

Update: SEC and CFTC Adopt Final Swap Definitional Rules, Triggering Compliance Dates for Multiple Dodd-Frank Act Rules

Today final rules recently adopted by the Securities and Exchange Commission (the “SEC”) and the Commodity Futures Trading Commission (the “CFTC” and, together with the SEC, the “Commissions”) defining the terms “swap” and “security-based swap” (the “swap definitional rules”) were published in the Federal Register. The final rules can be found [here](#). This marks a critical milestone in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) regulatory timeline, as the compliance dates for many other rules under the Dodd-Frank Act (some of which already have been finalized by the Commissions) are dependent on the effective date of these swap definitional rules, which is 60 days following the date of such publication, *i.e.*, October 12, 2012.

Under Title VII of the Dodd-Frank Act, regulation of the over-the-counter swaps market is divided between the SEC and the CFTC; the SEC has regulatory authority over security-based swaps, while the CFTC has regulatory authority over swaps. The swap definitional rules will enable market participants to determine whether transactions or instruments are swaps, and therefore subject to the rules regulating derivatives adopted by the CFTC under the Dodd-Frank Act, security-based swaps, and therefore subject to the rules regulating derivatives adopted by the SEC under the Dodd-Frank Act, or neither, and therefore not covered by either the SEC’s or the CFTC’s regulatory regime.

The swap definitional rules will become effective on Friday, October 12. Under the CFTC’s regulatory framework, the compliance date for a number of other rules will occur automatically in connection with (or following) the effective date of the swap definitional rules. A summary of certain of these rules which will have the greatest impact on buy-side users of derivatives, and their respective compliance dates, is included below.

Swap Definition

The final definition of “swap” generally tracks the definition set forth in Section 721(a)(21) of the Dodd-Frank Act and remains largely unchanged from the CFTC’s proposed swap definitional rules. Very generally, the definition includes interest rate swaps, commodity swaps, currency swaps, credit default swaps on broad-based security indices, forwards, foreign currency options, commodity options, non-deliverable forwards in foreign exchange, cross currency swaps, forward rate agreements, options to enter into swaps, forward swaps, total return swaps on broad-based security indices, and total return swaps on two or more loans. The final definition of swap also includes deliverable currency forwards and foreign exchange swaps, although the United States Department of the Treasury has proposed excluding such transactions from the definition of swap for most purposes under the Dodd-Frank Act (except reporting requirements and business conduct standards). Forwards on a nonfinancial commodity that are intended to be physically settled and securities forwards (including TBAs) are not swaps.

Security-Based Swap Definition

The final definition of “security-based swap” generally includes swaps based on a single security or loan or a narrow-based group or index of securities (including any interest therein or the value thereof), or events relating to a single issuer or issuers of securities in a narrow-based security index. Examples of security-based swaps are swaps on “yields” (where yield is a proxy for the price or value of a debt security, loan, or narrow-based security index), a total return swap on a single security, loan, or narrow-based security index, swaps on security futures, credit default swaps on narrow-based security indices, and credit default swaps where the

underlying reference is a single entity or a single obligation of a single entity (such as a specific bond, loan, or asset-backed security, or any tranche of any of the foregoing).

As noted above, swaps on a narrow-based securities index are security-based swaps, while swaps on a broad-based securities index are swaps. The Commissions adopted rules and guidance for determining whether an index is a narrow-based security index for this purpose. An index (other than in the context of an index credit default swap) is a narrow-based security index if it meets any of the following four criteria:

- it has nine or fewer component securities;
- a component security comprises more than 30 percent of the index's weighting;
- the five highest weighted component securities in the aggregate comprise more than 60 percent of the index's weighting; or
- the lowest weighted component securities comprising, in the aggregate, 25 percent 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), except that in the case of an index in respect of debt securities, a test measuring public availability of information regarding debt securities or issuers of debt securities in the index is used in lieu of the trading volume test.

In addition, the Commissions adopted separate criteria for determining whether an index is a narrow-based security index in the context of an index credit default swap. A credit default swap index that meets any of the following characteristics will be a narrow-based security index:

- it has nine or fewer component securities or non-affiliated issuers as reference entities;
- the effective notional amount allocated to the securities of any one issuer comprises more than 30 percent of the index's weighting;
- the effective notional amount allocated to the securities of any five non-affiliated issuers in the index comprises more than 60 percent of the index's weighting; or
- less than 80 percent of the index's weighting is comprised of reference entities that satisfy a public information availability test, or any reference entity that does not satisfy such test comprises 5 percent or more of such index's weighting. An entity satisfies the public information availability test if, for example, the entity is required to file reports pursuant to the Securities Exchange Act of 1934, the entity has a worldwide market value of outstanding common equity held by non-affiliates of \$700 million or more, or the entity (other than an entity issuing an asset-backed security) has outstanding debt with a remaining principal amount of at least \$1 billion.

Commodity Pool Operator and Commodity Trading Advisor Registration

The swap definitional rules will also be significant to fund sponsors and advisors as they analyze their commodity pool operator and commodity trading advisor registration status in the wake of the repeal of the registration exemption under CFTC Rule 4.13(a)(4) and modifications to the exclusion and exemption under CFTC Rules 4.5 and 4.13(a)(3), respectively. The final rule regarding these changes can be found [here](#). As a

result of these changes, fund sponsors and advisors will need to determine whether an alternative exemption is available or whether registration is required, and now will need to include swaps in calculating whether the Rule 4.5 exclusion or the Rule 4.13(a)(3) exemption is available.

Under the revised rules, the Rule 4.5 exclusion or the Rule 4.13(a)(3) exemption will be available for funds which trade only a *de minimis* level of commodity interests and which are not marketed as vehicles for trading in commodity interests; however, the analysis of whether a fund can rely on these provisions has been modified to take into account swaps trading in the *de minimis* threshold calculations. Under the Rule 4.13(a)(3) exemption, a fund generally must keep the aggregate initial margin or premium necessary to establish a commodity interest position at or below five percent of the liquidation value of the fund's portfolio, or keep the aggregate net notional value of its commodity interest trading from exceeding 100 percent of the liquidation value of the fund's portfolio. The same *de minimis* thresholds apply in the Rule 4.5 exclusion, but bona fide hedging transactions are excluded from the calculations. Private fund operators that have typically relied on Rule 4.13(a)(4) may be able to rely instead on the exemption in Rule 4.13(a)(3). However, doing so may be more difficult than in the past since swaps will now be taken into account. Please see Ropes & Gray's Alerts [here](#) and [here](#) for more information.

CFTC Rules: Compliance Timeline

Implementation of the Dodd-Frank Act regulatory scheme depends on the adoption of swap definitions, as several key CFTC rules hinge on their meaning and cannot be implemented until the swap definitional rules have become effective. As noted above, the swap definitional rules will become effective on October 12, 2012. Several CFTC rules will become effective on that date, with compliance dates for a number of other rules to follow. These compliance dates are set forth in the following table, which outlines some of the key CFTC regulations whose effective date has now been established as a result of the adoption of the swap definitional rules and summarizes in very general terms how these regulations will impact buy-side users of derivatives.

<u>Regulation</u>	<u>General Description of Regulation and Effective Date</u>
Registration and Business Conduct Standards	Directly applicable to swap dealers and major swap participants ("MSPs"), with indirect impact on the buy-side
Registration of Swap Dealers and MSPs (final rule available here)	October 12, 2012: Entities that qualify as swap dealers or MSPs must register with the CFTC and adhere to a wide variety of new requirements, including capital, margin and business conduct requirements. By this date, all entities that qualify as swap dealers or MSPs must apply for registration. As discussed in a previous Ropes & Gray Alert , the final rules set a high bar for the MSP category, excluding most buy-side participants from the requirement to register as an MSP. In addition, the "swap dealer" definition is construed narrowly, thereby including for the most part only traditional dealers in the OTC derivatives market and excluding most buy-side participants who are not undertaking traditional dealing activities.

<p>External Business Conduct Standards for Swap Dealers and MSPs (final rule available here)</p>	<p>October 15, 2012: For all swap dealers and MSPs, compliance with external business conduct standards in connection with entering into swaps (prohibiting certain abusive practices, requiring disclosures of material information to counterparties, and requiring swap dealers and MSPs to undertake certain due diligence relating to their dealings with counterparties) is required.</p> <p>These rules will not apply to non-swap dealer/MSP buy-side counterparties directly, but such counterparties will be indirectly affected by these requirements. For example, swap dealers are expected to seek additional representations and information from their counterparties in connection with compliance with these requirements. In addition, special rules apply to swap dealers' and MSPs' dealings with "special entities" (which generally include federal agencies, state and local government entities, employee benefit plans, governmental plans, and endowments). Among other things, when entering into a swap with a special entity, swap dealers/MSPs must have a reasonable basis to believe that the special entity (other than an ERISA plan) has an "independent representative" that meets certain criteria and performs certain duties relating to review of pricing and other matters.</p> <p>The International Swaps and Derivatives Association, Inc. is expected to publish a protocol today through which market participants can amend their existing trading documentation to incorporate certain of the provisions being sought by swap dealers in response to these requirements.</p>
<p>Recordkeeping and Reporting</p>	<p>Generally applicable to all parties to swap transactions</p>
<p>Real-Time Public Reporting of Swap Transaction Data (final rule available here)</p> <p>Swap Data Recordkeeping and Reporting Requirements (final rule available here)</p> <p>Swap Data Recordkeeping and Reporting Requirements: Pre-Enactment and Transition Swaps (final rule available here)</p>	<p>Parties to both cleared and uncleared swaps will be required to maintain certain records regarding each swap. In addition, certain information regarding each swap (whether cleared or uncleared) will be required to be reported to a swap data repository, which will make the information available to regulators, and also make the information (other than the identity of the parties) available to the public. In general, if one party to a swap is a swap dealer and the other party is not, the swap dealer has the reporting obligation. Separate recordkeeping and reporting requirements apply to so-called "historical swaps" (<i>i.e.</i>, swaps executed prior to the applicable compliance date for swap data recordkeeping and reporting, as described below, including swaps executed prior to enactment of the Dodd-Frank Act on July 21, 2010 but outstanding at any time after such date). Please see Ropes & Gray's Alert for more information regarding swap data recordkeeping and reporting requirements.</p> <p>October 12, 2012: For swap dealers and MSPs, compliance with these requirements is required with respect to interest rate and credit swaps (including off-facility swaps).</p> <p>January 9, 2013: For swap dealers and MSPs, compliance with these requirements is required with respect to all other asset classes, such as equity, foreign exchange, and other commodity swaps.</p> <p>April 9, 2013: For non-swap dealers and non-MSPs, compliance with these requirements is required with respect to all types of swaps.</p>

Position Limits	Applicable generally to all market participants trading in covered futures, options, and swaps
Position Limits for Futures and Swaps (final rule and interim final rule available here)	<p>The CFTC has established speculative position limits for 28 physical delivery commodity futures and options contracts, as well as for swaps that are economically equivalent to such contracts. Please see Ropes & Gray's Alerts here and here for more information regarding position limits for futures and swaps.</p> <p>October 12, 2012: Compliance for all spot-month limits and non-spot month legacy limits is required.</p> <p>For non-spot month non-legacy referenced contracts, the compliance date will be set forth by CFTC order establishing such limits approximately 12 months after the CFTC's collection of swap positional data.</p>

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Please contact the Ropes & Gray attorney who usually advises you with any questions you may have or if you would like additional information.