

## CFTC and SEC Adopt Rules Defining ‘Swap’ and ‘Security-Based Swap’

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On August 13, 2012, the Commodity Futures Trading Commission (CFTC) and Securities and Exchange Commission (SEC, and jointly, as the Commissions) published final rules (Final Rules)<sup>1</sup> in the Federal Register that define “swap,” “security-based swap” and other key terms and concepts that are critical to the implementation of the derivatives reforms required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).<sup>2</sup> The publication of the Final Rules in the Federal Register will start a countdown to compliance for many of the CFTC’s new rules regulating the swap markets and its participants.<sup>3</sup>

### Definition of ‘Swap’

The Dodd-Frank Act amended the Commodity Exchange Act (CEA) and the Securities Exchange Act of 1934 (Exchange Act) to provide statutory definitions for the terms swap, security-based swap, mixed swap and security-based swap agreement. As amended, the CEA defines swaps broadly to include “any agreement ... that provides on an executory basis for the exchange ... of 1 or more payments based on the value or level of 1 or more ... rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind ... 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.”<sup>4</sup> This broad statutory definition is subject to numerous exclusions.<sup>5</sup>

The Final Rules provide some additional guidance as to what types of agreements are included within and what types of agreements may be excluded from this broad statutory definition.

### Forward Contract Exclusion

The statutory definition of the term swap excludes forward contracts — transactions in a nonfinancial commodity (or a security) as long as the transaction is intended to be physically settled.<sup>6</sup> The CFTC interprets this forward contract exclusion to apply to commercial merchandising transactions and provides a safe harbor using its longstanding

1 See Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, **77 Fed. Reg. 48208** (Aug. 13, 2012).  
2 See Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010).  
3 See Skadden’s July 9, 2012 [client alert](#) for a discussion of significant compliance dates.  
4 7 U.S.C. § 1a(47).  
5 See 7 U.S.C. § 1a(47)(B).  
6 The CFTC interprets the term “nonfinancial commodity” to mean a commodity that can be physically delivered and that is an “exempt commodity” or an “agricultural commodity,” as those terms are defined in the CEA. **77 Fed. Reg. at 48232**. Nonfinancial commodities also may include certain intangible commodities, such as emissions allowance, as long as it can be physically delivered and consumed (e.g., by emitting the allowed amount of pollutant). See **77 Fed. Reg. at 48233**.

“Brent Interpretation,” expanded to apply to all nonfinancial commodity transactions.<sup>7</sup> The safe harbor provides that the intent to physically settle a transaction can be inferred where there is (1) a binding delivery obligation and (2) the parties normally make or take delivery of the commodity in the ordinary course of their business. If the parties to a transaction that satisfies the safe harbor later negotiate a “book-out,” instead of physically settling the transaction, the CFTC will not seek to recharacterize the transaction as a swap.<sup>8</sup>

Notwithstanding the Brent Interpretation safe harbor, the CFTC’s forward contract exclusion guidance would still require a facts-and-circumstances analysis of many types of transactions. In its lengthy discussion, the CFTC offers at least three different multifactor tests (one of which has seven factors) arising out of a few types of transactions described in public comments.<sup>9</sup> The guidance focuses on transactions (many of which are energy transactions) that have some sort of embedded optionality or contingency relating to delivery, such as price, quantity, or settlement or expiration date. At a high level, transactions with features such as price escalation clauses or volumetric optionality (or uncertainty) that depend on, for example, customer demand should not be swaps according to the Commissions.

### *Foreign Exchange Products, Forward Rate Agreements and Contracts for Differences*

The CEA provides the Secretary of the Treasury (Secretary) with the ability to exclude from the swap definition “foreign exchange forwards”<sup>10</sup> and “foreign exchange swaps,”<sup>11</sup> as those terms are narrowly defined in the CEA.<sup>12</sup> The Secretary has proposed to exclude these foreign exchange transactions from the swap definition, but that proposal has not been finalized. Until the Secretary makes a final determination, the Commissions have included foreign exchange forwards and foreign exchange swaps in the swap definition.

In the preamble to the Final Rules, the Commissions conclude that nondeliverable forwards (NDFs) in foreign currency,<sup>13</sup> currency swaps and cross-currency swaps,<sup>14</sup> and forward rate agreements (FRAs) are all swaps.<sup>15</sup> Contracts for differences generally will be considered by the Commissions to be swaps or security-based swaps, depending on the underlying reference.<sup>16</sup>

7 Because the Brent Interpretation has been expanded to apply to all nonfinancial commodities, the CFTC has withdrawn its 1993 Energy Exemption that allowed for physical netting agreements that allowed parties to net unintentionally offsetting future delivery obligations. See Exemption for Certain Contracts Involving Energy Products, 58 Fed. Reg. 21,286 (Apr. 20, 1993).

8 In response to comments concerning the documentation requirements for book-out transactions, the CFTC states that a book-out may be agreed upon orally, but it must be memorialized in some type of written or electronic form within a commercially reasonable timeframe. See 77 Fed. Reg. at 48230.

9 In its discussion, the CFTC goes to great lengths to try to ensure that market participants cannot use the forward contract exclusion to avoid the swap rules. The result is that market participants must analyze the facts and circumstances of, and may lack regulatory certainty for, many standard types of physical commodity transactions.

10 7 U.S.C. § 1a(24). A foreign exchange forward is defined 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. *Id.*

11 7 U.S.C. § 1a(25). A foreign exchange swap is defined as a transaction that solely involves (A) 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 (B) a reverse exchange of the two 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. *Id.*

12 7 U.S.C. § 1a(47)(E).

13 The Commissions determined that NDFs in foreign currency would not be foreign exchange forwards that could be excluded from the swap definition by the Secretary because they do not involve an exchange of currencies. See 77 Fed. Reg. at 48255.

14 The Commissions determined that currency swaps and cross-currency swaps would not be foreign exchange forwards that could be excluded from the swap definition by the Secretary because they have contingent or variable payments in different currencies. 77 Fed. Reg. at 48256.

15 The Commissions determined that FRAs cannot satisfy the forward contract exclusion because they do not involve nonfinancial commodities and cannot be physically delivered. 77 Fed. Reg. at 48259.

16 77 Fed. Reg. at 48260.

### *Consumer and Commercial Agreements*

In the preamble to the Final Rules, the Commissions provide a nonexclusive list of examples of consumer transactions (*i.e.*, those entered into by individuals primarily for personal, family or household purposes) and commercial transactions that are not considered to be swaps or security-based swaps.<sup>17</sup> With respect to commercial agreements, the Commissions' list includes: agreements effecting a business combination or transaction; agreements containing escalation clauses linked to a commodity (including an interest rate or a consumer price index); and fixed or variable interest rate commercial loans or mortgages entered into by banks and nonbanks.<sup>18</sup>

In an effort to provide some certainty as to other types of transactions, the preamble also lists indicia that the Commissions will use in the future to determine whether consumer or commercial transactions should be considered swaps or security-based swaps.<sup>19</sup> A commercial transaction will not be a swap or security-based swap if it:

- Does not contain payment obligations that are severable from the agreement;
- Is not traded on an organized market or over the counter;
- Is entered into by a commercial (or nonprofit) entity as principal to serve an independent commercial, business or nonprofit purpose; and
- Is entered into for other than speculative, hedging or investment purposes.

### *Insurance Safe Harbor*

The Final Rules provide a nonexclusive safe harbor from the swap and security-based swap definitions for certain qualifying insurance products. To qualify for the safe harbor, an insurance product must satisfy two requirements. First, the product must be offered by an entity that satisfies a "Provider Test," which requires the entity to be a state-regulated insurance company, reinsurer, nonadmitted insurer (subject to certain conditions), or state or federal governments (or their agencies and instrumentalities). Second, the product must be one of several products enumerated in the final rule or must satisfy each part of a four-part "Product Test."<sup>20</sup> Products that do not satisfy the requirements of the insurance safe harbor are not presumed to be swaps or security-based swaps; rather, a further facts-and-circumstances test would be used to determine whether the product is insurance, a swap or a security-based swap.

### *Guarantees of Swaps and Security-Based Swaps*

The Commissions reach diverging conclusions with respect to the regulatory treatment of guarantees of swaps and security-based swaps. In the preamble, the CFTC explains that a guarantee of a swap (but not a security-based swap or a mixed swap) is "an integral part of the swap" and, therefore, the CFTC believes the term "swap" must be interpreted to include a guarantee of such swap. To this end, the CFTC anticipates proposing reporting requirements with respect to guarantees of swaps.

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17 77 Fed. Reg. 48247.

18 *Id.*

19 *See id.*

20 CFTC Rule 1.3(xxx)(4)(i)(A). Under the "Product Test," first, the contract must require as a condition of performance that the beneficiary have an insurable interest throughout the duration of the contract. Second, the contract must require as a condition of performance that a loss occurs and be proven, and that any payment be limited to the value of the insurable interest. Third, the contract must not be traded separately from the insured interest on an organized market or over the counter. Finally, with respect to financial guaranty insurance only, the contract must require that, in the event of payment default or insolvency of the obligor, any acceleration of payments under the contract is at the sole discretion of the insurer.

In contrast, the SEC concludes that a guarantee of a security-based swap is not an integral part of the security-based swap. Instead, the SEC notes that security-based swaps are included in the definition of “security” in the Securities Act of 1933 (Securities Act) and the Exchange Act; therefore, the guarantee of a security-based swap is also a security.<sup>21</sup>

### **Distinguishing ‘Swaps’ From ‘Security-Based Swaps’**

The Dodd-Frank Act makes clear that the CFTC has regulatory authority over swaps and the SEC has regulatory authority over security-based swaps. In discussing whether particular agreements, contracts or transactions are swaps or security-based swaps, the preamble to the Final Rules uses the term “Title VII instrument” 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. The Commissions explain in the preamble that, generally, 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. Consistent with this general principle, the Commissions provide more specific guidance with respect to various types of instruments, including, among others, total return swaps, index credit default swaps (CDS) and instruments based on government debt obligations.

In terms of the definition of “narrow-based security index” — which, by statute and under the Final Rules, may be an underlying reference of a security-based swap agreement — the CEA and Exchange Act generally define that term as an index that has nine or fewer component securities. That statutory definition, however, is not exhaustive, and the statutes include three other, alternative means for qualifying as a narrow-based security index.<sup>22</sup> In the preamble to the Final Rules, the Commissions provide a further interpretation of the term “narrow-based security index” as it applies to index CDS.

### **Definition of ‘Mixed Swap’**

The CEA and Exchange Act define “mixed swap” as an agreement, contract or transaction that is a security-based swap and that is also based on either: (1) an underlying reference other than a single security or narrow-based security index (*e.g.*, an interest rate or other monetary rate, currency, commodity, etc.) or (2) the occurrence of an event associated with a potential financial, economic or commercial consequence (other than an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index). In the preamble to the Final Rules, the Commissions state that the product category of “mixed swaps” is intended to be narrow in scope and would include, for example, a Title VII instrument in which the underlying references are the value of corporate stock and the price of a commodity. Mixed swaps will be subject to regulation by both the CFTC and SEC, although the joint regulatory framework for bilateral uncleared mixed swaps will be different from the framework for all other mixed swaps.

### **Definition of ‘Security-Based Swap Agreement’**

Under the CEA and Exchange Act, a “security-based swap agreement” is a swap of which a material term is based on the price, yield, value or volatility of any security or any group of index of securities. By definition, however, a security-based swap agreement excludes security-based swaps. Thus, if a swap qualifies as a security-based swap, it would not be a security-based swap agreement. In the preamble to the Final Rules, the Commissions declined to further define security-based swap agreement, but did state that the following swaps, among others, would clearly fall within the definition of

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21 77 Fed. Reg. at 48227.

22 See 7 U.S.C. § 1a(35).

security-based swap agreement: (i) a swap based on a broad-based security index; (ii) 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; and (iii) a swap based on exempted securities (other than municipal securities) such as U.S. Treasury securities. Whereas the CFTC has primary regulatory authority over SBSAs, the SEC only has antifraud, anti-manipulation and certain other limited authority over SBSAs.

### **Anti-Evasion Authority**

The Dodd-Frank Act gives the CFTC the authority to address evasion (both in the United States and abroad) of the Dodd-Frank Act's Title VII provisions governing swaps regulation. To implement its anti-evasion authority, the CFTC has adopted anti-evasion rules as part of its Final Rules. Under these anti-evasion rules, transactions that are willfully structured to evade any swap-related requirement under Title VII will be deemed a "swap," and any such transactions will be considered when evaluating whether a person qualifies as a swap dealer or major swap participant.<sup>23</sup> The CFTC's rules clarify, however, that instruments structured as a security (including a security-based swap) under the federal securities laws will not be deemed a "swap." With respect to evasive conduct overseas, the CFTC has adopted a rule that makes it unlawful to conduct activities outside the United States to willfully evade or attempt to evade any provisions of the CEA or CFTC rules, regulations and orders promulgated thereunder. Such foreign activities, moreover, will be made subject to Title VII's requirements relating to swaps.

The SEC is not adopting anti-evasion rules with respect to security-based swaps at this time.

### **Effective Date and Compliance Dates**

The effective date and compliance date for the Final Rules, and the interpretations contained therein, is 60 days following their publication in the Federal Register, with two exceptions. First, the compliance date for the CFTC's interpretation regarding guarantees of swaps will be defined in a subsequent rule-making. Second, solely for purposes of the July 7, 2011, SEC order granting temporary exemptions to security-based swaps from certain Exchange Act provisions, the compliance date for the Final Rules further defining "security-based swap" will be 180 days following publication in the Federal Register. Once the compliance date kicks in for these rules further defining "security-based swap," the SEC order's temporary exemptions for security-based swaps will expire.

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23 Notably, the CFTC's rules do not provide a bright-line test regarding what constitutes "evasion." The preamble to the Final Rules instead states that the CFTC will apply a facts-and-circumstances approach to determine whether particular conduct is willfully evasive. Among the factors the CFTC will consider are: the form, label and documentation of a given instrument, transaction or entity; the extent to which a person has a legitimate business purpose for structuring the instrument, transaction or entity in a particular manner; and the extent to which the person's conduct involves deceit, deception or other unlawful or illegitimate activity to avoid swap regulatory requirements. [77 Fed. Reg. at 48300, 48301-302.](#)