Proskauer

CFTC and SEC Adopt Final Rules Defining Swaps

July 30, 2012

The Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) recently adopted a joint rule that defines which financial instruments will be considered "swaps" under the jurisdiction of the CFTC, which instruments will be considered "security-based swaps" under the jurisdiction of the SEC, and which instruments are "mixed swaps" subject to the jurisdiction of both agencies.

The table below summarizes which instruments fall into each category. Managers of private funds holding or trading any swaps subject to CFTC jurisdiction will need to register or file for an exemption with the CFTC by December 31, 2012 (or if later, by 60 days from the publication of the new rule in the Federal Register).

Swaps *(subject to CFTC jurisdiction)*	**Security-Based Swaps** *(subject to SEC jurisdiction)*	**Neither Swaps nor Security-Based Swaps**

Foreign Exchange: *> Forwards** *> Swaps** *> Non-Deliverable FX Forwards* *> Currency Swaps* *> Cross-Currency Swaps* *> Foreign Currency Options (not traded on a securities exchange)*		Foreign Exchange Spot Transactions (involving actual delivery within 2 business days) Foreign Currency Options that are traded on a securities exchange

Swaps, forward agreements and other financial instruments based on: *> Interest rates, including interest rate and forward rate swaps* *> "exempted securities" including U.S. Treasury securities and certain other government securities* *> "Yields" except where yield is a proxy for price or value of a security or narrow-based security index* *> Two or more loans* *> Futures other than security futures* *> Futures on certain foreign sovereign debt* *> Any "broad-based" security index (described below)*	Swaps and other financial instruments based on: *> A single security* *> Futures on a single security* *> A single loan* *> Any "narrow-based" security index (described below)*	Physically-settled forward contracts for non-financial commodities Loan participations Traditional insurance products, including annuities Consumer transactions for personal, family or household purposes
Options and Contracts for Differences based on any of above	Options and Contracts for Differences based on any of above	

** Foreign exchange forward contracts and swaps can be removed from the "swap" definition by the U.S. Treasury, but currently are "swaps" subject to CFTC jurisdiction.*

"Mixed swaps" are instruments that are security-based, but also based on the value of one or more rates or instruments that would normally be "swaps" and, accordingly, are considered both "swaps" and "security-based swaps."

What effect will the new rules have on private fund managers?

If a private fund holds any instrument that comes within the new "swaps" definition subject to CFTC jurisdiction (even if only a single contract, or for a minimal amount, or only for hedging purposes), then the manager of that fund will be required, on or before December 31, 2012, either:

- to file a simple notice of exemption under CFTC Rule 4.13(a)(3) with respect to that fund (and a separate notice for each other fund managed by the manager that trades swaps that are subject to CFTC jurisdiction under the new rule), provided that the trading of each such fund does not exceed the quantitative limits described below; or
- to register with the CFTC as a commodity pool operator (CPO) and to become a member of the National Futures Association (NFA).

What is the Rule 4.13(a)(3) "Limited Trading" Exemption?

The "limited trading" exemption under Rule 4.13(a)(3) is available for any private fund that trades instruments subject to CFTC jurisdiction, so long as either:

- the aggregate net notional value of futures and covered swap positions does not exceed 100% of the private fund's liquidation value, or
- the aggregate initial margin and premiums to establish futures and covered swap positions do not exceed 5% of the private fund's liquidation value (i.e., net asset value).

Entering into even a single swap subject to CFTC jurisdiction (for example, an interest rate or currency swap) may require a fund manager, at minimum, to file a notice under Rule 4.13(a)(3) with the CFTC on or before December 31, 2012 and to renew that notice on an annual basis thereafter.

How is a Fund-of-Funds affected by the new rules?

The CFTC takes the view that any fund-of-funds that invests in a commodity pool is itself a commodity pool. This means that a fund-of-funds sponsor or manager will need to review, and if necessary reach out to, all of the funds in which it invests in order to determine whether those underlying funds either do not trade futures, swaps or other instruments subject to CFTC jurisdiction as described above, or will qualify for the limited trading exemption under Rule 4.13(a)(3). If any of the underlying funds trade futures, swaps or other instruments subject to CFTC jurisdiction outside the Rule 4.13(a)(3) limits, then not only will the manager of the underlying fund be required to register with the CFTC, but the sponsor or manager of the fund-of-funds will also be required to register.

Which foreign exchange products fall within CFTC jurisdiction?

Most instruments related to foreign exchange and foreign currencies are now considered swaps subject to CFTC jurisdiction, including currency swaps, cross-currency swaps, currency options, foreign currency options, foreign exchange options, foreign exchange rate options and non-deliverable foreign exchange forwards. However, foreign currency options executed or traded on a national securities exchange are excluded from the swap definition.

Bona fide foreign exchange spot transactions (generally those settling via an actual delivery of the relevant currencies within two business days) are also not considered swaps. Bona fide foreign exchange spot transactions include foreign exchange transactions settling in more than two business days that are entered into solely to effect the purchase or sale of a foreign security, as long as the security and related foreign currency transactions are executed contemporaneously and actual delivery of the foreign security and foreign currency occurs by the relevant securities settlement deadline.

In addition, while foreign exchange forwards[1] and foreign exchange swaps[2] are now defined as swaps subject to CFTC jurisdiction, the Secretary of the Treasury has the authority to exempt foreign exchange forwards and foreign exchange swaps from the "swaps" definition. The Treasury has not yet taken any final action, although it likely will exempt at least foreign exchange forwards (other than non-deliverable foreign exchange forwards). However, until the final determination of the Treasury is issued, these instruments are swaps under CFTC jurisdiction.

Which interest rate derivatives fall within CFTC jurisdiction?

As a general rule, any instruments based on interest rates, monetary rates or yields are swaps regulated by the CFTC. If the "yield" is calculated based on the price or changes in price of a debt security, loan, or narrow-based security index, it is another way of expressing the price or value of a debt security, loan, or narrow-based security index, and would therefore generally be considered a security-based swap subject to the jurisdiction of the SEC. This interpretation would not apply to certain "exempted securities," including U.S. Treasury bonds, municipal securities, and other securities as specifically designated by the SEC, where the instruments based on the "yield" of such securities would be considered swaps subject to CFTC jurisdiction.

What is a "Narrow-Based Security Index" and a "Broad-Based Security Index"?

The term "index" is defined as "an index or group of securities, including any interest therein or based on the value thereof." Where an instrument is based on a "narrow-based security index," the instrument is considered to be a security-based swap (under the jurisdiction of the SEC). An instrument based on a "broad-based security index" will be considered a swap (under CFTC jurisdiction).

A "narrow-based security index" is any index that meets any of the following criteria:

- it consists of nine or fewer components;
- it contains one component that comprises more than 30% of the index's weighting;
- it contains five components that comprise more than 60% of the index's weighting; or
- the lowest 25% of the index's weighting has an average daily trading volume of less than $50,000,000 (or $30,000,000 in the case of indexes with more than 15 component securities), subject to certain conditions.

The CFTC and SEC previously have issued guidance with respect to volatility indexes and debt security indexes, and how to determine whether such indices are "narrow-based." A volatility index is not considered a narrow-based security index (i.e., it is a broad-based security index) when it meets all of the following criteria:

- it measures the magnitude of changes (as calculated in accordance with CFTC and SEC criteria) in the level of an underlying index that is not a narrow-based security index;

- it has more than nine component securities, all of which are options on the underlying broad-based index;
- it contains no one component security that comprises more than 30% of the index's weighting;
- its five highest-weighted component securities do not comprise in the aggregate more than 60% of the index's weighting;
- the lowest 25% of the index's weighting has an average daily trading volume of more than $50,000,000 (or $30,000,000 in the case of indexes with more than 15 component securities), subject to certain conditions;
- options on the index are listed and traded on a national securities exchange under the Securities Exchange Act of 1934; and
- the aggregate average daily trading volume in options on the index is at least 10,000 contracts per day, calculated as of the previous six calendar months.

A debt security index is not considered a narrow-based security index (i.e., it is a broad-based security index) when it meets all of the following criteria:

- it comprises more than nine debt securities that are issued by more than nine non-affiliated issuers;
- the securities of no issuer included in the index comprise in the aggregate more than 30% of the index's weighting;
- the securities of any five non-affiliated issuers in the index do not comprise in the aggregate more than 60% of the index's weighting; and
- its debt securities or issuers thereof satisfy certain public information availability requirements.

When is the status of an instrument determined?

The determination of an instrument's status as a swap, security-based swap or mixed swap should be made no later than when the parties offer to enter into the instrument. Once an instrument has been characterized as a swap or security-based swap, that characterization will remain the same throughout its life, unless its terms are modified. Similarly, where an instrument is based on a security index, the initial characterization of the index as either narrow-based or broad-based will not change unless the terms of the instrument are modified. For an example, where an instrument is based on an index that was characterized as narrow-based at the time the parties entered into the swap, the index will not be characterized differently if it later falls under the definition of a broad-based security index.

What other instruments are excluded from CFTC jurisdiction?

Forward Contracts

Certain forward contracts with respect to non-financial commodities are excluded from the swap and security-based swap definitions. Generally, a sale of a non-financial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled, will be excluded from the swap and security-based swap definitions. The exclusion of forward contracts from the swap definition will be interpreted consistently with prior CFTC positions excluding certain forwards from CFTC oversight.

Insurance Products

Most traditional insurance products provided by regulated insurance companies, such as health, property and life insurance or reinsurance of any traditional insurance products, are not considered swaps or security-based swaps.

Loan Participations

Loan participations are not considered swaps or security-based swaps if, depending on the facts and circumstances, they either (i) reflect a current or future direct or indirect ownership interest in the related loan or commitment, or (ii) are defined as securities under the federal securities laws.

Can instruments be structured to evade the new rules?

Any instruments that are willfully structured to evade regulation, including instruments structured to avoid the technical requirements of the swap definition, will nonetheless be considered "swaps" within the meaning of the definition. The CFTC will make a determination whether an activity is willfully evasive, depending on relevant facts and circumstances, including the extent to which the structure of a transaction has a relevant business purpose. Despite issuing broad anti-evasion rules, the CFTC declined to fully delineate the limits of such rules for fear of "provid(ing) potential wrongdoers with a roadmap for structuring evasive transactions." The SEC is not adopting anti-evasion rules at this time since it believes existing regulations such as the antifraud and manipulation provisions, which will apply to security-based swaps, should be sufficient.

What other effects will the new rules have on investment advisers?

An investment adviser that provides advice with respect to swaps subject to CFTC jurisdiction also may be required to register with the CFTC as a "commodity trading adviser" (CTA) and to become a member of the NFA if an exemption is not available.

An adviser may be exempt from CTA registration if:

- in the preceding twelve months, the adviser has not furnished commodity trading advice to more than 15 persons (each private fund being counted as a single person for this purpose) and does not hold itself out generally to the public as a CTA; or
- the manager is registered as a CPO, or is exempt from CPO registration, and only provides commodity trading advice to the pools that it manages; or
- the adviser is registered as an investment adviser with the SEC and provides commodity trading advice solely to:
    - a pool operated under Rule 4.13(a)(3);
    - certain entities subject to CFTC Rule 4.5 (including certain registered investment companies and employee benefit plans); and
    - commodity pools organized and operated outside the United States, but only if U.S. persons are not solicited to invest in the pool, no person affiliated with the pool conducts any marketing activity from within the United States and U.S. persons who are not "qualified eligible persons" (as defined in CFTC Rule 4.7) own no more than 10% of the pool.

Certain types of organizations that are exempt from registration as an investment adviser with the SEC, including family offices and nonprofit organizations, may not be exempt from CTA registration, depending on their operations.

Conclusion

If a private fund enters into even a single swap subject to CFTC jurisdiction, the manager or sponsor of the fund should consider whether it may be necessary either to register as a CPO with the CFTC or to file a notice claiming an exemption from registration under CFTC Rule 4.13(a)(3). If an adviser is providing investment advice to other types of clients, such as managed accounts or family office vehicles, the adviser should consider whether it may have an obligation to register as a CTA with the CFTC.

If you have any questions, please feel free to contact any of the Proskauer lawyers listed in this alert.

[1] A foreign exchange forward is "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."

[2] A foreign exchange swap is "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."

Assistance preparing this client alert was provided by Jason Slutsky, Rajesh Bandla and Elizabeth Dorsey.

Related Professionals

- **Arnold P. May**
  Partner
- **Amanda H. Nussbaum**
  Partner

- **Scott S. Jones**
  Partner
- **Charles (Chip) Parsons**
  Partner
- **Jamiel E. Poindexter**
  Partner
- **Marc A. Persily**
  Partner
- **Ira G. Bogner**
  Managing Partner
- **Sarah K. Cherry**
  Partner
- **Bruce L. Lieb**
- **Nigel van Zyl**
  Partner
- **Mary B. Kuusisto**
  Partner
- **Malcolm B. Nicholls III**
  Partner
- **David W. Tegeler**
- **Howard J. Beber**
  Partner
- **Robin A. Painter**
- **Stephen T. Mears**
  Partner