

# SEC/CFTC and Treasury Derivatives Proposals Under Dodd-Frank

**June 1, 2011**

*SEC/CFTC Proposal Regarding Product Definitions*

On April 27, 2011, the Securities and Exchange Commission (“SEC”) and the Commodity Futures Trading Commission (“CFTC”) (collectively, the “Commissions”) issued joint proposed rules and interpretive guidance (the “Proposed Rules”) to further define and solicit public comment on the terms “swap,” “security-based swap,” and “security-based swap agreement.” Products classified as such will be subject to the mandatory clearing and trading requirements of the Dodd-Frank Act. Comments regarding the Proposed Rules must be received by the Commissions on or before July 22, 2011.

The Proposed Rules explicitly confirm that foreign exchange (“FX”) products that are not FX forwards or swaps are included within the statutory definitions, consistent with the Treasury’s view (discussed below). Such products would encompass foreign currency options (non-exchange traded) (including those on FX forwards and FX swaps), non-deliverable forward contracts (NDFs) in foreign exchange, currency swaps and cross-currency swaps. Also included are commodity options, forward rate agreements, contracts for differences, and options to enter into swaps and forward swaps (swaptions).

The Proposed Rules enumerate certain products and transactions that are deemed to be outside the scope of the definitions; specifically, certain insurance products, consumer and commercial loan arrangements, and certain loan participations, provided that they satisfy the criteria set out by the Commissions:

## *Insurance Products*

Insurance products will be regulated as insurance and not swaps if:

- (i) The beneficiary has an insurable interest that is the subject of the contract or transaction and carries the risk of loss with respect to the interest continuously throughout the term (in contrast, the buyer of a credit default swap (“CDS”) need not suffer any loss as a result of the occurrence of a credit event);

(ii) A loss occurs and is proved, and any payment thereon is limited to the value of the insurable interest (there is no such limit associated with swaps);

(iii) The insurance product is not traded, separately from the insured interest, on an exchange or over-the-counter (while swaps generally also have not been tradable at-will in secondary market transactions without counterparty consent, they are routinely novated or assigned to third parties pursuant to industry standard terms); and

(iv) With respect to financial guaranty insurance (bond insurance or bond wraps), the beneficiary may not accelerate the payment of principal in the event of default or insolvency of the issuer. Any acceleration of payment must be solely at the discretion of the insurer (conversely, a CDS requires payment in full upon the occurrence of a credit event).

In addition, the product must be provided by:

(i) 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 any agency or instrumentality thereof, and such product is regulated as insurance under the laws of such state or the United States;

(ii) the United States or any of its agencies or instrumentalities (such insurance would include federal insurance of savings in banks, savings associations and credit unions, catastrophic crop insurance, flood insurance, federal insurance of certain pension obligations and terrorism risk insurance); or

(iii) in the case of reinsurance, a person located outside the United States to an insurance company that is eligible under the Proposed Rules once the product meets the product requirements discussed above and the total amount reimbursable by all reinsurers for the insurance product does not exceed the claims or losses paid by the insurer transferring the risk.

The following products are *de facto* outside the scope of the statutory definitions once they are provided by entities listed above: 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.

In addition to other comments, the Commissions are specifically soliciting views as to whether an insurance “wrap” of a swap (such as an interest rate swap related to municipal debt) should fall outside the swap definition (the Commissions differ on this issue), and whether the Commissions should include an additional criterion that payment on an insurance contract not be based on the price, rate, or level of a financial instrument, asset, or interest or any commodity (on the theory that such a requirement could help to prevent swaps from being executed in the guise of insurance in order to avoid the swaps regulatory regime) and, if so, whether the Commissions should carve out certain products such as variable life insurance and annuity products that deliver insurance guarantees that vary with the performance of specified assets.

#### *Consumer and Commercial Agreements*

Customary consumer and commercial agreements and transactions will fall outside the scope of the statutory definitions if they do not contain payment obligations, whether or not contingent, that are severable from the agreement or transaction; are not traded on an exchange or over-the-counter; in the case of consumer arrangements, involve an asset of which the consumer is the owner or beneficiary, or that the consumer is purchasing, or involve a service provided, or to be provided, by or to the consumer; and, in the case of commercial arrangements, are entered into by commercial or non-profit entities to serve an independent commercial, business or non-profit purpose, and are not for speculative, hedging, or investment purposes.

Examples of such consumer agreements would include agreements to acquire or lease real or personal property; agreements to purchase products or services at a fixed price or a capped or collared price at a future date or over a certain time period; and consumer loans or mortgages with variable rates of interest or embedded interest rate options. Examples of such commercial agreements would include employment contracts and retirement benefit arrangements; agreements for the purpose of effecting a business combination transaction; warehouse lending arrangements for acquiring an inventory of assets in anticipation of a securitization of such assets; and commercial agreements containing escalation clauses linked to an underlying commodity such as an interest rate or consumer price index.

### *Loan Participations*

The Commissions do not interpret the 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 and the loan participations are “true participations” (that is, the participant acquires a beneficial ownership interest in the underlying loans). Depending upon the facts and circumstances, a loan participation may be a security subject to regulation under the federal securities laws or an identified banking product subject to regulation by bank regulatory agencies.

The swap definition in the Dodd-Frank Act excludes forward contracts in nonfinancial commodities. The exclusion will operate in the same manner that the CFTC has historically operated the forward contract exclusion, including with respect to ‘book outs’ (where, rather than make or take delivery, commercial counterparties with multiple offsetting positions negotiate payment-of-differences through a separately negotiated cancellation agreement). Security forwards such as forward sales of mortgage-backed securities in the TBA market would fall within the forward contract exclusion.

The Proposed Rules also contain interpretive guidance clarifying whether particular agreements are swaps, security-based swaps or mixed swaps. The determination as to whether a given instrument is a swap or security-based swap is to be made at the time the instrument is entered into, and its characterization should not change over the life of the instrument unless the instrument itself is amended or modified. The Proposed Rules contain a mechanism whereby market participants may submit a request to the SEC and the CFTC to provide a joint interpretation as to the appropriate classification for any instrument.

#### *Treasury Proposed Determination to Exempt Foreign Exchange Swaps and Forwards*

On April 29, 2011, the Department of the Treasury (“Treasury”) issued a notice of proposed determination (the “Proposed Determination”) exempting FX swaps and forwards from the swap definition. Such products would remain subject to swap data repository trade reporting requirements (although not on a real-time basis), business conduct standards (including anti-fraud and anti-manipulation provisions) and anti-evasion requirements promulgated by the CFTC. Comments regarding the Proposed Determination must be received by Treasury on or before June 6, 2011.

An FX swap is narrowly defined under the Commodity Exchange Act as a transaction that solely involves (a) an exchange of two different currencies on a specific date at a fixed rate that is agreed at the inception of the contract covering the exchange; and (b) a reverse exchange of the two currencies at a later date and at a fixed rate that is agreed upon at the inception of the contract covering the exchange. An FX forward is likewise narrowly defined as a transaction that solely involves the exchange of two different currencies on a specific future date at a fixed rate agreed at the inception of the contract covering the exchange. As noted above, other FX derivatives, such as foreign currency options, currency swaps and NDFs would not be exempt from the swap definition (as they do not satisfy the statutory definitions of an FX swap or FX forward).

The Treasury Secretary’s rationale for exempting FX swaps and forwards from the Dodd-Frank regime is based upon the distinct characteristics and risk profile of the instruments which differ from those of other swaps and derivatives. Specifically:

- (i) FX swaps and forwards have fixed payment obligations, are settled on a physical basis, and are predominantly short-term instruments (as such, the risk profile is essentially one of settlement risk rather than counterparty credit risk which would apply with longer-term derivative instruments);
- (ii) Settlement risk is already effectively mitigated through the use of a well-functioning payment-versus-payment settlement system operated by CLS Bank International (thus, while central clearing could reduce credit risk the benefits would be marginal);
- (iii) The FX swaps and forwards market is already subject to strong regulatory oversight by central banks and prudential regulators that monitor FX exposures, internal controls and settlement practices;
- (iv) FX swaps and forwards trade in a highly transparent and liquid market across a range of electronic trading platforms (thus, mandatory exchange trading would not significantly improve price transparency or reduce trading costs); and
- (v) The unique characteristics of FX swaps and forwards would make it difficult and costly to structure the products so as to evade otherwise applicable regulatory requirements.

If the Treasury Secretary ultimately determines to exempt FX swaps and forwards, he must submit a separate determination to the appropriate committees of Congress explaining why such products are qualitatively different from other classes of swaps such that they are ill-suited for regulation as swaps, and identify the objective differences of FX swaps and forwards with respect to standard swaps that warrant an exempted status.

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- **Steven O. Weise**  
Partner