



Commodity Futures Trading Commission

Office of Public Affairs

Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581
www.cftc.gov

Q & A – Final Rules and Interpretations 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”

What is the purpose of the final rulemaking?

To: i) further define certain terms; ii) provide for the regulation of mixed swaps; and iii) adopt specified books and records rules. The final rulemaking includes proposed rules and interpretive guidance regarding the terms “swap,” “security-based swap,” and “security-based swap agreement,” which the Dodd-Frank Act requires the Commission and the SEC, in consultation with the Federal Reserve Board, to jointly further define. In addition, the statute provides that the Commissions shall jointly prescribe regulations regarding “mixed swaps” as are necessary to carry out the purposes of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), and to jointly adopt rules governing books and records requirements for “security-based swap agreements.”

What is included in the “swap” definition?

The statutory definition of “swap” is detailed and comprehensive. It includes, for example, interest rate swaps, commodity swaps, currency swaps, equity swaps and credit default swaps. To avoid confusion in certain areas, the Commissions are adopting rules and interpretations to clarify that a few types of transactions in particular are swaps. These include foreign exchange swaps and forwards (for further information, see questions about foreign exchange forwards and swaps below), foreign currency options, commodity options, non-deliverable forwards in foreign exchange, cross-currency swaps, forward rate agreements, contracts for differences, options to enter into swaps and forward swaps.

What is not included in the swap definition?

The Commissions are clarifying in their final rules and interpretations that certain types of products or transactions that could be covered by an expansive reading of the swap definition, but that traditionally have not been considered to be swaps, are not swaps. These products and transactions include traditional insurance products that meet certain criteria, certain consumer and commercial arrangements, and certain loan participations.

Are insurance policies swaps?

Insurance products that satisfy requirements specified in the final rules are not swaps or security-based swaps. The final rules include requirements for the product (the Product Test) and for the provider of the product (the Provider Test). In addition, the Commissions are further defining certain traditional insurance products, such as life insurance and property and casualty insurance, as not within the swap and security-based swap definitions, provided they are offered by persons who meet the Provider Test. The Commissions are clarifying that these rules are a “safe harbor,” meaning that just because a particular contract fails the requirements in the final rules, that does not necessarily mean the contract is a swap or security based swap; it will be evaluated under the facts and circumstances.

Will existing insurance contracts be considered swaps?

The Commissions are including a “grandfather” provision in the final rules, such that if a contract that was entered into on or before the effective date of the final rules, and it is offered in accordance with the requirements of the Provider Test in the final rules, the contract will not be considered a swap or security-based swap.

Are annuities swaps?

If the annuity is offered through a provider that meets the requirements of the Provider Test in the final rules, it will meet the requirements of the safe harbor and will not be considered a swap or security-based swap. In response to commenters, the Commissions are not including a requirement that annuities be subject to certain tax treatment under the Internal Revenue Code that was contained in the Proposing Release.

How is the CFTC going to interpret the forward exclusion from the swap definition and to treat commodity options embedded in forward contracts?

The swap definition in the Dodd-Frank Act excludes forward contracts in nonfinancial commodities. The CFTC is issuing an interpretation that this forward exclusion will be interpreted in a manner that is consistent with the CFTC’s historical interpretation of the existing forward contract exclusion with respect to futures contracts. In response to commenters, the CFTC is clarifying a number of issues:

- Providing guidance regarding nonfinancial commodities as commodities that may be physically delivered and are exempt or agricultural commodities, and regarding environmental commodities (e.g. offsets, allowances, and RECs) that they are nonfinancial commodities eligible for the forward exclusion from the swap definition.
- Although withdrawing the Energy Exemption, CFTC is clarifying that the alternative delivery procedures (netting, etc.) mentioned therein continue to apply.
- Providing guidance regarding forward with embedded volumetric optionality: Commenters in the energy industry asserted that many of their transactions contain volumetric optionality and should be considered forwards, while prior CFTC guidance restated in the proposal covered price optionality only. If among other things the volumetric optionality is due to physical factors or regulatory requirements beyond the control of the parties, the agreement, contract or transaction may qualify for the forward exclusions from the swap and future delivery definitions. The CFTC is requesting comment on its forwards with volumetric optionality interpretation.
- Providing guidance that certain contract provisions do not disqualify transactions for the forward exclusion (liquidated damages, renewal/evergreen provisions).
- Providing guidance regarding certain types of arrangements as described in the release, fuel delivery agreements and physical exchange transactions, that are not swaps.
- Providing guidance regarding certain physical commercial arrangements that are similar to leases that they are not options and may qualify for the forward exclusions under the facts and circumstances.
- Providing guidance regarding energy management agreements that such agreements do not alter the nature of the transactions conducted under them.

Do transactions that are “booked out” qualify for the forward exclusion from the swap definition?

The final release provides that “booked-out” transactions in nonfinancial commodities that are entered into by commercial participants in connection with their business, that meet the requirements specified in the Commission’s Brent Interpretation regarding forwards, and that are effectuated through a subsequent, separately-negotiated agreement, would qualify for the forward exclusion from the swap and future delivery definitions. The release also clarifies in response to a commenter that oral book-outs are permissible if they are followed in a commercially reasonable timeframe by a confirmation in some type of written or electronic form.

Are loan participations swaps?

The Commissions do not interpret the swap or security-based swap definitions to include loan participations in which the purchaser is acquiring a current or future direct or indirect ownership interest in the related loan or commitment that is the subject of the loan participation, and certain other conditions specified in the release are met. In response to commenters, the

Commissions are not including the requirement that the loan participation be a “true participation” as was stated in the Proposing Release. Depending on the facts and circumstances, a loan participation may be a security regulated by the SEC, or an identified banking product that, if offered by a bank, would be subject to the jurisdiction of the Federal bank regulatory agencies.

If the Treasury Secretary determines to exempt Foreign Exchange Forwards and Swaps from the swap definition, are there any regulatory requirements applicable to them under the Commodity Exchange Act (CEA)?

Yes. Under the Dodd-Frank Act, even if the Secretary of the Treasury determines that foreign exchange forwards or foreign exchange swaps should not be regulated as swaps, they still would be subject to swap reporting requirements (to a swap data repository, if available, or otherwise to the CFTC). Also, swap dealers and major swap participants engaging in foreign exchange forwards or foreign exchange swaps will still be subject to certain business conduct standards with respect to such transactions.

Are there other foreign exchange products that remain subject to the CEA?

Yes. All foreign exchange products that meet the swap definition, and are not foreign exchange forwards or foreign exchange swaps, remain subject to the CEA even if the Treasury Secretary exempts foreign exchange swaps and foreign exchange forwards. These products that remain subject to the CEA include foreign currency options (including those on foreign exchange forwards or foreign exchange swaps), non-deliverable forward contracts involving foreign exchange, currency swaps and cross-currency swaps.

How are transactions in regional transmission organizations (“RTOs”) and independent system operators (“ISOs”) treated?

Section 722 of the Dodd-Frank Act specifically addresses how the CFTC should approach products regulated by the Federal Energy Regulatory Commission (“FERC”) that also may be subject to CFTC jurisdiction. It permits the CFTC to exempt certain FERC-regulated instruments or other specified electricity transactions if the CFTC finds that such an exemption would be in the public interest. The release states that the treatment of these products will be considered under this public interest waiver process, rather than through this joint rulemaking to further define the term “swap.”

Have the Commissions distinguished between transactions that would be swaps regulated by the CFTC and transactions that would be security-based swaps regulated by the SEC?

Yes. The final release refers to swaps and security-based swap collectively as “Title VII instruments.” The classification of a Title VII instrument as a swap or a security-based swap generally is to be made prior to execution, but no later than when an offer is made to enter into the Title VII instrument. The final release identifies Title VII instruments based on a variety of specific types of interest and other monetary rates as swaps regulated by the CFTC, and Title VII instruments based on 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 price, as security-based swaps regulated by the SEC. It also addresses the appropriate classification of Title VII instruments based on government debt obligations and futures contracts.

Are Total Return Swaps (“TRS”) based on securities security-based swaps?

A TRS based on a single security or loan or on a narrow-based security index generally would be a security-based swap regulated by the SEC. However, if the TRS embeds interest-rate optionality (e.g., a cap, collar, call, or put) to shift or limit interest rate exposure, the inclusion of these terms would cause the TRS to be a mixed swap. Similarly, if a TRS also is based on non-security-based components (such as the price of oil, or a currency), it would be a mixed swap. Under the Dodd-Frank Act, a TRS based on a broad-based security index would be a swap regulated by the CFTC. A TRS on two or more loans likewise would be a swap subject to CFTC regulation.

Who regulates credit default swaps (CDS)?

The SEC regulates CDS on single names, loans and narrow-based security indexes. The CFTC regulates CDS based on broad-based security indexes. The Commissions are issuing detailed and objective rules to distinguish broad from narrow-based security indexes for purposes of CDS. These rules are similar to rules that the Commissions previously have issued with respect to debt security indexes, but tailored to index CDS in particular. The rules also address circumstances in which indexes migrate from broad-based to narrow-based, or vice versa.

What is a “mixed swap” and how will it be regulated?

A mixed swap is a transaction that is both a swap and a security-based swap. In order to facilitate the trading of these instruments in appropriate circumstances, the final rules provide that bilateral, uncleared mixed swaps, where one of the counterparties is dually registered as a dealer or major participant with both the CFTC and also with the SEC, will be subject to certain key provisions of the CEA and related CFTC rules as well as the requirements of the federal securities laws. For all other mixed swaps, the Commissions are issuing rules establishing a process whereby a person who desires or intends to list, trade, or clear such a mixed swap (or class thereof) can ask the agencies for a joint order providing for the regulation of the mixed swap pursuant to specified provisions of the CEA and/or the Securities Exchange Act of 1934 (“Exchange Act”). Absent such a joint order, the Dodd-Frank Act provides that such mixed swaps would be required to comply with parallel provisions of both the CEA and the Exchange Act.

If I don’t know whether a particular transaction is a swap, security-based swap, or mixed swap, is there a process by which I may request an interpretation from the Commissions?

Yes. Under the final rules, any person may submit a request to the CFTC and the SEC to provide a joint interpretation of whether a particular agreement, contract, or transaction (or class thereof) is a swap, security-based swap or mixed swap. In making a request, the requesting party must provide: all material information; a statement of the economic characteristics and purpose of the transaction; the requesting party’s determination as to whether the transaction should be characterized as a swap, a security-based swap, or a mixed swap and the basis for such determination; and any other information requested by either agency.

How long will it take to obtain such an interpretation?

If the Commissions determine to issue a joint interpretation, under the final rules it must be issued within 120 days after receipt of a complete submission requesting a joint interpretation. The Commissions may seek public comment with respect to such a joint interpretation; if they do, the 120-day deadline will be stayed during the comment period, but will recommence the business day after the public comment period ends. If the Commissions do not issue a joint interpretation within the prescribed time period, the rules require each Commission to publicly provide the reasons for not having done so.

What is a “security-based swap agreement” (“SBSA”)?

SBSAs are a type of swap related to securities over which the CFTC has full regulatory and enforcement authority under the Dodd-Frank Act, and where the SEC also has certain enforcement authority and access to information from certain CFTC regulated entities. SBSAs include swaps based on broad-based security indexes and certain exempted securities, such as U.S. Treasury bonds.

What books and records requirements apply to SBSAs?

The CFTC and SEC are issuing final rules stating that none of the following registrants would be required to keep additional books and records, including daily trading records, regarding SBSAs beyond the books and records that the CFTC is already requiring regarding swaps: swap dealers; major swap participants; security-based swap dealers; and major security-based swap participants. Similarly, swap data repositories would not be required to collect additional data or keep additional data or books and records regarding SBSAs beyond the books and records, and data, that the CFTC is requiring regarding swaps.

Do the final rules discuss the statutory provisions that address efforts to evade the swap-related requirements of the Dodd-Frank Act?

Yes. The CFTC is adopting rules to exercise the anti-evasion authority provided under the Dodd-Frank Act. The rules do not attempt to draw a bright line regarding what constitutes evasion, but rather provide that transactions that are willfully structured to evade the requirements of the Dodd-Frank Act will be treated as swaps. Interpretations also are provided with respect to certain types of circumstances that may, and may not, constitute evasion.