint interpretations and any decisions not to issue a joint interpretation (along with the explanation of the grounds for such decision), will be made publicly available at the conclusion of the review period.[1407]

4. Respondents

As discussed in the Proposing Release, the SEC believes that the relevant categories of persons that will submit requests under rule 3a68-2 under the Exchange Act will be swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants; SEFs, security-based SEFs and DCMs trading swaps; and SDRs, SBSDRs, DCOs clearing swaps, and clearing agencies clearing security-based swaps.[1408] The SEC estimates that the total number of such persons will be 475.[1409] Similarly, the SEC believes that the relevant

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1405 See supra part VI.

1406 See 17 CFR 200.81 and 17 CFR 140.98. See also supra part VI.

1407 See supra part VI.

1408 See Proposing Release at 29876.

1409 This total number includes an estimated 250 swap dealers, 50 major swap participants, 50 security-based swap dealers, 10 major security-based swap participants, 35 SEFs, 20 security-based SEFs, 12 DCOs, 17 DCMs, 15 SDRs, 10 SBSDRs, and 6 clearing agencies, as set forth by the CFTC and SEC, respectively, in their other Dodd-Frank Act rulemaking proposals. See Entity Definitions Release, supra note 12(regarding security-based swap dealers and major security-based swap participants); Registration of Swap Dealers and Major Swap Participants, supra note 1288 (regarding swap dealers and major security-based swap participants); SDR Proposing Release, supra note 1231 (regarding SBSDRs); Swap Data Repositories, supra note 6 (regarding SDRs); Core Principles and Other Requirements for Swap Execution Facilities, 76 FR 1214, Jan. 7, 2011 (regarding SEFs); Registration and Regulation of Security-Based Swap Execution Facilities, 76 FR 10948, Feb. 28, 2011 (regarding security-based SEFs); Derivatives Clearing Organization General Provisions and Core Principles, 76 FR 69334 (Nov. 8, 2011); Core

categories of persons that will submit a request under rule 3a68-4(c) under the Exchange Act will be SEFs, security-based SEFs, and DCMs trading swaps and estimates that the total number of such persons will be 72.[1410]

However, based on the SEC's experience and information received from commenters to the ANPR[1411] and during meetings with the public to discuss the Product Definitions generally, and taking into consideration the certainty provided by the rules and interpretive guidance in this release, the SEC believes that the number of requests for a joint interpretation to the Commissions pursuant to rule 3a68-2 under the Exchange Act will be small.[1412] With respect to proposed rule 3a68-4(c) under the Exchange Act, the SEC also estimates the number of requests for joint orders will be small.[1413] Pursuant to the Commissions' rules and interpretive guidance, a number of persons that engage in agreements, contracts, or transactions that are swaps, security-based swaps, or both (i.e., a mixed swap) will be certain that their agreements, contracts, or transactions are, indeed, swaps, security-based swaps, or both, (i.e., mixed swaps) and will not request an interpretation pursuant to rule 3a68-2 under the Exchange Act. Also, as the Commissions provide joint interpretations regarding whether agreements, contracts, or transactions (or classes thereof) are or are not swaps, security-based swaps, or both (i.e., mixed swaps), the SEC expects that the number of requests for interpretation will decrease over time. The SEC believes that the rules and interpretive guidance regarding swaps, security-based swaps,

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Principles and Other Requirements for Designated Contract Markets, 75 FR 80572, Dec. 22, 2010 (regarding DCMs); Clearing Agency Standards for Operation and Governance, 76 FR 14472, Mar. 16, 2011 (regarding clearing agencies).

1410 Id.

1411 See supra note 12 and accompanying text.

1412 See infra note 1414 and accompanying text.

1413 See infra note 1415and accompanying text.

and mixed swaps the Commissions are adopting, as well as the additional guidance issued pursuant to joint interpretations and orders under rules 3a68-2 and 3a68-4(c) under the Exchange Act, will result in a narrow pool of potential respondents, approximately 50,[1414] to the collection of information requirements of proposed rule 3a68-2 under the Exchange Act. Although the SEC does not have precise figures for the number of requests that persons will submit after the first year, the SEC believes it is reasonable to estimate that there likely will be fewer than 10 requests on average in each ensuing year.

Similarly, because the SEC believes that both the category of mixed swap transactions and the number of market participants that engage in mixed swap transactions are small, the SEC believes that the pool of potential persons requesting a joint order regarding the regulation of a specified, or specified class of, mixed swap pursuant to proposed rule 3a68-4(c) under the Exchange Act will be small. In addition, depending on the characteristics of a mixed swap (or class thereof), a person may choose not to submit a request pursuant to rule 3a68-4(c) under the Exchange Act. The SEC also notes that any joint order issued by the Commissions will apply to any person that subsequently lists, trades, or clears that specified, or specified class of, mixed swap, so that requests for joint orders could diminish over time. Also, persons may submit requests for an interpretation under rule 3a68-4(c) under the Exchange Act that do not result in an interpretation that the agreement, contract, or transaction (or class thereof) is a mixed swap.[1415] Also, those requests submitted pursuant to rule 3a68-2 under the Exchange Act that

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[1414] The SEC believes that there will be approximately 50 requests in the first year. See discussion infra part XI.B.5. The SEC recognizes that one person might submit more than one request but for purposes of the PRA is considering the submitter of each such request as a separate person.

[1415] The SEC believes it is reasonable to estimate that it will receive 20 requests in the first year and, as with rule 3a68-2 under the Exchange Act, it will count the submitter of each request as a separate person. See id.

result in an interpretation that the agreement, contract, or transaction (or class thereof) is not a mixed swap will reduce the pool of possible persons submitting a request regarding the regulation of particular mixed swaps (or class thereof) pursuant to rule 3a68-4(c) under the Exchange Act.

Furthermore, although certain requests made pursuant to rule 3a68-4(c) under the Exchange Act may be made without a previous request for a joint interpretation pursuant to rule 3a68-2 under the Exchange Act, the SEC believes that most requests under rule 3a68-2 under the Exchange Act that result in the interpretation that an agreement, contract, or transaction (or class thereof) is a mixed swap will result in a subsequent request for alternative regulatory treatment pursuant to rule 3a68-4(c) under the Exchange Act. The SEC believes that 90 percent, or 18 of the estimated 20 requests pursuant to rule 3a68-4(c) under the Exchange Act in the first year would be such "follow-on" requests.

In addition, not only the requesting party, but also any other person that subsequently lists, trades, or clears that mixed swap, will be subject to, and must comply with, the joint order regarding the regulation of the specified, or specified class of, mixed swap, as issued by the Commissions. Therefore, the SEC believes that the number of requests for a joint order regarding the regulation of mixed swaps, particularly involving specified classes of mixed swaps, will decrease over time. As discussed above, the SEC believes that as the Commissions provide joint orders regarding alternative regulatory treatment, the number of requests received will decrease over time. The SEC believes it is reasonable to estimate that there likely will be five requests on average in each ensuing year.

5. Paperwork Reduction Act Burden Estimates

Rules 3a68-2 and 3a68-4(c) under the Exchange Act require submission of certain information to the Commissions to the extent persons elect to request an interpretation and/or

alternative regulatory treatment. Rules 3a68-2 and 3a68-4(c) under the Exchange Act each require certain information that a requesting party must include in its request to the Commissions in order to receive a joint interpretation or order, as applicable.

a) Rule 3a68-2 Under the Exchange Act

Rule 3a68-2 will apply only to requests made by persons that desire an interpretation from the Commissions. For each agreement, contract, or transaction (or class thereof) for which a person requests the Commissions' joint interpretation under rule 3a68-2 under the Exchange Act, the requesting person will be required to provide certain information, as discussed above.[1416]

As discussed above, the SEC believes it is reasonable to estimate that 50 requests will be received in the first year. For purposes of the PRA, the SEC estimates the total paperwork burden associated with preparing and submitting a person's request to the Commissions pursuant to rule 3a68-2 under the Exchange Act will be 20 hours per request and associated costs of $12,000 for outside professionals, which the SEC believes will consist of services provided by attorneys.[1417] These total costs include all collection burdens associated with the rule, including burdens related to the initial determination requirements.

[1416] See discussion supra part VI.

[1417] See discussion supra part XI.A.4.e)ii). This estimate is based on information indicating that the average burden associated with preparing and submitting a no-action request to the SEC staff in connection with the identification of whether certain products are securities, which the SEC believes is a process similar to the process under rule 3a68-2 under the Exchange Act, is approximately 20 hours and associated costs of $12,000. Assuming these costs correspond to legal fees, which the SEC estimates at an hourly cost of $400, the SEC estimates that this cost is equivalent to approximately 30 hours ($12,000/$400). The estimated internal or company time burden for rule 3a68-2 under the Exchange Act has not changed from that included in the Proposing Release, but the estimated burden of the cost for outside professionals for rule 3a68-2 under the Exchange Act has been revised from that included in the Proposing Release to reflect updated data regarding hourly costs for the services of outside professionals. The estimate of the dollar burden for rule 3a68-2 under the Exchange Act in the Proposing Release was based on data from SIFMA's "Management & Professional Earnings in the Securities Industry 2009." See

Assuming 50 requests in the first year, the SEC estimates that this will result in an aggregate burden for the first year of 1000 hours of company time (50 requests x 20 hours/request) and $600,000 for the services of outside professionals (e.g., attorneys) (50 requests x 30 hours/request x $400). The estimated internal or company time burden for rule 3a68-2 under the Exchange Act has not changed from that included in the Proposing Release.[1418] However, the estimated burden of the cost for outside professionals for rule 3a68-2 under the Exchange Act has been revised from that included in the Proposing Release to reflect updated data regarding the hourly cost for an attorney.[1419]

As discussed above, the SEC believes that there will be 10 requests on average in each ensuing year, which results in an aggregate burden in each ensuing year of 200 hours of company time (10 requests x 20 hours/request) and $120,000 for the services of outside professionals (e.g., attorneys) (10 requests x 30 hours/request x $400).[1420]

b) Rule 3a68-4(c) Under the Exchange Act

Rule 3a68-4(c) under the Exchange Act will require any party requesting a joint order regarding the regulation of a specified, or specified class of, mixed swap under the rule to include certain information about the agreement, contract, or transaction (or class thereof) that is a mixed swap, including the specified parallel provisions that the person believes should apply to

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Proposing Release at 29876, note 345. The hourly rate used to estimate the PRA burdens is discussed above. See supra note 1344.

1418 See Proposing Release at 29876, 29877-78.

1419 See id.

1420 See discussion supra part XI.B.4.

the mixed swap (or class thereof), the reasons the person believes the specified parallel provisions will be appropriate for the mixed swap.[1421]

As discussed above, the SEC believes the number of requests that persons will submit pursuant to rule 3a68-4(c) under the Exchange Act is quite small given the limited types of agreements, contracts, and transactions (or classes thereof) the Commissions believe will constitute mixed swaps and that it will receive 20 requests in the first year.[1422] For purposes of the PRA, the SEC estimates the total paperwork burden associated with preparing and submitting a party's request to the Commissions pursuant to rule 3a68-4(c) under the Exchange Act will be 30 hours and associated costs of $20,000 for the services of outside professionals, which the SEC believes will consist of services provided by attorneys,[1423] per request for mixed swaps for which a request for a joint interpretation pursuant to rule 3a68-4(c) under the Exchange Act was not previously made.[1424] These total costs include all collection burdens associated with the rule, including burdens related to the initial determination requirements. Assuming 20 requests in the first year, the SEC estimates that this will result in an aggregate burden for the first year of 600

1421 See discussion supra part 0.

1422 See supra note 1415 and accompanying text.

1423 See supra note 1352.

1424 This estimate is based on information indicating that the average burden associated with preparing and submitting a no-action request to the SEC staff in connection with the regulatory treatment of certain securities products, which the SEC believes is a process similar to the process under rule 3a68-4(c) under the Exchange Act, is approximately 30 hours and associated costs of $20,000. Assuming these costs correspond to legal fees, which the SEC estimates at an hourly cost of $400 as discussed above, the SEC estimates that this cost is equivalent to approximately 50 hours ($20,000/$400). As with rule 3a68-2 under the Exchange Act, the estimated internal or company time burdens for rule 3a68-4(c) under the Exchange Act have not changed from those included in the Proposing Release, but the estimated burdens of the cost for outside professionals for rule 3a68-4(c) under the Exchange Act have been revised from those included in the Proposing Release to reflect updated data regarding hourly costs for the services of outside professionals.

hours of company time (20 requests x 30 hours/request) and $400,000 for the services of outside professionals (20 requests x 50 hours/request x $400).[1425]

As discussed above, the SEC believes that most requests under rule 3a68-2 under the Exchange Act that result in the interpretation that an agreement, contract, or transaction (or class thereof) is a mixed swap will result in a subsequent request for alternative regulatory treatment pursuant to rule 3a68-4(c) under the Exchange Act.

Also as discussed above, the SEC believes that 90 percent, or 18 of the estimated 20 requests pursuant to rule 3a68-4(c) under the Exchange Act in the first year, as discussed above will be "follow-on" requests. For mixed swaps for which a request for a joint interpretation pursuant to rule 3a68-2 under the Exchange Act was previously made, the SEC estimates the total paperwork burden under the PRA associated with preparing and submitting a party's request to the Commissions pursuant to rule 3a68-4(c) under the Exchange Act will be 10 hours fewer and $6,000 less per request than for mixed swaps for which a request for a joint interpretation pursuant to rule 3a68-2 under the Exchange Act was not previously made because certain, although not all, of the information required to be submitted and necessary to prepare pursuant to rule 3a68-4(c) under the Exchange Act will have been required to be submitted and necessary to prepare pursuant to rule 3a68-2 under the Exchange Act.[1426] The SEC estimates

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1425 See supra note 1415 and accompanying text.

1426 This estimate takes into account that certain information regarding the mixed swap (or class thereof), namely the material terms and the economic purpose, will have already been gathered and prepared as part of the request submitted pursuant to proposed rule 3a68-2 under the Exchange Act. The SEC estimates that these items constitute approximately 10 hours fewer and a reduction in associated costs of $6,000. Assuming these costs correspond to legal fees, which the SEC estimates at an hourly cost of $400, the SEC estimates that this cost is equivalent to approximately 15 hours ($6,000/$400). As noted above, these amounts are revised from those included in the Proposing Release to reflect updated data regarding the hourly costs for the services of outside professionals.

that this will result in an aggregate burden for such "follow-on" requests in the first year of 360 hours of company time (18 requests x 20 hours/request) and $252,000 for the services of outside professionals (18 requests x 35 hours/request x $400) and an aggregate burden for all requests in the first year of 420 hours of company time (2 requests x 30 hours/request and 18 requests x 20 hours/request) and $292,000 for the services of outside professionals (2 requests x 50 hours/request x $400 and 18 requests x 35 hours/request x $400).

The estimated internal or company time burden for rule 3a68-4(c) under the Exchange Act has not changed from that included in the Proposing Release.[1427] However, the estimated burden of the cost for outside professionals for rule 3a68-4(c) has been revised from that included in the Proposing Release to reflect updated data regarding the hourly cost for an attorney.[1428]

As discussed above, the SEC believes that there will be five requests on average in each ensuing year. Assuming five requests in each ensuing year, the SEC estimates that this will result in an aggregate burden in each ensuing year of 150 hours of company time (5 requests x 30 hours/request) and $100,000 for the services of outside professionals (5 requests x 50 hours/request x $400). As discussed above, however, assuming that approximately 90 percent, or 4 of the estimated 5 requests pursuant to rule 3a68-4(c) under the Exchange Act in each ensuing year are "follow-on" requests to requests for joint interpretation from the Commissions under rule 3a68-4(c) under the Exchange Act, the SEC estimates that this will result in an aggregate burden for such "follow-on" requests in each ensuing year of 80 hours of company time (4 requests x 20 hours/request) and $56,000 for the services of outside professionals (4

1427 See Proposing Release at 29876, 29878-79.

1428 See id.

requests x 35 hours/request x $400) and an aggregate burden for all requests in each ensuing year of 110 hours of company time (1 request x 30 hours/request and 4 requests x 20 hours/request) and $76,000 for the services of outside professionals (1 request x 50 hours/request x $40] and 4 requests x 35 hours/request x $400).

C. Regulatory Flexibility Act Certification

The Regulatory Flexibility Act ("RFA")[1429] requires Federal agencies, in promulgating rules, to consider the impact of those rules on small entities. Section 603(a)[1430] of the Administrative Procedure Act,[1431] as amended by the RFA, generally requires the SEC to undertake a regulatory flexibility analysis of all proposed rules, or proposed rule amendments, to determine the impact of such rulemaking on "small entities."[1432] Section 605(b) of the RFA provides that this requirement shall not apply to any proposed rule or proposed rule amendment, which if adopted, would not have a significant economic impact on a substantial number of small entities.[1433]

For purposes of SEC rulemaking in connection with the RFA, a small entity includes: (1) when used with reference to an "issuer" or a "person," other than an investment company, an "issuer" or "person" that, on the last day of its most recent fiscal year, had total assets of $5

1429 5 U.S.C. 601 et seq.

1430 5 U.S.C. 603(a).

1431 5 U.S.C. 551 et seq.

1432 Although section 601(b) of the RFA defines the term "small entity," the statute permits the Commissions to formulate their own definitions. The SEC has adopted definitions for the term small entity for the purposes of SEC rulemaking in accordance with the RFA. Those definitions, as relevant to this proposed rulemaking, are set forth in Rule 0-10, 17 CFR 240.0-10. See Statement of Management on Internal Accounting Control, 47 FR 5215, Feb. 4, 1982.

1433 See 5 U.S.C. 605(b).

million or less[1434] and (2) a broker-dealer with total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to rule 17a-5(d) under the Exchange Act,[1435] or, if not required to file such statements, a broker-dealer with total capital (net worth plus subordinated liabilities) of less than $500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and is not affiliated with any person (other than a natural person) that is not a small entity.[1436] Under the standards adopted by the Small Business Administration, small entities in the finance and insurance industry include the following: (1) for entities engaged in credit intermediation and related activities, entities with $175 million or less in assets;[1437] (2) for entities engaged in non-depository credit intermediation and certain other activities, entities with $7 million or less in annual receipts;[1438] (3) for entities engaged in financial investments and related activities, entities with $7 million or less in annual receipts;[1439] (4) for insurance carriers and entities engaged in related activities, entities with $7 million or less in annual receipts;[1440] and (5) for funds, trusts, and other financial vehicles, entities with $7 million or less in annual receipts.[1441]

The Proposing Release stated that, based on the SEC's existing information about the swap markets, the SEC believed that the swap markets, while broad in scope, are largely

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1434 See 17 CFR 240.0-10(a).

1435 See 17 CFR 240.17a-5(d).

1436 See 17 CFR 240.0-10(c).

1437 See 13 CFR 121.201 (Subsector 522).

1438 See id. at Subsector 522.

1439 See id. at Subsector 523.

1440 See id. at Subsector 524.

1441 See id. at Subsector 525.

dominated by entities such as those that would qualify as swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants (collectively, "swap market dealers and major participants") and that the SEC believed that such entities exceed the thresholds defining "small entities" set out above.[1442]

The Proposing Release also stated that, although it is possible that other persons may engage in swap and security-based swap transactions, the SEC did not believe that any of these entities would be "small entities" as defined in rule 0-10 under the Exchange Act[1443] and that feedback from industry participants about the swap markets indicates that only persons or entities with assets significantly in excess of $5 million (or with annual receipts significantly in excess of $7 million) participate in the swap markets.[1444]

The Proposing Release further stated that, to the extent that a small number of transactions did have a counterparty that was defined as a "small entity" under SEC rule 0-10, the SEC believed it is unlikely that the proposed rules and interpretive guidance would have a significant economic impact on that entity because the proposed rules and interpretive guidance simply would address whether certain products fall within the swap definition, address whether certain products are swaps, security-based swaps, SBSAs, or mixed swaps, provide a process for requesting interpretations of whether agreements, contracts, and transactions are swaps, security-based swaps, and mixed swaps, provide a process for requesting alternative regulatory treatment

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1442 See Proposing Release at 29887.

1443 See 17 CFR 240.0-10(a).

1444 See Proposing Release at 29887.

for mixed swaps, and specify that the books and records for SBSAs are those that are applicable to all entities.[1445]

As a result, the SEC certified that the proposed rules and interpretive guidance would not have a significant economic impact on a substantial number of small entities for purposes of the RFA, and requested written comments regarding this certification.[1446]

In response to the Proposing Release, one commenter, representing a number of market participants, submitted a comment to the CFTC related to the RFA.[1447] The commenter did not address the letter to the SEC or provide comments regarding the SEC's RFA analysis.[1448]

The SEC continues to believe that the types of entities that would participate in the swap markets – which generally would be swap market dealers and major participants – would not be "small entities" for purposes of the RFA. The final rules and interpretive guidance do not themselves impose any compliance obligations. Instead they describe the categories of agreements, contracts, and transactions that are outside the scope of the Product Definitions and delineate the jurisdictional divide between the SEC's and the CFTC's regulatory regime. Accordingly, the SEC certifies that the final rules and interpretive guidance would not have a significant economic impact on a substantial number of small entities for purposes of the RFA.

1445 See Proposing Release at 29887-88.

1446 See Proposing Release at 29888.

1447 See Letter from the National Rural Electric Cooperative Association, the American Public Power Association, the Large Public Power Council, the Edison Electric Institute, and the Electric Power Supply Association (July 22, 2011).

1448 See id.

XII. Statutory Basis and Rule Text

List of Subjects

17 CFR Part 1

Definitions, General swap provisions.

17 CFR Parts 230 and 240

Reporting and recordkeeping requirements, Securities.

Commodity Futures Trading Commission

Pursuant to the Commodity Exchange Act, 7 U.S.C. 1 et seq., as amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank Act"), and sections 712(a)(8), 712(d), 721(a), 721(b), 721(c), 722(d), and 725(g) of the Dodd-Frank Act, the CFTC is adopting rules 1.3(xxx) through 1.3(bbbb) and 1.6 through 1.9 under the Commodity Exchange Act.

Text of Final Rules

For the reasons stated in the preamble, the CFTC is amending Title 17, Chapter I, of the Code of Federal Regulations, as follows:

PART 1—GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

1. The authority citation for part 1 is revised to read as follows:

Authority: 7 U.S.C. 1a, 2, 5, 6, 6a, 6b, 6c, 6c, 6e, 6f, 6g, 6h, 6i, 6j, 6k, 6l, 6m, 6n, 6o, 6p, 6r, 7, 7a, 7b, 8, 9, 10, 12, 12a, 12c, 13a, 13a-1, 16, 16a, 21, 23, and 24.

2. Amend Sec. 1.3 by adding paragraphs (xxx), (yyy), (zzz), (aaaa) and (bbbb) to read as follows:

§ 1.3 Definitions

*** * * * ***

(xxx) Swap. (1) In general. The term swap has the meaning set forth in section 1a(47) of the Commodity Exchange Act.

(2) Inclusion of particular products. (i) The term swap includes, without limiting the meaning set forth in section 1a(47) of the Commodity Exchange Act, the following agreements, contracts, and transactions:

(A) A cross-currency swap;

(B) A currency option, foreign currency option, foreign exchange option and foreign exchange rate option;

(C) A foreign exchange forward;

(D) A foreign exchange swap;

(E) A forward rate agreement; and

(F) A non-deliverable forward involving foreign exchange.

(ii) The term swap does not include an agreement, contract, or transaction described in paragraph (xxx)(2)(i) of this section that is otherwise excluded by section 1a(47)(B) of the Commodity Exchange Act.

(3) Foreign exchange forwards and foreign exchange swaps. Notwithstanding paragraph (xxx)(2) of this section:

(i) A foreign exchange forward or a foreign exchange swap shall not be considered a swap if the Secretary of the Treasury makes a determination described in section 1a(47)(E)(i) of the Commodity Exchange Act.

(ii) Notwithstanding paragraph (xxx)(3)(i) of this section:

(A) The reporting requirements set forth in section 4r of the Commodity Exchange Act and regulations promulgated thereunder shall apply to a foreign exchange forward or foreign exchange swap; and

(B) The business conduct standards set forth in section 4s(h) of the Commodity Exchange Act and regulations promulgated thereunder shall apply to a swap dealer or major swap participant that is a party to a foreign exchange forward or foreign exchange swap.

(iii) For purposes of section 1a(47)(E) of the Commodity Exchange Act and this § 1.3(xxx), the term foreign exchange forward has the meaning set forth in section 1a(24) of the Commodity Exchange Act.

(iv) For purposes of section 1a(47)(E) of the Commodity Exchange Act and this § 1.3(xxx), the term foreign exchange swap has the meaning set forth in section 1a(25) of the Commodity Exchange Act.

(v) For purposes of sections 1a(24) and 1a(25) of the Commodity Exchange Act and this § 1.3(xxx), the following transactions are not foreign exchange forwards or foreign exchange swaps:

(A) A currency swap or a cross-currency swap;

(B) A currency option, foreign currency option, foreign exchange option, or foreign exchange rate option; and

(C) A non-deliverable forward involving foreign exchange.

(4) Insurance. (i) This paragraph is a non-exclusive safe harbor. The terms swap as used in section 1a(47) of the Commodity Exchange Act and security-based swap as used in section 1a(42) of the Commodity Exchange Act do not include an agreement, contract, or transaction that:

(A) By its terms or by law, as a condition of performance on the agreement, contract, or transaction:

(1) Requires the beneficiary of the agreement, contract, or transaction to have an insurable interest that is the subject of the agreement, contract, or transaction and thereby carry the risk of loss with respect to that interest continuously throughout the duration of the agreement, contract, or transaction;

(2) Requires that loss to occur and to be proved, and that any payment or indemnification therefor be limited to the value of the insurable interest;

(3) Is not traded, separately from the insured interest, on an organized market or over-the-counter; and

(4) With respect to financial guaranty insurance only, in the event of payment default or insolvency of the obligor, any acceleration of payments under the policy is at the sole discretion of the insurer; and

(B) Is provided:

(1)(i) By a person that is subject to supervision by the insurance commissioner (or similar official or agency) of any State or by the United States or an agency or instrumentality thereof, and (ii) such agreement, contract, or transaction is regulated as insurance under applicable State law or the laws of the United States;

(2)(i) Directly or indirectly by the United States, any State or any of their respective agencies or instrumentalities, or (ii) pursuant to a statutorily authorized program thereof; or

(3) In the case of reinsurance only, by a person to another person that satisfies the conditions set forth in paragraph (xxx)(4)(i)(B) of this section, provided that:

(i) Such person is not prohibited by applicable State law or the laws of the United States from offering such agreement, contract, or transaction to such person that satisfies the conditions set forth in paragraph (xxx)(4)(i)(B) of this section;

(ii) The agreement, contract, or transaction to be reinsured satisfies the conditions set forth in paragraph (xxx)(4)(i)(A) or paragraph (xxx)(4)(i)(C) of this section; and

(iii) Except as otherwise permitted under applicable State law, the total amount reimbursable by all reinsurers for such agreement, contract, or transaction may not exceed the claims or losses paid by the person writing the risk being ceded or transferred by such person; or

(4) In the case of non-admitted insurance, by a person who:

(i) 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

(ii) meets the eligibility criteria for non-admitted insurers under applicable State law; or

(C) Is provided in accordance with the conditions set forth in paragraph (xxx)(4)(i)(B) of this section and is one of the following types of products:

(1) surety bond;

(2) fidelity bond;

(3) life insurance;

(4) health insurance;

(5) long term care insurance;

(6) title insurance;

(7) property and casualty insurance;

(8) annuity;

(9) disability insurance;

(10) insurance against default on individual residential mortgages; and

(11) reinsurance of any of the foregoing products identified in paragraphs (1) through (10) above; or

(ii) The terms swap as used in section 1a(47) of the Commodity Exchange Act and security-based swap as used in section 1a(42) of the Commodity Exchange Act do not include an agreement, contract, or transaction that was entered into on or before the effective date of paragraph (xxx)(4) of this section, and that, at such time that it was entered into, was provided in accordance with the conditions set forth in paragraph (xxx)(4)(i)(B) of this section.

(5) State. For purposes of paragraph (xxx)(4) of this section, the term State means any state of the United States, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, or any other possession of the United States.

(6) Anti-Evasion:

(i) An agreement, contract, or transaction that is willfully structured to evade any provision of Subtitle A of the Wall Street Transparency and Accountability Act of 2010, including any amendments made to the Commodity Exchange Act thereby (Subtitle A), shall be deemed a swap for purposes of Subtitle A and the rules, regulations, and orders of the Commission promulgated thereunder.

(ii) An interest rate swap or currency swap, including but not limited to a transaction identified in paragraph (xxx)(3)(v) of this section, that is willfully structured as a foreign exchange forward or foreign exchange swap to evade any provision of Subtitle A shall be

deemed a swap for purposes of Subtitle A and the rules, regulations, and orders of the Commission promulgated thereunder.

(iii) An agreement, contract, or transaction of a bank that is not under the regulatory jurisdiction of an appropriate Federal banking agency (as defined in section 1a(2) of the Commodity Exchange Act), where the agreement, contract, or transaction is willfully structured as an identified banking product (as defined in section 402 of the Legal Certainty for Bank Products Act of 2000) to evade the provisions of the Commodity Exchange Act, shall be deemed a swap for purposes of the Commodity Exchange Act and the rules, regulations, and orders of the Commission promulgated thereunder.

(iv) The form, label, and written documentation of an agreement, contract, or transaction shall not be dispositive in determining whether the agreement, contract, or transaction has been willfully structured to evade as provided in paragraphs (xxx)(6)(i) through (xxx)(6)(iii) of this section.

(v) An agreement, contract, or transaction that has been willfully structured to evade as provided in paragraphs (xxx)(6)(i) through (xxx)(6)(iii) of this section shall be considered in determining whether a person that so willfully structured to evade is a swap dealer or major swap participant.

(vi) Notwithstanding the foregoing, no agreement, contract, or transaction structured as a security (including a security-based swap) under the securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47))) shall be deemed a swap pursuant to this § 1.3(xxx)(6) or shall be considered for purposes of paragraph (xxx)(6)(v) of this section.

(yyy) Narrow-based security index as used in the definition of "security-based swap."

(1) In general. Except as otherwise provided in paragraphs (zzz) and (aaaa) of this section, for purposes of section 1a(42) of the Commodity Exchange Act, the term narrow-based security index has the meaning set forth in section 1a(35) of the Commodity Exchange Act, and the rules, regulations and orders of the Commission thereunder.

(2) Tolerance period for swaps traded on designated contract markets, swap execution facilities, and foreign boards of trade. Notwithstanding paragraph (yyy)(1) of this section, solely for purposes of swaps traded on or subject to the rules of a designated contract market, swap execution facility, or foreign board of trade, a security index underlying such swaps shall not be considered a narrow-based security index if:

(i) (A) A swap on the index is traded on or subject to the rules of a designated contract market, swap execution facility, or foreign board of trade for at least 30 days as a swap on an index that was not a narrow-based security index; or

(B) Such index was not a narrow-based security index during every trading day of the six full calendar months preceding a date no earlier than 30 days prior to the commencement of trading of a swap on such index on a market described in paragraph (yyy)(2)(i)(A) of this section; and

(ii) The index has been a narrow-based security index for no more than 45 business days over three consecutive calendar months.

(3) Tolerance period for security-based swaps traded on national securities exchanges or security-based swap execution facilities. Notwithstanding paragraph (yyy)(1) of this section, solely for purposes of security-based swaps traded on a national securities exchange or security-based swap execution facility, a security index underlying such security-based swaps shall be considered a narrow-based security index if:

(i)(A) A security-based swap on the index is traded on a national securities exchange or security-based swap execution facility for at least 30 days as a security-based swap on a narrow-based security index; or

(B) Such index was a narrow-based security index during every trading day of the six full calendar months preceding a date no earlier than 30 days prior to the commencement of trading of a security-based swap on such index on a market described in paragraph (yyy)(3)(i)(A) of this section; and

(ii) The index has been a security index that is not a narrow-based security index for no more than 45 business days over three consecutive calendar months.

(4) Grace period.

(i) Solely with respect to a swap that is traded on or subject to the rules of a designated contract market, swap execution facility, or foreign board of trade, an index that becomes a narrow-based security index under paragraph (yyy)(2) of this section solely because it was a narrow-based security index for more than 45 business days over three consecutive calendar months shall not be a narrow-based security index for the following three calendar months.

(ii) Solely with respect to a security-based swap that is traded on a national securities exchange or security-based swap execution facility, an index that becomes a security index that is not a narrow-based security index under paragraph (yyy)(3) of this section solely because it was not a narrow-based security index for more than 45 business days over three consecutive calendar months shall be a narrow-based security index for the following three calendar months.

(zzz) Meaning of “issuers of securities in a narrow-based security index” as used in the definition of “security-based swap” as applied to index credit default swaps.

(1) Notwithstanding paragraph 1.3(yyy)(1) of this section, and solely for purposes of determining whether a credit default swap is a security-based swap under the definition of "security-based swap" in section 3(a)(68)(A)(ii)(III) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(68)(A)(ii)(III), as incorporated in section 1a(42) of the Commodity Exchange Act, the term issuers of securities in a narrow-based security index means issuers of securities included in an index (including an index referencing loan borrowers or loans of such borrowers) in which:

(i)(A) There are nine or fewer non-affiliated issuers of securities that are reference entities included in the index, provided that an issuer of securities shall not be deemed a reference entity included in the index for purposes of this section unless:

(1) A credit event with respect to such reference entity would result in a payment by the credit protection seller to the credit protection buyer under the credit default swap based on the related notional amount allocated to such reference entity; or

(2) The fact of such credit event or the calculation in accordance with paragraph (zzz)(1)(i)(A)(1) of this section of the amount owed with respect to such credit event is taken into account in determining whether to make any future payments under the credit default swap with respect to any future credit events;

(B) The effective notional amount allocated to any reference entity included in the index comprises more than 30 percent of the index's weighting;

(C) The effective notional amount allocated to any five non-affiliated reference entities included in the index comprises more than 60 percent of the index's weighting; or

(D) Except as provided in paragraph (zzz)(2) of this section, for each reference entity included in the index, none of the criteria in paragraphs (zzz)(1)(i)(D)(1) through (8) of this section is satisfied:

(1) The reference entity included in the index is required to file reports pursuant to section 13 or section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d));

(2) The reference entity included in the index is eligible to rely on the exemption provided in rule 12g3-2(b) under the Securities Exchange Act of 1934 (17 CFR 240.12g3-2(b));

(3) The reference entity included in the index has a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more;

(4) The reference entity included in the index (other than a reference entity included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)) has outstanding notes, bonds, debentures, loans, or evidences of indebtedness (other than revolving credit facilities) having a total remaining principal amount of at least $1 billion;

(5) The reference entity included in the index is the issuer of an exempted security as defined in section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)) (other than any municipal security as defined in section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29)));

(6) The reference entity included in the index is a government of a foreign country or a political subdivision of a foreign country;

(7) If the reference entity included in the index is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C.

78c(a)(77)), such asset-backed security was issued in a transaction registered under the Securities Act of 1933 (15 U.S.C. 77a et seq.) and has publicly available distribution reports; and

(8) For a credit default swap entered into solely between eligible contract participants as defined in section 1a(18) of the Commodity Exchange Act:

(i) The reference entity included in the index (other than a reference entity included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77))) makes available to the public or otherwise makes available to such eligible contract participant information about the reference entity included in the index pursuant to rule 144A(d)(4) under the Securities Act of 1933 (17 CFR 230.144A(d)(4));

(ii) Financial information about the reference entity included in the index (other than a reference entity included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77))) is otherwise publicly available; or

(iii) In the case of a reference entity included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)), information of the type and level included in publicly available distribution reports for similar asset-backed securities is publicly available about both the reference entity included in the index and such asset-backed security; and

(ii)(A) The index is not composed solely of reference entities that are issuers of exempted securities as defined in section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Securities Exchange Act

of 1934 (15 U.S.C. 78c(a)(29))), as in effect on the date of enactment of the Futures Trading Act of 1982); and

(B) Without taking into account any portion of the index composed of reference entities that are issuers of exempted securities as defined in section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29))), the remaining portion of the index would be within the term "issuer of securities in a narrow-based security index" under paragraph (zzz)(1)(i) of this section.

(2) Paragraph (zzz)(1)(i)(D) of this section will not apply with respect to a reference entity included in the index if:

(i) The effective notional amounts allocated to such reference entity comprise less than five percent of the index's weighting; and

(ii) The effective notional amounts allocated to reference entities included in the index that satisfy paragraph (zzz)(1)(i)(D) of this section comprise at least 80 percent of the index's weighting.

(3) For purposes of this § 1.3(zzz):

(i) A reference entity included in the index is affiliated with another reference entity included in the index (for purposes of paragraph (zzz)(3)(iv) of this section) or another entity (for purposes of paragraph (zzz)(3)(v) of this section) if it controls, is controlled by, or is under common control with, that other reference entity included in the index or other entity, as applicable; provided that each reference entity included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15

U.S.C. 78c(a)(77)) will not be considered affiliated with any other reference entity included in the index or any other entity that is an issuing entity of an asset-backed security.

(ii) Control for purposes of this section means ownership of more than 50 percent of the equity of a reference entity included in the index (for purposes of paragraph (zzz)(3)(iv) of this section) or another entity (for purposes of paragraph (zzz)(3)(v) of this section), or the ability to direct the voting of more than 50 percent of the voting equity of a reference entity included in the index (for purposes of paragraph (zzz)(3)(iv) of this section) or another entity (for purposes of paragraph (zzz)(3)(v) of this section).

(iii) In identifying a reference entity included in the index for purposes of this section, the term reference entity includes:

(A) An issuer of securities;

(B) An issuer of securities that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)); and

(C) An issuer of securities that is a borrower with respect to any loan identified in an index of borrowers or loans.

(iv) For purposes of calculating the thresholds in paragraphs (zzz)(1)(i)(A) through (1)(i)(C) of this section, the term reference entity included in the index includes a single reference entity included in the index or a group of affiliated reference entities included in the index as determined in accordance with paragraph (zzz)(3)(i) of this section (with each reference entity included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) being considered a separate reference entity included in the index).

(v) For purposes of determining whether one of the criterion in either paragraphs (zzz)(1)(i)(D)(1) through (zzz)(1)(i)(D)(4) of this section or paragraphs (zzz)(1)(iv)(D)(8)(i) and (a)(1)(iv)(D)(8)(ii) of this section is met, the term reference entity included in the index includes a single reference entity included in the index or a group of affiliated entities as determined in accordance with paragraph (zzz)(3)(i) of this section (with each issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) being considered a separate entity).

(aaaa) Meaning of "narrow-based security index" as used in the definition of "security-based swap" as applied to index credit default swaps.

(1) Notwithstanding paragraph 1.3(yyy)(1) of this section, and solely for purposes of determining whether a credit default swap is a security-based swap under the definition of "security-based swap" in section 3(a)(68)(A)(ii)(I) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(68)(A)(ii)(I), as incorporated in section 1a(42) of the Commodity Exchange Act, the term narrow-based security index means an index in which:

(i)(A) The index is composed of nine or fewer securities or securities that are issued by nine or fewer non-affiliated issuers, provided that a security shall not be deemed a component of the index for purposes of this section unless:

(1) A credit event with respect to the issuer of such security or a credit event with respect to such security would result in a payment by the credit protection seller to the credit protection buyer under the credit default swap based on the related notional amount allocated to such security; or

(2) The fact of such credit event or the calculation in accordance with paragraph (aaaa)(1)(i)(A)(1) of this section of the amount owed with respect to such credit event is taken

into account in determining whether to make any future payments under the credit default swap with respect to any future credit events;

(B) The effective notional amount allocated to the securities of any issuer included in the index comprises more than 30 percent of the index's weighting;

(C) The effective notional amount allocated to the securities of any five non-affiliated issuers included in the index comprises more than 60 percent of the index's weighting; or

(D) Except as provided in paragraph (aaaa)(2) of this section, for each security included in the index, none of the criteria in paragraphs (1)(i)(D)(1) through (8) is satisfied:

(1) The issuer of the security included in the index is required to file reports pursuant to section 13 or section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d));

(2) The issuer of the security included in the index is eligible to rely on the exemption provided in rule 12g3-2(b) under the Securities Exchange Act of 1934 (17 CFR 240.12g3-2(b));

(3) The issuer of the security included in the index has a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more;

(4) The issuer of the security included in the index (other than an issuer of the security that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77))) has outstanding notes, bonds, debentures, loans or evidences of indebtedness (other than revolving credit facilities) having a total remaining principal amount of at least $1 billion;

(5) The security included in the index is an exempted security as defined in section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)) (other than any municipal security as defined in section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29)));

(6) The issuer of the security included in the index is a government of a foreign country or a political subdivision of a foreign country;

(7) If the security included in the index is an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)), the security was issued in a transaction registered under the Securities Act of 1933 (15 U.S.C. 77a et seq.) and has publicly available distribution reports; and

(8) For a credit default swap entered into solely between eligible contract participants as defined in section 1a(18) of the Commodity Exchange Act:

(i) The issuer of the security included in the index (other than an issuer of the security that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77))) makes available to the public or otherwise makes available to such eligible contract participant information about such issuer pursuant to rule 144A(d)(4) of the Securities Act of 1933 (17 CFR 230.144A(d)(4));

(ii) Financial information about the issuer of the security included in the index (other than an issuer of the security that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77))) is otherwise publicly available; or

(iii) In the case of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)), information of the type and level included in public distribution reports for similar asset-backed securities is publicly available about both the issuing entity and such asset-backed security; and

(ii)(A) The index is not composed solely of exempted securities as defined in section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)), as in effect on the date

of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29))), as in effect on the date of enactment of the Futures Trading Act of 1982); and

(B) Without taking into account any portion of the index composed of exempted securities as defined in section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29))), the remaining portion of the index would be within the term "narrow-based security index" under paragraph (aaaa)(1)(i) of this section.

(2) Paragraph (aaaa)(1)(i)(D) of this section will not apply with respect to securities of an issuer included in the index if:

(i) The effective notional amounts allocated to all securities of such issuer included in the index comprise less than five percent of the index's weighting; and

(ii) The securities that satisfy paragraph (aaaa)(1)(i)(D) of this section comprise at least 80 percent of the index's weighting.

(3) For purposes of this § 1.3(aaaa):

(i) An issuer of securities included in the index is affiliated with another issuer of securities included in the index (for purposes of paragraph (aaaa)(3)(iv) of this section) or another entity (for purposes of paragraph (aaaa)(3)(v) of this section) if it controls, is controlled by, or is under common control with, that other issuer or other entity, as applicable; provided that each issuer of securities included in eh index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)) will

not be considered affiliated with any other issuer of securities included in the index or any other entity that is an issuing entity of an asset-backed security.

(ii) Control for purposes of this section means ownership of more than 50 percent of the equity of an issuer of securities included in the index (for purposes of paragraph (aaaa)(3)(iv) of this section) or another entity (for purposes of paragraph (aaaa)(3)(v) of this section), or the ability to direct the voting of more than 50 percent of the voting equity an issuer of securities included in the index (for purposes of paragraph (aaaa)(3)(iv) of this section) or another entity (for purposes of paragraph (aaaa)(3)(v) of this section).

(iii) In identifying an issuer of securities included in the index for purposes of this section, the term issuer includes:

(A) An issuer of securities; and

(B) An issuer of securities that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)).

(iv) For purposes of calculating the thresholds in paragraphs (zzz)(1)(i)(A) through (1)(i)(C) of this section, the term issuer of the security included in the index includes a single issuer of securities included in the index or a group of affiliated issuers of securities included in the index as determined in accordance with paragraph (aaaa)(3)(i) of this section (with each issuer of securities included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)) being considered a separate issuer of securities included in the index).

(v) For purposes of determining whether one of the criterion in either paragraphs (aaaa)(1)(i)(D)(1) through (aaaa)(1)(i)(D)(4) of this section or paragraphs (aaaa)(1)(iv)(D)(8)(i) and (aaaa)(1)(iv)(D)(8)(ii) of this section is met, the term issuer of the security included in the

index includes a single issuer of securities included in the index or a group of affiliated entities as determined in accordance with paragraph (aaaa)(3)(i) of this section (with each issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) being considered a separate entity).

(bbbb) Futures contracts on certain foreign sovereign debt. The term security-based swap as used in section 3(a)(68) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(68)), as incorporated in section 1a(42) of the Commodity Exchange Act, does not include an agreement, contract, or transaction that is based on or references a qualifying foreign futures contract (as defined in rule 3a12-8 under the Securities Exchange Act of 1934 (17 CFR 240.3a12-8)) on the debt securities of any one or more of the foreign governments enumerated in rule 3a12-8 under the Securities Exchange Act of 1934 (17 CFR 240.3a12-8), provided that such agreement, contract, or transaction satisfies the following conditions:

(1) The futures contract that the agreement, contract, or transaction references or upon which the agreement, contract, or transaction is based is a qualifying foreign futures contract that satisfies the conditions of rule 3a12-8 under the Securities Exchange Act of 1934 (17 CFR 240.3a12-8) applicable to qualifying foreign futures contracts;

(2) The agreement, contract, or transaction is traded on or through a board of trade (as defined in the Commodity Exchange Act);

(3) The debt securities upon which the qualifying foreign futures contract is based or referenced and any security used to determine the cash settlement amount pursuant to paragraph (bbbb)(4) of this section were not registered under the Securities Act of 1933 (15 U.S.C. 77 et seq.) or the subject of any American depositary receipt registered under the Securities Act of 1933;

(4) The agreement, contract, or transaction may only be cash settled; and

(5) The agreement, contract or transaction is not entered into by the issuer of the debt securities upon which the qualifying foreign futures contract is based or referenced (including any security used to determine the cash payment due on settlement of such agreement, contract or transaction), an affiliate (as defined in the Securities Act of 1933 (15 U.S.C. 77 et seq.) and the rules and regulations thereunder) of the issuer, or an underwriter of such issuer's debt securities.

* * * * *

4. Add §§ 1.6 through 1.9 to read as follows:

Sec.

1.6	Anti-evasion
1.7	Books and records requirements for security-based swap agreements
1.8	Interpretation of swaps, security-based swaps, and mixed swaps
1.9	Regulation of mixed swaps

*** * * * ***

§ 1.6 Anti-Evasion.

(a) It shall be unlawful to conduct activities outside the United States, including entering into agreements, contracts, and transactions and structuring entities, to willfully evade or attempt to evade any provision of the Commodity Exchange Act as enacted by Subtitle A of the Wall Street Transparency and Accountability Act of 2010 or the rules, regulations, and orders of the Commission promulgated thereunder (Subtitle A).

(b) The form, label, and written documentation of an agreement, contract, or transaction, or an entity, shall not be dispositive in determining whether the agreement, contract, or transaction, or entity, has been entered into or structured to willfully evade as provided in paragraph (a) of this section.

(c) An activity conducted outside the United States to evade as provided in paragraph (a) of this section shall be subject to the provisions of Subtitle A.

(d) Notwithstanding the foregoing, no agreement, contract, or transaction structured as a security (including a security-based swap) under the securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47))) shall be deemed a swap pursuant to this § 1.6.

§ 1.7 Books and records requirements for security-based swap agreements.

(a) A person registered as a swap data repository under section 21 of the Commodity Exchange Act and the rules and regulations thereunder:

(1) Shall not be required to keep and maintain additional books and records regarding security-based swap agreements other than the books and records regarding swaps required to be kept and maintained pursuant to section 21 of the Commodity Exchange Act and the rules and regulations thereunder; and

(2) Shall not be required to collect and maintain additional data regarding security-based swap agreements other than the data regarding swaps required to be collected and maintained by such persons pursuant to section 21 of the Commodity Exchange Act and the rules and regulations thereunder.

(b) A person shall not be required to keep and maintain additional books and records, including daily trading records, regarding security-based swap agreements other than the books and records regarding swaps required to be kept and maintained by such persons pursuant to section 4s of the Commodity Exchange Act and the rules and regulations thereunder if such person is registered as:

(1) A swap dealer under section 4s(a)(1) of the Commodity Exchange Act and the rules and regulations thereunder;

(2) A major swap participant under section 4s(a)(2) of the Commodity Exchange Act and the rules and regulations thereunder;

(3) A security-based swap dealer under section 15F(a)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-10(a)(1)) and the rules and regulations thereunder; or

(4) a major security-based swap participant under section 15F(a)(2) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-10(a)(2)) and the rules and regulations thereunder.

(c) The term security-based swap agreement has the meaning set forth in section 1a(47)(A)(v) of the Commodity Exchange Act.

§ 1.8 Requests for interpretation of swaps, security-based swaps, and mixed swaps.

(a) In general. Any person may submit a request to the Commission and the Securities and Exchange Commission to provide a joint interpretation of whether a particular agreement, contract, or transaction (or class thereof) is:

(1) A swap, as that term is defined in section 1a(47) of the Commodity Exchange Act and the rules and regulations promulgated thereunder;

(2) A security-based swap, as that term is defined in section 1a(42) of the Commodity Exchange Act and the rules and regulations promulgated thereunder; or

(3) A mixed swap, as that term is defined in section 1a(47)(D) of the Commodity Exchange Act and the rules and regulations promulgated thereunder.

(b) Request process. In making a request pursuant to paragraph (a) of this section, the requesting person must provide the Commission and the Securities and Exchange Commission with the following:

(1) All material information regarding the terms of the agreement, contract, or transaction (or class thereof);

(2) A statement of the economic characteristics and purpose of the agreement, contract, or transaction (or class thereof);

(3) The requesting person's determination as to whether the agreement, contract, or transaction (or class thereof) should be characterized as a swap, a security-based swap, or both, (i.e., a mixed swap), including the basis for such determination; and

(4) Such other information as may be requested by the Commission or the Securities and Exchange Commission.

(c) Request withdrawal. A person may withdraw a request made pursuant to paragraph (a) of this section at any time prior to the issuance of a joint interpretation or joint proposed rule by the Commission and the Securities and Exchange Commission in response to the request; provided, however, that notwithstanding such withdrawal, the Commission and the Securities and Exchange Commission may provide a joint interpretation of whether the agreement, contract, or transaction (or class thereof) is a swap, a security-based swap, or both (i.e., a mixed swap).

(d) Request by the Commission or the Securities and Exchange Commission. In the absence of a request for a joint interpretation under paragraph (a) of this section:

(1) If the Commission or the Securities and Exchange Commission receives a proposal to list, trade, or clear an agreement, contract, or transaction (or class thereof) that raises questions as to the appropriate characterization of such agreement, contract, or transaction (or class thereof) as a swap, a security-based swap, or both (i.e., a mixed swap), the Commission or the Securities

and Exchange Commission, as applicable, promptly shall notify the other of the agreement, contract, or transaction (or class thereof); and

(2) The Commission or the Securities and Exchange Commission, or their Chairmen jointly, may submit a request for a joint interpretation as described in paragraph (a) of this section; such submission shall be made pursuant to paragraph (b) of this section, and may be withdrawn pursuant to paragraph (c) of this section.

(e) Timeframe for joint interpretation.

(1) If the Commission and the Securities and Exchange Commission determine to issue a joint interpretation as described in paragraph (a) of this section, such joint interpretation shall be issued within 120 days after receipt of a complete submission requesting a joint interpretation under paragraph (a) or (d) of this section.

(2) The Commission and the Securities and Exchange Commission shall consult with the Board of Governors of the Federal Reserve System prior to issuing any joint interpretation as described in paragraph (a) of this section.

(3) If the Commission and the Securities and Exchange Commission seek public comment with respect to a joint interpretation regarding an agreement, contract, or transaction (or class thereof), the 120-day period described in paragraph (e)(1) of this section shall be stayed during the pendency of the comment period, but shall recommence with the business day after the public comment period ends.

(4) Nothing in this section shall require the Commission and the Securities and Exchange Commission to issue any joint interpretation.

(5) If the Commission and the Securities and Exchange Commission do not issue a joint interpretation within the time period described in paragraph (e)(1) or (e)(3) of this section, each

of the Commission and the Securities and Exchange Commission shall publicly provide the reasons for not issuing such a joint interpretation within the applicable timeframes.

(f) Joint proposed rule.

(1) Rather than issue a joint interpretation pursuant to paragraph (a) of this section, the Commission and the Securities and Exchange Commission may issue a joint proposed rule, in consultation with the Board of Governors of the Federal Reserve System, to further define one or more of the terms swap, security-based swap, or mixed swap.

(2) A joint proposed rule described in paragraph (f)(1) of this section shall be issued within the timeframe for issuing a joint interpretation set forth in paragraph (e) of this section.

§ 1.9 Regulation of mixed swaps.

(a) In general. The term mixed swap has the meaning set forth in section 1a(47)(D) of the Commodity Exchange Act.

(b) Regulation of bilateral uncleared mixed swaps entered into by dually-registered dealers or major participants. A mixed swap: (i) that is neither executed on nor subject to the rules of a designated contract market, national securities exchange, swap execution facility, security-based swap execution facility, or foreign board of trade; (ii) that will not be submitted to a derivatives clearing organization or registered or exempt clearing agency to be cleared; and (iii) where at least one party is registered with the Commission as a swap dealer or major swap participant and also with the Securities and Exchange Commission as a security-based swap dealer or major security-based swap participant, shall be subject to:

(1) The following provisions of the Commodity Exchange Act, and the rules and regulations promulgated thereunder:

(i) Examinations and information sharing: sections 4s(f) and 8 of the Commodity Exchange Act;

(ii) Enforcement: sections 2(a)(1)(B), 4(b), 4b, 4c, 4s(h)(1)(A), 4s(h)(4)(A), 6(c), 6(d), 6c, 6d, 9, 13(a), 13(b), and 23 of the Commodity Exchange Act;

(iii) Reporting to a swap data repository: section 4r of the Commodity Exchange Act;

(iv) Real-time reporting: section 2(a)(13) of the Commodity Exchange Act;

(v) Capital: section 4s(e) of the Commodity Exchange Act; and

(vi) Position Limits: section 4a of the Commodity Exchange Act; and

(2) The provisions of the federal securities laws, as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47)), and the rules and regulations promulgated thereunder.

(c) Process for determining regulatory treatment for other mixed swaps.

(1) In general. Any person who desires or intends to list, trade, or clear a mixed swap (or class thereof) that is not subject to paragraph (b) of this section may request the Commission and the Securities and Exchange Commission to issue a joint order permitting the requesting person (and any other person or persons that subsequently lists, trades, or clears that mixed swap) to comply, as to parallel provisions only, with specified parallel provisions of either the Commodity Exchange Act or the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), and the rules and regulations thereunder (collectively, specified parallel provisions), instead of being required to comply with parallel provisions of both the Commodity Exchange Act and the Securities Exchange Act of 1934. For purposes of this paragraph (c), parallel provisions means comparable provisions of the Commodity Exchange Act and the Securities Exchange Act of 1934 that were

added or amended by the Wall Street Transparency and Accountability Act of 2010 with respect to swaps and security-based swaps, and the rules and regulations thereunder.

(2) Request Process. A person submitting a request pursuant to paragraph (c)(1) of this section must provide the Commission and the Securities and Exchange Commission with the following:

(i) All material information regarding the terms of the specified, or specified class of, mixed swap;

(ii) The economic characteristics and purpose of the specified, or specified class of, mixed swap;

(iii) The specified parallel provisions, and the reasons the person believes such specified parallel provisions would be appropriate for the mixed swap (or class thereof); and

(iv) An analysis of:

(A) The nature and purposes of the parallel provisions that are the subject of the request;

(B) The comparability of such parallel provisions;

(C) The extent of any conflicts or differences between such parallel provisions; and

(D) Such other information as may be requested by the Commission or the Securities and Exchange Commission.

(3) Request withdrawal. A person may withdraw a request made pursuant to paragraph (c)(1) of this section at any time prior to the issuance of a joint order under paragraph (c)(4) of this section by the Commission and the Securities and Exchange Commission in response to the request.

(4) Issuance of orders. In response to a request under paragraph (c)(1) of this section, the Commission and the Securities and Exchange Commission, as necessary to carry out the

purposes of the Wall Street Transparency and Accountability Act of 2010, may issue a joint order, after notice and opportunity for comment, permitting the requesting person (and any other person or persons that subsequently lists, trades, or clears that mixed swap) to comply, as to parallel provisions only, with the specified parallel provisions (or another subset of the parallel provisions that are the subject of the request, as the Commissions determine is appropriate), instead of being required to comply with parallel provisions of both the Commodity Exchange Act and the Securities Exchange Act of 1934. In determining the contents of such joint order, the Commission and the Securities and Exchange Commission may consider, among other things:

(i) The nature and purposes of the parallel provisions that are the subject of the request;

(ii) The comparability of such parallel provisions; and

(iii) The extent of any conflicts or differences between such parallel provisions.

(5) Timeframe.

(i) If the Commission and the Securities and Exchange Commission determine to issue a joint order as described in paragraph (c)(4) of this section, such joint order shall be issued within 120 days after receipt of a complete request for a joint order under paragraph (c)(1) of this section, which time period shall be stayed during the pendency of the public comment period provided for in paragraph (c)(4) of this section and shall recommence with the business day after the public comment period ends.

(ii) Nothing in this section shall require the Commission and the Securities and Exchange Commission to issue any joint order.

(iii) If the Commission and the Securities and Exchange Commission do not issue a joint order within the time period described in paragraph (c)(5)(i) of this section, each of the

Commission and the Securities and Exchange Commission shall publicly provide the reasons for not issuing such a joint order within that timeframe.

Securities and Exchange Commission

Pursuant to the Securities Act, 15 U.S.C. 77a et seq., and particularly, sections 19 and 28 thereof, and the Exchange Act, 15 U.S.C. 78a et seq., and particularly, sections 3 and 23 thereof, and sections 712(a)(8), 712(d), 721(a), 761(a) of the Dodd-Frank Act, the SEC is adopting rule 194 under the Securities Act and rules 3a68-1a through 3a68-5 and 3a69-1 through 3a69-3 under the Exchange Act.

Text of Final Rules

For the reasons stated in the preamble, the SEC is amending Title 17, Chapter II of the Code of the Federal Regulations as follows:

PART 230 – GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933

1. The authority citation for Part 230 continues to read, in part, as follows:

Authority: 15 U.S.C. 77b, 77b note, 77c, 77d, 77f, 77g, 77h, 77j, 77r, 77s, 77z-3, 77sss, 78c, 78d, 78j, 78l, 78m, 78n, 78o, 78o-7 note, 78t, 78w, 78ll(d), 78mm, 80a-8, 80a-24, 80a-28, 80a-29, 80a-30, 80a-37, and Pub. L. 111-203, §712, 124 Stat. 1376 (2010) unless otherwise noted.

* * * * *

2. Section 230.194 is added to read as follows:

§ 230.194 Definitions of the terms "swap" and "security-based swap" as used in the Act.

(a) The term swap as used in section 2(a)(17) of the Act (15 U.S.C. 77b(a)(17)) has the same meaning as provided in section 3(a)(69) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(69)) and the rules and regulations thereunder.

(b) The term security-based swap as used in section 2(a)(17) of the Act (15 U.S.C. 77b(a)(17)) has the same meaning as provided in section 3(a)(68) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(68)) and the rules and regulations thereunder.

PART 240 – GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

3. The general authority citation for Part 240 is revised to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77jjj, 77kkk, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78n-1, 78o, 78o-4, 78o-8, 78p, 78q, 78s, 78u-5, 78w, 78x, 78dd(b), 78dd(c), 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, 7201 et seq., and 8302; 18 U.S.C. 1350; 12 U.S.C. 5221(e)(3), and Pub. L. 111-203, §712, 124 Stat. 1376 (2010), unless otherwise noted.

* * * * *

4. Add an undesignated center heading and §§ 240.3a68-1a through 240.3a68-5 and §§ 240.3a69-1 through 240.3a69-3 to read as follows:

Further Definition of Swap, Security-Based Swap, and Security-Based Swap Agreement; Mixed Swaps; Security-Based Swap Agreement Recordkeeping

240.3a68-1a Meaning of "issuers of securities in a narrow-based security index" as used in section 3(a)(68)(A)(ii)(III) of the Act.
240.3a68-1b Meaning of "narrow-based security index" as used in section 3(a)(68)(A)(ii)(I) of the Act.
240.3a68-2 Requests for interpretation of swaps, security-based swaps, and mixed swaps.
240.3a68-3 Meaning of "narrow-based security index" as used in the definition of "security-based swap."
240.3a68-4 Regulation of mixed swaps.
240.3a68-5 Regulation of certain futures contracts on foreign sovereign debt.
240.3a69-1 Safe Harbor Definition of "security-based swap" and "swap" as used in sections 3(a)(68) and 3(a)(69) of the Act—insurance.
240.3a69-2 Definition of "swap" as used in section 3(a)(69) of the Act—additional products.
240.3a69-3 Books and records requirements for security-based swap agreements.

* * * * *

§ 240.3a68-1a Meaning of "issuers of securities in a narrow-based security index" as used in section 3(a)(68)(A)(ii)(III) of the Act.

(a) Notwithstanding § 240.3a68-3(a), and solely for purposes of determining whether a credit default swap is a security-based swap under section 3(a)(68)(A)(ii)(III) of the Act (15 U.S.C. 78c(a)(68)(A)(ii)(III)), the term <u>issuers of securities in a narrow-based security index</u> as used in section 3(a)(68)(A)(ii)(III) of the Act means issuers of securities included in an index (including an index referencing loan borrowers or loans of such borrowers) in which:

(1)(i) There are nine or fewer non-affiliated issuers of securities that are reference entities included in the index, provided that an issuer of securities shall not be deemed a reference entity included in the index for purposes of this section unless:

(A) A credit event with respect to such reference entity would result in a payment by the credit protection seller to the credit protection buyer under the credit default swap based on the related notional amount allocated to such reference entity; or

(B) The fact of such credit event or the calculation in accordance with paragraph (a)(1)(i)(A) of this section of the amount owed with respect to such credit event is taken into account in determining whether to make any future payments under the credit default swap with respect to any future credit events;

(ii) The effective notional amount allocated to any reference entity included in the index comprises more than 30 percent of the index's weighting;

(iii) The effective notional amount allocated to any five non-affiliated reference entities included in the index comprises more than 60 percent of the index's weighting; or

(iv) Except as provided in paragraph (b) of this section, for each reference entity included in the index, none of the criteria in paragraphs (a)(1)(iv)(A) through (a)(1)(iv)(H) of this section is satisfied:

(A) The reference entity included in the index is required to file reports pursuant to section 13 or section 15(d) of the Act (15 U.S.C. 78m or 78o(d));

(B) The reference entity included in the index is eligible to rely on the exemption provided in § 240.12g3-2(b);

(C) The reference entity included in the index has a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more;

(D) The reference entity included in the index (other than a reference entity included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77))) has outstanding notes, bonds, debentures, loans, or evidences of indebtedness (other than revolving credit facilities) having a total remaining principal amount of at least $1 billion;

(E) The reference entity included in the index is the issuer of an exempted security as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)) (other than any municipal security as defined in section 3(a)(29) of the Act (15 U.S.C. 78c(a)(29)));

(F) The reference entity included in the index is a government of a foreign country or a political subdivision of a foreign country;

(G) If the reference entity included in the index is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)), such asset-backed security was issued in a transaction registered under the Securities Act of 1933 (15 U.S.C. 77a et seq.) and has publicly available distribution reports; and

(H) For a credit default swap entered into solely between eligible contract participants as defined in section 3(a)(65) of the Act (15 U.S.C. 78c(a)(65)):

(1) The reference entity included in the index (other than a reference entity included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77))) makes available to the public or otherwise makes available to such eligible contract participant information about the reference entity included in the index pursuant to § 230.144A(d)(4)) of this chapter;

(2) Financial information about the reference entity included in the index (other than a reference entity included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77))) is otherwise publicly available; or

(3) In the case of a reference entity included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)), information of the type and level included in publicly available distribution reports for similar asset-backed securities is publicly available about both the reference entity included in the index and such asset-backed security; and

(2)(i) The index is not composed solely of reference entities that are issuers of exempted securities as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Act (15 U.S.C. 78c(a)(29))), as in effect on the date of enactment of the Futures Trading Act of 1982); and

(ii) Without taking into account any portion of the index composed of reference entities that are issuers of exempted securities as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Act (15 U.S.C.

78c(a)(29))), the remaining portion of the index would be within the term "issuer of securities in a narrow-based security index" under paragraph (a)(1) of this section.

(b) Paragraph (a)(1)(iv) of this section will not apply with respect to a reference entity included in the index if:

(1) The effective notional amounts allocated to such reference entity comprise less than five percent of the index's weighting; and

(2) The effective notional amounts allocated to reference entities included in the index that satisfy paragraph (a)(1)(iv) of this section comprise at least 80 percent of the index's weighting.

(c) For purposes of this section:

(1) A reference entity included in the index is affiliated with another reference entity included in the index (for purposes of paragraph (c)(4) of this section) or another entity (for purposes of paragraph (c)(5) of this section) if it controls, is controlled by, or is under common control with, that other reference entity included in the index or other entity, as applicable; provided that each reference entity included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) will not be considered affiliated with any other reference entity included in the index or any other entity that is an issuing entity of an asset-backed security.

(2) Control for purposes of this section means ownership of more than 50 percent of the equity of a reference entity included in the index (for purposes of paragraph (c)(4) of this section) or another entity (for purposes of paragraph (c)(5) of this section), or the ability to direct the voting of more than 50 percent of the voting equity of a reference entity included in the index

(for purposes of paragraph (c)(4) of this section) or another entity (for purposes of paragraph (c)(5) of this section).

(3) In identifying a reference entity included in the index for purposes of this section, the term reference entity includes:

(i) An issuer of securities;

(ii) An issuer of securities that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)); and

(iii) An issuer of securities that is a borrower with respect to any loan identified in an index of borrowers or loans.

(4) For purposes of calculating the thresholds in paragraphs (a)(1)(i) through (a)(1)(iii) of this section, the term reference entity included in the index includes a single reference entity included in the index or a group of affiliated reference entities included in the index as determined in accordance with paragraph (c)(1) of this section (with each reference entity included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) being considered a separate reference entity included in the index).

(5) For purposes of determining whether one of the criterion in either paragraphs (a)(1)(iv)(A) through (a)(1)(iv)(D) of this section or paragraphs (a)(1)(iv)(H)(1) and (a)(1)(iv)(H)(2) of this section is met, the term reference entity included in the index includes a single reference entity included in the index or a group of affiliated entities as determined in accordance with paragraph (c)(1) of this section (with each issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) being considered a separate entity).

§ 240.3a68-1b Meaning of "narrow-based security index" as used in section 3(a)(68)(A)(ii)(I) of the Act.

(a) Notwithstanding § 240.3a68-3(a), and solely for purposes of determining whether a credit default swap is a security-based swap under section 3(a)(68)(A)(ii)(I) of the Act (15 U.S.C. 78c(a)(68)(A)(ii)(I)), the term narrow-based security index as used in section 3(a)(68)(A)(ii)(I) of the Act means an index in which:

(1)(i) The index is composed of nine or fewer securities or securities that are issued by nine or fewer non-affiliated issuers, provided that a security shall not be deemed a component of the index for purposes of this section unless:

(A) A credit event with respect to the issuer of such security or a credit event with respect to such security would result in a payment by the credit protection seller to the credit protection buyer under the credit default swap based on the related notional amount allocated to such security; or

(B) The fact of such credit event or the calculation in accordance with paragraph (a)(1)(i)(A) of this section of the amount owed with respect to such credit event is taken into account in determining whether to make any future payments under the credit default swap with respect to any future credit events;

(ii) The effective notional amount allocated to the securities of any issuer included in the index comprises more than 30 percent of the index's weighting;

(iii) The effective notional amount allocated to the securities of any five non-affiliated issuers included in the index comprises more than 60 percent of the index's weighting; or

(iv) Except as provided in paragraph (b) of this section, for each security included in the index none of the criteria in paragraphs (a)(1)(iv)(A) through (a)(1)(iv)(H) of this section is satisfied:

(A) The issuer of the security included in the index is required to file reports pursuant to section 13 or section 15(d) of the Act (15 U.S.C. 78m or 78o(d));

(B) The issuer of the security included in the index is eligible to rely on the exemption provided in §240.12g3-2(b);

(C) The issuer of the security included in the index has a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more;

(D) The issuer of the security included in the index (other than an issuer of the security that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77))) has outstanding notes, bonds, debentures, loans, or evidences of indebtedness (other than revolving credit facilities) having a total remaining principal amount of at least $1 billion;

(E) The security included in the index is an exempted security as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)) (other than any municipal security as defined in section 3(a)(29) of the Act (15 U.S.C. 78c(a)(29)));

(F) The issuer of the security included in the index is a government of a foreign country or a political subdivision of a foreign country;

(G) If the security included in the index is an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)), the security was issued in a transaction registered under the Securities Act of 1933 (15 U.S.C. 77a et seq.) and has publicly available distribution reports; and

(H) For a credit default swap entered into solely between eligible contract participants as defined in section 3(a)(65) of the Act (15 U.S.C. 78c(a)(65)):

(1) The issuer of the security included in the index (other than an issuer of the security that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77))) makes available to the public or otherwise makes available to such eligible contract participant information about such issuer pursuant to § 230.144A(d)(4)) of this chapter;

(2) Financial information about the issuer of the security included in the index (other than an issuer of the security that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77))) is otherwise publicly available; or

(3) In the case of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)), information of the type and level included in public distribution reports for similar asset-backed securities is publicly available about both the issuing entity and such asset-backed security; and

(2)(i) The index is not composed solely of exempted securities as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Act (15 U.S.C. 78c(a)(29))), as in effect on the date of enactment of the Futures Trading Act of 1982); and

(ii) Without taking into account any portion of the index composed of exempted securities as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Act (15 U.S.C. 78c(a)(29))), the remaining portion of the index would be within the term “narrow-based security index” under paragraph (a)(1) of this section.

(b) Paragraph (a)(1)(iv) of this section will not apply with respect to securities of an issuer included in the index if:

(1) The effective notional amounts allocated to all securities of such issuer included in the index comprise less than five percent of the index's weighting; and

(2) The securities that satisfy paragraph (a)(1)(iv) of this section comprise at least 80 percent of the index's weighting.

(c) For purposes of this section:

(1) An issuer of securities included in the index is affiliated with another issuer of securities included in the index (for purposes of paragraph (c)(4) of this section) or another entity (for purposes of paragraph (c)(5) of this section) if it controls, is controlled by, or is under common control with, that other issuer or other entity, as applicable; provided that each issuer of securities included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) will not be considered affiliated with any other issuer of securities included in the index or any other entity that is an issuing entity of an asset-backed security.

(2) Control for purposes of this section means ownership of more than 50 percent of the equity of an issuer of securities included in the index (for purposes of paragraph (c)(4) of this section) or another entity (for purposes of paragraph (c)(5) of this section), or the ability to direct the voting of more than 50 percent of the voting equity an issuer of securities included in the index (for purposes of paragraph (c)(4) of this section) or another entity (for purposes of paragraph (c)(5) of this section).

(3) In identifying an issuer of securities included in the index for purposes of this section, the term <u>issuer</u> includes:

(i) An issuer of securities; and

(ii) An issuer of securities that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)).

(4) For purposes of calculating the thresholds in paragraphs (a)(1)(i) through (a)(1)(iii) of this section, the term issuer of the security included in the index includes a single issuer of securities included in the index or a group of affiliated issuers of securities included in the index as determined in accordance with paragraph (c)(1) of this section (with each issuer of securities included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) being considered a separate issuer of securities included in the index).

(5) For purposes of determining whether one of the criterion in either paragraphs (a)(1)(iv)(A) through (a)(1))(iv)(D) of this section or paragraphs (a)(1)(iv)(H)(1) and (a)(1)(iv)(H)(2) of this section is met, the term issuer of the security included in the index includes a single issuer of securities included in the index or a group affiliated entities as determined in accordance with paragraph (c)(1) of this section (with each issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) being considered a separate entity).

§ 240.3a68-2 Requests for interpretation of swaps, security-based swaps, and mixed swaps.

(a) In general. Any person may submit a request to the Commission and the Commodity Futures Trading Commission to provide a joint interpretation of whether a particular agreement, contract, or transaction (or class thereof) is:

(1) A swap, as that term is defined in section 3(a)(69) of the Act (15 U.S.C. 78c(a)(69)) and the rules and regulations promulgated thereunder;

(2) A security-based swap, as that term is defined in section 3(a)(68) of the Act (15 U.S.C. 78c(a)(68)) and the rules and regulations promulgated thereunder; or

(3) A mixed swap, as that term is defined in section 3(a)(68)(D) of the Act and the rules and regulations promulgated thereunder.

(b) Request process. In making a request pursuant to paragraph (a) of this section, the requesting person must provide the Commission and the Commodity Futures Trading Commission with the following:

(1) All material information regarding the terms of the agreement, contract, or transaction (or class thereof);

(2) A statement of the economic characteristics and purpose of the agreement, contract, or transaction (or class thereof);

(3) The requesting person's determination as to whether the agreement, contract, or transaction (or class thereof) should be characterized as a swap, a security-based swap, or both (i.e., a mixed swap), including the basis for such determination; and

(4) Such other information as may be requested by the Commission or the Commodity Futures Trading Commission.

(c) Request withdrawal. A person may withdraw a request made pursuant to paragraph (a) of this section at any time prior to the issuance of a joint interpretation or joint proposed rule by the Commission and the Commodity Futures Trading Commission in response to the request; provided, however, that notwithstanding such withdrawal, the Commission and the Commodity Futures Trading Commission may provide a joint interpretation of whether the agreement, contract, or transaction (or class thereof) is a swap, a security-based swap, or both (i.e., a mixed swap).

(d) Request by the Commission or the Commodity Futures Trading Commission. In the absence of a request for a joint interpretation under paragraph (a) of this section:

(1) If the Commission or the Commodity Futures Trading Commission receives a proposal to list, trade, or clear an agreement, contract, or transaction (or class thereof) that raises questions as to the appropriate characterization of such agreement, contract, or transaction (or class thereof) as a swap, a security-based swap, or both (i.e., a mixed swap), the Commission or the Commodity Futures Trading Commission, as applicable, promptly shall notify the other of the agreement, contract, or transaction (or class thereof); and

(2) The Commission or the Commodity Futures Trading Commission, or their Chairmen jointly, may submit a request for a joint interpretation as described in paragraph (a) of this section; such submission shall be made pursuant to paragraph (b) of this section, and may be withdrawn pursuant to paragraph (c) of this section.

(e) Timeframe for joint interpretation.

(1) If the Commission and the Commodity Futures Trading Commission determine to issue a joint interpretation as described in paragraph (a) of this section, such joint interpretation shall be issued within 120 days after receipt of a complete submission requesting a joint interpretation under paragraph (a) or (d) of this section.

(2) The Commission and the Commodity Futures Trading Commission shall consult with the Board of Governors of the Federal Reserve System prior to issuing any joint interpretation as described in paragraph (a) of this section.

(3) If the Commission and the Commodity Futures Trading Commission seek public comment with respect to a joint interpretation regarding an agreement, contract, or transaction (or class thereof), the 120-day period described in paragraph (e)(1) of this section shall be stayed

during the pendency of the comment period, but shall recommence with the business day after the public comment period ends.

(4) Nothing in this section shall require the Commission and the Commodity Futures Trading Commission to issue any joint interpretation.

(5) If the Commission and the Commodity Futures Trading Commission do not issue a joint interpretation within the time period described in paragraph (e)(1) or (e)(3) of this section, each of the Commission and the Commodity Futures Trading Commission shall publicly provide the reasons for not issuing such a joint interpretation within the applicable timeframes.

(f) Joint proposed rule.

(1) Rather than issue a joint interpretation pursuant to paragraph (a) of this section, the Commission and the Commodity Futures Trading Commission may issue a joint proposed rule, in consultation with the Board of Governors of the Federal Reserve System, to further define one or more of the terms swap, security-based swap, or mixed swap.

(2) A joint proposed rule described in paragraph (f)(1) of this section shall be issued within the timeframe for issuing a joint interpretation set forth in paragraph (e) of this section.

§ 240.3a68-3 Meaning of "narrow-based security index" as used in the definition of "security-based swap."

(a) In general. Except as otherwise provided in § 240.3a68-1a and § 240.3a68-1b, for purposes of section 3(a)(68) of the Act (15 U.S.C. 78c(a)(68)), the term narrow-based security index has the meaning set forth in section 3(a)(55) of the Act (15 U.S.C. 78c(a)(55)), and the rules, regulations, and orders of the Commission thereunder.

(b) Tolerance period for swaps traded on designated contract markets, swap execution facilities and foreign boards of trade. Notwithstanding paragraph (a) of this section, solely for purposes of swaps traded on or subject to the rules of a designated contract market,

swap execution facility, or foreign board of trade pursuant to the Commodity Exchange Act (7 U.S.C. 1 et seq.), a security index underlying such swaps shall not be considered a narrow-based security index if:

(1)(i) A swap on the index is traded on or subject to the rules of a designated contract market, swap execution facility, or foreign board of trade pursuant to the Commodity Exchange Act (7 U.S.C. 1 et seq.) for at least 30 days as a swap on an index that was not a narrow-based security index; or

(ii) Such index was not a narrow-based security index during every trading day of the six full calendar months preceding a date no earlier than 30 days prior to the commencement of trading of a swap on such index on a market described in paragraph (b)(1)(i) of this section; and

(2) The index has been a narrow-based security index for no more than 45 business days over three consecutive calendar months.

(c) Tolerance period for security-based swaps traded on national securities exchanges or security-based swap execution facilities. Notwithstanding paragraph (a) of this section, solely for purposes of security-based swaps traded on a national securities exchange or security-based swap execution facility, a security index underlying such security-based swaps shall be considered a narrow-based security index if:

(1)(i) A security-based swap on the index is traded on a national securities exchange or security-based swap execution facility for at least 30 days as a security-based swap on a narrow-based security index; or

(ii) Such index was a narrow-based security index during every trading day of the six full calendar months preceding a date no earlier than 30 days prior to the commencement of

trading of a security-based swap on such index on a market described in paragraph (c)(1)(i) of this section; and

(2) The index has been a security index that is not a narrow-based security index for no more than 45 business days over three consecutive calendar months.

(d) Grace period.

(1) Solely with respect to a swap that is traded on or subject to the rules of a designated contract market, swap execution facility or foreign board of trade pursuant to the Commodity Exchange Act (7 U.S.C. 1 et seq.), an index that becomes a narrow-based security index under paragraph (b) of this section solely because it was a narrow-based security index for more than 45 business days over three consecutive calendar months shall not be a narrow-based security index for the following three calendar months.

(2) Solely with respect to a security-based swap that is traded on a national securities exchange or security-based swap execution facility, an index that becomes a security index that is not a narrow-based security index under paragraph (yyy)(3) of this section solely because it was not a narrow-based security index for more than 45 business days over three consecutive calendar months shall be a narrow-based security index for the following three calendar months.

§ 240.3a68-4 Regulation of mixed swaps.

(a) In general. The term mixed swap has the meaning set forth in section 3(a)(68)(D) of the Act (15 U.S.C. 78c(a)(68)(D)).

(b) Regulation of bilateral uncleared mixed swaps entered into by dually-registered dealers or major participants. A mixed swap:

(1) That is neither executed on nor subject to the rules of a designated contract market, national securities exchange, swap execution facility, security-based swap execution facility, or foreign board of trade;

(2) That will not be submitted to a derivatives clearing organization or registered or exempt clearing agency to be cleared; and

(3) Where at least one party is registered with the Commission as a security-based swap dealer or major security-based swap participant and also with the Commodity Futures Trading Commission as a swap dealer or major swap participant, shall be subject to:

(i) The following provisions of the Commodity Exchange Act (7 U.S.C. 1 et seq.), and the rules and regulations promulgated thereunder, set forth in the rules and regulations of the Commodity Futures Trading Commission:

(A) Examinations and information sharing: 7 U.S.C. 6s(f) and 12;

(B) Enforcement: 7 U.S.C. 2(a)(1)(B), 6(b), 6b, 6c, 6s(h)(1)(A), 6s(h)(4)(A), 9, 13b, 13a-1, 13a-2, 13, 13c(a), 13c(b), 15 and 26;

(C) Reporting to a swap data repository: 7 U.S.C. 6r;

(D) Real-time reporting: 7 U.S.C. 2(a)(13);

(E) Capital: 7 U.S.C. 6s(e); and

(F) Position Limits: 7 U.S.C. 6a; and

(ii) The provisions of the federal securities laws, as defined in section 3(a)(47) of the Act (15 U.S.C. 78c(a)(47)), and the rules and regulations promulgated thereunder.

(c) Process for determining regulatory treatment for other mixed swaps.

(1) In general. Any person who desires or intends to list, trade, or clear a mixed swap (or class thereof) that is not subject to paragraph (b) of this section may request the Commission and the Commodity Futures Trading Commission to issue a joint order permitting the requesting person (and any other person or persons that subsequently lists, trades, or clears that mixed swap) to comply, as to parallel provisions only, with specified parallel provisions of either the

Act (15 U.S.C. 78a et seq.) or the Commodity Exchange Act (7 U.S.C. 1 et seq.), and the rules and regulations thereunder (collectively, specified parallel provisions), instead of being required to comply with parallel provisions of both the Act and the Commodity Exchange Act. For purposes of this paragraph (c), parallel provisions means comparable provisions of the Act and the Commodity Exchange Act that were added or amended by the Wall Street Transparency and Accountability Act of 2010 with respect to security-based swaps and swaps, and the rules and regulations thereunder.

(2) Request process. A person submitting a request pursuant to paragraph (c)(1) of this section must provide the Commission and the Commodity Futures Trading Commission with the following:

(i) All material information regarding the terms of the specified, or specified class of, mixed swap;

(ii) The economic characteristics and purpose of the specified, or specified class of, mixed swap;

(iii) The specified parallel provisions, and the reasons the person believes such specified parallel provisions would be appropriate for the mixed swap (or class thereof); and

(iv) An analysis of:

(A) The nature and purposes of the parallel provisions that are the subject of the request;

(B) The comparability of such parallel provisions;

(C) The extent of any conflicts or differences between such parallel provisions; and

(D) Such other information as may be requested by the Commission or the Commodity Futures Trading Commission.

(3) Request withdrawal. A person may withdraw a request made pursuant to paragraph (c)(1) of this section at any time prior to the issuance of a joint order under paragraph (c)(4) of this section by the Commission and the Commodity Futures Trading Commission in response to the request.

(4) Issuance of orders. In response to a request under paragraph (c)(1) of this section, the Commission and the Commodity Futures Trading Commission, as necessary to carry out the purposes of the Wall Street Transparency and Accountability Act of 2010, may issue a joint order, after notice and opportunity for comment, permitting the requesting person (and any other person or persons that subsequently lists, trades, or clears that mixed swap) to comply, as to parallel provisions only, with the specified parallel provisions (or another subset of the parallel provisions that are the subject of the request, as the Commissions determine is appropriate), instead of being required to comply with parallel provisions of both the Act (15 U.S.C. 78a et seq.) and the Commodity Exchange Act (7 U.S.C. 1 et seq.). In determining the contents of such joint order, the Commission and the Commodity Futures Trading Commission may consider, among other things:

(i) The nature and purposes of the parallel provisions that are the subject of the request;

(ii) The comparability of such parallel provisions; and

(iii) The extent of any conflicts or differences between such parallel provisions.

(5) Timeframe.

(i) If the Commission and the Commodity Futures Trading Commission determine to issue a joint order as described in paragraph (c)(4) of this section, such joint order shall be issued within 120 days after receipt of a complete request for a joint order under paragraph (c)(1) of this

section, which time period shall be stayed during the pendency of the public comment period provided for in paragraph (c)(4) of this section and shall recommence with the business day after the public comment period ends.

(ii) Nothing in this section shall require the Commission and the Commodity Futures Trading Commission to issue any joint order.

(iii) If the Commission and the Commodity Futures Trading Commission do not issue a joint order within the time period described in paragraph (c)(5)(i) of this section, each of the Commission and the Commodity Futures Trading Commission shall publicly provide the reasons for not issuing such a joint order within that timeframe.

§ 240.3a68-5 Regulation of certain futures contracts on foreign sovereign debt.

Futures contracts on certain foreign sovereign debt. The term security-based swap as used in section 3(a)(68) of the Act (15 U.S.C. 78c(a)(68)) does not include an agreement, contract, or transaction that is based on or references a qualifying foreign futures contract (as defined in §240.3a12-8 on the debt securities of any one or more of the foreign governments enumerated in §240.3a12-8, provided that such agreement, contract, or transaction satisfies the following conditions:

(a) The futures contract that the agreement, contract, or transaction references or upon which the agreement, contract, or transaction is based is a qualifying foreign futures contract that satisfies the conditions of §240.3a12-8 applicable to qualifying foreign futures contracts;

(b) The agreement, contract, or transaction is traded on or through a board of trade (as defined in 7 U.S.C. 2);

(c) The debt securities upon which the qualifying foreign futures contract is based or referenced and any security used to determine the cash settlement amount pursuant to paragraph

(4) of this section were not registered under the Securities Act of 1933 (15 U.S.C. 77 et seq.) or the subject of any American depositary receipt registered under the Securities Act of 1933;

(d) The agreement, contract, or transaction may only be cash settled; and

(e) The agreement, contract or transaction is not entered into by the issuer of the debt securities upon which the qualifying foreign futures contract is based or referenced (including any security used to determine the cash payment due on settlement of such agreement, contract or transaction), an affiliate (as defined in the Securities Act of 1933 (15 U.S.C. 77 et seq.) and the rules and regulations thereunder) of the issuer, or an underwriter of such issuer's debt securities.

§ 240.3a69-1 Safe Harbor Definition of "security-based swap" and "swap" as used in sections 3(a)(68) and 3(a)(69) of the Act—insurance

(a) This paragraph is a non-exclusive safe harbor. The terms security-based swap as used in section 3(a)(68) of the Act (15 U.S.C. 78c(a)(68)) and swap as used in section 3(a)(69) of the Act (15 U.S.C. 78c(a)(69)) do not include an agreement, contract, or transaction that:

(1) By its terms or by law, as a condition of performance on the agreement, contract, or transaction:

(i) Requires the beneficiary of the agreement, contract, or transaction to have an insurable interest that is the subject of the agreement, contract, or transaction and thereby carry the risk of loss with respect to that interest continuously throughout the duration of the agreement, contract, or transaction;

(ii) Requires that loss to occur and to be proved, and that any payment or indemnification therefor be limited to the value of the insurable interest;

(iii) Is not traded, separately from the insured interest, on an organized market or over the counter; and

(iv) With respect to financial guaranty insurance only, in the event of payment default or insolvency of the obligor, any acceleration of payments under the policy is at the sole discretion of the insurer; and

(2) Is provided:

(i)(A) By a person that is subject to supervision by the insurance commissioner (or similar official or agency) of any State, as defined in section 3(a)(16) of the Act (15 U.S.C. 78c(a)(16)), or by the United States or an agency or instrumentality thereof; and

(B) Such agreement, contract, or transaction is regulated as insurance under applicable State law or the laws of the United States;

(ii)(A) Directly or indirectly by the United States, any State or any of their respective agencies or instrumentalities; or

(B) Pursuant to a statutorily authorized program thereof; or

(iii) In the case of reinsurance only by a person to another person that satisfies the conditions set forth in paragraph (a)(2) of this section, provided that:

(A) Such person is not prohibited by applicable State law or the laws of the United States from offering such agreement, contract, or transaction to such person that satisfies the conditions set forth in paragraph (a)(2) of this section;

(B) The agreement, contract, or transaction to be reinsured satisfies the conditions set forth in paragraph (a)(1) or (3) of this section; and

(C) Except as otherwise permitted under applicable State law, the total amount reimbursable by all reinsurers for such agreement, contract, or transaction may not exceed the claims or losses paid by the person writing the risk being ceded or transferred by such person; or

(iv) In the case of non-admitted insurance by a person who:

(A) 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

(B) Meets the eligibility criteria for non-admitted insurers under applicable State law; or

(3) Is provided in accordance with the conditions set forth in paragraph (a)(2) of this section and is one of 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 identified in paragraphs (i) through (x) of this section.

(b) The terms security-based swap as used in section 3(a)(68) of the Act (15 U.S.C. 78c(a)(68)) and swap as used in section 3(a)(69) of the Act (15 U.S.C. 78c(a)(69)) do not include an agreement, contract, or transaction that was entered into on or before the effective date of this

section and that, at such time that it was entered into, was provided in accordance with the conditions set forth in paragraph (a)(2) of this section.

§ 240.3a69-2 Definition of "swap" as used in section 3(a)(69) of the Act—additional products.

(a) In general. The term swap has the meaning set forth in section 3(a)(69) of the Act (15 U.S.C. 78c(a)(69)).

(b) Inclusion of particular products. (1) The term swap includes, without limiting the meaning set forth in section 3(a)(69) of the Act (15 U.S.C. 78c(a)(69)), the following agreements, contracts, and transactions:

(i) A cross-currency swap;

(ii) A currency option, foreign currency option, foreign exchange option and foreign exchange rate option;

(iii) A foreign exchange forward;

(iv) A foreign exchange swap;

(v) A forward rate agreement; and

(vi) A non-deliverable forward involving foreign exchange.

(2) The term swap does not include an agreement, contract, or transaction described in paragraph (b)(1) of this section that is otherwise excluded by section 1a(47)(B) of the Commodity Exchange Act (7 U.S.C. 1a(47)(B)).

(c) Foreign exchange forwards and foreign exchange swaps. Notwithstanding paragraph (b)(2) of this section:

(1) A foreign exchange forward or a foreign exchange swap shall not be considered a swap if the Secretary of the Treasury makes a determination described in section 1a(47)(E)(i) of the Commodity Exchange Act (7 U.S.C. 1a(47)(E)(i)).

(2) Notwithstanding paragraph (c)(1) of this section:

(i) The reporting requirements set forth in section 4r of the Commodity Exchange Act (7 U.S.C. 6r) and regulations promulgated thereunder shall apply to a foreign exchange forward or foreign exchange swap; and

(ii) The business conduct standards set forth in section 4s(h) of the Commodity Exchange Act (7 U.S.C. 6s) and regulations promulgated thereunder shall apply to a swap dealer or major swap participant that is a party to a foreign exchange forward or foreign exchange swap.

(3) For purposes of section 1a(47)(E) of the Commodity Exchange Act (7 U.S.C. 1a(47)(E)) and this section, the term foreign exchange forward has the meaning set forth in section 1a(24) of the Commodity Exchange Act (7 U.S.C. 1a(24)).

(4) For purposes of section 1a(47)(E) of the Commodity Exchange Act (7 U.S.C. 1a(47)(E)) and this section, the term foreign exchange swap has the meaning set forth in section 1a(25) of the Commodity Exchange Act (7 U.S.C. 1a(25)).

(5) For purposes of sections 1a(24) and 1a(25) of the Commodity Exchange Act (7 U.S.C. 1a(24) and (25)) and this section, the following transactions are not foreign exchange forwards or foreign exchange swaps:

(i) A currency swap or a cross-currency swap;

(ii) A currency option, foreign currency option, foreign exchange option, or foreign exchange rate option; and

(iii) A non-deliverable forward involving foreign exchange.

§ 240.3a69-3 Books and records requirements for security-based swap agreements.

(a) A person registered as a swap data repository under section 21 of the Commodity Exchange Act (7 U.S.C. 24a) and the rules and regulations thereunder:

(1) Shall not be required to keep and maintain additional books and records regarding security-based swap agreements other than the books and records regarding swaps required to be kept and maintained pursuant to section 21 of the Commodity Exchange Act (7 U.S.C. 24a) and the rules and regulations thereunder; and

(2) Shall not be required to collect and maintain additional data regarding security-based swap agreements other than the data regarding swaps required to be collected and maintained by such persons pursuant to section 21 of the Commodity Exchange Act (7 U.S.C. 24a) and the rules and regulations thereunder.

(b) A person shall not be required to keep and maintain additional books and records, including daily trading records, regarding security-based swap agreements other than the books and records regarding swaps required to be kept and maintained by such persons pursuant to section 4s of the Commodity Exchange Act (7 U.S.C. 6s) and the rules and regulations thereunder if such person is registered as:

(1) A swap dealer under section 4s(a)(1) of the Commodity Exchange Act (7 U.S.C. 6s(a)(1)) and the rules and regulations thereunder;

(2) A major swap participant under section 4s(a)(2) of the Commodity Exchange Act (7 U.S.C. 6s(a)(2)) and the rules and regulations thereunder;

(3) A security-based swap dealer under section 15F(a)(1) of the Act (15 U.S.C. 78o-10(a)(1)) and the rules and regulations thereunder; or

(4) A major security-based swap participant under section 15F(a)(2) of the Act (15 U.S.C. 78o-10(a)(2)) and the rules and regulations thereunder.

(c) The term security-based swap agreement has the meaning set forth in section 3(a)(78) of the Act (15 U.S.C. 78c(a)(78)).

PART 241 – INTERPRETATIVE RELEASES RELATING TO THE SECURITIES EXCHANGE ACT OF 1934 AND GENERAL RULES AND REGULATIONS THEREUNDER

5. Part 241 is amended by adding Release No. 34–67453 and the release date of July 18, 2012, to the list of interpretative releases.

By the Commodity Futures Trading Commission.

David A. Stawick
Secretary

Date: July 18, 2012

By the Securities and Exchange Commission.

Elizabeth M. Murphy
Secretary

Date: July 18, 2012

Product Definitions Contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act—CFTC Voting Summary and Statements of CFTC Commissioners

Note: The following appendices will not appear in the Code of Federal Regulations

CFTC Voting Summary

On this matter, Chairman Gensler and Commissioners Sommers, O'Malia and Wetjen voted in the affirmative; Commissioner Chilton voted in the negative.

Statement of CFTC Chairman Gary Gensler

I support the final rulemaking to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) requirement to further define "swap" and other products that come under swaps market reform. The Commodity Futures Trading Commission (CFTC) worked closely with the Securities and Exchange Commission (SEC), in consultation with the Federal Reserve, on the final rules and interpretations to further define "swaps," "security-based swaps," "mixed swaps" and "security-based swap agreements."

The statutory definition as laid out by Congress of swap is very detailed. These final rules and interpretations are consistent with that detailed definition and Congressional intent. For example, interest rate swaps, currency swaps, commodity swaps, including energy, metals and agricultural swaps, and broad-based index swaps, such as index credit default swaps, are all swaps. Consistent with Congress's definition of swaps, the rule also defines options as swaps.

In preparing this final rulemaking, staff worked to address the more than 140 comments that were submitted by the public in response to the product further definition proposal. Many of

the commenters asked the Commissions to specifically provide guidance on what is not a swap or security-based swap.

For example, under the Commodity Exchange Act, the CFTC does not regulate forward contracts. Over the decades, there have been a series of orders, interpretations and cases that market participants have come to rely upon regarding the exception from futures regulation for forwards and forwards with embedded options. Consistent with that history, the Dodd-Frank Act excluded from the definition of a swap "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled." The Commission is interpreting that exclusion in a manner that is consistent with Commission precedent and, in response to commenters, is providing increased clarity on the forward exclusion from futures regulation. The final release provides guidance regarding forwards with embedded volumetric options, like those used within the electricity markets, and is requesting comment on this interpretation.

Further, consistent with the Dodd-Frank Act, insurance products will not be regulated as swaps. Similarly, this final rulemaking clarifies that certain consumer and commercial arrangements that historically have not been considered swaps, such as consumer mortgage rate locks, contracts to lock in the price of home heating oil and contracts relating to inventory or equipment, also will not be regulated as swaps.

The rule provides clarity on the dividing line between "swaps" and "security-based swaps" or both, i.e. mixed swaps. The rule also provides a process for requesting joint interpretations in circumstances where there are questions. These dividing lines and the process will benefit market participants, as they will provide greater clarity as to what regulatory requirements apply when they transact in the derivatives markets.

Lastly, the final release includes specific provisions that guard against transactions that are willfully structured to evade Dodd-Frank Act swaps market reforms.

I'd like to express my appreciation for their dedication to completing this rule to Chairman Mary Schapiro and her fellow Commissioners at the SEC, as well as the staff, including Robert Cook, Brian Bussey, Amy Starr, Donna Chambers, Christie March, Andy Schoeffler, Wenchi Hu, John Guidroz and Sarah Otte.

I'd also like to thank the CFTC's hardworking staff: Julian Hammar, Lee Ann Duffy, David Aron, Terry Arbit, Eric Juzenas and Stephen Kane.

Dissent of CFTC Commissioner Chilton on Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping

I respectfully dissent from this joint final rule and interpretive guidance because I have reservations about certain aspects of the Commodity Futures Trading Commission's ("Commission") interpretive guidance on forward contracts. Apart from this specific area, I agree with the joint release and would support its adoption.

I am dissenting from the interpretive guidance for two chief reasons. First, I believe that the Commission should make stronger efforts to ensure market participants claim the forward contract exclusion only under appropriate circumstances, consistent with its interpretive guidance. The Commission should apply a rebuttable presumption that contracts do not have as their predominant feature actual delivery in instances where market participants often do not follow the delivery settlement term in a contract. The Commission should set forth the conditions for a safe harbor, consistent with its interpretation of the forward contract exclusion, for market participants that often do not terminate "forward" contracts through physical delivery that includes some affirmative statement to the Commission explaining the circumstances

leading to non-delivery. This safe harbor, in my view, would encourage market participants to submit information that would vastly improve the ability of the Commission to ensure that market participants claiming the forward contract exclusion are doing so appropriately, consistent with the law and Commission and staff interpretation of the law.

Second, the Commission has failed to provide adequate legal certainty to market participants engaging in contracts with embedded volumetric commodity options, particularly those that can terminate without physical delivery. Contracts with embedded commodity options that can negate the physical delivery term have optionality that targets the delivery term of the contract and therefore cannot be seen as having as a predominant feature actual delivery, a necessary element in any forward contract under applicable Commission precedent. The Commission has failed to perform an analysis of these types of contracts in an excess of caution that may invite confusion, at best, and evasion, at worst.

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")1 imposes new safeguards on hitherto unregulated markets. These safeguards increase the integrity of the markets by, e.g., improving market transparency and thereby deterring abuses of the sorts seen in recent decades. These safeguards inevitably increase compliance costs, particularly in the initial phase of implementation. As I can predict with absolute certainty, bad actors (à la Amaranth) will be drawn to dark markets in search of spoils. Less ill-intentioned or

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[1] See Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010). The text of the Dodd-Frank Act may be accessed at http://www.cftc.gov/LawRegulation/OTCDERIVATIVES/index.htm.

"grey" actors may follow them in search of lower compliance costs. The Commission should not cede swaths of jurisdiction because such markets have not hitherto given rise to concerns.2

The Commission proposed3 and is now adopting an approach to the forward contract exclusion that draws on "the principles underlying" the Brent Interpretation.4 I agree generally with this approach (I voted in the affirmative on releasing the proposal). In addition, the Commission recognizes that the underlying purpose of a transaction is a critical factor in determining whether a given transaction is more appropriately classified as a forward or swap (or commodity option).5 I commend this clarification and hope it is applied or further clarified in a

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2 See Financial Crisis Inquiry Commission, "The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States," Jan. 2011, at 25, available at http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf ("concluding that "enactment of . . . [the Commodity Futures Modernization Act of 2000 ("CFMA")] to ban the regulation by both the federal and state governments of over-the-counter (OTC) derivatives was a key turning point in the march toward the financial crisis.").

3 See Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 FR 29818, 29829, May 23, 2011.

4 Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 FR ___, ___ ("Adopting Release"); Statutory Interpretation Concerning Forward Transactions, 55 FR 39188, Sept. 25, 1990 ("Brent Interpretation"). I note that the Commission did not endorse the outcome of the Brent Interpretation.

5 I recognize (and perhaps the Commission has quietly recognized as well) the merit in the dissent of former Commissioner Fowler West to the Brent Interpretation and am heartened to find elements of his analytical approach in this release. Commissioner West, among other things, emphasized the importance of the underlying purpose of a transaction in a forward contract analysis. Id., Dissent of Commissioner Fowler West, available at http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/fwestdissent092090.pdf (because, among other things, 15-day Brent contracts are entered into for the purpose of hedging or speculation rather than for the purpose of transferring ownership in crude oil they do not sufficiently resemble forward contracts to be excluded from the CEA) citing CFTC v. Co. Petro Marketing Group, Inc., 680 F.2d 573, 580 (9th Cir. 1982). Commissioner West's dissent presaged the Brent market aberrations of the 1990s and early 2000s that some tied to squeezes of the Brent delivery complex through a hoarding of "forwards" that made leveraged cash-settled contract positions designed to benefit from such aberrations very profitable. While I endorse the Commission's approach to affirming the principles contained in the Brent Interpretation, I believe future interpretive guidance should apply the lessons of the past two-plus decades of market and regulatory history and apply the Brent Interpretation principles in that light. In this dissent,

way that affirms the principles underlying the Brent Interpretation without endorsing the outcome of the Brent Interpretation.

1. Safe Harbor for "Forwards" that Often do not Terminate with Actual Delivery

I believe that the Commission should make stronger efforts to ensure market participants claim the forward contract exclusion only under appropriate circumstances. I am concerned that the forward contract exclusion may be abused if not intentionally evaded by the lack of safeguards to ensure its appropriate application.[6] This concern is exacerbated by the fact that actors claiming the forward contract exclusion are not subject to any reporting requirements, nor have we even provided for a safe harbor that encourages such reporting. In light of the transparency the CEA now provides for futures, options, and swaps markets, the regulatory differential between these regulated markets and unregulated markets, like forward markets, is going to encourage regulatory arbitrage. Despite substantial progress in improving the Commission's visibility into regulated markets, the Commission has failed to set forth interpretive guidance that ensures that, at the minimum, it can see and understand the transactions that market participants claim as being subject to the forward contract exclusion. I believe the Commission should be more active when it comes to ensuring that the forward contract exclusion is properly applied, particularly in instances where an ostensible "forward" closely resembles, in form, purpose, or economic substance regulated products.

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however, I do not need to go so far as to reinterpret the principles underlying the Brent Interpretation: even based on a conservative review of our precedent I feel we did not provide the market adequate clarity.

[6] See Adopting Release.

The Commission has endorsed the purpose of a transaction as a factor in determining a contract's eligibility for the forward contract exclusion.[7] The Brent Interpretation or the Commission's re-interpretation of it notwithstanding, I believe that when few "forward" contracts for a given market participant result in delivery, then there is sufficient ground for the Commission to have doubt about the appropriateness of the forward contract exclusion claim. Moreover, under such circumstances the Commission should have doubt about the underlying purpose of the claimed "forwards." Therefore, the Commission should apply a rebuttable presumption that the market participant may not be engaging in transactions that have as their predominant feature actual delivery.

At the same time, the Commission should specify the means by which this presumption may be rebutted. I believe that the Commission provide for a safe harbor for market participants that regularly engage in transactions they believe to qualify for the forward contract exclusion that, nonetheless, often do not terminate with delivery (e.g., in less than 20% of instances as measured by number of "forward" contracts or by potential total quantity under all "forward" contracts). This non-delivery could be of the result of, for example, exercised embedded volumetric optionality or through book-outs. Market participants claiming this safe harbor should include a brief, periodic statement that explains the reason why their forward transactions, in general terms or with more specificity as is necessary for the Commission to determine whether the presumption that the market participant is inappropriately claiming the forward contract exclusion is rebutted.

I request comment on my proposed safe harbor concept. I encourage the Commission to adopt some version of this safe harbor in order to allay the very real concerns I and, indeed,

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[7] See Adopting Release.

many market participants and many in the public have expressed to me that unregulated forwards markets could become a refuge for those that thrive in opacity. Our regulations implementing the Dodd-Frank Act will vastly improve transparency in regulated futures, options, and swaps markets. Unfortunately, our interpretive guidance today does little to ensure even any visibility for regulators in how players in the physical commodity markets, so critical to the Commission's mission, are claiming the forward contract exclusion: the unwatched back door out of the transparency-related requirements of the CEA.

2. Legal Certainty for Certain Commodity Options

Section 4c(b) of the CEA provides:

> No person shall offer to enter into, enter into or confirm the execution of, any transaction involving any commodity regulated under this chapter which is of the character of, or is commonly known to the trade as, an ''option'', "privilege'", ''indemnity'', ''bid'', ''offer'', ''put'', ''call'', ''advance guaranty'', or ''decline guaranty'', contrary to any rule, regulation, or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe. Any such order, rule, or regulation may be made only after notice and opportunity for hearing, and the Commission may set different terms and conditions for different markets.[8]

Through this decades-old provision, Congress gave the Commission jurisdiction and plenary rulemaking authority over physical commodity option transactions.[9] The Dodd-Frank Act not only preserved this plenary authority over commodity options, but also reaffirmed the reach of the CEA over commodity options. Section 721 of the Dodd-Frank Act added section 1a(47) to the CEA, defining "swap'' to include not only ''any agreement, contract, or transaction

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[8] CEA section 4c(b), 7 U.S.C. 6c(b).

[9] CEA section 4c(b) has been in the Act in substantially the same form since it was added by the Commodity Futures Trading Commission Act of 1974. See Public Law 93–463, October 23, 1974.

commonly known as,'' among other things, ''a commodity swap,''[10] but also ''[an] option of any kind that is for the purchase or sale, or based on the value, of 1 or more * * * commodities * * *''[11], i.e. commodity options.[12] While commodity options are subject to the Commission's plenary jurisdiction, the Commission has limited jurisdiction over forward contracts.[13]

In the Brent Interpretation, the Commission found certain Brent oil contracts to be eligible for the forward contract exclusion, notwithstanding the fact that such transactions "may ultimately result in performance through the payment of cash as an alternative to actual physical transfer or delivery of the commodity." The Commission found that when delivery obligations

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10 See CEA section 1a(47)(A)(iii), 7 U.S.C. 1a(47)(A)(iii).

11 See CEA section 1a(47)(A)(i), 7 U.S.C. 1a(47)(A)(i). Note that the swap definition excludes options on futures (which must be traded on a DCM pursuant to part 33 of the Commission's regulations) (see CEA section 1a(47)(B)(i), 7 U.S.C. 1a(47)(B)(i)), but it includes options on physical commodities (whether or not traded on a DCM) (see CEA section 1a(47)(A)(i), 7 U.S.C. 1a(47)(A)(i)).

12 The Commission's regulations define a commodity option transaction or commodity option as ''any transaction or agreement in interstate commerce which is or is held out to be of the character of, or is commonly known to the trade as, an 'option,' 'privilege,' 'indemnity,' 'bid,' 'offer,' 'call,' 'put,' 'advance guaranty' or 'decline guaranty'.'' 17 CFR 1.3(hh).

13 See CEA section 1a(47)(B)(ii), 7 U.S.C. 1a(47)(B)(ii) (excluding from the definition of "swap" contracts involving "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled."). See also CEA section 8(d), 7 U.S.C. 12(d), which directs the CFTC to investigate the marketing conditions of commodities and commodity products and byproducts, including supply and demand for these commodities, cost to the consumer, and handling and transportation charges; CEA sections 6(c), 6(d) and 9(a)(2), 7 U.S.C. 9, 13b, and 13(a)(2), which proscribe any manipulation or attempt to manipulate the price of any commodity in interstate commerce; and CEA section 6(c) as amended by section 753 of the Dodd-Frank Act, which contains prohibitions regarding manipulation and false reporting with respect to any commodity in interstate commerce, including prohibiting any person to (i) "use or employ, or attempt to use or employ . . . any manipulative or deceptive device or contrivance" (section 6(c)(1)); (ii) "to make any false or misleading statement of material fact" to the CFTC or "omit to state in any such statement any material fact that is necessary to make any statement of material fact made not misleading in any material respect" (section 6(c)(2)); and (iii) "manipulate or attempt to manipulate the price of any swap, or of any commodity in interstate commerce . . ." (section 6(c)(3)). See also Rule 180.1(a) under the CEA, 17 CFR 180.1(a) (broadly prohibiting in connection with a commodity in interstate commerce manipulation, false or misleading statements or omissions of material fact to the Commission, fraud or deceptive practices or courses of business, and false reporting).

under a forward were terminated pursuant to a separate and individually negotiated "book-out" agreement, the parties escaped the physical delivery obligation traditionally required to claim the forward contract exclusion. The Commission also emphasized two features (among others) of the Brent oil contracts at issue: (1) the absence of a contractual right to offset (or to terminate without delivery) the transaction "by the terms of the contracts as initially entered into" and (2) the counterparties had to incur "substantial economic risks of a commercial nature" relating to actual delivery in order to claim the exclusion. Underlying the Brent Interpretation, other CFTC precedent, and the Commission's approach to the interpretive guidance on the forward contract exclusion is the essential feature of forward contracts: actual delivery (and not potential delivery).[14]

The Commission has failed to provide adequate legal certainty to market participants engaging in contracts with embedded volumetric commodity options, particularly those that can terminate without physical delivery. Contracts that are composed of a forward delivery obligation component combined with an embedded commodity option that can render delivery optional ("zero-delivery" embedded volumetric options) are not forwards because the predominant feature of the contract cannot be actual delivery under these circumstances (more literally, the predominant feature is potential delivery which is an essential characteristic of commodity options). Such contracts include a contractual right to offset through the exercise of the volumetric option that can extinguish the delivery obligation. Because such contracts have a commodity option component that mitigates the risk incurred from an underlying forward delivery obligation, these contracts may fail to meet the incurring "economic risks of a commercial nature" element. Moreover, the purpose of the delivery optionality in these types of

[14] See Adopting Release.

contracts shares a common purpose with commodity options: to provide market participants a means to hedge commodity quantity risk of a commercial nature. The Commission should therefore clarify, in any future interpretive guidance, that zero-delivery embedded volumetric options are generally commodity options because the delivery obligation is not obligatory.

The confluence of these features, as analyzed under a conservative reading of the Brent Interpretation, leads me to conclude that contracts with embedded zero-delivery option components cannot be said to have actual delivery as their essential feature. Other relevant Commission precedent is consistent with this analysis. Most recently, in In re Wright, a forward contract containing pricing optionality was found to be a forward contract because the optionality:

> (i) May be used to adjust the forward 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.[15]

In re Wright is distinguishable because it involves pricing optionality, not volumetric optionality–the latter a feature the Commission has not hitherto opined on in the context of the forward contract exclusion. As the emphasized section of the block quote immediately above discusses, the interpretation there turned on the fact that the optionality in the In re Wright options did "not target the delivery term." Optionality that can result in zero delivery "targets the delivery term," in direct contrast to the In re Wright options. I commend the Commission for not overextending (to put it charitably) In re Wright to cover zero-delivery volumetric

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[15] See In re Wright, CFTC Docket No. 97-02, 2010 WL 4388247 (Oct. 25, 2010) (emphasis added). See also Characteristics Distinguishing Cash and Forward Contracts and ''Trade'' Options, 50 FR 39656 (Sept. 30, 1985) (finding that hedge-to-arrive contracts with pricing optionality could be categorized as forwards so long as it created a binding delivery obligation that could only be annulled in the event of a crop failure, in which case liquidated damages may apply).

optionality, as argued by some commenters. Nonetheless, the Commission did not clarify that a contract that provides for optionality that can render delivery optional cannot therefore have as its predominant feature actual delivery because the optionality "targets the delivery term."[16]

Instead of, in my opinion, a proper application of the statute and precedent, the Commission has adopted a seven-element interpretation that applies to contracts with embedded volumetric optionality. This interpretative approach would potentially allow contracts with zero-delivery option components to nonetheless claim the forward contract exclusion when:

1. the embedded optionality does not undermine the overall nature of the agreement, contract, or transaction as a forward contract;
2. the predominant feature of the agreement, contract, or transaction is actual delivery;
3. the embedded optionality cannot be severed and marketed separately from the overall agreement, contract, or transaction in which it is embedded;
4. the seller of a nonfinancial commodity underlying the agreement, contract, or transaction with embedded volumetric optionality intends, at the time it enters into the agreement, contract, or transaction, to deliver the underlying nonfinancial commodity if the optionality is exercised;
5. the buyer of a nonfinancial commodity underlying the agreement, contract or transaction with embedded volumetric optionality intends, at the time it enters into the agreement, contract, or transaction, to take delivery of the underlying nonfinancial commodity if it exercises the embedded volumetric optionality;

[16] In re Wright, CFTC Docket No. 97-02, 2010 WL 4388247 (Oct. 25, 2010).

6. both parties are commercial parties; and

7. the exercise or non-exercise of the embedded volumetric optionality is based primarily on physical factors, or regulatory requirements, that are outside the control of the parties and are influencing demand for, or supply of, the nonfinancial commodity.

The first two elements, in particular, invoke the Brent Interpretation and related precedent.[17] The seventh and most problematic element seems to imply that supply and demand, i.e., economic factors, could be a primary factor in the exercise or non-exercise of an embedded volumetric option. I fear how broadly this element could be interpreted by those predisposed to interpret the CEA in an opportunistic light. When can supply and demand factors not be correlated with physical factors? Does this mean that if delivery renders such a contract unprofitable for a party to such a contract that they can elect not to deliver? If that is the case, then the contract is a commodity option.[18]

I would amend the seventh element by making it clear the exercise or non-exercise for physical factors that influence demand and supply can negate the delivery obligation only in exceptional circumstances. If delivery renders a contract merely unprofitable and the contract permits a party to elect not to deliver, such a contract is not a forward and is a commodity option.

In addition, I would require, consistent with the third, "severability," element, that in order to claim the forward contract exclusion where the contract at issue contains a zero-delivery embedded volumetric option, the parties must sever the forward contract component, which has as its purpose the delivery of commodities, from the remaining commodity option component,

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[17] See Adopting Release.

[18] See, e.g., 50 FR 39656, 39660.

which has as its purpose the management of the commodity quantity risk associated with operating a commercial enterprise.[19] The commodity option component of these transactions could be eligible for a trade option exemption[20] that exempts (and importantly, does not exclude) them from many CEA requirements.[21]

Moreover, while the Adopting Release's guidance is the first of its kind and therefore an incremental step toward more legal certainty, it doesn't directly address embedded zero-delivery volumetric optionality specifically or any of the conceivable specific variations of such contracts. I believe this to be a flaw; a flaw that did not exist in a previous version of this document.

The Commission should affirm in any relevant future interpretive guidance the formal features in the Brent Interpretation's forward contract exclusion, e.g., that the delivery obligation cannot be offset based on terms contained in the contract, that any delivery obligation be appropriately booked-out (in a separate transaction), or that the contract involve incurring "substantial economic risks of a commercial nature."[22] In the absence of the Commission's courage to provide for more legal certainty on these kinds of transactions, I stress the application of the third, severability, element in the Commission's seven-element interpretation and note that

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19 These forward contract and commodity option hybrid contracts can, as I understand it, generally be severed into two separate forward and commodity option contracts. Some commenters suggested that many "peaking" contracts involve volumetric optionality that cannot be severed, but I have yet to be convinced that the same party that is the "seller" under these contracts cannot simply become the appropriate counterparty when such contracts are severed into a forward contract component and a commodity option component that can offset or book-out the buyer's obligation to take delivery.

20 Commodity Options, 77 FR 25320, Apr. 27, 2012, codified at 17 CFR 32.3.

21 As of July 10, 2012, the Commission has received 12 comments on the interim final rule setting forth the trade option exemption.

22 The Commission's inclusion of the underlying purpose of a transaction as a factor in determining its classification as a forward, commodity option, or other form of swap. The Commission will, under the interpretive guidance, consider the "purpose of the claimed forward" and whether its purpose is to sell physical commodities, hedge risk, or speculate. See Adopting Release.

as long as a market participant can decompose a pre-Dodd-Frank Act transaction into components, such action would not be in violation of the CEA if the resulting agreements, contracts, or transactions (1) neatly fall into forward, commodity option, or other swap contract buckets and (2) are dealt with as such.[23]

I look forward to receiving and reviewing comments on the Commission's interpretation, in particular those submitted in response to Question Seven.[24] I also welcome comments on this statement too, of course, particularly as it relates to zero-delivery embedded volumetric options. I am particularly interested in understanding under what circumstances such embedded option contracts and other contracts can be structured to evade Dodd-Frank Act requirements in a way that creates plausible deniability for one or both counterparties that they did not "willfully" intend to structure a transaction in a manner intended to evade. Should the Commission, instead of my proposed approach, follow a rebuttable presumption approach with respect to zero-delivery embedded option contracts whereby the presumption can be rebutted by a certification of facts that indicate a true commercial purpose for the transaction?

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23 See Adopting Release, fn 337 ("When a forward contract includes an embedded option that is severable from the forward contract, the forward can remain subject to the forward contract exclusion, if the parties document the severance of the embedded option component and the resulting transactions, i.e. a forward and an option. Such an option would be subject to the CFTC's regulations applicable to commodity options.").

24 Id. ("Do the agreements, contracts, and transactions listed in question no. 6 above have embedded optionality in the first instance? Based on descriptions by commenters, it appears that they may have a binding obligation for delivery, but have no set amount specified for delivery. Instead, delivery (including the possibility of nominal or zero delivery) is determined by the terms and conditions contained within the agreement, contract, or transaction (including, for example, the satisfaction of a condition precedent to delivery, such as a commodity price or temperature reaching a level specified in the agreement, contract, or transaction). That is, the variation in delivery is not driven by the exercise of embedded optionality by the parties. Do the agreements, contracts, and transactions listed in question no. 6 exhibit these kinds of characteristics? If so, should the CFTC consider them in some manner other than its forward interpretation? Why or why not?").