



CFTC and SEC Publish Key Swap Product Definition Rules under Dodd-Frank, Starting a Countdown to Compliance

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On August 13, 2012, the U.S. Securities and Exchange Commission ("SEC") and U.S. Commodity Futures Trading Commission ("CFTC" and, together with the SEC, the "Commissions"), published in the Federal Register joint final rules and interpretive guidance 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").¹ The scope of these terms determines which transactions, and which parties to a transaction, will be subject to many of the derivatives regulatory provisions of Title VII of the Dodd-Frank Act, including requirements for recordkeeping and reporting, mandatory clearing and trade execution, collateral segregation and margin levels, and registration as a regulated entity such as a swap dealer or major swap participant. For derivatives market participants, the publication of the product definition rules also starts a countdown to the compliance dates of many provisions whose effectiveness had been tolled pending the adoption of these final product definitions. The product definition rules generally take effect on October 12, 2012.

In the final rules and guidance, the Commissions declined to elaborate upon the full range of interpretive issues raised by the Dodd-Frank Act's definitional criteria for determining whether a particular derivative is a "swap" or "security-based swap."² Instead, the Commissions focus on a few commonly transacted products, most notably foreign exchange and currency derivatives, commodity and security forwards, total return swaps, and credit default swaps. They also provide some added detail regarding guarantees of swaps and security-based swaps, certain product features relating to interest rates or government debt obligations, jurisdictional and compliance considerations for products subject to joint SEC-CFTC oversight as "mixed swaps" or "security-based swap agreements," the exclusion of certain consumer and commercial transactions from the product definitions, a safe harbor for certain insurance products, anti-evasion authority of the Commissions, and the process by which parties may request a public determination by the Commissions as to the status of a particular product under the definitions.

¹ "Further Definition of 'Swap,' 'Security-Based Swap,' and 'Security-Based Swap Agreement'; Mixed Swaps; Security-Based Swap Agreement Recordkeeping," CFTC and SEC Joint Final Rule; Interpretations; Request for Comment on an Interpretation, 77 Fed. Reg. 48208 (August 13, 2012) (the "Adopting Release").

² See 77 Fed. Reg. at 48211 ("The statutory definitions of the terms 'swap' and 'security-based swap' are detailed and comprehensive, and the Commissions believe that extensive 'further definition' of the terms by rule is not necessary.").

GENERAL SCOPE OF THE PRODUCT DEFINITIONS

In general, whether a derivative product is a “swap” or “security-based swap” depends on its particular characteristics. The Dodd-Frank Act outlines a variety of characteristics that could bring a product within the scope of either definition, subject to a list of exclusions.³ The term “swap” generally applies to certain derivative products referencing instruments (other than single securities, single loans, or narrow-based security indexes) such as interest rates, exchange rates, commodities, or currencies, subject to applicable exclusions.⁴ The term “security-based swap” generally includes certain products referencing single securities, single loans, or narrow-based security indexes, also subject to exclusions.⁵ The Dodd-Frank Act generally charges the CFTC with jurisdiction over swaps and the SEC with jurisdiction over security-based swaps, though the SEC also has some anti-fraud and other authority with respect to a subset of swaps that relate to securities, referred to as “security-based swap agreements” (as discussed further below).⁶ A “mixed swap” incorporates features of both swaps and security-based swaps, and is subject to joint jurisdiction of the Commissions.⁷

The joint final rules and interpretive guidance address the following notable issues that may arise in determining whether a particular product is a “swap,” “security-based swap,” or “mixed swap,” or whether certain exclusions from the product definitions may apply.

FOREIGN EXCHANGE/CURRENCY DERIVATIVES

The final rules provide a non-exhaustive list of several types of foreign exchange and currency derivatives included as swaps,⁸ including as summarized in the table below.

<i>Foreign Exchange/Currency Derivatives Included within the Definition of “Swap”</i>	
(1)	<u>Foreign currency options</u> (other than foreign currency options traded on a national securities exchange) ⁹
(2)	<u>Non-deliverable forwards involving foreign exchange</u> : products that, by their terms, are generally cash-settled in a reference currency (such as USD) rather than physically settled through an exchange of two different currencies ¹⁰
(3)	<u>Currency swaps and cross-currency swaps</u> : products that generally involve swaps of interest rates denominated in different currencies ¹¹

³ See 7 U.S.C. § 1a(47) (defining “swap”) and 15 U.S.C. § 78c(a)(68) (defining “security-based swap”).

⁴ See 7 U.S.C. § 1a(47).

⁵ See 15 U.S.C. § 78c(a)(68).

⁶ See 77 Fed. Reg. at 48210.

⁷ See *id.*

⁸ 17 C.F.R. §§ 1.3(xxx)(2)(i), 1.3(xxx)(3).

⁹ See 77 Fed. Reg. at 48254.

¹⁰ See 77 Fed. Reg. at 48255-48256.

¹¹ The Commissions use the term “currency swap” to refer to a swap that exchanges a fixed rate against a fixed rate and the term “cross-currency swap” to refer to a swap that exchanges a fixed rate against a floating rate (a cross-currency coupon swap) or a floating rate for a floating rate (a cross-currency basis swap), as well as cross-currency annuity swaps or amortizing cross-currency swaps, in each case with the two legs denominated in different currencies. See 77 Fed. Reg. at 48256, n. 556-57.

Foreign Exchange/Currency Derivatives Included within the Definition of “Swap,” Subject to Exemptive Determination by the Treasury Department

- (1) Foreign exchange forwards, 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.”¹²
- (2) Foreign exchange swaps, defined as “a transaction that solely involves (A) an exchange of two different currencies on a specific date 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.”¹³

The final rules also confirm that physically settled foreign exchange forwards and foreign exchange swaps are swaps unless the Secretary of the Treasury issues a written determination that either or both: (i) should not be regulated as swaps and (ii) are not structured to evade the Dodd-Frank Act in violation of any rule promulgated by the CFTC.¹⁴ The Treasury Department has issued a Notice of Proposed Determination to exempt these foreign exchange products, but has not yet finalized its determination.¹⁵ Even if the Treasury Department ultimately exempts such products from the swap definition, certain Dodd-Frank Act requirements will continue to apply, such as reporting obligations of parties to any such transaction and business conduct standards for swap dealers and major swap participants with respect to such foreign exchange products.¹⁶ Any determination by the Treasury Department with respect to foreign exchange forwards and foreign exchange swaps will also not affect the classification as swaps of other foreign exchange and currency derivatives, including those listed in the first table above.¹⁷

The CFTC’s interpretive guidance also clarifies that the term “swap” does not include bona fide foreign currency spot transactions, notwithstanding the fact that such spot transactions may settle on a date later than the trade date (*i.e.*, a settlement cycle such as T+2 would not render a foreign currency spot transaction a forward contract for purposes of the “swap” definition).¹⁸

INTEREST RATE DERIVATIVES

The Dodd-Frank Act’s statutory language includes most interest rate derivatives – such as interest rate swaps and interest rate caps, floors, collars, and other interest rate options or combinations of interest rate options – within the definition of “swap.”¹⁹ The final rules and

¹² 7 U.S.C. § 1a(24).

¹³ 7 U.S.C. § 1a(25).

¹⁴ See 7 U.S.C. § 1a(47)(E) (authorizing such determination by the Secretary of the Treasury).

¹⁵ See 76 Fed. Reg. 25774 (May 5, 2011).

¹⁶ See 7 U.S.C. §§ 1a(47)(E)(iii)-(iv) and 17 C.F.R. § 1.3(xxx)(3)(ii).

¹⁷ See 17 C.F.R. § 1.3(xxx)(3)(v). Any such determination by the Treasury Department would also not exempt any foreign exchange forward or foreign exchange swap traded on a designated contract market or swap execution facility, or cleared by a derivatives clearing organization, from applicable antifraud or anti-manipulation provisions under the Commodity Exchange Act. See 77 Fed. Reg. at 48253, n. 512.

¹⁸ See 77 Fed. Reg. at 48256-48257.

¹⁹ 7 U.S.C. § 1a(47)(A).

interpretive guidance provide little further elaboration, other than to note that, broadly speaking, Title VII Instruments²⁰ based on interest or other monetary rates would be swaps, while Title VII Instruments based on the yield or value of a single security, loan, or narrow-based security index would be security-based swaps.²¹

EQUITY OPTIONS

The Dodd-Frank Act excludes from the definition of “swap” and “security-based swap” “any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities, including any interest therein or based on the value thereof, that is subject to [the Securities Act of 1933 and the Securities Exchange Act of 1934],”²² but the Commissions declined in the final rulemaking to provide additional guidance as to the exact contours of this exclusion. In practice, each option should be carefully analyzed to determine whether it fits within the exclusion, based on the facts, circumstances, and economics of the transaction.

PHYSICALLY SETTLED NONFINANCIAL COMMODITY FORWARDS AND SECURITY FORWARDS

The Dodd-Frank Act expressly excludes from the definitions of “swap” and “security-based swap” “any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled” (the “Forward Contract Exclusion”).²³ The Commissions’ interpretive guidance further elaborates as to the scope of this exclusion with respect to nonfinancial commodity forwards, commodity forwards with embedded options, and security forwards.

Physically Settled Nonfinancial Commodity Forwards

The CFTC interprets the exclusion for nonfinancial commodity forwards to apply to contracts for the purchase or sale of an exempt commodity or agricultural commodity (as both terms are defined in the Commodity Exchange Act (“CEA”))²⁴ that can be physically delivered, under which the parties have a bona fide intent to make or take delivery. In general, the CFTC states that it considers the exemption directed towards “private commercial merchandising transactions which create enforceable obligations to deliver but in which delivery is deferred for

²⁰ The Adopting Release refers to the combined set of transactions that are swaps, or would be swaps but for the carve-out of security-based swaps from the definition of “swap,” as “Title VII Instruments” (i.e., “Title VII Instrument” means any agreement, contract, or transaction that is included within the definition of either “swap” or “security-based swap”). See 77 Fed. Reg. at 48262.

²¹ See 77 Fed. Reg. at 48262.

²² 7 U.S.C. § 1a(47)(B)(iii).

²³ 7 U.S.C. § 1a(47)(B)(ii).

²⁴ The CEA defines an “exempt commodity” as a commodity that is not an agricultural commodity or excluded commodity. The term “excluded commodity” generally refers to certain financial instruments or measures such as interest rates, exchange rates, currencies, indexes, and securities, among others. See 7 U.S.C. §§ 1a(19) and 1a(20). The CFTC interprets the term “nonfinancial commodity” to include certain intangible commodities capable of being physically delivered, such as emissions allowances. See 77 Fed. Reg. at 48232-48235.

reasons of commercial convenience or necessity,” where the “primary purpose . . . is to transfer ownership of the commodity and not to transfer solely its price risk.”²⁵ Under certain circumstances in which actual delivery fails to occur, the CFTC may still allow the exclusion to apply, so long as it can determine or infer – based on the applicable facts and circumstances – that the parties truly intended to physically settle the transaction.²⁶

Physically Settled Nonfinancial Commodity Forward Contracts with Embedded Options

The CFTC notes that while the statutory swap definition expressly includes commodity options as swaps,²⁷ physically settled nonfinancial commodity forward contracts that would otherwise qualify for the Forward Contract Exclusion, but which contain certain embedded option features, may still be able to qualify for the exclusion. The CFTC will evaluate the facts and circumstances of the transaction as a whole in determining whether the contract qualifies for the Forward Contract Exclusion, with particular focus on the factors summarized in the table below.²⁸

<i>Otherwise Qualifying Commodity Forward Contracts with Embedded Options</i> Criteria to qualify for the Forward Contract Exclusion²⁹	
(1)	The embedded option may be used to adjust the forward contract price, but not to undermine the overall nature of the contract as a forward;
(2)	The embedded option does not target the delivery term in such a manner as to eliminate actual delivery as the predominant feature of the contract; and
(3)	The embedded option cannot be severed and marketed separately from the overall forward contract.

²⁵ 77 Fed. Reg. at 48228.

²⁶ See 77 Fed. Reg. at 48232-48244. In particular, the CFTC states that it will draw upon, with certain modifications, relevant precedent developed in the futures regulatory context. Most notably, the CFTC adopts a modified version of its “Brent Interpretation” (*Statutory Interpretation Concerning Forward Transactions*, 55 FR 39188 (Sept. 25, 1990) (relating to net settlement as a result of a separate, individually negotiated cancellation agreement referred to as a “book-out”)), expanded to apply to nonfinancial commodities generally. See 77 Fed. Reg. at 48228-48229.

²⁷ Certain physically settled options involving a commercial user of the commodity underlying the option may qualify for the “trade option” exemption from many of the regulatory provisions relating to swaps. See 17 C.F.R. § 32.3. See also “Commodity Options,” CFTC Final Rule and Interim Final Rule, 77 Fed. Reg. 25320 (April 27, 2012).

²⁸ See 77 Fed. Reg. at 48237-42.

²⁹ See 77 Fed. Reg. at 48237.

Otherwise Qualifying Commodity Forward Contracts with Embedded Volumetric Options

(interim final rule)

For contracts with embedded volumetric options, the following added criteria also apply³⁰

- (4) The buyer and seller of the underlying commodity intend at the outset to make and take delivery of a non-nominal volume of the commodity even if the embedded option is exercised;
- (5) Both parties are “commercial parties” (*i.e.*, both parties regularly make/take delivery of the applicable commodity in the ordinary course of their business); and
- (6) The optionality as to volume is primarily driven by physical factors or regulatory requirements that influence supply and demand and that are outside the parties’ control, such that the optionality is a commercially reasonable way to address uncertainty associated with those factors.

Security Forwards

The Dodd-Frank Act excludes from the “swap” and “security-based swap” definitions (1) purchases and sales of securities on a fixed or contingent basis³¹ and (2) sales of securities for deferred delivery that are intended to be physically delivered.³² In a security forward, the Commissions consider the sale of the security to occur at the time the parties to the transaction enter into the contract, with the delivery deferred or delayed.³³ The interpretive guidance provides that such transactions therefore fall outside the scope of the “swap” and “security-based swap” definitions when the parties intend at the outset to physically settle the transaction.³⁴ The Commissions declined to provide a bright line test for determining bona fide intent to deliver, instead stating their intent to rely on a facts-and-circumstances analysis.³⁵ The Commissions also did not discuss security forwards that could be physically settled, but also allow for additional settlement methods, such as where one or both parties have the option to elect cash settlement or net share settlement.³⁶

³⁰ See 77 Fed. Reg. at 48239.

³¹ See 7 U.S.C. §§ 1a(47)(B)(v) (excluding from the “swap” and “security-based swap” definitions “any agreement, contract, or transaction providing for the purchase or sale of 1 or more securities on a fixed basis that is subject to [the Securities Act of 1933 and Securities Exchange Act of 1934]”) and 1a(47)(B)(vi) (excluding from the “swap” and “security-based swap” definitions “any agreement, contract, or transaction providing for the purchase or sale of 1 or more securities on a contingent basis that is subject to [the Securities Act of 1933 and Securities Exchange Act of 1934], unless the agreement, contract, or transaction predicates the purchase or sale on the occurrence of a bona fide contingency that might reasonably be expected to affect or be affected by the creditworthiness of a party other than a party to the agreement, contract, or transaction”).

³² See 7 U.S.C. § 1a(47)(B)(ii).

³³ See 77 Fed. Reg. at 48244-48245.

³⁴ See *id.*

³⁵ See 77 Fed. Reg. at 48245.

³⁶ See *id.*

TOTAL RETURN SWAPS, CREDIT DEFAULT SWAPS, AND THE DEFINITION OF “NARROW-BASED SECURITY INDEX”

Total Return Swaps (“TRS”)

A TRS on a single security, loan, or narrow-based security index generally would be a security-based swap subject to SEC regulation, while a TRS based on an index other than a narrow-based security index or on two or more loans generally would be a swap subject to CFTC regulation. If a TRS that would otherwise be a security-based swap also includes certain characteristics of a swap, the TRS would be a mixed swap.³⁷ The Commissions narrowly interpret the scope of the mixed swap category, so that if the terms of a TRS create interest rate or currency exposures incidental to the primary purpose of the TRS—for example, if a TRS uses variable interest rates for financing reasons incidental to the counterparties’ purposes and risks assumed in entering into the TRS—such features would not cause a TRS that would otherwise be a security-based swap to be characterized as a mixed swap. If, however, a TRS that would otherwise be a security-based swap incorporates additional elements that create interest rate, currency, commodity, or similar exposures that are unrelated to the financing of the security-based swap or otherwise shift or limit risks that are related to the financing of the security-based swap—for example, if the TRS embeds interest-rate optionality (such as a cap, collar, call, or put) to shift or limit interest rate exposure or embeds another non-securities component (such as the price of oil or a currency hedge)—the TRS would be a mixed swap.³⁸

Credit Default Swaps (“CDS”)

The SEC generally regulates CDS on single names, loans, and narrow-based security indexes, while the CFTC generally regulates CDS based on indexes other than narrow-based security indexes (such as a broad-based security index).³⁹ As discussed below, the interpretive guidance provides criteria to determine whether a security index underlying an index CDS is narrow-based or broad-based.

Definition of “Narrow-Based Security Index”

As noted above, a Title VII Instrument for which the underlying reference asset is a “narrow-based security index” is a security-based swap subject to SEC jurisdiction, whereas a Title VII Instrument for which the underlying reference asset is an index other than a narrow-based security index (such as a broad-based security index or index of instruments other than securities) is a swap subject to CFTC jurisdiction. The final rulemaking generally follows the existing Exchange Act and CEA definition of “narrow-based security index”⁴⁰ for purposes of

³⁷ The Dodd-Frank Act describes “mixed swap” in the definitions of “security-based swap” and “swap” as a security-based swap that is also “based on the value of 1 or more interest or other rates, currencies, commodities, instruments of indebtedness, indices, quantitative measures, other financial or economic interest or property of any kind (other than a single security or a narrow-based security index), or the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence” 15 U.S.C. § 78c(a)(68)(D) and 7 U.S.C. § 1a(47)(D).

³⁸ 77 Fed. Reg. at 48264-48267.

³⁹ See 77 Fed. Reg. at 48271.

⁴⁰ 15 U.S.C. § 78c(a)(55)(B) and (C); 7 U.S.C. § 1a(35). See also 77 Fed. Reg. at 48271 n. 727.

the “security-based swap” and “swap” definitions, with some additional considerations.⁴¹ The Commissions note that the term “index” in this context refers to any “index or group of securities, including any interest therein or based on the value thereof,” and therefore includes not only portfolios of securities selected or created by a third-party index provider, but also baskets or groups of securities selected or created by the parties to the derivative transaction.⁴²

The interpretive guidance explains that the determination of whether a Title VII Instrument is a swap, security-based swap, or mixed swap occurs prior to execution, but no later than when the parties offer to enter into the instrument.⁴³ The characterization does not change throughout the duration of the Title VII Instrument unless the instrument is amended or modified in a material respect during its term. For a Title VII Instrument based on a security index, therefore, if such security index is initially determined to be a broad-based security index, but later becomes a narrow-based security index during the life of the instrument (without amendment or modification of the instrument in a material respect), such Title VII Instrument will remain subject to CFTC regulation as a swap, even after such change to the reference index.⁴⁴

Where a Title VII Instrument references a security index that may, but will not necessarily, migrate from broad-based to narrow-based (or vice versa) according to predetermined criteria or a self-executing formula set forth at the time of execution, such Title VII Instrument will be considered a swap, security-based swap, or mixed swap based on the nature of the index at the time of execution. If such criteria or formula would intentionally cause the security index to migrate from narrow-based to broad-based (or vice versa) during the duration of the instrument, the Title VII Instrument based on that index would be a mixed-swap.⁴⁵ If the counterparties to a Title VII Instrument based on a security index have discretion, either directly or indirectly (*e.g.*, through an investment advisor or third party index provider), to change the weighting or composition of securities in the security portfolio, such security portfolio will be treated as a narrow-based security index, and the Title VII Instrument referencing the security portfolio will be either a security-based swap or mixed swap, depending on its other characteristics.⁴⁶

The final rules adopt criteria for determining whether a security index is narrow-based or broad-based, along with modified criteria that apply if the index in question is a debt security index or volatility index, or if the instrument referencing the index is a CDS. In general, the Commissions will consider in each case the number of component references in an index and the relative concentration or weighting of the components. The remaining criteria, which the Commissions refer to as the average daily trading volume test and public information availability test, apply depending on the type of index at issue, as summarized in the tables below.

⁴¹ See 77 Fed. Reg. at 48271-48273.

⁴² See 77 Fed. Reg. at 48285. See also 15 U.S.C. § 78c(a)(68)(E).

⁴³ 77 Fed. Reg. at 48262 and 48285-48287.

⁴⁴ See 77 Fed. Reg. at 48286.

⁴⁵ See 77 Fed. Reg. at 48286-48287.

⁴⁶ See *id.* See also *supra* note 37.

<i>Criteria for Determining Whether a Security Index is a “Narrow-Based Security Index”:</i> If the answer to any one of the questions below is “yes,” the index is narrow-based ⁴⁷	
<i>Number and Concentration Criteria</i>	
(1)	Does the index have nine or fewer component securities?
(2)	Does any single component security comprise more than 30% of the index’s total weighting?
(3)	Do the five highest weighted component securities in the aggregate comprise more than 60% of the index’s weighting?
<i>Average Daily Trading Volume Test</i>	
(4)	Do the lowest weighted component securities comprising 25% of the index’s weighting have an aggregate dollar value of average daily trading volume of less than \$50 million (or in the case of an index with more than 15 component securities, \$30 million)? ⁴⁸

<i>Criteria for Determining Whether a Debt Security Index is a “Narrow-Based Security Index”⁴⁹</i>	
<i>Number and Concentration Criteria:</i> If the answer to any one of questions (1)-(3) below is “yes,” the index is narrow-based	
(1)	Is the index comprised of nine or fewer debt securities issued by nine or fewer non-affiliated issuers?
(2)	Do the securities of any issuer in the index comprise more than 30% of the index’s total weighting?
(3)	Do the securities of any five non-affiliated issuers comprise more than 60% of the index’s total weighting?
<i>Public Information Availability Test:</i> If the answers to all of questions (1)-(3) are “no,” the index will only be narrow-based if none of criteria (4)-(8) below are satisfied	
(4)	The issuer of the security included in the index is required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (the “ <u>Exchange Act</u> ”);
(5)	The issuer of the security included in the index has a worldwide market value of its outstanding common equity held by non-affiliates of \$700 million or more;

⁴⁷ See 15 U.S.C. § 78c(a)(55)(B). See also 77 Fed. Reg. at 48271.

⁴⁸ If there are two or more securities with equal weighting that could be included in the calculation of the lowest weighted component securities comprising, in the aggregate, 25% of the index’s weighting, such securities shall be ranked from lowest to highest dollar value of average daily trading volume and shall be included in the calculation based on their ranking starting with the lowest ranked security. See 15 U.S.C. 78c(a)(55)(B).

⁴⁹ See 77 Fed. Reg. at 48272. See also Joint Final Rules: Application of the Definition of Narrow-Based Security Index to Debt Securities Indexes and Security Futures on Debt Securities, 71 Fed. Reg. 39434 (Jul. 13, 2006).

- (6) The issuer of the security included in the index has outstanding notes, bonds, debentures or evidences of indebtedness having a total remaining principal amount of at least \$1 billion;
- (7) The security is an exempted security under the Exchange Act and the rules promulgated thereunder; and
- (8) The issuer of the security included in the index is a government or foreign country or a political subdivision of a foreign country.

Criteria for Determining Whether a Security Index Underlying a CDS is a “Narrow-Based Security Index”

Number and Concentration Criteria:

If the answer to any one of questions (1)-(3) below is “yes,” the index underlying an index CDS is narrow-based⁵⁰

- (1) Are there nine or fewer non-affiliated issuers of securities or securities that are references in the index?⁵¹
- (2) Does the effective notional amount allocated to any reference entity or security of any issuer included in the index comprise more than 30% of the index’s weighting?
- (3) Does the effective notional amount allocated to any five non-affiliated reference entities, or to the securities of any five non-affiliated issuers, included in the index comprise more than 60% of the index’s weighting?

Public Information Availability Test:

If the answers to all of questions (1)-(3) are “no,” the index will only be narrow-based if none of criteria (4)-(10) below are satisfied⁵²

- (4) The reference entity or the issuer of the security included in the index is required to file reports pursuant to the Exchange Act or the regulations thereunder;
- (5) The reference entity or the issuer of the security included in the index is eligible to rely on the exemption provided in Exchange Act Rule 12g3-2(b);⁵³
- (6) The reference entity or issuer of the security included in the index has a worldwide market value of its outstanding common equity held by non-affiliates of \$700 million or more;
- (7) The reference entity or issuer included in the index has outstanding notes, bonds, debentures, loans, or evidences of indebtedness (other than revolving credit facilities) having a total remaining principal amount of at least \$1 billion;

⁵⁰ See 77 Fed. Reg. at 48275-48276.

⁵¹ The interpretive guidance sets forth specific criteria for determining whether a security or an issuer of such security should be deemed a reference entity in an index. See 77 Fed. Reg. at 48275.

⁵² See 77 Fed. Reg. at 48278-48280.

⁵³ 17 C.F.R. § 240.12g3-2(b).

- (8) The reference entity included in the index is an issuer of an exempted security or the security included in the index is an exempted security under Section 3(a)(12) of the Exchange Act and the rules promulgated thereunder;
- (9) The reference entity or issuer is a government or foreign country or a political subdivision of a foreign country;
- (10) If the reference entity or issuer of the security included in the index is an issuing entity of asset-backed securities, such asset-backed security was issued in a transaction registered under the Securities Act of 1933 (the “Securities Act”) and has publicly available distribution reports.

DERIVATIVES BASED ON CERTAIN GOVERNMENT DEBT OBLIGATIONS

The interpretive guidance notes that Title VII Instruments based on certain “exempted securities” under Section 3a(12) of the Exchange Act,⁵⁴ such as U.S. Treasury securities and other securities guaranteed by the U.S. government as to principal and interest, are classified as swaps, whereas Title VII Instruments based on other government debt not within the Exchange Act definition of “exempted securities,” such as foreign government debt, will be classified as security-based swaps.⁵⁵

CERTAIN INSURANCE PRODUCTS, CONSUMER AND COMMERCIAL ARRANGEMENTS, AND LOAN PARTICIPATIONS

The interpretive guidance explains that certain types of products or transactions that could be covered by an expansive reading of the “swap” or “security-based swap” definition, but that traditionally have not been considered to be swaps or security-based swaps, do not fall within the scope of either term.⁵⁶ In each case, the Commissions will engage in a facts-and-circumstances analysis to determine whether a particular product is excluded from the swap and security-based swap definitions.⁵⁷ The interpretive guidance addresses a few categories specifically, including insurance,⁵⁸ loan participations,⁵⁹ and certain consumer and commercial arrangements.⁶⁰ The final rules also provide a non-exclusive safe harbor for certain insurance products that meet the applicable requirements.⁶¹

⁵⁴ 15 U.S.C. § 78c(a)(12).

⁵⁵ See 77 Fed. Reg. at 48264.

⁵⁶ See 77 Fed. Reg. at 48211.

⁵⁷ See 77 Fed. Reg. at 48211-48252.

⁵⁸ See 77 Fed. Reg. at 48212-48213.

⁵⁹ See 77 Fed. Reg. at 48251.

⁶⁰ See 77 Fed. Reg. at 48246-48247.

⁶¹ See 17 C.F.R. § 1.3(xxx)(4). See also 77 Fed. Reg. at 48212-27.

OTHER ISSUES ADDRESSED BY THE FINAL RULES AND INTERPRETIVE GUIDANCE

Guarantees of Swaps and Security-Based Swaps

The CFTC indicates in its interpretive guidance that it intends to treat guarantees of swaps as part of the underlying swap, adding that it plans to address the practical implications of such interpretation in a separate, future release.⁶² The SEC declined to adopt an interpretation as to whether a guarantee of a security-based swap constitutes part of the underlying security-based swap, though the SEC does state that it does not consider such a guarantee to itself be a separate security-based swap.⁶³ The interpretive guidance also notes that, because the definition of “security” under the Securities Act includes both security-based swaps and guarantees of securities, guarantees of security-based swaps generally also fall within the definition of “security,” and therefore will be subject to attendant federal securities law considerations as such.⁶⁴ The SEC indicates that it will separately address any reporting obligations relating to guarantees of security-based swaps, as well as issues involving cross-border guarantees, through future rulemaking or other guidance.⁶⁵

Compliance Considerations Relating to Mixed Swaps

The Commissions interpret the scope of the term “mixed swap” – which refers to instruments that will be treated simultaneously as both security-based swaps and swaps – to apply narrowly.⁶⁶ This class of Title VII Instruments generally includes derivatives with multiple underlying references, at least one of which is characteristic of security-based swaps, and another of which is characteristic of swaps.⁶⁷ The interpretive guidance lists as an example a Title VII Instrument in which the underlying references are the value of an oil corporation stock and the price of oil.⁶⁸

The joint rules provide for some relief from overlapping or duplicative compliance obligations for parties to a mixed swap due to the product’s status as both a swap and security-based swap. Where at least one party to a mixed swap is dually-registered with the CFTC as a swap dealer or major swap participant and with the SEC as a security-based swap dealer or major security-based swap participant, the joint rules provide that bilateral uncleared mixed swaps⁶⁹ will be subject to all applicable provisions of the federal securities laws, a limited number of provisions

⁶² See 77 Fed. Reg. at 48225-48227.

⁶³ See 77 Fed. Reg. at 48227.

⁶⁴ See 77 Fed. Reg. at 48227. See also Temporary Exemptions and Other Temporary Relief, Together With Information on Compliance Dates for New Provisions of the Securities Exchange Act of 1934 Applicable to Security-Based Swaps, 76 Fed. Reg. 36287 (June 22, 2011) (the “SEC Effective Date Order”).

⁶⁵ See *id.*

⁶⁶ See 77 Fed. Reg. at 48291.

⁶⁷ See *supra* note 37.

⁶⁸ See 77 Fed. Reg. at 48291.

⁶⁹ The rule defines a “bilateral uncleared mixed swap” as a mixed swap that: (i) is neither executed on, nor subject to, the rules of a designated contract market, national securities exchange, swap execution facility, security-based swap execution facility, or foreign board of trade and (ii) will not be submitted to a designated clearing organization or registered or exempt clearing agency to be cleared. See 17 C.F.R. § 1.9(b) and Exchange Act Rule 3a68-4(b), 17 C.F.R. § 240.3a68-4(b).

of the CEA, and the anti-fraud, anti-manipulation, and other provisions of the business conduct standards of the CEA.⁷⁰

Absent a joint rule or order by the Commissions permitting an alternative regulatory approach, persons who desire or intend to list, trade, or clear a mixed swap that is not a bilateral uncleared mixed swap will be required to comply with all applicable Dodd-Frank Act provisions relating to both swaps and security-based swaps. The Commissions have, however, adopted a process by which any person may request the Commissions to publicly issue a joint order permitting compliance with only one set of specified parallel provisions for swaps and security-based swaps, rather than with both sets of parallel provisions.⁷¹

Security-Based Swap Agreements

The term “security-based swap agreement” (“SBSA”) refers to certain swaps over which the CFTC has regulatory authority, but with respect to which the SEC has anti-fraud, anti-manipulation, and certain other authority.⁷² While the Commissions declined to provide a bright line test to define SBSAs, the interpretive guidance provides a number of examples, including swaps based on broad-based security indexes, index CDS based on broad-based indexes, and swaps based on U.S. Treasury securities or certain other “exempted securities” (as defined in Section 3a of the Exchange Act).⁷³ The Commissions also state in the interpretive guidance that they will not impose any additional books and records requirements for SBSAs beyond those already applicable for swaps.⁷⁴

Anti-Evasion

The final rules include several CFTC provisions designed to prevent the willful (*i.e.*, intentional or with reckless disregard) evasion of the Dodd-Frank Act’s comprehensive regulation scheme for swaps. In determining whether a transaction has been willfully structured to evade regulation, the CFTC will evaluate each activity on a case-by-case basis but will consider, among other factors, whether the structure has a legitimate business purpose and whether it involves deceit, deception, or other unlawful or illegitimate activity, and will not consider form, label, or written documentation dispositive. Transactions willfully structured to evade the rules will count as swaps for purposes of determining an entity’s status as a swap dealer or major swap participant. The CFTC rules do not apply to any transaction structured as a security.⁷⁵

The SEC declined to adopt anti-evasion rules for security-based swaps as part of the final rules. The SEC notes that since security-based swaps are “securities” for purposes of the federal securities laws, all of the SEC’s existing regulatory authority, including anti-fraud and anti-manipulation provisions, will apply to security-based swaps.⁷⁶

⁷⁰ See 77 Fed. Reg. at 48292.

⁷¹ See 77 Fed. Reg. at 48292-48293.

⁷² See 15 U.S.C. § 78c(a)(78) and 7 U.S.C. §§ 1a(47)(A)(v). See also 77 Fed. Reg. at 48293-48294.

⁷³ See 77 Fed. Reg. at 48294. See also 15 U.S.C. § 78c(a)(12) (defining “exempted security”).

⁷⁴ See 77 Fed. Reg. at 48294.

⁷⁵ See 17 C.F.R. §§ 1.3(xxx)(6)(vi) and 1.6(d). See also 77 Fed. Reg. at 48297-48302.

⁷⁶ See 77 Fed. Reg. at 48303-48305.

Process for Requesting Interpretations as to the Classification of a Product

An interested person can request a joint interpretation by the Commissions regarding whether a particular agreement, contract, or transaction is a swap, security-based swap, or mixed swap. The requesting party must provide the Commissions with all material information regarding the terms of the Title VII Instrument; a statement of the economic characteristics and purpose of the transaction; the requesting party's determination as to whether the transaction should be characterized as a swap, a security-based swap, or a mixed swap; and any other information requested by either Commission. If the Commissions decide to issue a joint interpretation, they must do so within 120 days after receipt of a complete submission. If the Commissions seek public comment with respect to the joint interpretation, the 120-day deadline will be stayed during the comment period and will recommence the business day after the period ends. If the Commissions do not issue a joint interpretation within the prescribed time period, the final rules require each Commission to publicly provide its reasons for not doing so.⁷⁷

COUNTDOWN TO COMPLIANCE BEGINS

The product definition rules generally take effect on October 12, 2012, which is 60 days after their publication in the *Federal Register*.⁷⁸ The publication of the final rules also triggers the implementation of other CFTC rules whose compliance dates have so far been tolled pending the adoption of these final definitions.⁷⁹ Appendix A illustrates the applicable compliance dates for some of the key rules finalized by the CFTC.⁸⁰

The SEC has taken a number of actions intended to clarify which U.S. securities laws apply to security-based swaps as of the effective date of Title VII on July 16, 2011 and has provided interim exemptions from certain provisions of the Securities Act, the Exchange Act, and the Trust Indenture Act.⁸¹ The October 12, 2012 compliance date for the product definition rules

⁷⁷ See 17 C.F.R. § 1.8 and Exchange Act Rule 3a68-2, 17 C.F.R. § 240.3a68-2. See also 77 Fed. Reg. at 48294-48296.

⁷⁸ The compliance date for the interpretation regarding guarantees of swaps will be set forth in a separate CFTC release on that topic. See 77 Fed. Reg. at 48304.

⁷⁹ See CFTC Final Order regarding Effective Date for Swap Regulation, 76 Fed. Reg. 42508 (July 19, 2011), as amended by 76 Fed. Reg. 80233 (Dec. 23, 2011) and 77 Fed. Reg. 41260 (July 13, 2012) (the "CFTC Effective Date Order").

⁸⁰ The CFTC has also issued proposed interpretive guidance relating to the cross-border application of certain swaps provisions and a proposed exemptive order relating to the effective dates of certain provisions relating to swap dealers and major swap participants, which, if adopted and depending on the final forms adopted, could affect some compliance dates for some market participants. See Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 Fed. Reg. 41214 (July 12, 2012), and Exemptive Order Regarding Compliance with Certain Swap Regulations, 77 Fed. Reg. 41110 (July 12, 2012).

⁸¹ See SEC Effective Date Order, Order Granting Temporary Exemptions Under the Securities Exchange Act of 1934 in Connection With the Pending Revision of the Definition of "Security" To Encompass Security-Based Swaps, and Request for Comment, 76 Fed. Reg. 39927 (July 7, 2011) (the "Exchange Act Exemptive Order"), and Exemptions for Security-Based Swaps, 76 Fed. Reg. 40605 (July 11, 2011) (the "Security-Based Swaps Interim Final Rule").

will trigger the expiration of some of the temporary relief that the SEC previously granted to securities-based swaps market participants under interim actions.⁸²

The SEC intends to effect regulations relating to security-based swaps in accordance with its policy statement published on June 14, 2012.⁸³ According to the policy statement, before further implementing the comprehensive regulatory scheme for security-based swaps, the SEC plans to first propose cross-border rules defining the scope of Title VII as it applies to non-U.S. security-based swap market participants.⁸⁴ Under the policy statement, the next step in the process would be the implementation of registration requirements and applicable duties and core principles for security-based swap data repositories and the commencement of security-based swap data reporting.⁸⁵ The final phase of implementation under the policy statement would be the establishment of clearing procedures and the commencement of mandatory clearing, the registration and regulation of security-based swap dealers and major security-based swap participants, and the registration of security-based swap execution facilities and the commencement of the mandatory trade execution requirement.

With the publication of the final product definition rules triggering the implementation of some of the key CFTC rules, derivatives market participants will need to be aware of fast-approaching deadlines for new compliance responsibilities.

⁸² On October 12, 2012, certain exemptions available under the Security-Based Swaps Interim Final Rule, 77 F.R. 40605 (July 11, 2011), will expire unless the SEC extends or modifies the exemption or adopts other exemptions. In addition, on February 11, 2013, the exemption for eligible contract participants in connection with a person's activities involving security-based swaps and the exemption for registered broker-dealers with respect to security-based swaps will expire. *See* Exchange Act Exemptive Order at 39938 and Adopting Release at 48304.

⁸³ Statement of General Policy on the Sequencing of the Compliance Dates for Final Rules Applicable to Security-Based Swaps Adopted Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act, 77 Fed. Reg. 35625 (June 14, 2012) (the "SEC Policy Statement") at 35626-35627.

⁸⁴ The SEC intends to address comments to such proposed cross-border rules through the process of finalizing its other substantive rules and supplemented by the adoption of final rules in a complementary separate rulemaking. The SEC has indicated that certain rules regarding clearing agency governance may be adopted prior to the cross-border proposal. SEC Policy Statement at 35631, 35635.

⁸⁵ SEC Policy Statement at 35631-35632. The SEC adopted an interim final temporary rule that required counterparties to pre-enactment security-based swaps to report certain information to a registered security-based swap data repository or to the SEC by the earlier of (1) the compliance date established in the final permanent security-based swap reporting rules or (2) within 60 days after a registered security-based swap data repository commences operations. The SEC also issued an interpretive note to the rule requiring counterparties to retain information relating to the terms of such security-based swaps. *See* Reporting of Security-Based Swap Transaction Data, 75 Fed. Reg. 64643 (Oct. 20, 2010). This interim final temporary rule was to remain in effect until the earlier of the operative date of the permanent recordkeeping and reporting rules for security-based swap transactions to be adopted by the SEC or January 12, 2012. According to the SEC Policy Statement, the SEC staff currently is considering what further action, if any, to recommend the SEC take with regard to the interim final temporary rule and interpretive note. *See* SEC Policy Statement at 35627.

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This memorandum is for general information purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as our recent memoranda, can be obtained from our website, www.simpsonthacher.com.

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Appendix A

Compliance Dates for Certain CFTC Final Rules*

Compliance Dates for End-Users		
Rule	Compliance Date	Citation
Swap Data Recordkeeping and Reporting Requirements: Pre-Enactment and Transition Swaps for Non-SDs and Non-MSPs ⁱ	April 10, 2013	77 Fed. Reg. 35200 (June 12, 2012)
Real-Time Reporting for Swaps and Swap Data Recordkeeping and Reporting for Non-SDs and Non-MSPs	April 10, 2013	77 Fed. Reg. 1182 (January 9, 2012) 77 Fed. Reg. 2136 (January 13, 2012)

Compliance Dates for Entities Other Than End-Usersⁱⁱ

Rule	Compliance Date	Citation
Registration		
Registration for Swap Dealers (“SDs”) ⁱⁱⁱ and Major Swap Participants (“MSPs”) ^{iv}	October 12, 2012	77 Fed. Reg. 2613 (January 19, 2012)
Compliance with Commodity Pool Operator (“CPO”) Exemption in Amended CFTC Rule 4.5 for Registered Investment Companies and Compliance with Rescission of CPO Exemption in CFTC Rule 4.13(a)(4)	December 31, 2012	77 Fed. Reg. 11252 (February 24, 2012) ^v
External Business Conduct Standards		
External Business Conduct Standards	October 15, 2012	77 Fed. Reg. 9734 (February 17, 2012)
Internal Business Conduct Standards		
Monitoring of Position Limits, Diligent Supervision, Conflicts of Interest Policies and Procedures, General Information: Availability for Disclosure and Inspection, and Antitrust Considerations for SDs and MSPs	October 12, 2012	77 Fed. Reg. 20128 (April 3, 2012)
Clearing Member Risk Management for SDs and MSPs	October 12, 2012	77 Fed. Reg. 21278 (April 9, 2012)

Reporting, Recordkeeping, and Daily Trading Records Requirements and Risk Management Program for SDs and MSPs	SDs and MSPs under U.S. prudential regulation or registered with SEC:	Other SDs and MSPs:	77 Fed. Reg. 20128 (April 3, 2012)
	October 12, 2012	October 12, 2012	
Business Continuity and Disaster Recovery	October 12, 2012	December 29, 2012	77 Fed. Reg. 20128 (April 3, 2012)
Chief Compliance Officer for SDs and MSPs	October 12, 2012	March 29, 2013	77 Fed. Reg. 20128 (April 3, 2012)
Reporting and Recordkeeping			
Real-Time Reporting for Swaps and Swap Data Recordkeeping and Reporting for SDs and MSPs ^{vi}	Interest rate and credit swaps: October 12, 2012		77 Fed. Reg. 1182 (January 9, 2012)
	Equity, FX, and other commodity swaps: January 10, 2013		77 Fed. Reg. 2136 (January 13, 2012)
Swap Data Recordkeeping and Reporting Requirements: Pre-Enactment and Transition Swaps for SDs and MSPs ^{vii}	Interest rate and credit swaps: October 12, 2012 Equity, FX, and other commodity swaps: January 10, 2013		77 Fed. Reg. 35200 (June 12, 2012)
Swap Data Repositories - Core Principles, Duties and Registration	October 12, 2012		76 Fed. Reg. 54538 (September 1, 2011)

Compliance Dates for Commodity Options, Agricultural Swaps, and Position Limits

Rule	Compliance Date	Citation
Final Rule and Interim Final Rule for Commodity Options	October 12, 2012 ^{viii}	77 Fed. Reg. 25320 (April 27, 2012)
Agricultural Swaps	October 12, 2012	76 Fed. Reg. 49291 (August 10, 2011)
Position Limits for Futures and Swaps – Phase 1 ^{ix}	October 12, 2012	76 Fed. Reg. 71626 (November 18, 2011)

* Reference should be made to the relevant rulemaking release(s) and to the CFTC Effective Date Order for the details of each requirement and its implementation schedule. *See* CFTC Final Order regarding Effective Date for Swap Regulation, 76 Fed. Reg. 42508 (July 19, 2011), as amended by 76 Fed. Reg. 80233 (Dec. 23, 2011) and 77 Fed. Reg. 41260 (July 13, 2012).

ⁱ These final rules establish a two-tiered recordkeeping and reporting hierarchy, which imposes heightened recordkeeping and reporting requirements on historical swaps that were in existence on or after April 25, 2011, versus historical swaps that expired prior to April 25, 2011. For further explanation, please see our June 20, 2012 memorandum, *The CFTC Adopts Final Rules on the Recordkeeping and Reporting of Historical Swaps*, available at <http://www.stblaw.com/content/Publications/pub1431.pdf>.

ⁱⁱ The CFTC has issued proposed interpretive guidance relating to the cross-border application of certain swaps provisions and a proposed exemptive order relating to the effective dates of certain provisions relating to swap dealers and major swap participants, which, if adopted and depending on the final forms adopted, could affect some compliance dates for some market participants. *See* *Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act*, 77 Fed. Reg. 41214 (July 12, 2012), and *Exemptive Order Regarding Compliance with Certain Swap Regulations*, 77 Fed. Reg. 41110 (July 12, 2012).

ⁱⁱⁱ For more information regarding the scope of the term “Swap Dealer,” please see 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/content/Publications/pub1413.pdf>.

^{iv} For more information regarding the scope of the term “Major Swap Participant,” please see 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/content/Publications/pub1414.pdf>.

^v *See also* CFTC Letter No. 12-03 Re: Request for No-Action Relief from Rescission of Regulation 4.13(a)(4) and Amendments to Regulation 4.5 (July 10, 2012).

^{vi} These regulations establish an extensive recordkeeping and reporting regime, which has significant implications for all swap counterparties, including end-users. Alongside record retention and

retrievability requirements, the final rules create a dual framework for the periodic and real-time reporting of swap transaction data. This scheme implements Section 727 of the Dodd-Frank Act, which requires all swaps, whether cleared or uncleared, to be reported to swap data repositories that will collect and maintain swap transaction data, making such information available to regulators and, to a lesser extent, the public. For further explanation, please see our February 21, 2012 memorandum, Overview of Final Rules on Recordkeeping and Reporting of Swaps, available at <http://www.stblaw.com/content/Publications/pub1374.pdf>.

^{vii} See *supra* note i and accompanying text.

^{viii} Certain portions of the rule have different compliance dates. See SEC Final Order Regarding Commodity Options, 77 Fed. Reg. 25320 (April 27, 2012), at 25328-25329; see also CFTC Letter No. 12-06 Re: Temporary Relief for Persons Eligible for the Trade Option Exemption from the Requirements of §§ 32.3(b) and 32.3(c)(1), (3), (4) and (5) of the Commission's Regulations (August 14, 2012).

^{ix} Spot month limits in 28 commodities and non-spot month limits in 9 legacy agricultural commodities.

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