



Commodity Futures Trading Commission

Office of Public Affairs

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Proposed Rules and Interpretive Guidance i) Further Defining “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; ii) Regarding “Mixed Swaps”; and iii) Governing Books and Records for “Security-Based Swap Agreements”

The Commodity Futures Trading Commission (“Commission”) is proposing rules and interpretative guidance i) to further define the terms “swap,” “security-based swap,” and “security-based swap agreement”; ii) prescribing regulations regarding “mixed swaps”; and iii) governing books and records for “security-based swap agreements.” This is a joint rulemaking with the Securities and Exchange Commission (“SEC”).

Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)

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 Commission 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.

Definition of “Swap” and “Security-Based Swap”

The Commissions believe that the definitions of “swap” and “security-based swap” in Title VII are detailed and comprehensive. Several commenters to an Advance Notice of Proposed Rulemaking regarding the definitions that the Commissions issued last summer expressed concern that the definitions could be read broadly to include certain types of transactions that previously had not been considered swaps or security-based swaps. In response to those comments, the Commissions are clarifying in the proposed rules and interpretive guidance that certain insurance products, consumer and commercial agreements, and loan participations are not swaps or security-based swaps.

Transactions that are Not Swaps or Security-Based Swaps

Insurance

The Commissions are proposing rules and interpretive guidance that would clarify that certain contracts, and the entity providing them, meeting certain specified requirements would be considered insurance and not swaps or security-based swaps.

- Requirements for the Contract
 - the beneficiary must have an insurable interest that is the subject of the contract and thereby bear the risk of loss with respect to that interest continuously throughout the duration of the contract;
 - the loss must occur and be proved;
 - any payment or indemnification for loss must be limited to the value of the insurable interest;
 - the contract must not be 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 a payment default or insolvency of the obligor, any acceleration of payments under the policy must be at the sole discretion of the insurer.
- The Person or Entity Providing the Contract Must be One of the following:
 - a company organized as an insurance company whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies and that is subject to supervision by the insurance commissioner of any state or by the United States or an agency or instrumentality thereof, and the contract is regulated as insurance under the laws of such state or the United States;
 - the United States or any of its agencies or instrumentalities, or by any person pursuant to a statutorily authorized program thereof; or
 - in the case of reinsurance only, a person located outside the United States providing the contract to an insurance company eligible under the proposed rules, provided that: i) such person outside the United States is not prohibited by any law of any state or of the United States from offering such contract to such an insurance company; ii) the product to be reinsured meets the requirements under the proposed rules to be an insurance product; and iii) the total amount reimbursable by all reinsurers for the insurance product cannot exceed the claims or losses paid by the cedant.

The proposed guidance provides that certain types of products, irrespective of whether they meet these requirements, are insurance and not swaps or security-based swaps if offered by a regulated insurance company. These products are surety bonds, life insurance, health insurance, long-term care insurance, title insurance, property and casualty insurance, and annuity products the income on which is subject to tax treatment under Section 72 of the Internal Revenue Code.

Consumer and Commercial Transactions

The Commissions are proposing interpretive guidance that certain 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.

- Consumer Transactions: Transactions entered into by consumers (natural persons or their agents) as principals primarily for personal, family or household purposes that would not be considered swaps or security-based swaps under the proposed interpretive guidance include:
 - 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);

- 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 by the consumer only if the loan or mortgage is made thereto; and
 - consumer loans or mortgages with variable rates of interest, 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.
- **Commercial Transactions:** The types of commercial transactions that involve customary business arrangements (whether or not involving a for-profit entity) that would not be considered swaps or security-based swaps under the proposed interpretive guidance include:
 - employment contracts and retirement benefit arrangements;
 - sales, servicing, or distribution arrangements;
 - transactions for the purpose of effecting a business combination transaction;
 - 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);
 - mortgage or mortgage purchase commitments, or sales of installment loan agreements or contracts or receivables;
 - fixed or variable interest rate commercial loans entered into by non-banks; and
 - commercial 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.

The proposed guidance includes factors that the Commissions will consider in determining whether other consumer and commercial transactions that are not specifically listed should be considered swaps or security-based swaps.

Loan Participations

Loan participations are not swaps or security-based swaps if the purchaser is acquiring a current or future direct or indirect ownership interest in the related loan and they are “true participations,” as discussed in the release.

Forward Exclusion from the Swap Definition for Nonfinancial Commodities

The CFTC is proposing interpretive guidance clarifying the scope of the forward contract exclusion for nonfinancial commodities that is included in the statutory swap definition.

- The proposed guidance provides that the forward exclusion in nonfinancial commodities should be interpreted in a manner consistent with the CFTC’s historical interpretation of the existing forward exclusion with respect to futures contracts.
- The principles underlying the CFTC’s “Brent Interpretation” regarding “book-outs” transactions also would apply to the forward exclusion from the swap definition for nonfinancial commodities. Market participants that regularly make or take delivery of the referenced commodity in the ordinary course of their business, where the book-out transaction is effectuated through a subsequent, separately negotiated agreement, should qualify for the forward exclusion from the swap definition.
- CFTC’s 1993 Energy Exemption would be withdrawn as no longer necessary in light of the extension of the Brent Interpretation to nonfinancial commodities.
- Options embedded in forwards would also be treated consistently with the CFTC’s prior interpretations.

Transactions That Are Swaps or Security-Based Swaps

The Commissions are proposing rules and interpretive guidance clarifying that certain types of transactions are within the scope of the definitions of swap and security-based swap.

Proposed Rule That Certain Transactions are Swaps:

- Foreign Exchange (“FX”) Forwards and FX Swaps:
 - These products are defined as swaps, subject to a determination by the Secretary of the Treasury, as permitted under Title VII, to exempt them.
 - If exempted by Treasury, the proposed rules reflect the provision of the statute that certain requirements will continue to apply, including reporting and business conduct standards.
- FX Products that are outside Treasury’s determination and are swaps (unless otherwise excluded in the statute):
 - Foreign Currency Options
 - Non-Deliverable Forwards in Foreign Exchange
 - Currency Swaps and Cross-Currency Swaps
- Forward Rate Agreements, notwithstanding their “forward” label, are swaps (unless otherwise excluded in the statute).

Proposed Interpretive guidance that options on swaps, forward swaps and certain contracts for differences are swaps or security-based swaps.

Relationship Between Swaps and Security-Based Swaps

The Commissions are proposing interpretive guidance to clarify 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 the release) are swaps, security-based swaps or both (i.e., mixed swaps).

General principles

- The proposed guidance provides that the determination of whether a Title VII Instrument is a swap, security-based swap or mixed swap, is made at the inception of the instrument.
- That characterization remains the same throughout the life of the instrument (unless the instrument is amended or modified in a material respect).

Interest Rates, Other Monetary Rates and Yields

- Title VII Instruments on interest rates and other monetary rates (including interbank offered rates, money market rates, government target rates, general lending rates, rates from indexes, and other monetary rates) are swaps.
- Title VII Instruments on “yields,” where “yield” is a proxy for the price or value of a debt security, loan or narrow-based security index are security-based swaps, except in the case of certain government debt obligations.
- Government Debt Obligations
 - Title VII Instruments on rates or yields of U.S. Treasuries and other exempted securities (other than municipal securities) are swaps and are not security-based swaps.

Total Return Swaps (“TRS”)

- A TRS on a single security, loan, or narrow-based security index generally would be a security-based swap.
- Where counterparties embed interest-rate optionality or a non-securities component into the TRS (e.g., the price of oil, a currency hedge), it would be a mixed swap.

Title VII Instruments Based on Futures

- Generally, Title VII Instruments on futures are swaps; Title VII Instruments on security futures are security-based swaps.
- The CFTC and SEC request comment on how to treat Title VII Instruments on futures on foreign sovereign debt exempted by the SEC for purposes of futures trading.

The Terms “Narrow-Based Security Index” and “Issuers of Securities in a Narrow-Based Security Index” in the Security-Based Swap Definition

The Commissions are proposing rules and interpretive guidance to address several issues regarding the terms “narrow-based security index” and “issuers of securities in a narrow-based security index” in the security-based swap definition, including: i) the applicability of past guidance of the Commissions regarding criteria for distinguishing broad from narrow-based security indexes to Title VII Instruments; ii) 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; iii) the meaning of the term “index”; iv) a tolerance period rule governing Title VII Instruments traded on trading platforms where the security index temporarily moves from broad-based to narrow-based or vice versa ; and v) a grace period rule governing Title VII Instruments on trading platforms where the security index moves from broad-based to narrow-based or vice versa and the move is not temporary. These issues are addressed as follows:

- The statutory definition, as well as past guidance of the CFTC/SEC in the context of security futures regarding volatility and debt indexes, applies to swaps and security-based swaps.
- Index CDS
 - The Commissions are proposing a new test for determining whether an index underlying an index CDS is broad or narrow, building on the 2006 joint SEC/CFTC rules for debt indexes, but tailored to index CDS.
- Security Indexes/Portfolios
 - Where parties to a Title VII Instrument directly/indirectly have discretion to change the composition/weighting of securities in a portfolio, the Title VII Instrument is a security-based swap.
 - Where there is an underlying security index for which there are predetermined criteria or a self-executing formula for adjusting the security index that is not subject to change/modification, a Title VII instrument on the index would be a swap or security-based swap depending on composition/weighting of the index, unless the predetermined criteria or self-executing formula would cause the index to become narrow-based or vice-versa, in which case it would be a mixed swap.
- Indexes That “Migrate” from Broad to Narrow or Vice Versa
 - The rule that the determination of a Title VII Instrument as a swap or security-based swap is made at inception and does not change throughout its life applies to Title VII Instruments based on indexes of securities, regardless of whether the Title VII Instrument was entered into bilaterally or was executed through a trade on an exchange.
 - Where pre-existing criteria or formula for a broad-based portfolio underlying a Title VII Instrument would cause it to become narrow-based or vice versa, the Title VII Instrument would be a “mixed swap.”
 - Proposed rules regarding Title VII Instruments on trading platforms provide the following –
 - A market participant who enters into a Title VII Instrument on a trading platform on a broad-based or narrow-based security index that migrates from broad-based to narrow-based

or vice versa may hold that position until the expiration of the instrument, without any change in regulatory responsibilities, requirements, or obligations.

- In order to avoid market disruption, where market participants seek to offset or enter into new swaps (or security-based swaps) where the underlying index has migrated from broad to narrow (or vice versa), the tolerance period and grace period rules applicable to futures trading would apply.
- Settlement of Broad-Based Index CDS
 - If a broad-based index CDS requires mandatory physical settlement, it would be a mixed swap.
 - If a broad-based index CDS requires cash settlement or auction settlement, it would be a swap, and would 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.

Mixed Swaps

Mixed swaps are both swaps and security-based swaps. In the proposal, the Commissions state the belief that the scope of the mixed swap definition is, and is intended to be, narrow. The Commissions also propose two rules regarding the regulation of mixed swaps:

- The first proposed rule would provide a regulatory framework with which parties to bilateral uncleared mixed swaps, where at least one of the parties is dually registered with both Commissions, would need to comply. Under the proposed rule, in order to facilitate the trading of these instruments in appropriate circumstances, certain key provisions of the CEA and related CFTC rules as well as the requirements of the federal securities laws would apply to such mixed swaps.
- For all other mixed swaps, the second proposed rule would establish a process for persons to request that the Commissions issue a joint order permitting such persons (and any other person that subsequently lists, trades, or clears that class of mixed swap) to comply, as to parallel provisions only, with specified parallel provisions of either the CEA or the Exchange Act, and related rules and regulations, instead of being required to comply with parallel provisions of both the CEA and the Exchange Act.

Security-Based Swap Agreements

Security-based swap agreements (“SBSAs”) are swaps involving securities over which the CFTC has regulatory and enforcement authority, but for which the SEC also has antifraud and certain other authority. The Commissions are providing guidance regarding the types of products that are SBSAs, which include:

- Swaps on broad-based security indexes; and
- Swaps on exempted securities (other than municipal securities), such as U.S. Treasuries.

The Dodd-Frank Act requires that the Commissions adopt rules regarding books and records requirements for SBSAs. The CFTC has proposed, prior to today, rules governing books and records for swaps, which would apply to swaps that also are SBSAs. The Commissions do not believe that additional books and records requirements are necessary for SBSAs. The Commissions therefore are proposing rules to clarify that there would not be additional books and records requirements regarding SBSAs other than those that the CFTC has proposed for swaps.

Process for Requesting Interpretations Re. Swaps, Security-Based Swaps and Mixed Swaps

The Commissions are proposing rules instituting a process for interested persons to request a joint interpretation by the Commissions regarding whether a particular Title VII instrument (or class of Title VII instruments) is a swap, a

security-based swap, or a mixed swap. The process is modeled on the statutory process for novel derivative products contained in Section 718 of the Dodd-Frank Act.

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.

Anti-Evasion

Pursuant to authority granted in the Dodd-Frank Act, the CFTC is proposing a rule that would define as swaps those transactions that are willfully structured to evade the provisions of Title VII governing the regulation of swaps.

Specific provisions would apply in similar fashion to currency and interest rate swaps that are willfully structured as foreign exchange forwards or foreign exchange swaps to fall within a determination by the Secretary of Treasury to exempt such products, and to products of a bank that is not under the regulatory jurisdiction of an appropriate Federal banking agency and that are willfully structured as identified banking products to evade the new regulatory regime for swaps.

The Dodd-Frank Act also gives the CFTC authority to prevent evasion of Title VII that occurs outside of the United States. The CFTC is proposing rules to address this potential evasion of Title VII as well.