



## SEC and CFTC Finalize Key Swap Product Definitions under Dodd-Frank, Triggering the Effectiveness or Phase-In of Many Dodd-Frank Derivatives Regulatory Provisions

July 12, 2012

On July 6, 2012, and July 10, 2012, the U.S. Securities and Exchange Commission (“SEC”) and U.S. Commodity Futures Trading Commission (“CFTC” and, collectively with the SEC, the “Commissions”), respectively, approved joint final rules further defining the terms “swap,” “security-based swap,” “mixed swap,” and “security-based swap agreement” pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). These rules determine which derivative products will be subject to SEC and CFTC regulation under the Dodd-Frank Act, and their publication in the Federal Register—expected to occur shortly in the near future—will trigger the effective dates of many of the Dodd-Frank Act’s derivatives regulatory provisions whose effectiveness has so far been tolled pending the adoption of these final product definitions.

Although the SEC and CFTC have not yet made public the text of the final rules, this client alert provides a preliminary overview based on the Commissions’ fact sheets, the CFTC’s Q&A release, and discussion during the CFTC’s open meeting approving the rules, with a focus on certain commonly used derivative products that will likely be covered as “swaps” or “security-based swaps.”<sup>1</sup> We will provide a more detailed analysis of the final rules and their interpretations upon their release.

The publication of the final product definition rules in the Federal Register will trigger the implementation of other final derivatives-related rules promulgated under the Dodd-Frank Act, subject to any applicable phase-in provisions or forthcoming exemptive relief. Users of derivative products that are “swaps” or “security-based swaps” will need to consider the impact of swap data recordkeeping and reporting requirements<sup>2</sup> on their compliance policies as

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<sup>1</sup> See CFTC Fact Sheet available at:

[http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/fd\\_factsheet\\_final.pdf](http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/fd_factsheet_final.pdf); CFTC Q&A Release available at:

[http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/fd\\_qa\\_final.pdf](http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/fd_qa_final.pdf); and SEC Fact Sheet available at: <http://sec.gov/news/press/2012/2012-130.htm>. The webcast of the CFTC’s Open Meeting on the 28<sup>th</sup> Series of Rulemakings under the Dodd-Frank Act is available online at: <http://onlinevideoservice.com/clients/cftc/archive.htm>. The SEC approved the rules during a closed meeting.

<sup>2</sup> See Swap Data Recordkeeping and Reporting Requirements, 77 F.R. 2136 (Jan. 13, 2012), Swap Data Recordkeeping and Reporting Requirements: Pre-Enactment and Transition Swaps, 77 F.R. 35200 (June 12, 2012), and Real-Time Public Reporting of Swap Transaction Data, 77 F.R. 1182 (Jan. 9, 2012). See also Overview of Final Rules on Recordkeeping and Reporting of Swaps, available at

well as their swap documentation and execution process. Some products may also be subject to a requirement that trades be entered into via a clearinghouse and/or executed on a swap execution facility, or be subject to margin requirements. Persons who may be considered a swap dealer, security-based swap dealer, major swap participant, or major security-based swap participant must register with the CFTC or SEC<sup>3</sup> and will be subject to regulation on matters including business conduct, capital and margin requirements, heightened reporting and recordkeeping requirements, and position limits monitoring, among other provisions.<sup>4</sup>

The joint final rules also affect other U.S. law requirements that may take into account derivative transactions or activities, including whether a private fund—such as a hedge fund or private equity fund—may become subject to regulation by the CFTC as a “commodity pool” under the U.S. Commodity Exchange Act based on its swap activities.<sup>5</sup> If a private fund is deemed to be a commodity pool in light of the “swap” definition, the manager to this type of private fund should assess the fund’s status in order to determine whether the manager will be required to either claim an exemption from registration as “commodity pool operator” (“CPO”) (and if necessary, as a “commodity trading advisor” (“CTA”)) or register with the CFTC as a CPO or as a CTA.<sup>6</sup> Furthermore, private funds that currently meet the de minimis exemption

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<http://stblaw.com/siteContent.cfm?contentID=4&itemID=75&focusID=1374>, and The CFTC Adopts Final Rules on the Recordkeeping and Reporting of Historical Swaps, available at <http://www.stblaw.com/siteContent.cfm?contentID=4&itemID=75&focusID=1431>.

<sup>3</sup> The CFTC has currently proposed an exemptive order that would delay the compliance date with respect to certain requirements for swap dealers and major swap participants. See CFTC Notice of Proposed Exemptive Order and Request for Comment Regarding Compliance with Certain Swap Regulations (2012). The SEC has not yet proposed comparable exemptive relief relating to security-based swap dealers or major security-based swap participants.

<sup>4</sup> See, e.g., Further Definition of “Swap Dealer,” Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant,” and “Eligible Contract Participant,” 77 FR 30596 (May 23, 2012); Registration of Swap Dealers and Major Swap Participants, 77 F.R. 2613 (Jan. 19, 2012); Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 77 F.R. 9734 (Feb. 17, 2012); and Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants, 77 F.R. 20128 (Apr. 3, 2012). See also our May 2, 2012 memorandum, *CFTC and SEC Adopt New Rules Further Defining “Swap Dealer” and “Security-based Swap Dealer,”* available at: <http://www.stblaw.com/siteContent.cfm?contentID=4&itemID=75&focusID=1413>, and our May 3, 2012 memorandum, *CFTC and SEC Adopt New Rules Further Defining “Major Swap Participant” and “Major Security-Based Swap Participant,”* available at: <http://www.stblaw.com/siteContent.cfm?contentID=4&itemID=75&focusID=1414>.

<sup>5</sup> A “commodity pool” is a collective investment vehicle that invests in futures, options on futures, and swaps. The managers and advisers of commodity pools are regulated by the CFTC unless otherwise exempt or excluded pursuant to the U.S. Commodity Exchange Act or CFTC regulations. For further explanation, see our April 16, 2012 memorandum, *Fund Managers Alert: CFTC Rescinds Exemptions and Expands its Regulations* (the “April 16 Memorandum”) available at <http://www.simpsonthacher.com/content/Publications/pub1402.pdf>.

<sup>6</sup> Managers who have claimed the CFTC Rule 4.13(a)(4) CPO exemption prior to April 24, 2012 may rely on such exemption until December 31, 2012. Similarly, managers who have claimed the CFTC Rule 4.14(a)(8) CTA exemption due to their advice to a CPO claiming the CFTC Rule 4.13(a)(4) exemption may rely on this CTA exemption until December 31, 2012.

under CFTC Rule 4.13(a)(3) will need to reevaluate whether they continue to do so under the new definition.<sup>7</sup>

The Commissions' fact sheets, the CFTC's Q&A release, and the CFTC's discussion during its open meeting state that the final rule will address certain commonly transacted derivatives as summarized below:

- **Interest Rate Derivatives.** The CFTC states that most interest rate derivatives (such as interest rate swaps, options, caps, collars, floors, or swaptions) will generally fall within the definition of "swap," though the final rule text will provide greater detail.<sup>8</sup>
- **Commodity Derivatives.** The Dodd-Frank act includes commodity swaps as "swaps,"<sup>9</sup> but excludes nonfinancial commodity forwards intended to be physically settled.<sup>10</sup> The CFTC indicates that the final rule and accompanying interpretive guidance will provide further clarification as to the scope of the nonfinancial commodity forward exclusion.<sup>11</sup>
- **Foreign Exchange Derivatives.** The CFTC states that the final rules will provide that foreign exchange swaps and foreign exchange forwards will be included as "swaps," subject to any final determination by the Treasury Department to exempt them. Even if the Treasury Department exempts such products, however, the CFTC notes that certain Dodd-Frank Act requirements will continue to apply, such as recordkeeping, reporting and business conduct standards. The CFTC also notes that the final rule will include as "swaps" other foreign exchange derivatives not subject to the Treasury Department's determination, including foreign currency options (other than foreign currency options traded on a national securities exchange), non-deliverable forwards in foreign exchange, currency swaps, and cross-currency swaps.<sup>12</sup>
- **Credit Default Swaps and Total Return Swaps.** The SEC and CFTC both indicate that the Adopting Release will offer further guidelines for distinguishing which types of credit default swaps ("CDS") and total return swaps ("TRS") will be subject to SEC jurisdiction as "security-based swaps," CFTC jurisdiction as "swaps," or joint SEC-CFTC jurisdiction as "mixed swaps."<sup>13</sup> The Dodd-Frank Act generally provides that CDS or TRS based on single securities, single loans, or narrow-based security indexes will be "security-based swaps," while other CDS and TRS will be "swaps" or "mixed swaps," depending on their particular features.<sup>14</sup>
- **Equity Options and Equity Forwards.** The Dodd-Frank Act expressly excludes from the definition of "swap" and "security-based swap" equity options and physically-settled equity forwards.<sup>15</sup> It remains to be seen whether the final rule and interpretive guidance will clarify whether cash-settled equity forwards will also be excluded.

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<sup>7</sup> For further explanation, please see the April 16, 2012 Memorandum.

<sup>8</sup> See CFTC Fact Sheet, pp. 6-7.

<sup>9</sup> See 7 U.S.C. § 1a(47)(A)(iii)(XXII).

<sup>10</sup> See 7 U.S.C. § 1a(47)(B)(ii).

<sup>11</sup> See CFTC Fact Sheet, p. 5.

<sup>12</sup> See CFTC Fact Sheet, pp. 5-6. See also 7 U.S.C. § 1a(47)(E).

<sup>13</sup> See CFTC Fact Sheet, pp. 6-8; SEC Fact Sheet, pp. 5-6.

<sup>14</sup> See 7 U.S.C. §§ 1a(47)(A)(iii) and 1a(47)(D); 15 U.S.C. § 78c(a)(68)(A)(i).

<sup>15</sup> See 7 U.S.C. §§ 1a(47)(B)(i) and 1a(47)(B)(iii).

As previously noted, the foregoing is based on preliminary information made available by the Commissions, as the Commissions have not yet publicly released the final rule text or interpretive guidance. We will provide a more detailed analysis of the final rules and their interpretations upon their release.

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