The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 26360

August 1, 2012

CFTC and SEC Adopt Further Definition of "Swap" and "Security-Based Swap"

[26360]

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 50-12
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 39-12
INVESTMENT ADVISER MEMBERS No. 23-12
SEC RULES MEMBERS No. 71-12
VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 10-12 RE: CFTC AND SEC ADOPT FURTHER DEFINITION OF "SWAP" AND "SECURITY-BASED SWAP"

The Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") jointly adopted new rules and interpretations to further define the terms "swap," "security-based swap" ("SB swap"), and "security-based swap agreement" ("SBSA") pursuant to section 712(d)(1) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). [1] Specifically, the CFTC and the SEC ("Commissions") adopted rules and interpretations regarding, among others, (1) the regulatory treatment of insurance products, consumer and commercial contracts, and certain foreign-exchange related and other instruments; (2) the scope of the exclusion of forward contracts from the swap and SB swap definitions; (3) the classification of swaps and SB swaps involving interest rates (or other monetary rates) and yields; (4) total return swaps; (5) swaps and SB swaps based on futures contracts; (6) the use of the definition of "narrow-based security index" in distinguishing between certain swaps and SB swaps, including credit-default swaps ("CDS") and index CDS; and (7) the scope of mixed swaps and the regulation of mixed swaps. Moreover, the Commissions adopted rules to clarify that there will be no additional books and records requirements applicable to SBSAs other than those required for swaps. The Commissions also adopted rules to provide a mechanism for requesting from the Commissions an interpretation regarding whether a particular type of agreement, contract or transaction is a swap, SB swap or a mixed swap and on the applicability of certain regulatory requirements to particular mixed swaps. The CFTC also adopted anti-evasion rules.

The final rules and the interpretations will be effective 60 days after date of publication in the Federal Register. The compliance date for the final rules and interpretations also will be 60 days after date of publication in the Federal Register with two exceptions. [2] Moreover, the effective date of the definitions will trigger effectiveness of many of the swaps rules

that already have been adopted by the Commissions. A summary of the final rules and interpretations that may be of interest to funds is provided below. This memorandum focuses on foreign exchange products, particularly non-deliverable forward contracts involving foreign exchange ("NDFs"), and insurance products.

Foreign Exchange Products

The Dodd-Frank Act provides that "foreign exchange forwards" [3] and "foreign exchange swaps" [4] shall be considered swaps under the swap definition unless the Treasury Secretary issues a written determination that foreign exchange swaps and/or foreign exchange forwards should not be regulated as swaps and are not structured to evade the Dodd-Frank Act and the rules adopted thereunder. Even if these instruments are determined by the Treasury Secretary to be exempt from the definition of "swap" under the CEA, certain provisions of the CEA added by the Dodd-Frank Act would continue to apply to such transactions. [5]

In the Adopting Release, the Commissions clarified the status of NDFs, foreign exchange options, currency swaps, and cross-currency swaps. According to the Commissions, the new rules explicitly define the term "swap" to include such products, and a determination by the Treasury Secretary regarding foreign exchange forwards and foreign exchange swaps would not affect the status of these products.

NDFs

An NDF is similar to a forward foreign exchange contract except that the NDF does not require physical delivery of two currencies at maturity. An NDF contract typically is settled in a reserve currency, such as U.S. dollars. One of the currencies involved in the transaction (e.g., an emerging market currency) may be subject to capital controls or other restrictions and therefore "nondeliverable."

In the Adopting Release, the Commissions determined that an NDF falls within the definition of a swap because the financial risk transfer is not accompanied by a transfer of an ownership interest in any asset or liability. The Commissions also took the view that NDFs do not meet the definitions of "foreign exchange forward" or "foreign exchange swap" because NDFs do not involve an "exchange" of two different currencies but are settled by payment in one currency. [6] The Commissions also believe that NDFs 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.

With respect to ICI's comment on the Proposing Release that the term "exchange" should be read more broadly to include the economic exchange that occurs in net settlement rather than being narrowly read as the physical "exchange" of two different currencies, the Commissions responded that these arguments primarily raise policy issues and that the Commissions' conclusions are based on the statute's plain language in the definition of the term "foreign exchange forward." In an exchange between Commissioners Sommers and O'Malia and the CFTC staff at the open meeting, the staff noted that it did not believe it had the statutory authority to further define an NDF as a foreign exchange forward but was of the view that the CFTC could exempt NDFs from the substantive requirements of the CEA.

Foreign Currency Options, Currency Swaps, and Cross-Currency Swaps

The Commissions also adopted rules to define explicitly the term "swap" to include foreign

currency options (other than foreign currency options traded on a national securities exchange) and to provide that foreign currency options are not foreign exchange forwards or foreign exchange swaps under the CEA.

In addition, the Commissions took the position that currency swaps and cross-currency swaps (both of which can be described as swaps in which the fixed legs or floating legs based on various interest rates are exchanged in different currencies) are not foreign exchange swaps because they require contingent or variable payments in different currencies even though they may involve an exchange of foreign 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 later date, 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 while currency swaps and cross-currency swaps involve other elements.

Foreign Exchange Spot Transactions

The Commissions provided an interpretation that a bona fide foreign exchange spot transaction (i.e., a foreign exchange transaction that is settled on the customary deadline of the relevant spot market) is not within the definition of the term "swap." A foreign exchange transaction generally will be considered a bona fide spot transaction if it settles by an actual delivery of the relevant currencies within two business days. A foreign exchange transaction with a longer settlement period may be considered a bona fide spot transaction depending on the customary settlement deadline of the relevant market. 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 if certain conditions are met. [7]

Insurance Safe Harbor

In the Adopting Release, the Commissions generally took the view that state or federally regulated insurance products that are provided by persons that are subject to state or federal insurance supervision should not be considered swaps or SB swaps if they satisfy the requirements of the non-exclusive safe harbor provided in the final rules. [8] Moreover, the Commissions adopted a grandfather provision that will exclude any agreement, contract or transaction entered into on or before the effective date of the definitions under certain circumstances (as described below).

Product and Provider Tests

For an insurance product not to be considered a swap or SB swap, it must satisfy a two-part test – "Product Test" and "Provider Test." The "Product Test" sets forth four criteria for an agreement, contract, or transaction to be considered insurance. The terms "swap" and "SB swap" will not include an agreement, contract or transaction that, by its terms or by law, as a condition of performance:

1. requires the beneficiary to have an insurable interest that is the subject of the agreement, contract or transaction and 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 be proved, and that any payment or indemnification 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. for financial guaranty insurance, 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 "Provider Test" requires that an agreement, contract, or transaction that satisfies the Product Test must be provided:

1. 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 under applicable state law or the laws of the United States;
2. directly or indirectly by the United States, any state or any of their respective agencies or instrumentalities or pursuant to a statutorily authorized program; or
3. for reinsurance, by a person to another person that satisfies the "Provider Test" under certain conditions; [9] or
4. in the case of non-admitted insurance [10] by a person who satisfies certain conditions. [11]

Enumerated Products

The Commissions also adopted new rules listing types of traditional insurance products that would fall outside the definitions ("Enumerated Products"). These include: 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; and reinsurance (including retrocession) of any of the foregoing. To be excluded from the definition of "swap" or "SB swap," the person providing the Enumerated Product also must satisfy the Provider Test. The Commissions also declined to expand the list of Enumerated Products to include 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 because these products do not receive the benefit of state insurance guaranty funds and their providers are not limited to insurance companies. The Commissions noted that these products should be considered in a facts and circumstances analysis for determining whether they fall within the definition of a swap or SB swap.

Grandfather Provision for Existing Insurance Transactions

The Commissions adopted rules that provide that an agreement, contract, or transaction entered into on or before the effective date of the definitions will be considered insurance and not fall within the swap and SB swap definitions if, at such time it was entered into, such agreement, contract, or transaction was provided in accordance with the Provider Test.

Guarantees

In the Adopting Release, the CFTC found that insurance of an agreement, contract or transaction that falls within the swap definition (and is not an SB swap or mixed swap) is functionally or economically similar to a guarantee of a swap (that is not an SB swap or mixed swap) offered by a non-insurance company. The CFTC believes that a guarantee of a swap (that is not an SB swap or mixed swap) is a term of that swap. Therefore, the CFTC interprets the term "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 expects to address in a separate release the practical implications

of interpreting the term “swap” to include guarantees of swaps.

The SEC, however, believes that a guarantee of an obligation under a SB swap, including financial guaranty insurance of an SB swap, is not a separate SB swap. The SEC did not adopt an interpretation that a guarantee of an SB swap is part of the SB swap. The SEC will consider requiring, as part of its rulemaking relating to the reporting of SB swaps, the reporting of information about any guarantees and the guarantors of obligations under SB swaps in connection with the reporting of the SB swap transactions. The SEC stated that a guarantee of a security also is a security under the Securities Act of 1933 and therefore a guarantee of an SB swap is a security subject to federal securities laws.

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endnotes

[1] Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, RIN 3038-AD46, Release No. 33-9338, available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister071012c.pdf (July 18, 2012) (“Adopting Release”). 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”).

[2] 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 and the compliance date for the final rules further defining the term “SB Swap” will be 180 days after date of publication in the Federal Register only for the purposes of the SEC order temporarily exempting SB swaps from the Securities Exchange Act of 1934 and the SB swaps interim final rules that provide exemptions for certain SB swaps under the Securities Exchange Act of 1934, the Securities Act of 1933, and the Trust Indenture Act of 1939.

[3] A “foreign exchange forward” is defined in the Commodity Exchange Act (“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.

[4] A “foreign exchange swap” is defined in the CEA as a transaction that solely involves an exchange of two different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange and a reverse exchange of the two currencies at a later date at a fixed rate that is agreed upon on the inception of the contract covering the exchange.

[5] Transactions in those instruments would continue to 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.

[6] The Commissions also stated that a foreign exchange transaction, which is created as or intended to be a “foreign exchange forward,” and then is modified so that the parties settle in a reference currency do not conform with the definition of “foreign exchange forward” in the CEA.

[7] The CFTC will consider a transaction to be a bona fide spot foreign exchange transaction if the agreement, contract or transaction for the purchase or sale of an amount of foreign currency is equal to the price of a foreign security with respect to which (1) the security and related foreign currency transactions are executed contemporaneously to effect delivery by the relevant securities settlement deadline and (2) actual delivery of the foreign security and foreign currency occurs by the deadline.

[8] There is no implication or presumption that an agreement, contract, or transaction that does not meet the requirements of the safe harbor is a swap or a SB swap. Further analysis of the applicable facts and circumstances would be required for such an agreement, contract, or transaction to determine whether it is insurance and not a swap or SB swap.

[9] These conditions include 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 products enumerated in the final rules to be excluded from the definitions; 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 (a person writing the risk being ceded or transferred to a reinsurer).

[10] “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.

[11] The person must be located outside 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 meet the eligibility criteria for non-admitted insurers under applicable state law.
