



## U.S. COMMODITY FUTURES TRADING COMMISSION

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### Office of the General Counsel

CFTC Letter No. 12-64  
No-Action  
December 21, 2012  
Office of the General Counsel

#### **Re: Time Limited No-Action Relief: Compo Equity Total Return Swaps**

Ladies and Gentlemen:

This letter responds to a request submitted by Davis Polk & Wardell LLP, on behalf of certain clients, addressed to the Division of Market Oversight of the Commodity Futures Trading Commission (“CFTC”), which has been referred to this Office.<sup>1</sup> The Davis Polk Letter requests relief from certain obligations under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) and related CFTC regulations applicable to a specific derivative product known as a compo equity total return swap. The Office of General Counsel (“OGC”) has determined to issue time-limited no-action relief through June 30, 2013, as described herein.

#### Background

In August 2010, the CFTC and the Securities and Exchange Commission (“SEC” and, together with the CFTC, the “Commissions”) jointly issued an advance notice of proposed rulemaking and request for public comment regarding “Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act.”<sup>2</sup> The Commissions considered comments received in response to the Definitions ANPRM when developing their joint proposed rules and proposed interpretations regarding “Further Definition of ‘Swap,’ ‘Security-Based Swap,’ and ‘Security-Based Swap Agreement’; Mixed Swaps; Security-Based Swap Agreement Recordkeeping.”<sup>3</sup> When discussing total return swaps in the Products NPRM, the Commissions stated,

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<sup>1</sup> See Letter from James T. Rothwell and Daniel N. Budofsky, Davis Polk & Wardwell LLP, to Richard Shilts, Director, Division of Market Oversight of the Commission, Dec. 5, 2012, available on the CFTC’s website at [http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=59004&SearchText=\(“Davis Polk Letter”\)](http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=59004&SearchText=(“Davis Polk Letter”)). The Davis Polk Letter was submitted on behalf of Barclays Bank PLC; Citibank NA; Credit Suisse; Deutsche Bank AG; Goldman, Sachs & Co.; JPMorgan Chase Bank, N.A.; Morgan Stanley; and UBS AG.

<sup>2</sup> 75 FR 51429, Aug. 20, 2010 (“Definitions ANPRM”).

<sup>3</sup> 76 FR 29818, May 23, 2011 (“Products NPRM”).

The Commissions believe that when . . . interest rate payments act merely as a financing component in a [total return swap], or in any other security-based swap, the inclusion of such interest rate terms would not cause the security-based swap to be characterized as a mixed swap. . . . However, the Commissions note that 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 additional elements may cause the security-based swap to be a mixed swap.<sup>4</sup>

In a request for public comment in the Products NPRM, the Commissions asked,

78. Do market participants embed foreign currency swaps into a foreign currency payment component of a [total return swap]? If so, how frequently and for what purpose?<sup>5</sup>

The Securities Industry and Financial Markets Association (“SIFMA”) submitted a comment letter stating, among other things, its belief that “terms of a total return swap (“TRS”) that create interest rate or currency exposures incidental to the swap should not cause a transaction that otherwise would be deemed to be [a security-based swap] to be characterized as a mixed swap . . . .<sup>6</sup> The SIFMA Letter cited a quanto equity swap as an example “where a TRS can provide for some interest rate or currency exposure that is incidental to the primary purpose of the TRS.”<sup>7</sup> Subsequently, CFTC staff participated in a telephone conference with SIFMA and others during which SIFMA’s comment regarding total return equity swaps, including quanto and compo equity swaps, was discussed.<sup>8</sup>

In August 2012, the Commissions jointly published final rules and interpretations under the Commodity Exchange Act (“CEA”) and the Securities Exchange Act of 1934 (“Exchange Act”) to, among other things, further define the terms “swap,” “security-based swap,” and “security-based swap agreement,” and to address “mixed swaps.”<sup>9</sup> In the Product Definitions Adopting Release, in response to the SIFMA comments, the Commissions interpreted quanto

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<sup>4</sup> Id. at 29842 (footnote omitted).

<sup>5</sup> Id. at 29843.

<sup>6</sup> Letter from Kenneth E. Bentsen, Jr., Executive Vice President, Public Policy and Advocacy, SIFMA, Jul. 22, 2011 (“SIFMA Letter”), available on the CFTC’s website at <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47928&SearchText>, at 2.

<sup>7</sup> Id. at 7.

<sup>8</sup> See Call with SIFMA regarding equity TRS, Ex Parte No: 459, Nov. 30, 2011, available on the CFTC’s website at <http://comments.cftc.gov/PublicComments/ViewExParte.aspx?id=459&SearchText>.

<sup>9</sup> See Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement;” Mixed Swaps; Security-Based Swap Agreement Recordkeeping,” 77 FR 48208, Aug. 13, 2012 (“Product Definitions Adopting Release”).

equity swaps to be security-based swaps where certain conditions are satisfied.<sup>10</sup> “[F]or illustrative purposes,”<sup>11</sup> the Commissions also interpreted compo equity swaps, “a similar but contrasting product,”<sup>12</sup> to be mixed swaps because the Commissions determined that “the currency exposure obtained via a compo equity swap is not incidental to the equity exposure for purposes of determining mixed swap status.”<sup>13</sup>

### Requests for Relief

After the effective date of the regulations and interpretations contained in the Product Definitions Adopting Release, several financial institutions (“Dealers”) informed staff of the Commissions that they had believed that all foreign equity total return swaps on single securities or narrow-based indices would be security-based swaps, subject solely to the jurisdiction of the SEC; they further advised that the market was surprised by the Commissions’ interpretation treating compo equity swaps as mixed swaps. The Davis Polk Letter represents that “[t]he classification of compo equity total return swaps as mixed swaps will have very significant short-term consequences for both sell-side and buy-side market participants.”<sup>14</sup> It states: “The Dealers estimate that ‘compo’ swaps on non-U.S. dollar denominated stocks represent 15-20% of the total market for equity total return swaps transacted with U.S. persons. By contrast, ‘quanto’ swaps represent significantly less than 1% of the market.”<sup>15</sup>

The Dealers represent that the Commissions’ interpretation regarding compo equity swaps, which they represent they did not expect, has complicated their plans to reorganize their businesses to comply with the new registration, recordkeeping, reporting, and business conduct requirements under the Dodd-Frank Act. The Dealers assert that their clients also were caught unawares by the Commissions’ interpretation and had not anticipated that they might have to register with the CFTC, and comply with the CFTC’s regulations regarding swaps, as a result of entering into compo equity swaps. The Davis Polk Letter further represents that: i) “[b]uilding the necessary infrastructure . . . on the timetable required for compliance with the CFTC’s rules would be extremely difficult;” and ii) “without additional time to prepare for such registration and such treatment [of compo equity swaps as mixed swaps, certain] entities will be precluded from conducting their businesses as planned, resulting in a significant disruption of the market for foreign equity total return swaps.”<sup>16</sup> The CFTC also has received comments describing the

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<sup>10</sup> Id. at 48265. Descriptions of the quanto equity swap and compo equity swap products can be found in the materials cited in footnotes 654 and 658, respectively, of the Product Definitions Adopting Release.

<sup>11</sup> Id. at 48265.

<sup>12</sup> Id.

<sup>13</sup> Id. at 48265-6.

<sup>14</sup> Davis Polk Letter at 3.

<sup>15</sup> Id.

<sup>16</sup> Id. at 3, 4.

details of the compo equity total return swap product and arguing that it should be treated the same way as a quanto equity swap.<sup>17</sup>

#### Time-Limited No-Action Relief

Based on the Dealers' representations regarding the difficulty of complying with the CFTC's compliance timetables with respect to compo equity total return swaps, OGC has determined that time-limited no-action relief is appropriate. Accordingly, before July 1, 2013, OGC will not recommend that the CFTC commence enforcement action against any person in connection with any failure of such person to comply with any provision of the Dodd-Frank Act or the rules promulgated thereunder (other than those relating to the Commission's anti-fraud and anti-manipulation authority) to the extent such failure arises solely because such person treats a compo equity total return swap solely as a security-based swap and not as a mixed swap.

As a condition to reliance upon this no-action position, market participants shall act reasonably and in good faith in progressing to full compliance with all CEA requirements and CFTC regulations applicable to mixed swaps with respect to compo equity total return swaps by July 1, 2013.<sup>18</sup> Despite the no-action position taken herein expiring on a certain future date, affected persons are required to come into full compliance with the CEA and the CFTC's regulations with respect to compo equity total return swaps as soon as the technical and operational issues preventing timely compliance have been resolved, even if such resolution occurs prior to such future expiration date. During the pendency of the no-action period, and prior to reporting compo equity total return swap transaction data records to a swap data repository, affected persons must retain records with respect to all transactions covered by this no-action position and make such records available to the Commission for inspection and production immediately upon request to the extent provided in and in accordance with applicable law, rule, or regulation.

This letter, and the positions taken herein, represent the views of OGC only, and do not necessarily represent the position or view of the CFTC or of any other office or division of the CFTC. The relief issued by this letter applies only to compo equity total return swaps. The relief issued by this letter does not excuse affected persons from compliance with any other applicable requirements contained in the CEA or in the CFTC's regulations issued thereunder. Further, this letter, and the relief contained herein, is based upon the representations and information provided to OGC. Any different or changed material facts or circumstances might render this letter void. As with all no-action letters, OGC retains the authority to condition

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<sup>17</sup> See, e.g., letter from Ilene Froom, Jones Day, Dec. 4, 2012, available on the CFTC's website at <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58970&SearchText=>.

<sup>18</sup> This includes the reporting of historical and transition swaps, entered into prior to July 1, 2013, pursuant to part 46 of the Commission's regulations. As of July 1, 2013, compo equity swap activities from October 12, 2012 through June 30, 2013 count in determining whether de minimis or other thresholds have been exceeded for swap dealer, major swap participant, commodity pool operator or other registration purposes.

further, modify, suspend, terminate, or otherwise restrict the terms of the no-action relief provided herein, in its discretion.

Should you have any questions, please do not hesitate to contact Terry Arbit, Deputy General Counsel ([tarbit@cftc.gov](mailto:tarbit@cftc.gov); 202-418-5357); Lee Ann Duffy, Assistant General Counsel ([lduffy@cftc.gov](mailto:lduffy@cftc.gov); 202-418-6763); or David Aron, Counsel ([daron@cftc.gov](mailto:daron@cftc.gov); 202-418-6621).

Very truly yours,

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General Counsel

cc: Regina Thoele, Compliance  
National Futures Association, Chicago