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Commodity Futures Trading Commission

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Securities and Exchange Commission

17 CFR Part 240

Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping; Proposed Rule

COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 1

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SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 33–9204; 34–64372; File No. S7–16–11]

RIN 3235–AL14

Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping

AGENCIES: Commodity Futures Trading Commission; Securities and Exchange Commission.

ACTION: Joint proposed rules; proposed interpretations.

SUMMARY: In accordance with section 712(a)(8), section 712(d)(1), sections 712(d)(2)(B) and (C), sections 721(b) and (c), and section 761(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") (collectively, "Commissions"), in consultation with the Board of Governors of the Federal Reserve System ("Board"), are jointly issuing proposed rules and proposed interpretive guidance under the Commodity Exchange Act ("CEA") and the Securities Exchange Act of 1934 ("Exchange Act") to further define the terms "swap," "security-based swap," and "security-based swap agreement" (collectively, "Product Definitions"), regarding "mixed swaps," and governing books and records with respect to "security-based swap agreements."

DATES: Comments should be received on or before July 22, 2011.

ADDRESSES: Comments may be submitted, identified by File No. S7–16–11, by any of the following methods:

CFTC:

- *Agency Web site,* via its Comments Online process: *http://comments.cftc.gov.* Follow the instructions for submitting comments through the Web site.
- *Mail:* David A. Stawick, Secretary, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581.
- *Hand Delivery/Courier:* Same as mail above.
- *Federal eRulemaking Portal: http://www.regulations.gov.* Follow the instructions for submitting comments.

Please submit your comments using only one method. "*Product Definitions*" must be in the subject field of responses submitted via e-mail, and clearly indicated on written submissions. All comments must be submitted in English, or if not, accompanied by an English translation. Comments will be posted as received to *http://www.cftc.gov.* You should submit only information that you wish to make available publicly. If you wish the CFTC to consider information that you believe is exempt from disclosure under the Freedom of Information Act, a petition for confidential treatment of the exempt information may be submitted according to the procedures established in section 145.9 of the CFTC's regulations.[1]

The CFTC reserves the right, but shall have no obligation, to review, pre-screen, filter, redact, refuse or remove any or all of your submission from www.cftc.gov that it may deem to be inappropriate for publication, including obscene language. All submissions that have been redacted or removed that contain comments on the merits of the rulemaking will be retained in the public comment file and will be considered as required under the Administrative Procedure Act and other applicable laws, and may be accessible under the Freedom of Information Act.

SEC

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/proposed.shtml*);
- Send an e-mail to *rule-comments@sec.gov.* Please include File Number S7–16–11 on the subject line; or
- Use the Federal eRulemaking Portal (*http://www.regulations.gov*). Follow the instructions for submitting comments.

Paper Comments

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090. All submissions should refer to File Number S7–16–11. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The SEC will post all comments on the SEC's Internet Web site (*http://www.sec.gov/rules/proposed.shtml*). Comments are also available for Web site viewing and printing in the SEC's Public Reference Room, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. All comments received will be posted without change; the SEC does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: CFTC: Julian E. Hammar, Assistant General Counsel, at 202–418–5118, *jhammar@cftc.gov,* Mark Fajfar, Assistant General Counsel, at 202–418–6636, *mfajfar@cftc.gov,* or David E. Aron, Counsel, at 202–418–6621, *daron@cftc.gov,* Office of General Counsel, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581; SEC: Matthew A. Daigler, Senior Special Counsel, at 202–551–5578, Cristie L. March, Attorney-Adviser, at 202–551–5574, or Leah M. Drennan, Attorney-Adviser, at 202–551–5507, Division of Trading and Markets, or Michael J. Reedich, Special Counsel, or Tamara Brightwell, Senior Special Counsel to the Director, at 202–551–3500, Division of Corporation Finance, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–7010.

SUPPLEMENTARY INFORMATION: The Commissions jointly are proposing new rules and interpretive guidance under the CEA and the Exchange Act relating to the Product Definitions, mixed swaps, and security-based swap agreements.

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[1] 17 CFR 145.9.

I. Background

On July 21, 2010, President Obama signed the Dodd-Frank Act into law.[2] Title VII of the Dodd-Frank Act[3] ("Title VII") established a comprehensive new regulatory framework for swaps and security-based swaps. The legislation was enacted, among other reasons, to reduce risk, increase transparency, and promote market integrity within the financial system, including by: (i) Providing for the registration and comprehensive regulation of swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants; (ii) imposing clearing and trade execution requirements on swaps and security-based swaps, subject to certain exceptions; (iii) creating rigorous recordkeeping and real-time reporting regimes; and (iv) enhancing the rulemaking and enforcement authorities of the Commissions with respect to, among others, all registered entities and intermediaries subject to the Commissions' oversight.

Section 712(d)(1) of the Dodd-Frank Act provides that the Commissions, in consultation with the Board, shall jointly further define the terms "swap," "security-based swap," and "security-based swap agreement" ("SBSA").[4] Section 712(a)(8) of the Dodd-Frank Act provides further that the Commissions shall jointly prescribe such regulations regarding "mixed swaps" as may be necessary to carry out the purposes of Title VII. In addition, sections 721(b) and 761(b) of the Dodd-Frank Act provide that the Commissions may adopt rules to further define terms included in subtitles A and B, respectively, of Title VII, and sections 721(c) and 761(b) of the Dodd-Frank Act provide the Commissions with authority to define the terms "swap" and "security-based swap," as well as the terms "swap dealer," "major swap participant," "security-based swap dealer," and "major security-based swap participant," to include transactions and entities that have been structured to evade the requirements of subtitles A and B, respectively, of Title VII.

Section 712(d)(2)(B) of the Dodd-Frank Act requires the Commissions, in consultation with the Board, to jointly adopt rules governing books and records requirements for SBSAs by persons registered as swap data repositories ("SDRs") under the CEA,[5] including uniform rules that specify the data elements that shall be collected and maintained by each SDR.[6] Similarly,

[2] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010). The text of the Dodd-Frank Act is available at *http://www.cftc.gov/LawRegulation/OTCDERIVATIVES/index.htm.*

[3] Pursuant to section 701 of the Dodd-Frank Act, Title VII may be cited as the "Wall Street Transparency and Accountability Act of 2010."

[4] In addition, section 719(d)(1)(A) of the Dodd-Frank Act requires the Commissions to conduct a joint study, within 15 months of enactment, to determine whether stable value contracts, as defined in section 719(d)(2) of the Dodd-Frank Act, are encompassed by the swap definition. If the Commissions determine that stable value contracts are encompassed by the swap definition, section 719(d)(1)(B) of the Dodd-Frank Act requires the Commissions jointly to determine whether an exemption for those contracts from the swap definition is appropriate and in the public interest. Section 719(d)(1)(B) also requires the Commissions to issue regulations implementing the determinations made under the required study. Until the effective date of such regulations, the requirements under Title VII do not apply to stable value contracts, and stable value contracts in effect prior to the effective date of such regulations are not considered swaps. *See* section 719(d) of the Dodd-Frank Act. The Commissions currently are conducting the required joint study and will consider whether to propose any implementing regulations (including, if appropriate, regulations determining that stable value contracts: (i) are not encompassed within the swap definition; or (ii) are encompassed within the definition but are exempt from the swap definition) at the conclusion of that study.

[5] 7 U.S.C. 1 *et seq.*

[6] The CFTC has issued proposed rules regarding SDRs and, separately, swap data recordkeeping and reporting. *See* Regulations Establishing and

Continued

section 712(d)(2)(C) of the Dodd-Frank Act requires the Commissions, in consultation with the Board, to jointly adopt rules governing books and records for SBSAs, including daily trading records, for swap dealers, major swap participants, security-based swap dealers, and security-based swap participants.[7]

Under the comprehensive framework for regulating swaps and security-based swaps established in Title VII, the CFTC is given regulatory authority over swaps,[8] the SEC is given regulatory authority over security-based swaps,[9] and the Commissions shall jointly prescribe such regulations regarding mixed swaps as may be necessary to carry out the purposes of Title VII.[10] In addition, the SEC is given antifraud authority over, and access to information from, certain CFTC-regulated entities regarding SBSAs, which are a type of swap related to securities over which the CFTC is given regulatory authority.[11]

To assist the Commissions in further defining the Product Definitions (as well as certain other definitions) and in prescribing regulations regarding mixed swaps as may be necessary to carry out the purposes of Title VII, the Commissions published an advance notice of proposed rulemaking ("ANPR") in the **Federal Register** on August 20, 2010.[12] The comment period for the ANPR closed on September 20, 2010.[13] The Commissions received comments addressing the Product Definitions and/or mixed swaps in response to the ANPR, as well as comments in response to the Commissions' informal solicitations,[14] from a wide range of commenters.

The Commissions have reviewed the comments received, and the staffs of the Commissions have met with many market participants and other interested parties to discuss the definitions.[15] Moreover, the Commissions' staffs have consulted extensively with each other as required by sections 712(a)(1) and (2) of the Dodd-Frank Act and have consulted with staff of the Board as required by section 712(d) of the Dodd-Frank Act.

Based on this review and consultation, the Commissions are proposing interpretive guidance, and in some instances also proposing rules, regarding, among other things: (i) The regulatory treatment of insurance products; (ii) the exclusion of forward contracts from the swap and security-based swap definitions; (iii) the regulatory treatment of certain consumer and commercial contracts; (iv) the regulatory treatment of certain foreign-exchange related and other instruments; (v) swaps and security-based swaps involving interest rates (or other rates) and yields; (vi) total return swaps ("TRS"); (vii) the application of the definition of "narrow-based security index" in distinguishing between certain swaps and security-based swaps, including credit default swaps ("CDS") and index CDS; and viii) the specification of certain swaps and security-based swaps that are, and are not, mixed swaps. In addition, the Commissions are proposing rules: (i) establishing books and records requirements applicable to SBSAs; (ii) providing a mechanism for requesting the Commissions to interpret whether a particular type of agreement, contract, or transaction (or class of agreements, contracts, or transactions) is a swap, security-based swap, or both (*i.e.,* a mixed swap); and (iii) providing a mechanism for evaluating the applicability of certain regulatory requirements to particular mixed swaps. Finally, the CFTC is proposing rules to

Governing the Duties of Swap Dealers and Major Swap Participants, 75 FR 71397, Nov. 23, 2010; Swap Data Recordkeeping and Reporting Requirements, 75 FR 76573, Dec. 8, 2010. The SEC has also issued proposed rules regarding security-based swap data repositories ("SBSDRs"), including rules specifying data collection and maintenance standards for SBSDRs, as well as rules regarding security-based swap data recordkeeping and reporting. *See* Security-Based Swap Data Repository Registration, Duties, and Core Principles, 75 FR 77306, Dec. 10, 2010; Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information, 75 FR 75208, Dec. 2, 2010.

[7] The CFTC has issued proposed rules regarding recordkeeping requirements for swap dealers and major swap participants. *See* Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants, 75 FR 76666, Dec. 9, 2010.

[8] Section 721(a) of the Dodd-Frank Act defines the term "swap" by adding section 1a(47) to the CEA, 7 U.S.C. 1a(47). This new swap definition also is cross-referenced in new section 3(a)(69) of the Exchange Act, 15 U.S.C. 78c(a)(69). Citations to provisions of the CEA and the Exchange Act, 15 U.S.C. 78a *et seq.,* in this release refer to the numbering of those provisions after the effective date of Title VII, except as indicated.

[9] Section 761(a) of the Dodd-Frank Act defines the term "security-based swap" by adding new section 3(a)(68) to the Exchange Act, 15 U.S.C. 78c(a)(68). This new security-based swap definition also is cross-referenced in new CEA section 1a(42), 7 U.S.C. 1a(42). The Dodd-Frank Act also explicitly includes security-based swaps in the definition of security under the Exchange Act and the Securities Act of 1933 ("Securities Act"), 15 U.S.C. 77a *et seq.*

[10] Section 721(a) of the Dodd-Frank Act describes the category of "mixed swap" by adding new section 1a(47)(D) to the CEA, 7 U.S.C. 1a(47)(D). Section 761(a) of the Dodd-Frank Act also includes the category of "mixed swap" by adding new section 3(a)(68)(D) to the Exchange Act, 15 U.S.C. 78c(68)(D). A mixed swap is defined as a subset of security-based swaps that also are 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 (other than the occurrence, non-occurrence, or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition, or financial obligations of the issuer).

[11] Section 761(a) of the Dodd-Frank Act defines the term "security-based swap agreement" by adding new section 3(a)(78) to the Exchange Act, 15 U.S.C. 78c(a)(78). The CEA includes the definition of "security-based swap agreement" in subparagraph (A)(v) of the swap definition in CEA section 1a(47), 7 U.S.C. 1a(47). The only difference between these definitions is that the definition of SBSA in the Exchange Act specifically excludes security-based swaps (*see* section 3(a)(78)(B) of the Exchange Act, 15 U.S.C. 78c(a)(78)(B)), whereas the definition of SBSA in the CEA does not contain a similar exclusion. Instead, under the CEA, the exclusion for security-based swaps is placed in the general exclusions from the swap definition (*see* CEA section 1a(47)(B)(x), 7 U.S.C. 1a(47)(B)(x)). Although the statutes are slightly different structurally, the Commissions interpret them to have consistent meaning that the category of security-based swap agreements excludes security-based swaps.

[12] *See* Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 FR 51429, Aug. 20, 2010. The ANPR also solicited comment regarding the definitions of the terms "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant," and "eligible contract participant." These definitions are the subject of a separate joint proposed rulemaking by the Commissions. *See* Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 FR 80174, Dec. 21, 2010 ("Entity Definitions"). The Commissions also provided the public with the ability to present their views more generally on implementation of the Dodd-Frank Act through their Web sites, dedicated electronic mailboxes, and meetings with interested parties. *See* Public Comments on SEC Regulatory Initiatives Under the Dodd-Frank Act/Meetings with SEC Officials located at *http://www.sec.gov/spotlight/regreform comments.shtml;* Public Submissions, located at *http://comments.cftc.gov/PublicComments/ReleasesWithComments.aspx;* External Meetings, located at *http://www.cftc.gov/LawRegulation/DoddFrankAct/ExternalMeetings/index.htm.*

[13] Copies of all comments received by the SEC on the ANPR are available on the SEC's Internet Web site, located at *http://www.sec.gov/comments/s7-16-10/s71610.shtml.* Comments are also available for Web site viewing and printing in the SEC's Public Reference Room, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of all comments received by the CFTC on the ANPR are available on the CFTC's Internet Web site, located at *http://www.cftc.gov/LawRegulation/DoddFrankAct/OTC_2_Definitions.html.*

[14] *See supra* note 12.

[15] Information about meetings that CFTC staff have had with outside organizations regarding the implementation of the Dodd-Frank Act is available at *http://www.cftc.gov/LawRegulation/DoddFrankAct/ExternalMeetings/index.htm.* Information about meetings that SEC staff have had with outside organizations regarding the product definitions is available at *http://www.sec.gov/comments/s7–16–10/s71610.shtml#meetings.* The views expressed in the comments in response to the ANPR, in response to the Commissions' informal solicitations, and at such meetings are collectively referred to as the views of "commenters."

implement the anti-evasion authority provided in the Dodd-Frank Act.

The Commissions believe that the proposed rules and interpretive guidance will further the purposes of Title VII. While the Commissions believe that these proposals, if adopted, would appropriately effect the intent of the Dodd-Frank Act, the Commissions are very interested in commenters' views as to whether those purposes have been achieved, and, if not, how to improve these proposals.

II. Scope of Definitions of Swap and Security-Based Swap

A. Introduction

Title VII of the Dodd-Frank Act applies to a wide variety of agreements, contracts, and transactions classified as swaps or security-based swaps. The statute lists these agreements, contracts, and transactions in the definition of the term "swap." [16] The statutory definition of the term "swap" also has various exclusions,[17] rules of construction, and other provisions for the interpretation of the definition.[18] One of the exclusions to the definition of the term "swap" is for security-based swaps.[19] The term "security-based swap," in turn, is defined as an agreement, contract, or transaction that is a "swap" (without regard to the exclusion from that definition for security-based swaps) and that also has certain characteristics specified in the statute.[20] Thus, the statutory definition of the term "swap" also determines the scope of agreements, contracts, and transactions that could be security-based swaps.

The statutory definitions of "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. Nevertheless, several commenters have stated,[21] and the Commissions agree, that the definitions could be read to include certain types of agreements, contracts, and transactions that previously have not been considered swaps or security-based swaps and that nothing in the legislative history of the Dodd-Frank Act appears to suggest that Congress intended such agreements, contracts, and transactions to be regulated as swaps or security-based swaps under Title VII. The Commissions thus believe that it is important to clarify the treatment under the definitions of certain types of agreements, contracts, and transactions, such as insurance products and certain consumer and commercial contracts.

In addition, commenters also raised questions regarding, and the Commissions believe that it is important to clarify: (i) The exclusion for forward contracts from the definitions of the terms "swap" and "security-based swap;" and (ii) the status of certain commodity-related products (including various foreign exchange products and forward rate agreements ("FRAs")) under the definitions of the terms "swap" and "security-based swap." Finally, the Commissions are providing guidance regarding certain interpretive issues related to the definitions.[22]

B. Proposed Rules and Interpretive Guidance Regarding Certain Transactions Outside the Scope of the Definitions of the Terms "Swap" and "Security-Based Swap"

1. Insurance Products

A number of commenters expressed concern that the definitions of the terms "swap" and "security-based swap" potentially could include certain types of insurance products [23] because the statutory definition of the term "swap" includes, in part, any agreement, contract, or transaction "that provides for any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence." [24] The Commissions do not interpret this clause to mean that products historically treated as insurance products should be included within the swap or security-based swap definition.[25]

The Commissions are aware of nothing in Title VII to suggest that Congress intended for insurance products to be regulated as swaps or security-based swaps. Moreover, that swaps and insurance products are subject to different regulatory regimes is reflected in section 722(b) of the Dodd-Frank Act which, in new section 12(h) of the CEA, provides that a swap "shall not be considered to be insurance" and "may not be regulated as an insurance contract under the law of any State." [26]

[16] *See* CEA section 1a(47)(A), 7 U.S.C. 1a(47)(A). This swap definition is also cross-referenced in new section 3(a)(69) of the Exchange Act, 15 U.S.C. 78c(a)(69).

[17] *See* CEA section 1a(47)(B), 7 U.S.C. 1a(47)(B), clauses (i)–(x).

[18] *See* CEA sections 1a(47)(C)–(F), 7 U.S.C. 1a(47)(C)–(F).

[19] *See* CEA section 1a(47)(B)(x), 7 U.S.C. 1a(47)(B)(x).

[20] *See* section 3(a)(68) of the Exchange Act, 15 U.S.C. 78c(a)(68).

[21] *See, e.g.,* Letter from Edward J. Rosen, Cleary Gottlieb Steen & Hamilton LLP, Sept. 21, 2010 ("Cleary Letter"); Letter from Robert Pickel, Executive Vice President, International Swaps and Derivatives Association, Inc., Sept. 20, 2010 ("ISDA Letter").

[22] Some commenters raised concerns regarding the treatment of inter-affiliate swaps and security-based swaps. *See, e.g.,* Cleary Letter; Letter from Coalition for Derivatives End Users, Sept. 20, 2010 ("CDEU Letter"); ISDA Letter; Letter from Richard A. Miller, Vice President and Corporate Counsel, Prudential Financial Inc., Sept. 17, 2010; Letter from Richard M. Whiting, The Financial Services Roundtable, Sept. 20, 2010. A few commenters suggested that the Commissions should further define the term "swap" or "security-based swap" to exclude inter-affiliate transactions. *See* Cleary Letter; CDEU Letter. The Commissions are considering whether inter-affiliate swaps or security-based swaps should be treated differently from other swaps or security-based swaps in the context of the Commissions' other Title VII rulemakings.

[23] *See, e.g.,* Letter from Ernest C. Goodrich, Jr., Managing Director—Legal Department, and Marcelo Riffaud, Managing Director—Legal Department, Deutsche Bank AG, Sept. 20, 2010 ("Deutsche Bank Letter"); Letter from Sean W. McCarthy, Chairman, Association of Financial Guaranty Insurers, Sept. 20, 2010 ("AFGI Letter"); Letter from Robert J. Duke, The Surety & Fidelity Association of America, Sept. 20, 2010 ("SFAA Letter"); Letter from J. Stephen Zielezienski, Senior Vice President & General Counsel, American Insurance Association, Sept. 20, 2010; Letter from Franklin W. Nutter, President, Reinsurance Association of America, Sept. 20, 2010 ("RAA Letter"); Letter from James M. Olsen, Senior Director Accounting and Investment Policy, Property Casualty Insurers Association of America, Sept. 17, 2010; Letter from Jane L. Cline, President, and Therese M. Vaughan, Chief Executive Officer, National Association of Insurance Commissioners, Sept. 20, 2010; Letter from Joseph W. Brown, Chief Executive Officer, MBIA Inc., Sept. 20, 2010 ("MBIA Letter"); Cleary Letter; Letter from White & Case LLP ("White & Case Letter"), Sept. 20, 2010; Letter from Carl B. Wilkerson, Vice President and Chief Counsel, Securities & Litigation, American Council of Life Insurers, Nov. 12, 2010 ("ACLI Letter"); Letter from Stephen E. Roth, James M. Cain, and W. Thomas Conner, Sutherland Asbill & Brennan LLP, for the Committee of Annuity Insurers, Dec. 3, 2010.

[24] CEA section 1a(47)(A)(ii), 7 U.S.C. 1a(47)(A)(ii).

[25] The Commissions also believe it was not the intent of Congress through the swap and security-based swap definitions to preclude the provision of insurance to individual homeowners and small businesses that purchase property and casualty insurance. *See* CEA section 2(e), 7 U.S.C. 2(e) and section 6(l) of the Exchange Act, 15 U.S.C. 78f(l) (prohibiting individuals and small businesses that do not meet specified financial thresholds or other conditions from entering into swaps or security-based swaps other than on or subject to the rules of regulated futures and securities exchanges).

[26] 7 U.S.C. 16(h). Moreover, other provisions of the Dodd-Frank Act address the status of insurance more directly, and more extensively, than Title VII. For example, Title V of the Dodd-Frank Act requires the newly established Federal Insurance Office to conduct a study and submit a report to Congress, within 18 months of enactment of the Dodd-Frank Act, on the regulation of insurance, including the consideration of Federal insurance regulation. Notably, the Federal Insurance Office's authority under Title V extends primarily to monitoring and information gathering; its ability to promulgate Federal insurance regulation that preempts state insurance regulation is significantly restricted. *See* section 502 of the Dodd-Frank Act (codified in various sections of 31 U.S.C.). Title X of the Dodd-Frank Act also specifically excludes the business of insurance from regulation by the Bureau of Consumer Financial Protection. *See* section 1027(m) of the Dodd-Frank Act, 12 U.S.C. 5517(m) ("The [Bureau of Consumer Financial Protection]

Continued

Accordingly, the Commissions believe that state or Federally regulated insurance products that are provided by state or Federally regulated insurance companies [27] that otherwise could fall within the definitions should not be considered swaps or security-based swaps so long as they satisfy the proposed rules or comport with the related proposed interpretive guidance.[28] At the same time, however, the Commissions are concerned that agreements, contracts, or transactions that are swaps or security-based swaps might be characterized as insurance products to evade the regulatory regime under Title VII of the Dodd-Frank Act. Accordingly, the Commissions are proposing rules and interpretive guidance that would clarify that agreements, contracts, or transactions meeting certain requirements would be considered insurance and not swaps or security-based swaps.

The proposed rules contain two subparts; the first subpart addresses the agreement, contract, or transaction and the second subpart addresses the entity providing that agreement, contract, or transaction. More specifically, with respect to the former, paragraph (i) of proposed rule 1.3(xxx)(4) under the CEA and paragraph (a) of proposed rule 3a69–1 under the Exchange Act would clarify, as discussed in more detail below, that the terms "swap" and "security-based swap" would not include an agreement, contract, or transaction that, by its terms or by law, as a condition of performance:

- Requires the beneficiary of the agreement, contract, or transaction to have an insurable interest that is the subject of the agreement, contract, or transaction and thereby carry the risk of loss with respect to that interest continuously throughout the duration of the agreement, contract, or transaction;
- Requires that loss to occur and to be proved, and that any payment or indemnification therefor be limited to the value of the insurable interest;
- Is not traded, separately from the insured interest, on an organized market or over-the-counter; and
- With respect to financial guaranty insurance only, in the event of payment default or insolvency of the obligor, any acceleration of payments under the policy is at the sole discretion of the insurer.

In addition, the second subpart of the proposed rules, in paragraph (ii) of proposed rule 1.3(xxx)(4) under the CEA and paragraph (b) of proposed rule 3a69–1 under the Exchange Act, would require that, in order to be excluded from the swap and security-based swap definitions as an insurance product, the agreement, contract, or transaction must be provided:

- By a company that is organized as an insurance company whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies and that is subject to supervision by the insurance commissioner (or similar official or agency) of any state [29] or by the United States or an agency or instrumentality thereof, and such agreement, contract, or transaction is regulated as insurance under the laws of such state or the United States;
- By the United States or any of its agencies or instrumentalities, or pursuant to a statutorily authorized program thereof; or
- In the case of reinsurance only, by a person located outside the United States to an insurance company that is eligible under the proposed rules, provided that: (i) such person is not prohibited by any law of any state or of the United States from offering such agreement, contract, or transaction to such an insurance company; (ii) the product to be reinsured meets the requirements under the proposed rules to be an insurance product; and (iii) the total amount reimbursable by all reinsurers for such insurance product cannot exceed the claims or losses paid by the cedant.[30]

In order for an agreement, contract, or transaction to qualify as an insurance product that would not be a swap or security-based swap: (i) The agreement, contract, or transaction would have to meet the criteria in the first subpart of the proposed rules and (ii) the person or entity providing the agreement, contract, or transaction would have to meet the criteria in the second subpart of the proposed rules.[31] The fact that an agreement, contract, or transaction qualifies as an insurance product does not exclude it from the swap or security-based swap definitions if it is not provided by a qualifying person or entity, nor does the fact that a product is regulated by an insurance regulator exclude it from the swap or security-based swap definitions if the agreement, contract, or transaction does not satisfy the criteria for insurance set forth in the proposed rules.[32]

In addition, the Commissions are proposing interpretive guidance to clarify that, independent of paragraph (i) of proposed rule 1.3(xxx)(4) under the CEA and paragraph (a) of proposed rule 3a69–1 under the Exchange Act, certain insurance products do not fall within the swap or security-based swap definitions so long as they are provided in accordance with paragraph (ii) of proposed rule 1.3(xxx)(4) under the CEA and paragraph (b) of proposed rule 3a69–1 under the Exchange Act.

(a) Types of Insurance Products [33]

Paragraph (i) of proposed rule 1.3(xxx)(4) under the CEA and paragraph (a) of proposed rule 3a69–1 under the Exchange Act would set forth four criteria for an agreement, contract, or transaction to be considered insurance. First, the proposed rules would require that the beneficiary have an "insurable interest" underlying the

may not define as a financial product or service, by regulation or otherwise, engaging in the business of insurance."); section 1027(f) of the Dodd-Frank Act, 12 U.S.C. 5517(f) (excluding persons regulated by a state insurance regulator, except to the extent they are engaged in the offering or provision of consumer financial products or services or otherwise subject to certain consumer laws as set forth in Title X of the Dodd-Frank Act).

[27] As discussed above, the establishment of the Federal Insurance Office under Title V of the Dodd-Frank Act suggests that Federal insurance law could be established in the future. The Commissions believe that the proposed rules should, therefore, include a specific reference to Federal insurance law.

[28] To the extent an insurance product does not fall within the language of the swap definition by its terms, it would not need to satisfy the requirements under the proposed rules in order to avoid being considered a swap or security-based swap.

[29] The term "State" is defined in section 3(a)(16) of the Exchange Act to mean "any State of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States." 15 U.S.C. 78c(a)(16). The CFTC is proposing to incorporate this definition into proposed rule 1.3(xxx)(4) for purposes of ensuring consistency between the CFTC and SEC rules further defining the term "swap."

[30] The "cedant" is the insurer writing the risk being ceded or transferred to such person located outside the United States.

[31] The Commissions note that certain variable life insurance and annuity products are securities and would not be swaps or security-based swaps regardless of whether they met the requirements under the proposed rules. *See* CEA section 1a(47)(B)(v), 7 U.S.C. 1a(47)(B)(v) (excluding from the definition of "swap" any "agreement, contract, or transaction providing for the purchase or sale of 1 or more securities on a fixed basis that is subject to—(I) the [Securities Act]; and (II) the [Exchange Act]"). *See also SEC* v. *United Benefit Life Ins. Co.,* 387 U.S. 202 (1967) (holding that a "flexible fund" annuity contract was not entitled to exemption under section 3(a)(8) of the Securities Act, 15 U.S.C. 77c(a)(8), for insurance and annuities); *SEC* v. *Variable Annuity Life Ins. Co.,* 359 U.S. 65 (1959) (holding that a variable annuity was not entitled to exemption under section 3(a)(8) of the Securities Act, 15 U.S.C. 77c(a)(8), for insurance and annuities).

[32] The Commissions note that Title VII provides flexibility to address the facts and circumstances of new products that may be marketed or sold as insurance, for the purpose of determining whether they satisfy the requirements of the proposed rules, through joint interpretations pursuant to section 712(d)(4) of the Dodd-Frank Act.

[33] *See supra* note 23, regarding comments received addressing this criterion.

agreement, contract, or transaction at every point in time during the term of the agreement, contract, or transaction for that agreement, contract, or transaction to qualify as insurance. The requirement that the beneficiary be at risk of loss (which could be an adverse financial, economic, or commercial consequence) with respect to the interest that is the subject of the agreement, contract, or transaction at all times throughout the term of the agreement, contract, or transaction would ensure that an insurance contract beneficiary has a stake in the interest on which the agreement, contract, or transaction is written.[34] Similarly, the provision of the proposed rules that would require the beneficiary to have the insurable interest continuously during the term of the agreement, contract, or transaction is designed to ensure that payment on the insurance product is inextricably connected to both the beneficiary and the interest on which the insurance product is written. In contrast to an insurance product, a CDS (which may be a swap or a security-based swap) does not require the purchaser of protection to hold any underlying obligation issued by the reference entity on which the CDS is written.[35]

Second, the requirement that an actual loss occur and be proved under the proposed rules similarly would ensure that the beneficiary has a stake in the insurable interest that is the subject of the agreement, contract, or transaction. If the beneficiary can demonstrate actual loss, that loss would "trigger" performance by the insurer on the agreement, contract, or transaction such that, by making payment, the insurer is indemnifying the beneficiary for such loss. In addition, limiting any payment or indemnification to the value of the insurable interest aids in distinguishing swaps and security-based swaps (where there is no such limit) from insurance.[36]

Third, the proposed rules would require that the insurance product not be traded, separately from the insured interest, on an organized market or over-the-counter. With limited exceptions,[37] insurance products traditionally have been neither entered into on or subject to the rules of an organized exchange nor traded in secondary market transactions (*i.e.,* they are not traded on an organized market or over-the-counter). Whereas swaps and security-based swaps also generally have not been tradable at-will in secondary market transactions (*i.e.,* on an organized market or over-the-counter) without counterparty consent, the Commissions understand that swaps and security-based swaps are routinely novated or assigned to third parties, usually pursuant to industry standard terms and documents.[38] For the foregoing reasons, the Commissions believe that lack of trading separately from the insured interest is a feature of insurance that is useful in distinguishing insurance from swaps and security-based swaps.

Fourth, the proposed rules would address financial guarantee policies, also known as bond insurance or bond wraps.[39] Although such products can be economically similar to products such as CDS, they have certain key characteristics that distinguish them from swaps and security-based swaps.[40] For example, under a financial guarantee policy, the insurer typically is required to make timely payment of any shortfalls in the payment of scheduled interest to the holders of the underlying guaranteed obligation. Also, for particular bonds that are covered by a financial guarantee policy, the indenture, related documentation, and/or the financial guarantee policy will provide that a default in payment of principal or interest on the underlying bond will not result in acceleration of the obligation of the insurer to make payment of the full amount of principal on the underlying guaranteed obligation unless the insurer, in its sole discretion, opts to make payment of principal prior to the final scheduled maturity date of the underlying guaranteed obligation. Conversely, under a CDS, a protection seller frequently is required to make payment of the relevant settlement amount to the protection buyer upon demand by the protection buyer after any credit event involving the issuer.[41]

The Commissions do not believe that financial guarantee policies, in general, should be regulated as swaps or security-based swaps. However, because of the close economic similarity of financial guarantee insurance policies guaranteeing payment on debt securities to CDS, the Commissions also are proposing that, in addition to the criteria noted above with respect to insurance generally, financial guarantee policies also would have to satisfy the requirement that they not permit the beneficiary of the policy to accelerate the payment of any principal due on the debt securities. This requirement would further distinguish financial guarantee policies from CDS because, as discussed above, the latter generally requires payment of the relevant settlement amount on the CDS after demand by the protection buyer.

[34] Requiring that a beneficiary of an insurance policy have a stake in the interest traditionally has been justified on public policy grounds. For example, a beneficiary that does not have a property right in a building might have an incentive to profit from arson.

[35] Standard CDS documentation stipulates that the incurrence or demonstration of a loss may not be made a condition to the payment on the CDS or the performance of any obligation pursuant to the CDS. *See, e.g.,* Int'l Swaps and Derivatives Ass'n, "2003 ISDA Credit Derivatives Definitions," art. 9.1(b)(i) (2003) ("2003 Definitions) ("[T]he parties will be obligated to perform * * * irrespective of the existence or amount of the parties' credit exposure to a Reference Entity, and Buyer need not suffer any loss nor provide evidence of any loss as a result of the occurrence of a Credit Event.").

[36] To the extent an insurance product provides for such items as, for example, a rental car for use while the car that is the subject of an automobile insurance policy is being repaired, the Commissions would consider such items as constituting part of the value of the insurable interest.

[37] *See, e.g.,* "Life Settlements Task Force, Staff Report to the United States Securities and Exchange Commission" ("In an effort to help make the bidding process more efficient and to facilitate trading of policies after the initial settlement occurs, some intermediaries have considered or instituted a trading platform for life settlements."), available at *http://www.sec.gov/news/studies/2010/lifesettlements-report.pdf* (July 22, 2010).

[38] *See, e.g.,* Int'l Swaps and Derivatives Ass'n, "2005 Novation Protocol," available at *http://www.isda.org/2005novationprot/docs/NovationProtocol.pdf* (2005); Int'l Swaps and Derivatives Ass'n, "ISDA Novation Protocol II," available at *http://www.isda.org/isdanovationprotII/docs/NPII.pdf* (2005); Int'l Swaps and Derivatives Ass'n, 2003 Definitions, *supra* note 35, Exhibits E (Novation Agreement) and F (Novation Confirmation).

[39] Several commenters expressed concern that the swap and security-based swap definitions could encompass financial guarantee policies. *See, e.g.,* AFGI Letter; Letter from James M. Michener, General Counsel, Assured Guaranty, Dec. 14, 2010 ("Assured Guaranty Letter"); MBIA Letter; Letter from the Committee on Futures and Derivatives Regulation of the New York City Bar Association, Sept. 20, 2010. Financial guarantee policies are used by entities such as municipalities to provide greater assurances to potential purchasers of their bonds and thus reduce their interest costs. *See* "Report by the United States Securities and Exchange Commission on the Financial Guarantee Market: The Use of the Exemption in section 3(a)(2) of the Securities Act of 1933 for Securities Guaranteed by Banks and the Use of Insurance Policies to Guarantee Debt Securities" (Aug. 28, 1987).

[40] *See, e.g.,* AFGI Letter (explaining the differences between financial guaranty policies and CDS); Letter from James M. Michener, General Counsel, Assured Guaranty, Sept. 13, 2010 (noting that the Financial Accounting Standards Board has issued separate guidance on accounting for financial guaranty insurance and CDS); Deutsche Bank Letter (noting that financial guaranty policies require the incurrence of loss for payment, whereas CDS do not).

[41] While a CDS requires payment in full on the occurrence of a credit event, the Commissions recognize that there are other financial instruments, such as corporate guarantees of commercial loans and letters of credit supporting payments on loans or debt securities, that allow for acceleration of payment obligations without such guarantees or letters of credit being swaps or security-based swaps.

The Commissions believe that requiring all of the criteria in paragraph (i) of proposed rule 1.3(xxx)(4) under the CEA and paragraph (a) of proposed rule 3a69–1 under the Exchange Act would help limit the application of the proposed rules to products appropriately regulated as insurance and provide that products appropriately subject to the regulatory regime under Title VII of the Dodd-Frank Act are regulated as swaps or security-based swaps. As a result, the Commissions believe that these requirements would help prevent the proposed rules from being used to circumvent the applicability of the swap and security-based swap regulatory regimes under Title VII.

However, the Commissions are considering an additional criterion as well. One ANPR commenter suggested that the proposed rules require that, in order to qualify as insurance that is excluded from the swap definition, payment on an agreement, contract, or transaction not be based on the price, rate, or level of a financial instrument, asset, or interest or any commodity.[42] Such a requirement could help to prevent swaps from being executed in the guise of insurance in order to avoid the regulatory regime established by Title VII. It may ensure that an agreement, contract, or transaction is not treated as insurance if it is used for speculative purposes or to influence prices in derivatives markets. Yet, another ANPR commenter stated that such a requirement for an agreement, contract, or transaction to qualify as insurance rather than a swap "is not consistent with common variable life insurance and variable annuity products, which deliver insurance guarantees that do vary with the performance of specified assets."[43]

The Commissions request comment on whether, in order for an agreement, contract, or transaction to be considered insurance pursuant to paragraph (i) of proposed rule 1.3(xxx)(4) under the CEA and paragraph (a) of proposed rule 3a69–1 under the Exchange Act, the Commissions should require that payment not be based on the price, rate, or level of a financial instrument, asset, or interest or any commodity. If so, the Commissions also request comment on whether variable annuity contracts (where the income is subject to tax treatment under section 72 of the Internal Revenue Code) and variable universal life insurance should be excepted from such a requirement.[44]

Although the proposed criteria should appropriately identify agreements, contracts, and transactions that should be considered to be insurance, the Commissions also are proposing interpretive guidance that certain enumerated types of insurance products are outside the scope of the statutory definitions of swap and security-based swap under the Dodd-Frank Act. These products are surety bonds, life insurance, health insurance, long-term care insurance, title insurance, property and casualty insurance, and annuity products the income on which is subject to tax treatment under section 72 of the Internal Revenue Code.[45] The Commissions believe that these enumerated insurance products do not bear the characteristics of the transactions that Congress subjected to the regulatory regime for swaps and security-based swaps under the Dodd-Frank Act.[46] As a result, excluding these enumerated insurance products should appropriately place traditional insurance products outside the scope of the swap and security-based swap definitions. Such insurance products, however, would need to be provided in accordance with paragraph (ii) of proposed rule 1.3(xxx)(4) under the CEA and paragraph (b) of proposed rule 3a69–1 under the Exchange Act, as discussed below, and such insurance products would need to be regulated as insurance.

(b) Providers of Insurance Products

The second subpart of the proposed rules, in paragraph (ii) of proposed rule 1.3(xxx)(4) under the CEA and paragraph (b) of proposed rule 3a69–1 under the Exchange Act, would require that, in addition to meeting the product requirements discussed above (or being subject to the interpretive guidance regarding enumerated insurance products provided above) the agreement, contract, or transaction be provided by a person or entity that meets certain criteria. Generally, the product would have to be provided by a company that is organized as an insurance company whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by companies whose insurance business is subject to supervision by the insurance commissioner (or similar official or agency) of any state[47] or by the United States or an agency or instrumentality thereof, and such agreement, contract, or transaction is regulated as insurance under the laws of such state or of the United States.[48]

The requirement that the agreement, contract, or transaction be provided by a state or Federally regulated insurance company would help ensure that entities that are not regulated under insurance laws are not able to avoid regulation under Title VII of the Dodd-Frank Act as well. The Commissions believe that this requirement also should help prevent regulatory gaps that otherwise might exist between insurance regulation and the regulation of swaps and security-based swaps.

The proposed rules also would require that the agreement, contract, or transaction provided by the insurance company be regulated as insurance under the laws of the state in which it is regulated or the United States. The purpose of this proposed requirement is that an agreement, contract, or transaction that satisfies the other conditions of the proposed rules must be subject to regulatory oversight as an insurance product. As a result of the requirement that an insurance regulator must have determined that the agreement, contract, or transaction being sold is insurance (*i.e.,* because state insurance regulators are banned from regulating swaps as insurance),[49] the Commissions believe that this condition would help prevent products that are swaps or security-based swaps from being characterized as insurance products in order to evade the regulatory regime under Title VII of the Dodd-Frank Act.

The Commissions also believe that it is appropriate to exclude insurance that is issued by the United States or any of its agencies or instrumentalities, or pursuant to a statutorily authorized program thereof, from regulation as swaps or security-based swaps. Such

[42] *See* Cleary Letter.

[43] *See* ACLI Letter.

[44] 26 U.S.C. 72. *See also supra* note 31.

[45] *Id.*

[46] The list of enumerated insurance products is generally consistent with the provisions of section 302(c)(2) of the Gramm-Leach-Bliley Act ("GLBA"), 15 U.S.C. 6712(c)(2), which addresses insurance underwriting in national banks.

[47] *See supra* note 29, regarding the definition of "State" contained in the proposed rules.

[48] This paragraph of the proposed rules is substantially similar to the definition of an insurance company under the Federal securities laws. *See* section 2(a)(13) of the Securities Act, 15 U.S.C. 77b(a)(13); section 2(a)(17) of the Investment Company Act of 1940, 15 U.S.C. 80a–2(a)(17). These definitions also include reinsurance companies. In order to ensure regulatory consistency, the Commissions believe that it is appropriate to include substantially the same definition of an insurance company as currently exists elsewhere in the Federal securities laws, but the Commissions are requesting comment regarding the role played by a receiver or similar official or any liquidating agent for such insurance company, in its capacity as such, rather than proposing this provision of the insurance company definition.

[49] *See* section 722(b) of the Dodd-Frank Act.

insurance would include, for example, Federal insurance of savings in banks, savings associations, and credit unions; catastrophic crop insurance; flood insurance; Federal insurance of certain pension obligations; and terrorism risk insurance. Accordingly, the proposed rules would provide that products meeting the criteria discussed above that are required for an agreement, contract, or transaction to qualify as insurance are excluded from the swap and security-based swap definitions if they are provided by the Federal government or pursuant to a statutorily authorized program thereof.

Finally, the Commissions believe that where an agreement, contract, or transaction qualifies as insurance excluded from the swap and security-based swap definitions, the lawful reinsurance of that agreement, contract, or transaction similarly should be excluded. Such reinsurance would be excluded from the definitions even if the reinsurer is located abroad and is not state or Federally regulated. Accordingly, the proposed rules would provide that an agreement, contract, or transaction of reinsurance would be excluded from the swap and security-based swap definitions if it is provided by a person located outside the United States, if such person is not prohibited by any law of any state or the United States from offering such reinsurance to a state or Federally regulated insurance company, so long as the product to be reinsured meets the requirements under the proposed rules to be an insurance product, and the total amount reimbursable by all reinsurers for such insurance product cannot exceed the claims or losses paid by the cedant.

The proposed rules would cover only an agreement, contract, or transaction by an insurance company and would not affect the characterization of the asset that is being insured. For example, if an agreement, contract, or transaction insures or guarantees the payment on a security, the security would remain subject to all applicable securities laws. The guarantee agreement, contract, or transaction, however, would not be regulated as a swap or security-based swap if it meets all of the requirements of the proposed rules.[50]

One commenter has stated that monoline insurance companies (also called financial guarantors) continue to guarantee payments under interest rate swaps related to municipal debt.[51] The CFTC believes that an insurance "wrap" of a swap may not be sufficiently different from the underlying swap to suggest that Congress intended the former to fall outside the definition of the term "swap" in Title VII.

The SEC, however, believes that, where an agreement, contract, or transaction is a security-based swap, the insurance of that security-based swap should not be regulated pursuant to Title VII, provided that the insurance meets the proposed requirements discussed above.[52]

The Commissions request comment on this issue generally, and also on the particular questions set forth in the Request for Comment section below.

The Commissions also are considering whether the issuer of such insurance (or guarantee) in respect of swaps or security-based swaps entered into by an affiliate or third party could be considered to be a major swap participant or major security-based swap participant. The Commissions have requested comment in the proposing release for the definitions of the terms "major swap participant" and "major security-based swap participant".[53]

Request for Comment

1. The Commissions request comment on all aspects of proposed rule 1.3(xxx)(4) under the CEA and proposed rule 3a69–1 under the Exchange Act and the interpretive guidance in this section.

2. Do the proposed criteria for identifying an agreement, contract, or transaction that would not fall within the swap or security-based swap definitions appropriately encompass insurance and reinsurance products? If not, what types of insurance or reinsurance products are not encompassed, and why?

3. Are there certain products that are commonly known as swaps or security-based swaps, or that more appropriately should be considered swaps or security-based swaps, that could satisfy the criteria in proposed rule 1.3(xxx)(4) under the CEA and proposed rule 3a69–1 under the Exchange Act?

4. Is the proposed requirement that the beneficiary of an agreement, contract, or transaction have an insurable interest that is the subject of the agreement, contract, or transaction, and thereby carry the risk of loss with respect to that interest continuously throughout the duration of the agreement, contract, or transaction in order for the agreement, contract, or transaction not to fall within the swap or security-based swap definition, an effective criterion in determining whether a product is insurance? Why or why not?

5. Is the proposed requirement that loss occur and be proved, and that any payment or indemnification therefor be limited to the value of the insurable interest, in order for an agreement, contract, or transaction not to fall within the swap or security-based swap definition, an effective criterion in determining whether a product is insurance? Why or why not? Is the requirement that any payment or indemnification for proved loss be limited to the value of the insurable interest consistent with conventional insurance analysis across a broad range of products (including traditional property and casualty products)? Are there particular products where such a limitation would not be appropriate? If so, please provide a detailed description of such products and why such a limitation would not be appropriate.

6. Is the proposed requirement that the agreement, contract, or transaction is not traded, separately from the insured interest, on an organized market or over-the-counter, an effective criterion in determining whether a product is insurance? Why or why not?

7. Should the Commissions add, as a requirement for an insurance agreement, contract, or transaction to not be characterized as a swap, that the agreement, contract, or transaction not be based on the price, rate, or level of a financial instrument, asset, or interest or any commodity? Would such a requirement be an effective criterion in distinguishing insurance from swaps and security-based swaps? Why or why not? If so, should the Commissions add any carve outs from the requirement, such as, for example, variable universal life insurance, or annuity contracts where the income is subject to tax treatment under section 72 of the Internal Revenue Code? Why or why not? Would such a requirement help preclude the use of the proposed rules for products that are swaps or security-based swaps? Why or why not? Would such a requirement preclude the use of the proposed rules for products that currently are insurance? If so, what

[50] The guarantee agreement, contract, or transaction, however, could itself be a security that is subject to the Federal securities laws." *See, e.g.,* section 2(a)(1) of the Securities Act, 15 U.S.C. 77b(a)(1) (including in the statutory definition of "security" a guarantee of a security).

[51] *See* Letter from Bruce E. Stern, Chairman, Association of Financial Guaranty Insurers Government Affairs Committee, Feb. 18, 2011, at 11–12 ("[F]inancial guarantors have often guaranteed, through the issuance of a financial guaranty insurance policy, the obligations of unaffiliated parties under swaps with other unaffiliated parties. These insurance policies typically cover obligations of municipalities under interest rate or basis swaps relating to bonds issued by municipalities or in connection with asset backed securities.").

[52] *See supra* note 32.

[53] *See* proposed Entity Definitions, *supra* note 12.

insurance products would be precluded by such a requirement, and how? How are insurance payments determined today?

8. Is the proposed requirement that, with respect to financial guaranty insurance, in the event of payment default or insolvency of the obligor, any acceleration of payments under the policy be at the sole discretion of the insurer an effective criterion in determining whether a financial guaranty policy is insurance that does not fall within the swap or security-based swap definition? Why or why not?

9. Does the interpretive guidance proposed in this section appropriately identify certain enumerated insurance products as traditional insurance products that would not fall within the swap or security-based swap definition if the provider of the product satisfies the requirements of the proposed rules? Why or why not? Is the interpretive guidance proposed in this section sufficient? Why or why not? Are there additional types of traditional insurance that should be similarly enumerated? If so, which ones and why? Could the exclusion of any of the enumerated insurance products serve to exclude products that should be regulated as swaps or security-based swaps? If so, which ones and why? Should the enumerated insurance products be required to be provided in accordance with paragraph (ii) of proposed rule 1.3(xxx)(4) under the CEA and paragraph (b) of proposed rule 3a69–1 under the Exchange Act? Why or why not? If not, please provide a detailed explanation of the insurance products that should not be subject to these requirements. Are there insurance products currently offered that do not meet these criteria? If so, please provide details regarding such products and their providers.

10. The Commissions are proposing guidance that certain enumerated types of insurance products, including property and casualty insurance, are outside the scope of the statutory definitions of the terms "swap" and "security-based swap" under the Dodd-Frank Act. The Commissions request comment generally as to the proposed guidance regarding property and casualty insurance. The CFTC also requests comment on whether the products specified in section 302(c)(2) of the GLBA, which names certain insurance products, including private passenger or commercial automobile, homeowners, mortgage, commercial multiperil, general liability, professional liability, workers' compensation, fire and allied lines, farm owners multiperil, aircraft, fidelity, surety, medical malpractice, ocean marine, inland marine, and boiler and machinery insurance, should be considered traditional property and casualty insurance. Why or why not? If so, please provide an explanation of the product and how it differs from transactions that should be subject to the swap regulatory regime of the Dodd-Frank Act. The SEC also requests comment on whether the products specified in section 302(c)(2) of the GLBA should be enumerated in the Commissions' proposed guidance regarding property and casualty insurance as outside of the scope of the swap and security-based swap definitions? Are there other categories of traditional property and casualty insurance that should be specifically enumerated? If so, please provide a detailed description of such other categories of property and casualty insurance that should be specifically identified, and why. If there are certain types of property and casualty insurance that fall within the swap definition, will that affect the ability of persons, including consumers and businesses, to protect their properties against losses? If so, please provide a detailed explanation.

11. Are there situations in which an insurance product may be assigned to another party that are not addressed by the criteria in proposed rule 1.3(xxx)(4) under the CEA and proposed rule 3a69–1 under the Exchange Act? Is additional clarification necessary to address such situations? If so, what clarification?

12. Is the proposed requirement that the agreement, contract, or transaction be provided by a company that is organized as an insurance company whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies and that is subject to supervision by the insurance commissioner (or similar official or agency) of any state, as defined in section 3(a)(16) of the Exchange Act, or by the United States or an agency or instrumentality thereof, and that the agreement, contract, or transaction be regulated as insurance under the laws of such state or of the United States, an effective criterion in determining whether an agreement, contract, or transaction falls within the swap or security-based swap definition? Does it sufficiently preclude the use of the proposed rules by unregulated entities? Why or why not? Does it sufficiently prevent evasion of the requirements of Title VII with respect to agreements, contracts, or transactions that are swaps or security-based swaps? Why or why not?

13. Are there circumstances under which a receiver or similar official or any liquidating agency for a state or Federally regulated insurance company, acting in its capacity as such, would be providing insurance rather than administering an insurance product that is provided by an insurance company? Please provide a detailed explanation of any such circumstances. If there are such circumstances, should the proposed rules include a provision that an agreement, contract, or transaction that satisfies the criteria of insurance but that is provided by a receiver or similar official or any liquidating agency for a state or Federally regulated insurance company, in its capacity as such, qualify as insurance that is excluded from the swap and security-based swap definition? Why or why not?

14. Do the proposed rules appropriately treat an agreement, contract, or transaction that satisfies the criteria of insurance but that is provided by the United States or any of its agencies or instrumentalities, or pursuant to a statutorily authorized program thereof, as insurance that is excluded from the swap and security-based swap definition? Why or why not? Are there other types of government-issued insurance products that are not covered by paragraph (ii) of proposed rule 1.3(xxx)(4) under the CEA and paragraph (b) of proposed rule 3a69–1 under the Exchange Act? Do states or state agencies or instrumentalities provide insurance products? Should the proposed requirement also include a provision that the agreement, contract, or transaction can be provided by any state or any of its agencies or instrumentalities, or pursuant to a statutorily authorized program thereof? Why or why not?

15. Do the proposed rules appropriately treat reinsurance by a person located outside the United States of a product meeting the requirements for insurance under the proposed rules, so long as the total amount reimbursable by all of the reinsurers for such insurance product cannot exceed the claims or losses paid by the cedant, as insurance excluded from the swap and security-based swap definitions if such person is not prohibited by any law of any state or of the United States from offering such reinsurance to a state or Federally regulated insurance company? Do these provisions of the proposed rules sufficiently prevent evasion of the requirements of Title VII with respect to agreements, contracts, or transactions that are swaps or security-based swaps? Why or why not?

16. Are there additional criteria for identifying contracts, agreements, or transactions that are insurance and not swaps or security-based swaps that the Commissions should consider? Please provide detailed information and empirical data, to the extent possible, supporting any suggested criteria.

17. Should the proposed rules relating to insurance include a provision related to whether a product is recognized at fair value on an ongoing basis with changes in fair value reflected in earnings under U.S. generally accepted accounting principles? If so, what specific challenges may be encountered in light of the proposed Accounting Standards Update "Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities," issued by the Financial Accounting Standards Board ("FASB") on May 26, 2010? Is recognizing a product at fair value on an ongoing basis (with changes in fair value reflected in earnings) inconsistent with treating such a product as insurance rather than a swap or security-based swap? Why or why not? Please provide examples of specific products and their correct accounting treatment under U.S. generally accepted accounting principles.

18. Where an agreement, contract, or transaction falls within the swap definition, should insurance of that agreement, contract, or transaction also be included in the swap definition? Why or why not? Is the insurance wrap of a swap sufficiently different (economically or otherwise) from the swap that is insured? Why or why not? Would the regulation of such swap "wraps" as swaps impose costs on or otherwise impact the underlying cash markets (*e.g.,* the ability to issue, and cost of issuing, municipal debt)? Please quantify to the extent possible. Would treating such "wraps" as insurance falling outside the swap definition frustrate or undermine Title VII's objectives in regulating the swap markets in any way? Why or why not? Please provide empirical data and analysis to the extent possible.

19. Where an agreement, contract, or transaction falls within the security-based swap definition, should the insurance of that agreement, contract, or transaction also be included in the security-based swap definition? Why or why not? Would the regulation of insurance on a security-based swap as a security-based swap under Title VII impose costs or otherwise impact the underlying cash markets (*e.g.,* the ability to issue, and cost of issuing, municipal debt)? Please quantify to the extent possible. Would regulating such products as insurance rather than as security-based swaps frustrate or undermine Title VII's objectives in regulating the security-based swap and swap markets? Why or why not? Please provide a detailed explanation and empirical data to the extent possible.

20. Should the proposed rules include a provision similar to section 302(c)(1) of the GLBA [54] that would provide that any product regulated as insurance before July 21, 2010 (the date the Dodd-Frank Act was signed into law) and provided in accordance with paragraph (ii) of proposed rule 1.3(xxx)(4) under the CEA and paragraph (b) of proposed rule 3a69–1 would be considered insurance and not fall within the swap definition? Why or why not? Should different criteria apply to products regulated as insurance before July 21, 2010? Why or why not? If so, please provide a detailed description of what different criteria should apply.

21. The Commissions understand that swap guarantees may be offered by non-insurance companies. Should the Commissions provide guidance as to whether swap or security-based swap guarantees (that are not guarantees or insurance policies offered by insurance companies discussed above) should be considered swaps or security-based swaps? Why or why not?

2. The Forward Contract Exclusion

The definitions of the terms "swap" and "security-based swap" do not include forward contracts. They exclude "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled".[55] Commenters have requested guidance from the Commissions regarding the scope of this exclusion. The Commissions believe it is appropriate to provide guidance to market participants regarding the applicability of the exclusion from the definitions of swap and security-based swap for forward contracts with respect to nonfinancial commodities [56] and securities.

(a) Forward Contracts in Nonfinancial Commodities

The wording of the forward contract exclusion from the swap definition with respect to nonfinancial commodities is similar, but not identical, to the forward contract exclusion from the definition of "future delivery" in the CEA, which excludes "any sale of any cash commodity for deferred shipment or delivery".[57] Several ANPR commenters expressed the view that, with respect to nonfinancial commodities, the forward contract exclusion from the swap definition should be interpreted in the same manner as the CFTC has interpreted the forward contract exclusion from the term "future delivery" and, in particular, that the CFTC's "Brent Interpretation" [58] should apply to "book out" transactions for purposes of the forward exclusion from the swap definition.[59] The CFTC believes that clarification of the scope of the forward contract exclusion from the swap definition with respect to nonfinancial commodities is appropriate.[60]

[54] 15 U.S.C. 6712(c)(1).

[55] CEA section 1a(47)(B)(ii), 7 U.S.C. 1a(47)(B)(ii).

[56] The discussion in subsections (a) and (b) of this section applies solely to the exclusion of nonfinancial commodity forwards from the swap definition in the Dodd-Frank Act.

[57] CEA section 1a(27), 7 U.S.C. 1a(27). The CEA does not define the term "futures contract." Rather, the CEA refers to a futures contract as a "contract of sale of a commodity for future delivery." *See, e.g.,* CEA section 2(a)(1)(A), 7 U.S.C. 2(a)(1)(A) (providing the CFTC with exclusive jurisdiction over "contracts of sale of a commodity for future delivery" (other than security futures) traded or executed on, among other things, a designated contract market ("DCM")); CEA section 4(a), 7 U.S.C. 6(a) (a "contract for the purchase or sale of a commodity for future delivery" other than a contract made on an exchange located outside the United States must be conducted on or subject to the rules of, among other things, a DCM). Accordingly, by excluding forward contracts from the CEA's definition of the term "future delivery," the CEA provides that a forward contract is not a contract of sale of a commodity for future delivery and, hence, not a futures contract.

[58] Statutory Interpretation Concerning Forward Transactions, 55 FR 39188, Sept. 25, 1990 ("Brent Interpretation").

[59] *See* Letter from Joanne T. Medero, Managing Director, BlackRock, Sept. 20, 2010 ("BlackRock Letter"), Letter from Matt Schatzman, Senior Vice President, Energy Marketing, BG Americas and Global LNC, Sept. 20, 2010 ("BG Letter"); Cleary Letter; Letter from Edward W. Gallagher, President, Dairy Risk Management Services, a division of Dairy Farmers of America, Inc., Sept. 20, 2010 ("DFA Letter"); Letter from Eric Dennison, Sr. Vice President and General Counsel, Stephanie Miller, Assistant General Counsel—Commodities, and Bill Hellinghausen, Director of Regulatory Affairs, EDF Trading North America, LLC, Sept. 20, 2010 ("EDF Letter"); Richard F. McMahon, Jr., Executive Director, Edison Electric Institute, Sept. 20, 2010 ("EEI Letter"); Letter from John M. Damgard, President, Futures Industry Association, Sept. 20, 2010 ("FIA Letter"); Letter from Richard Ostrander, Managing Director and Counsel, Morgan Stanley, Sept. 20, 2010 ("Morgan Stanley Letter"); Letter of Michael Greenberger, JD, Law School Professor, University of Maryland School of Law, Sept. 20, 2010 ("University of Maryland Letter"); R. Michael Sweeney, Jr., Mark W. Menezes, and David T. McIndoe, Hunton & Williams, LLP, on behalf of the Working Group of Commercial Energy Firms, Sept, 20, 2010 ("WGCEF Letter"); Letter from Paul H. Stebbins, Chairman and Chief Executive Officer, World Fuel Services Corporation, Sept. 17, 2010 ("World Fuel Letter").

[60] As discussed in part II.D.1 below, the terminology and documentation used by the parties are not dispositive of whether a particular agreement, contract, or transaction is a swap or security-based swap under the CEA or Exchange Act. Thus, if an agreement, contract, or transaction

Continued

Forward contracts with respect to nonfinancial commodities are commercial merchandising transactions. The primary purpose of the contract is to transfer ownership of the commodity and not to transfer solely its price risk. The CFTC has noted:

> The underlying postulate of the [forward] exclusion is that the [CEA's] regulatory scheme for futures trading simply should not apply to private commercial merchandising transactions which create enforceable obligations to deliver but in which delivery is deferred for reasons of commercial convenience or necessity.[61]

The CFTC believes that the forward contract exclusion in the Dodd-Frank Act with respect to nonfinancial commodities should be read consistently with this established, historical understanding that a forward contract is a commercial merchandising transaction.

Many commenters discussed the issue of whether the requirement in the Dodd-Frank Act that a transaction be "intended to be physically settled" in order to qualify for the forward exclusion from the swap definition with respect to nonfinancial commodities reflects a change in the standard for determining whether a transaction is a forward contract.[62] Because a forward contract is a commercial merchandising transaction, intent to deliver historically has been an element of the CFTC's analysis of whether a particular contract is a forward contract.[63] In assessing the parties' expectations or intent regarding delivery, the CFTC consistently has applied a "facts and circumstances" test.[64] Therefore, the CFTC reads the "intended to be physically settled" language in the swap definition with respect to nonfinancial commodities to reflect a directive that intent to deliver a physical commodity be a part of the analysis of whether a given contract is a forward contract or a swap, just as it is a part of the CFTC's analysis of whether a given contract is a forward contract or a futures contract.

Commenters also requested clarification of the treatment of one type of forward contract—"book-out" transactions—in the context of the forward exclusion from the swap definition with respect to nonfinancial commodities. The issue of book-outs first arose in 1990 in the Brent Interpretation[65] because the parties to the crude oil contracts in that case could individually negotiate cancellation agreements, or "book-outs," with other parties.[66] In describing these transactions, the CFTC stated:

> It is noteworthy that while such [book-out] agreements may extinguish a party's delivery obligation, they are separate, individually negotiated, new agreements, there is no obligation or arrangement to enter into such agreements, they are not provided for by the terms of the contracts as initially entered into, and any party that is in a position in a distribution chain that provides for the opportunity to book-out with another party or parties in the chain is nevertheless entitled to require delivery of the commodity to be made through it, as required under the contracts.[67]

Thus, in the scenario at issue in the Brent Interpretation, the contracts created a binding obligation to make or take delivery without providing any right to offset, cancel, or settle on a payment-of-differences basis. The "parties enter[ed] into such contracts with the recognition that they may be required to make or take delivery." [68]

On these facts, the Brent Interpretation concluded that the

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with respect to a nonfinancial commodity qualifies for the forward exclusion from the swap definition, it would not be a swap even if the parties refer to it as a swap or document it using an industry standard form agreement that is typically used for swaps. Conversely, such an agreement, contract, or transaction that does not qualify for the forward exclusion from the swap definition would not be excluded even if the parties refer to it as a forward contract.

[61] Brent Interpretation, *supra* note 58, at 39190. The CFTC has reiterated this view in more recent adjudicative orders. *See, e.g., In re Grain Land Coop.,* [2003–2004 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 29,636 (CFTC Nov. 25, 2003); *In re Competitive Strategies for Agric., Ltd.,* [2003–2004 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 29,635 (CFTC Nov. 25, 2003). Courts have expressed this view as well. *See, e.g., Salomon Forex, Inc.* v. *Tauber,* 8 F.3d 966, 971 (4th Cir. 1993) ("[C]ash forwards are generally individually negotiated sales * * * in which actual delivery of the commodity is anticipated, but is deferred for reasons of commercial convenience or necessity."); *CFTC* v. *Int'l Fin. Serv. (N.Y.),* 323 F. Supp. 2d 482, 495 (S.D.N.Y. 2004). *See also CFTC* v. *Co Petro Mktg. Grp., Inc., 680 F.2d 573, 579–580 (9th Cir. 1982); CFTC* v. *Noble Metals Int'l, Inc.,* 67 F.3d 766, 772–773 (9th Cir. 1995; *CFTC* v. *Am. Metal Exch. Corp.,* 693 F. Supp. 168, 192 (D.N.J. 1988); *CFTC* v. *Morgan, Harris & Scott, Ltd.,* 484 F. Supp. 669, 675 (S.D.N.Y. 1979) (forward contract exclusion does not apply to speculative transactions in which delivery obligations can be extinguished under the terms of the contract or avoided for reasons other than commercial convenience or necessity).

[62] *See, e.g.,* BG Letter (forward exclusion for swaps should be consistent with the forward exclusion from futures); BlackRock Letter (the CFTC should interpret "intended to be physically settled" consistently with existing CFTC principles, including book outs); DFA Letter (forward exclusion for swaps should be interpreted consistently with the CFTC's prior forward contract interpretations and precedent, including forwards requiring delivery but including embedded options); EDF Letter (forward exclusion from the definition of swap should be construed in a consistent manner with the forward exclusion under the CEA); EEI Letter (forward exclusion from swap definition should be interpreted consistently with the forward exclusion from futures); FIA Letter (the Commissions should, through rulemaking or interpretation, provide that the "intent" standard in the forward exclusion with respect to swaps will be interpreted the same as the existing forward exclusion with respect to futures); Morgan Stanley Letter (the forward exclusion from the swap definition should be interpreted consistently with the forward exclusion from futures); University of Maryland Letter (forward exclusion from swap definition intended to be consistent with the forward exclusion from futures); WGCEF Letter (physical delivery forwards should be distinguished from swaps under standards identical to those used in forwards vs. futures); World Fuel Letter (forward exclusion for swaps should be interpreted in a manner consistent with the forward exclusion from futures).

[63] As recently as October 25, 2010, the CFTC observed in *In re Wright* that "it is well-established that the intent to make or take delivery is the critical factor in determining whether a contract qualifies as a forward." *In re Wright,* CFTC Docket No. 97–02, 2010 WL 4388247 at *3 (CFTC Oct. 25, 2010) (*citing In re Stovall, et al.,* [1977–1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) 20,941 (CFTC Dec. 6, 1979); Brent Interpretation, *supra* note 58). In *Wright,* the CFTC noted that "[i]n distinguishing futures from forwards, the [CFTC] and the courts have assessed the transaction as a whole with a critical eye toward its underlying purpose. Such an assessment entails a review of the overall effect of the transaction as well as a determination as to what the parties intended." *Id.* at *3 (*quoting* Policy Statement Concerning Swap Transactions, 54 FR 30694, July 21, 1989 ("Swap Policy Statement") (citations and internal quotations omitted).

[64] In its recent decision in *In re Wright,* the CFTC applied its facts and circumstances test in an administrative enforcement action involving hedge-to-arrive contracts for corn, and observed that "[o]ur views of the appropriateness of a multi-factor analysis remain unchanged." *Wright, supra* note 63, n.13. The CFTC let stand the administrative law judge's conclusion that the hedge-to-arrive contracts at issue in the case were forward contracts. *Id.* at **5–6. *See also Grain Land, supra* note 61; *Competitive Strategies for Agric., supra* note 61.

[65] *See* Brent Interpretation, *supra* note 58. The CFTC issued the Brent Interpretation in response to a Federal court decision that held that certain 15-day Brent system crude oil contracts were illegal off-exchange futures contracts. *See Transnor (Bermuda) Ltd.* v. *BP N. Am. Petroleum,* 738 F. Supp. 1472 (S.D.N.Y. 1990). The Brent Interpretation provided clarification that the 15-day Brent system crude oil contracts were forward contracts that were excluded from the CEA definition of "future delivery," and thus were not futures contracts. *See* Brent Interpretation, *supra* note 58.

[66] The Brent Interpretation described these "book-outs" as follows: "In the course of entering into 15-day contracts for delivery of a cargo during a particular month, situations often arise in which two counterparties have multiple, offsetting positions with each other. These situations arise as a result of the effectuation of multiple, independent commercial transactions. In such circumstances, rather than requiring the effectuation of redundant deliveries and the assumption of the credit, delivery and related risks attendant thereto, the parties may, but are not obligated to and may elect not to, terminate their contracts and forego such deliveries and instead negotiate payment-of-differences pursuant to a separate, individually negotiated cancellation agreement referred to as a 'book-out.' Similarly, situations regularly arise when participants find themselves selling and purchasing oil more than once in the delivery chain for a particular cargo. The participants comprising these 'circles' or 'loops' will frequently attempt to negotiate separate cancellation agreements among themselves for the same reasons and with the same effect described above." Brent Interpretation, *supra* note 58, at 39190.

[67] *Id.* at 39192.

[68] *Id.* at 39189.

contracts were forward contracts, not futures contracts:

Under these circumstances, the [CFTC] is of the view that transactions of this type which are entered into between commercial participants in connection with their business, which create specific delivery obligations that impose substantial economic risks of a commercial nature to these participants, but which may involve, in certain circumstances, string or chain deliveries of the type described * * * are within the scope of the [forward contract] exclusion from the [CFTC's] regulatory jurisdiction.[69]

Although the CFTC did not expressly discuss intent to deliver, the Brent Interpretation concluded that transactions retained their character as commercial merchandising transactions, notwithstanding the practice of terminating commercial parties' delivery obligations through "book-outs" as described. At any point in the chain, one of the parties could refuse to enter into a new contract to book-out the transaction and, instead, insist upon delivery pursuant to the parties' obligations under their contract.

The CFTC believes that the principles underlying the Brent Interpretation similarly should apply to the forward exclusion from the swap definition with respect to nonfinancial commodities. To summarize, then, the CFTC believes that: (i) The forward contract exclusion from the swap definition with respect to nonfinancial commodities should be interpreted in a manner that is consistent with the CFTC's historical interpretation of the forward contract exclusion from the definition of the term "future delivery"; (ii) intent to deliver is an essential element of a forward contract excluded from both the swap and future delivery definitions, and such intent in both instances should be evaluated based on the CFTC's established multi-factor approach; and (iii) book-out transactions in nonfinancial commodities that meet the requirements specified in the Brent Interpretation, and that are effectuated through a subsequent, separately-negotiated agreement, should qualify for the forward exclusion from the swap definition.[70]

As noted above, the Brent Interpretation applies to "commercial participants in connection with their business." [71] Market participants that regularly make or take delivery of the referenced commodity (in the case of the Brent Interpretation, a tanker full of Brent oil) in the ordinary course of their business meet that standard. Such entities qualify for the forward exclusion from both the future delivery and swap definitions for their forward transactions under the Brent Interpretation even if they enter a subsequent transaction to "book out" the forward contract rather than make or take delivery. Intent to make or take delivery can be inferred from the binding delivery obligation for the referenced commodity in the contract and the fact that the parties to the contract do, in fact, regularly make or take delivery of the referenced commodity in the contract in the ordinary course of their business.

Some commenters to the ANPR requested clarification with regard to the application of the CFTC's 1993 order exempting certain energy contracts from regulation under the CEA (the "Energy Exemption") [72] after enactment of the Dodd-Frank Act.[73] The Energy Exemption extended the Brent Interpretation regarding the forward contract exclusion from the term "future delivery" to energy commodities other than oil. The CFTC believes that the book-out provisions of the Brent Interpretation similarly should apply to the forward contract exclusion from the swap definition for nonfinancial commodities besides oil. Further, the CFTC also is proposing interpretive guidance herein that the Brent Interpretation with respect to the application of the forward contract exclusion from the term "future delivery" in the context of book-out transactions applies not just to oil, but to all nonfinancial commodities. The CFTC, therefore, is proposing to withdraw the Energy Exemption, while retaining and extending through this interpretive guidance the Brent Interpretation regarding book-outs under the forward contract exclusion with respect to nonfinancial commodities.[74]

(b) Commodity Options and Commodity Options Embedded in Forward Contracts

Some commenters responding to the ANPR requested clarification regarding the status of commodity options under the swap definition.[75] Questions also were raised regarding options embedded in forward contracts, *i.e.,* whether a forward contract with respect to a nonfinancial commodity that contains an embedded option can still qualify for the forward contract exclusion from the swap definition.[76]

The statutory swap definition explicitly provides that commodity

[69] *Id.* at 39192.

[70] This interpretive guidance is consistent with legislative history. *See* 156 Cong. Rec. H5247 (June 30, 2010) (colloquy between U.S. House Committee on Agriculture Chairman Collin Peterson and Representative Leonard Boswell during the debate on the Conference Report for the Dodd-Frank Act, in which Chairman Peterson stated: "Excluding physical forward contracts, including book-outs, is consistent with the CFTC's longstanding view that physical forward contracts in which the parties later agree to book-out their delivery obligations for commercial convenience are excluded from its jurisdiction. Nothing in this legislation changes that result with respect to commercial forward contracts."). *See also* 156 Cong. Rec. H5248–49 (June 30, 2010) (introducing into the record a letter authored by Senator Blanche Lincoln, Chairman of the U.S. Senate Committee on Agriculture, Nutrition and Forestry, and Christopher Dodd, Chairman U.S. Senate Committee on Banking, Housing, and Urban Affairs, stating that the CFTC is encouraged "to clarify through rulemaking that the exclusion from the definition of swap for 'any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled' is intended to be consistent with the forward contract exclusion that is currently in the [CEA] and the CFTC's established policy and orders on this subject, including situations where commercial parties agree to 'book-out' their physical delivery obligations under a forward contract.").

[71] *See* Brent Interpretation, *supra* note 58, at 39192.

[72] Exemption for Certain Contracts Involving Energy Products, 58 FR 21286, Apr. 20, 1993. The Energy Exemption generally applies to certain energy contracts: (i) Entered into by persons reasonably believed to be within a specified class of commercial and governmental entities; (ii) that are bilateral contracts between two parties acting as principals; (iii) the material economic terms of which are subject to individual negotiation by the parties; and (iv) that impose binding obligations on the parties to make and receive delivery of the underlying commodity, with no right of either party to effect a cash settlement of their obligations without the consent of the other party (except pursuant to a bona fide termination right such as default). Like the Brent Interpretation, the Energy Exemption provides that the parties can enter into a subsequent book-out settlement of the obligation in a manner other than by physical delivery of the commodity specified in the contract. *Id.* at 21294.

[73] *See, e.g.,* WGCEF letter. The CFTC issued the Energy Exemption shortly after Congress had provided the CFTC with exemptive authority pursuant to CEA section 4(c), 7 U.S.C. 6(c), in section 502 of the Futures Trading Practices Act of 1992, Public Law 102–546, 106 Stat. 3590 (1993).

[74] To avoid any uncertainty, the CFTC also notes that the Dodd-Frank Act supersedes the Swap Policy Statement. The CFTC is aware that some commenters have suggested that the Commissions should exercise their authority to further define the term "eligible contract participant" to encompass the "line of business" provision of the Swap Policy Statement. *See* Swap Policy Statement, supra note 63, at 30696–30697. The Commissions will address these comments in their joint final rulemaking with respect to the Entity Definitions. *See supra* note 12.

[75] *See, e.g.,* World Fuel Letter (exclusion for commercial options set forth in CFTC Regulation 32.4 should also be an exclusion from the swap definition).

[76] *See, e.g.,* Letter from Patrick Kelly, Policy Advisor, API, Sept. 20, 2010 ("API Letter"), EEI Letter; Letter from Daniel S.M. Dolan, VP, Policy Research & Communications, Electric Power Supply Association, Sept. 20, 2010 ("EPSA Letter") (physically settled options should be included in the forward exclusion from the swap definition); DFA Letter; ISDA Letter. One commenter suggested that the CFTC should apply to each contract with an enforceable delivery obligation a rebuttable presumption of intent to deliver, even if an option to cash settle is included in that contract. *See* WGCEF Letter.

options are swaps.[77] Accordingly, the CFTC recently proposed revisions to its existing options rules in parts 32 and 33 of its regulations with respect to the treatment of commodity options under the Dodd-Frank Act, and requested public comment on those proposed revisions.[78] The question of the application of the forward exclusion from the swap definition with respect to nonfinancial commodities, where commodity options are embedded in forward contracts (including embedded options to cash settle such contracts), is similar to that arising under the CEA's existing forward contract exclusion from the definition of the term "future delivery." The CFTC's Office of General Counsel addressed forward contracts that contained embedded options in a 1985 interpretive statement ("1985 Interpretation"),[79] which the CFTC recently adhered to in its adjudicatory Order in the *Wright* case.[80] While both were issued prior to the effective date of the Dodd-Frank Act, the CFTC believes that it would be appropriate to apply this guidance to the treatment of forward contracts in nonfinancial commodities that contain embedded options under the Dodd-Frank Act.

In *Wright,* the CFTC described the 1985 Interpretation and stated that the CFTC traditionally has engaged in a two-step analysis of "embedded options" in which the first step focuses on whether the option operates on the price or the delivery term of the forward contract and the second step focuses on secondary trading.[81] The CFTC believes that these same principles can be applied with respect to the forward contract exclusion from the swap definition for nonfinancial commodities in the Dodd-Frank Act, too. That is, a forward contract that contains an embedded commodity option or options [82] would be considered an excluded nonfinancial commodity forward contract (and not a swap) if the embedded option(s): (i) May be used to adjust the forward contract price, but do not undermine the overall nature of the contract as a forward contract; (ii) do not target the delivery term, so that the predominant feature of the contract is actual delivery; and (iii) cannot be severed and marketed separately from the overall forward contract in which they are embedded.[83] Conversely, where the embedded commodity option(s) render delivery optional, the predominant feature of the contract cannot be actual delivery and, therefore, the embedded option(s) to not deliver preclude treatment of the contract as a forward contract for a nonfinancial commodity. The CFTC would look to the specific facts and circumstances of the transaction as a whole to evaluate whether any embedded optionality operates on the price or delivery term of the contract, and whether an embedded commodity option is marketed or traded separately from the underlying contract, to determine whether that transaction qualifies for the forward contract exclusion from the swap definition for nonfinancial commodities.[84] The CFTC believes that such an approach would help prevent commodity options that should fall within the swap definition from qualifying for the forward contract exclusion for nonfinancial commodities instead.

(c) Security Forwards [85]

No commenters sought clarification of the exclusion from the swap and security-based swap definitions for the "sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled," in the context of most sales of securities for deferred shipment or delivery; however, some commenters sought clarification of this exclusion in the context of mortgage securitizations.[86] The Commissions believe it is appropriate to address how the exclusions from the definitions of swap and security-based swap apply to security forwards and other purchases and sales of securities.

The Dodd-Frank Act excludes purchases and sales of securities from the definitions of swap and security-based swap in a number of different clauses.[87] Under these exclusions, purchases and sales of securities on a fixed or contingent basis [88] and sales of securities for deferred shipment or delivery that are intended to be physically delivered [89] are explicitly excluded from the definitions of swap and security-based swap.[90] The exclusion from the definitions of swap and security-based swap of a sale of a security for deferred shipment or delivery involves an agreement to purchase securities, or groups or indexes of securities, at a future date at a certain price.

[77] 7 U.S.C. 1a(47)(A)(i). Options on securities and certain options on foreign currency are excluded from the swap definition by CEA sections 1a(47)(B)(iii) and (iv), respectively. 7 U.S.C. 1a(47)(B)(iii) and (iv). These options are not subject to the Commissions' proposed guidance in this section.

[78] *See* Commodity Options and Agricultural Swaps, 76 FR 6095, Feb. 3, 2011.

[79] *See* Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options, 50 FR 39656, Sept. 30, 1985.

[80] *Wright, supra* note 63.

[81] *Id.* at n.5. In *Wright,* the CFTC affirmed the Administrative Law Judge's holding that an option embedded in a hedge-to-arrive contract did not violate CFTC rules regarding the sale of agricultural trade options. The CFTC first concluded that the puts at issue operated to adjust the forward price and did not render the farmer's overall obligation to make delivery optional. Then, turning to the next step of the analysis, the CFTC explained that "the put and [hedge-to-arrive contract] operated as a single contract, and in most cases were issued simultaneously * * *. We do not find that any put was severed from its forward or that either of [the put or the hedge-to-arrive contract] was traded separately from the other. We hold that in these circumstances, no freestanding option came into being. * * *" *Id.* at *7.

[82] The CFTC believes that "options" in the plural would include, for example, a situation in which the embedded optionality involves option combinations, such as costless collars, that operate on the price term of the agreement, contract, or transaction.

[83] *See Wright, supra* note 63, at **6–7.

[84] This facts and circumstances approach to determining whether a particular embedded option takes a transaction out of the forward contract exclusion for nonfinancial commodities is consistent with the CFTC's historical approach to determining whether a particular embedded option takes a transaction out of the forward contract exclusion from the CEA definition of the term "future delivery." *See Wright, supra* note 63, at *5 ("As we have held since *Stovall,* the nature of a contract involves a multi-factor analysis . * * *").

[85] The discussion above regarding the exclusion from the swap definition for forward contracts on nonfinancial commodities does not apply to the exclusion from the swap and security-based swap definitions for security forwards or to the distinction between security forwards and security futures products.

[86] Specifically, commenters requested clarification that the swap and security-based swap definitions do not include buying and selling mortgages and forward trading of agency (*i.e.,* Federal Home Loan Mortgage Corporation ("Freddie Mac"), Federal National Mortgage Association ("Fannie Mae"), and Government National Mortgage Association ("Ginnie Mae") mortgage-backed securities ("MBS") in the "To-Be-Announced" ("TBA") market in order to provide the certainty needed to avoid unnecessary disruption of the securitization market. *See* Letter from Stephen H. McElhennon, Vice President & Deputy General Counsel, Fannie Mae, Sept. 20, 2010 ("Fannie Mae Letter"); Letter from Lisa M. Ledbetter, Freddie Mac, Sept. 20, 2010.

[87] *See* CEA sections 1a(47)(B)(ii), (v), and (vi), 7 U.S.C. 1a(47)(B)(ii), (v), and (vi).

[88] *See* CEA section 1a(47)(B)(v), 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 and Exchange Act]"); CEA section 1a(47)(B)(vi), 7 U.S.C. 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 and Exchange Act], 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").

[89] *See* CEA section 1a(47)(B)(ii), 7 U.S.C. 1a(47)(B)(ii).

[90] The Commissions note that calling an agreement, contract, or transaction a swap or security-based swap does not determine its status. *See* discussion *supra* part II.D.1.

As with other purchases and sales of securities, security forwards are excluded from the definitions of swap and security-based swap. The sale of the security in this case occurs at the time the forward contract is entered into with the performance of the contract deferred or delayed. If such agreement, contract, or transaction is intended to be physically settled, the Commissions believe it would be within the security forward exclusion and therefore outside the swap and security-based swap definitions.[91] Moreover, as a purchase or sale of a security, the Commissions believe it also would be within the exclusions for the purchase or sale of one or more securities on a fixed basis (or, depending on its terms, a contingent basis) and, therefore, outside the swap and security-based swap definitions.[92]

As noted above, commenters requested specific guidance in the context of forward sales of MBS that are guaranteed or sold by Fannie Mae, Freddie Mac, and Ginnie Mae and the mortgages underlying such MBS.

MBS guaranteed or sold by Fannie Mae, Freddie Mac and Ginnie Mae are eligible to be sold in the TBA market, which is essentially a forward or delayed delivery market.[93] The TBA market has been described as one that "allows mortgage lenders essentially to sell the loans they intend to fund even before the loans are closed."[94] In the TBA market, the lender enters into a forward contract to sell MBS and agrees to deliver MBS on the settlement date in the future. The specific MBS that will be delivered in the future may not yet be created at the time the forward contract is entered into.[95] The Commissions believe that such forward sales of MBS in the TBA market would fall within the exclusion for sales of securities on a deferred settlement or delivery basis even though the precise MBS are not in existence at the time the forward MBS sale is entered into.[96] Moreover, as the purchase or sale of a security, the Commissions believe such forward sales of MBS in the TBA market would fall within the exclusions for the purchase or sale of one or more securities on a fixed basis (or, depending on its terms, a contingent basis) and therefore outside the swap and security-based swap definitions.[97]

Request for Comment

22. The Commissions request comment on all aspects of the proposed interpretive guidance set forth in this section regarding the forward contract exclusion from the swap and security-based swap definitions with respect to nonfinancial commodities and securities.

23. Is the proposed interpretive guidance set forth in this section sufficient with respect to the application of the forward contract exclusion from the swap definition with respect to nonfinancial commodities? If not, what changes should be made? Commenters also are invited to comment on whether the application of the Brent Interpretation generally, and its conclusions regarding book-outs in particular, is appropriate to the forward exclusion from the swap definition with respect to nonfinancial commodities. Would it permit transactions that should be subject to the swap regulatory regime to fall outside of the Dodd-Frank Act?

24. Is it appropriate, in light of the Dodd-Frank Act, for the CFTC to withdraw the Energy Exemption while concurrently retaining the Brent Interpretation, and extending it to the forward contract exclusion from the definition of "future delivery" and the swap definition, for book-out transactions in all nonfinancial commodities? Why or why not? Is the conclusion that the Dodd-Frank Act supersedes the Swap Policy Statement appropriate? Why or why not?

25. Are there any provisions of the Energy Exemption or Swap Policy Statement that the Commissions should consider incorporating into the definitions rulemakings (other than the request already submitted by some commenters in response to the proposed Entity Definitions that the "line of business" provision of the Swap Policy Statement be incorporated into the definition of the term "eligible contract participant" ("ECP"))? If so, please explain in detail how such provisions are consistent with the requirements of the Dodd-Frank Act and would not permit transactions that should be subject to the swap regulatory regime to fall outside of the Dodd-Frank Act.

26. How frequently do book-out transactions of the type described in the Brent Interpretation occur with respect to nonfinancial commodities? Please provide descriptions of any such transactions, and data with respect to their frequency. Are there any nonfinancial commodities or transactions to which the Brent Interpretation should not apply, either with respect to the forward contract exclusion from the definition of "future delivery" or the forward contract exclusion from the swap definition, or both? Why or why not?

27. Should a minimum contract size for a transaction in a nonfinancial commodity (*e.g.,* a tanker full of Brent oil) be required in order for the transaction to qualify as a forward contract under the Brent Interpretation with respect to the future delivery and swap definitions? Why or why not? If so, what standards should apply to determine such a minimum contract size? Should the Brent Interpretation for nonfinancial commodities with respect to the future delivery and swap definitions be limited to market participants that meet certain requirements? Why or why not? If so, does the "eligible commercial entity" definition in CEA section 1a(17)[98] provide an appropriate requirement? Why or why not? What other requirements, if any, should be imposed?

28. How often, and to what extent, do entities that do not regularly make or take delivery of the commodity in the ordinary course of their business engage in transactions that should qualify as forward contracts? Should such contracts qualify for the safe harbor provided by the Brent Interpretation? Why or why not? If so, how can it be demonstrated that the primary purpose of such transaction is to acquire or sell the physical commodity? Would including these transactions in the scope of the Brent Interpretation permit transactions that should be subject to the swap regulatory regime to fall outside of the Dodd-Frank Act? If so, could this concern be addressed by imposing conditions in order to qualify for the forward exclusion? What conditions, if any, would be appropriate?

29. Are "ring" or "daisy chain" markets for forward contracts, such as the 15-day Brent market, primarily used for commercial merchandising, or do they serve other purposes such as price discovery or risk management? Please explain in detail.

30. Should contracts in nonfinancial commodities that may qualify as forward contracts be permitted to trade on registered trading platforms such as DCMs or swap execution facilities ("SEFs")? If so, are additional guidance

[91] *See* CEA section 1a(47)(B)(ii), 7 U.S.C. 1a(47)(B)(ii).

[92] *See* CEA sections 1a(47)(B)(v) and (vi), 7 U.S.C. 1a(47)(B)(v) and (vi).

[93] Task Force on Mortgage-Backed Securities Disclosure, "Staff Report: Enhancing Disclosure in the Mortgage-Backed Securities Markets," part II.E.2 (Jan. 2003).

[94] *Id.*

[95] *Id.*

[96] *See* CEA section 1a(47)(B)(ii), 7 U.S.C. 1a(47)(B)(ii).

[97] *See* CEA sections 1a(47)(B)(v) and (vi), 7 U.S.C. 1a(47)(B)(v) and (vi).

[98] 7 U.S.C. 1a(17).

or rules necessary to determine whether contracts traded on such platforms are excluded from the CEA definition of "future delivery" and/or the swap definition? If so, please describe in detail such markets and explain what further guidance or rules would be appropriate? Should conditions be imposed with respect to the nature of the market participants or the percentage of transactions that must result in delivery over a specified measurement period, or both? If so, what conditions would be appropriate?

31. Should the Commissions provide guidance regarding the scope of the term "nonfinancial commodity" in the forward contract exclusion from the swap definition? If so, how and where should the Commissions draw the line between financial and nonfinancial commodities?

32. Should the forward contract exclusion from the swap definition apply to environmental commodities such as emissions allowances, carbon offsets/credits, or renewable energy certificates? If so, please describe these commodities, and explain how transactions can be physically settled where the commodity lacks a physical existence (or lacks a physical existence other than on paper)? Would application of the forward contract exclusion to such environmental commodities permit transactions that should be subject to the swap regulatory regime to fall outside the Dodd-Frank Act?

33. Are there other factors that should be considered in determining how to characterize forward contracts with embedded options with respect to nonfinancial commodities? If so, what factors should be considered? Do provisions in forward contracts with respect to nonfinancial commodities other than delivery and price contain embedded optionality? How do such provisions operate? Please provide a detailed analysis regarding how such provisions should be analyzed under the Dodd-Frank Act.

34. Is the analysis of forward contracts with embedded options in the 1985 Interpretation and the CFTC's *Wright* decision appropriately applied to transactions entered into after the effective date of the Dodd-Frank Act? Why or why not? If not, how should the analysis be modified?

35. How would the proposed interpretive guidance set forth in this section affect full requirements contracts, capacity contracts, reserve sharing agreements, tolling agreements, energy management agreements, and ancillary services? Do these agreements, contracts, or transactions have optionality as to delivery? If so, should they—or any other agreement, contract, or transaction in a nonfinancial commodity that has optionality as to delivery—be excluded from the swap definition? If so, please provide a detailed analysis of such agreements, contracts, or transactions and how they can be distinguished from options that are to be regulated as swaps pursuant to the Dodd-Frank Act. To what extent are any such agreements, contracts, or transactions in the electric industry regulated by the Federal Energy Regulatory Commission ("FERC"), State regulatory authorities, regional transmission organizations ("RTOs"), independent system operators ("ISOs") or market monitoring units associated with RTOs or ISOs?

36. Is there any issue with respect to the treatment of commodity options that the Commissions have not addressed and that should be addressed as a definitional matter in this rulemaking?

37. Should the Commissions provide more detailed guidance regarding what constitutes a security forward? For instance, should the Commissions provide more guidance on what it means for a security forward to be "intended to be physically settled"? If so, what further guidance would be appropriate?

38. Should the Commissions provide more guidance regarding when forward sales of MBS in the TBA market would fall within the exclusion for sales of securities on a deferred settlement or delivery basis? Is there any more guidance the Commissions should provide regarding types of transactions that occur in the TBA market?

3. Consumer and Commercial Agreements, Contracts, and Transactions

Commenters on the ANPR pointed out a number of areas in which a broad reading of the swap and security-based swap definitions could cover certain consumer and commercial arrangements that historically have not been considered swaps or security-based swaps. Examples of such instruments cited by commenters include evidences of indebtedness with a variable rate of interest;[99] commercial contracts containing acceleration, escalation, or indexation clauses;[100] agreements to acquire personal property or real property, or to obtain mortgages;[101] employment, lease, and service agreements, including those that contain contingent payment arrangements;[102] and consumer mortgage and utility rate caps.[103]

Consumers enter into various types of agreements, contracts, and transactions as part of their household and personal lives that may have attributes that could be viewed as falling within the swap or security-based swap definition. Similarly, businesses and other entities, whether or not for profit, also enter into agreements, contracts, and transactions as part of their operations relating to, among other things, acquisitions or sales of property (tangible and intangible), provisions of services, employment of individuals, and other matters that could be viewed as falling within the definitions.

The Commissions do not believe that Congress intended to include these types of customary consumer and commercial agreements, contracts, or transactions in the swap or security-based swap definition, to limit the types of persons that can enter into or engage in them, or to otherwise to subject these agreements, contracts, or transactions to the regulatory scheme for swaps and security-based swaps. The Commissions, therefore, are proposing the following interpretive guidance to assist consumers and businesses in understanding whether certain agreements, contracts, or transactions that they enter into would be regulated as swaps or security-based swaps.

With respect to consumers, the Commissions believe that the types of agreements, contracts, or transactions that should not be considered swaps or security-based swaps when entered into by consumers (natural persons or their agents) as principals primarily for personal, family, or household purposes, include:

- Agreements, contracts, or transactions to acquire or lease real or personal property, to obtain a mortgage, to provide personal services, or to sell or assign rights owned by such consumer (such as intellectual property rights);
- Agreements, contracts, or transactions to purchase products or services at a fixed price or a capped or collared price, at a future date or over a certain time period (such as agreements to purchase home heating fuel);[104]

[99] *See* Cleary Letter; Letter from Kenneth E. Auer, President and CEO, The Farm Credit Council, Sept. 20, 2010 ("Farm Credit Council Letter").

[100] *See* Cleary Letter; White & Case Letter.

[101] *See* White & Case Letter; Fannie Mae Letter.

[102] *See* BlackRock Letter.

[103] *See* White & Case Letter; Deutsche Bank Letter.

[104] These agreements, contracts, or transactions involve physical delivery which is deferred for convenience or necessity and thus can be viewed as being akin to forward purchase agreements (sometimes with embedded options, in the case of those with price caps), which were discussed above

• Agreements, contracts, or transactions that provide for an interest rate cap or lock on a consumer loan or mortgage, where the benefit of the rate cap or lock is realized only if the loan or mortgage is made to the consumer; and

• Consumer loans or mortgages with variable rates of interest or embedded interest rate options, including such loans with provisions for the rates to change upon certain events related to the consumer, such as a higher rate of interest following a default.

The types of commercial agreements, contracts, or transactions that involve customary business arrangements (whether or not involving a for-profit entity) and would not be considered swaps or security-based swaps under this proposed interpretive guidance include:

• Employment contracts and retirement benefit arrangements;

• Sales, servicing, or distribution arrangements;

• Agreements, contracts, or transactions for the purpose of effecting a business combination transaction; [105]

• The purchase, sale, lease, or transfer of real property, intellectual property, equipment, or inventory;

• Warehouse lending arrangements in connection with building an inventory of assets in anticipation of a securitization of such assets (such as in a securitization of mortgages, student loans, or receivables); [106]

• Mortgage or mortgage purchase commitments, or sales of installment loan agreements or contracts or receivables;

• Fixed or variable interest rate commercial loans entered into by non-banks [107]; and

• Commercial agreements, contracts, and transactions (including, but not limited to, leases, service contracts, and employment agreements) containing escalation clauses linked to an underlying commodity such as an interest rate or consumer price index.

The Commissions intend this proposed interpretive guidance to allow consumers to engage in customary transactions relating to their households and personal or family activities without concern that such arrangements would be considered swaps or security-based swaps. Similarly, applying this guidance to customary commercial arrangements should allow commercial and non-profit entities to continue to operate their businesses and operations without significant disruption and ensure that the swap and security-based swap definitions are not read to include commercial and non-profit operations that historically have not been considered to involve swaps or security-based swaps.

The types of agreements, contracts, and transactions discussed above are not intended to be exhaustive of the customary consumer or commercial arrangements that should not be considered to be swaps or security-based swaps. There may be other, similar types of agreements, contracts, and transactions that also should not be considered to be swaps or security-based swaps. In determining whether similar types of agreements, contracts, and transactions entered into by consumers or commercial entities are swaps or security-based swaps, the Commissions intend to consider the characteristics and factors that are common to the consumer and commercial transactions listed above:

• They do not contain payment obligations, whether or not contingent, that are severable from the agreement, contract, or transaction;

• They are not traded on an organized market or over-the-counter; and

• In the case of consumer arrangements, they:

—Involve an asset of which the consumer is the owner or beneficiary, or that the consumer is purchasing, or they involve a service provided, or to be provided, by or to the consumer, or

• In the case of commercial arrangements, they are entered into:

—By commercial or non-profit entities as principals (or by their agents) to serve an independent commercial, business, or non-profit purpose, and

—Other than for speculative, hedging, or investment purposes.

Two of the key components reflected in these characteristics that distinguish these agreements, contracts, and transactions from swaps and security-based swaps are that: (i) The payment provisions of the arrangements are not severable; and (ii) the agreement, contract, or transaction is not traded on an organized market or over-the-counter—so that such arrangements would not involve risk-shifting arrangements with financial entities, as would be the case for swaps and security-based swaps.[108]

This proposed interpretive guidance is not intended to be the exclusive means for consumers and commercial or non-profit entities to determine whether their agreements, contracts, or transactions fall within the swap or security-based swap definition. If there is a type of agreement, contract, or transaction that is not enumerated above, or does not have all the characteristics and factors that are listed above (including new types of arrangements that may be developed in the future), but that a party to the agreement, contract, or transaction believes is not a swap or security-based swap, the Commissions invite such party to seek an interpretation from the Commissions as to whether the agreement, contract, or transaction is a swap or security-based swap.

Request for Comment

39. Is interpretive guidance of the type proposed in this section necessary with respect to the application of the swap and security-based swap definitions to certain consumer and commercial agreements, contracts, or transactions?

40. Is the interpretive guidance proposed in this section useful,

in the context of the exclusion from the swap definition for forward contracts in nonfinancial commodities. While the CFTC traditionally has viewed forward contracts in nonfinancial commodities as limited to commercial merchandising transactions, the Commissions view consumer agreements, contracts, and transactions involving periodic or future purchases of consumer products and services, such as agreements to purchase energy commodities to heat or cool consumers' homes, as transactions that are not swaps.

[105] These business combination transactions include, for example, a reclassification, merger, consolidation, or transfer of assets as defined under the Federal securities laws or any tender offer subject to section 13(e) and/or section 14(d) or (e) of the Exchange Act, 15 U.S.C. 78m(e) and/or 78n(d) or (e). These business combination agreements, contracts, or transactions can be contingent on the continued validity of representations and warranties and can contain earn-out provisions and contingent value rights.

[106] The Commissions believe that such lending arrangements included in this category are traditional borrower/lender arrangements documented using, for example, a loan agreement or indenture, as opposed to a synthetic lending arrangement documented in the form of, for example, a TRS. The Commissions also note that securitization transaction agreements also may contain contingent obligations if the representations and warranties about the underlying assets are not satisfied.

[107] *See infra* note 115 regarding identified banking products.

[108] There also are alternative regulatory regimes that have been enacted as part of the Dodd-Frank Act specifically to provide enhanced protections to consumers relating to various consumer transactions. *See, e.g.,* the Consumer Financial Protection Act of 2010, Public Law 111–203, title X, 124 Stat. 1376 (July 21, 2010) (establishing the Bureau of Consumer Financial Protection to regulate a broad category of consumer products and amending certain laws under the jurisdiction of the Federal Trade Commission); the Mortgage Reform and Anti-Predatory Lending Act, Public Law 111–203, title XIV, 124 Stat. 1376 (July 21, 2010) (amending existing laws, and adding new provisions, related to certain mortgages). Some of these agreements, contracts, or transactions are subject to regulation by the Federal Trade Commission and other Federal financial regulators and state regulators.

appropriate, and sufficient for persons to consider when evaluating whether agreements, contracts, or transactions of the types described in this section fall within the swap or security-based swap definition?

41. In particular, are the listed characteristics and factors for consumer transactions and for commercial transactions appropriate for purposes of evaluating whether agreements, contracts, or transactions fall within the swap or security-based swap definition? If not, what characteristics or factors should be included or excluded, and why? Are any of the characteristics or factors too narrow or too broad? If so, how should the listed characteristics and factors be modified, and why?

42. Is a joint interpretation as provided for in section 712(d)(4) of the Dodd-Frank Act, pursuant to the proposed process discussed in part VI below, an appropriate means of addressing any further interpretive questions?

43. Does the interpretive guidance proposed in this section sufficiently enumerate the types of consumer and commercial agreements, contracts, or transactions that should not be considered swaps or security-based swaps? If not, please provide details of other types of such agreements, contracts, or transactions and an explanation of the reasons why the definitions should not apply to them.

44. Is the treatment of consumer or commercial contracts containing payment arrangements sufficiently clear? For example, should the interpretive guidance expressly address any other specific types of contracts, such as installment sales contracts, financings used in normal business operations (such as receivables financings), pensions and other post-retirement benefits, contracts relating to the performance of a service, standby liquidity agreements, indemnification agreements, reimbursement agreements, or affiliate guarantees? Why or why not?

45. Is the treatment of purchases, sales, leases, or transfers of equipment and inventory sufficiently flexible to not interfere with ordinary business operations? As an alternative, should the guidance expressly cover the purchase, sale, lease, or transfer of assets (excluding financial assets) that are anticipated to be owned, leased, licensed, produced, manufactured, processed, or merchandized by one of the parties or an affiliate? Why or why not?

4. Loan Participations

Two commenters inquired whether loan participations fall within the scope of the swap and security-based swap definitions.[109] According to these commenters, loan participations arise when a lender transfers the economic risks and benefits of all or a portion of a loan it has entered into with a borrower to another party as an alternative or precursor to assigning to such person the loan or an interest in the loan.[110] Two types of loan participations are offered in the market today according to these commenters: LSTA-style participations and LMA-style participations.[111] An LSTA-style participation "specifically provides that the participation is intended by the parties to be treated as a sale by the grantor and a purchase by the participant" and "is intended to effect a 'true sale' of the loan from the grantor to the participant and put the participant's beneficial ownership interest in the loan beyond the reach of the grantor's bankruptcy estate."[112] By contrast, an LMA-style participation, while not effecting a sale, "creates a current debtor-creditor relationship between the grantor and the participant under which a future ownership interest is conveyed."[113] Neither type of loan participation is a "synthetic" transaction according to the March LSTA letter because "they are merely transfers of cash loan positions" and "[t]he ratio of underlying loan to participation is always one-to-one."

Depending on the facts and circumstances, a loan participation may be a security under the Federal securities laws and, as such, the loan participation would be excluded from the definition of swap as the purchase and sale of a security on a fixed or contingent basis.[114] In addition, depending on the facts and circumstances, a loan participation may be an identified banking product and, as such, would be excluded from CFTC jurisdiction and from the "security-based swap" and "security-based swap agreement" definitions.[115]

The Commissions do not interpret the swap and security-based swap definitions to include loan participations in which the purchaser is acquiring a current or future direct or indirect ownership interest in the related loan and the loan participations are "true participations" (the participant acquires a beneficial ownership interest in the underlying loans).[116]

Request for Comment

46. Should any of the enumerated agreements, contracts, or transactions be considered swaps or security-based swaps whether in general or in certain narrow circumstances? If so, which ones and why? In particular, how are loan participations similar to and different from loan TRS? Does the proposed guidance adequately distinguish between loan participations similar to and different from loan TRS?

47. Does the Commissions' proposed interpretive guidance regarding loan participations exclude from the swap or security-based swap definitions agreements, contracts, or transactions

[109] *See* Letter from R. Bram Smith, Executive Director, The Loan Syndications and Trading Association, Jan. 25, 2011 ("January LSTA Letter") and letter from Elliot Ganz, General Counsel, The Loan Syndications and Trading Association, Mar. 1, 2011 ("March LSTA Letter, and collectively with the January LSTA Letter, "LSTA Letters"); Letter from Clare Dawson, Managing Director, Loan Market Association, Feb. 23, 2011.

[110] *See* Loan Market Association, "Guide to Syndicated Loans," section 6.2.5 ("Risk participation may be provided by a new lender as an interim measure before it takes full transfer of a loan."), available at *http://www.lma.eu.com/uploads/files/Introductory_Guides/Guide_to_Par_Syndicated_Loans.pdf.*

[111] The LSTA is The Loan Syndications and Trading Association. The LMA is the Loan Market Association.

[112] *See* January LSTA Letter (citation omitted).

[113] *See* LSTA Letters. *But see* Jon Kibbe, Julia Lu and Carl Winkworth, Richards Kibbe & Orbe, LLP, "Dodd-Frank Crosses the Pond: Unintended Consequences for LMA–Style Loan Participations?," 3 (Nov. 12, 2010) ("The grantor of an LMA-style participation does not grant an ownership interest in the loan to the participant.") ("LMA–Style LP Memo"), available at *http://www.rkollp.com/assets/attachments/Dodd-Frank%20Crosses%20the%20Pond%20-%20Unintended%20Consequences%20for%20LMA–Style%20Loan%20Participations.pdf.*

[114] *See* CEA sections 1a(47)(B)(v) and (vi), 7 U.S.C. 1a(47)(b)(v) and (vi), as amended by section 721(a)(21) of the Dodd-Frank Act (excluding purchases and sales of a security on a fixed or contingent basis, respectively from the swap definition).

[115] *See* section 403(a) of the Legal Certainty for Bank Products Act of 2000, 7 U.S.C. 27a(a), as amended by section 725(g)(2) of the Dodd-Frank Act (providing that, under certain circumstances, the CEA shall not apply to, and the CFTC shall not exercise regulatory authority over, identified banking products, and the definitions of the terms "security-based swap" and "security-based swap agreement" shall not include identified banking products).

[116] *See generally* Richard M. Gray and Suhrud Mehta, Milbank Tweed Hadley & McCloy LLP, "US and UK compared Fundamental differences remain between the markets. But is it worth considering using a New York participation agreement in an English deal?," International Financial Law Review (Oct. 1, 2009) (discussing differences between New York and English participation markets and features distinguishing true participations from financings), available at *http://www.milbank.com/NR/rdonlyres/B95C06AD–C3CA–44C9–8433–B6021C4455C9/0/102009_IFLR_USandUKcompared_RGray_SMehta.pdf;* Cleary, Gottlieb, Steen & Hamilton, *Memorandum for the Financial Accounting Standards Board,* Re: Participations (June 14, 2004) (discussing, among other things, what a "good" or "true" participation is under the Uniform Commercial Code, the Bankruptcy Code, case law, and other authority), available at *http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175817895286&blobheader=application%2Fpdf.*

that are swaps or security-based swaps? If so, please describe such agreements, contracts, or transactions and suggested adjustments to the proposed guidance to capture such agreements, contracts, or transactions as swaps or security-based swaps.

48. Is the Commissions' proposed interpretive guidance regarding loan participations as not falling within the swap and security-based swap definitions appropriate? Why or why not? Should the Commissions provide further guidance on what constitutes an "ownership interest" in the loan underlying a loan participation? If so, what should such guidance provide?

49. Do all loan participations convey a current or future direct or indirect ownership interest from the grantor to the participant or sub-participant? If so, what indicia of ownership are conveyed and when, particularly in LMA-style loan participations? Do loan participations use leverage? If so, how?

50. Are any swaps or security-based swaps partly or fully defeased?

51. Should the Commissions provide further guidance regarding the scope of "true participation?" If so, how should the Commissions delineate the scope thereof?

C. Proposed Rules and Interpretive Guidance Regarding Certain Transactions Within the Scope of the Definitions of the Terms "Swap" and "Security-Based Swap"

1. In General

In light of provisions in the Dodd-Frank Act that specifically address certain foreign exchange products, the Commissions are proposing rules to clarify the status of products such as foreign exchange forwards, foreign exchange swaps, foreign exchange options, non-deliverable forwards involving foreign exchange ("NDFs"), and cross-currency swaps. The Commissions also are proposing a rule to clarify the status of FRAs and providing interpretive guidance regarding: (i) Combinations and permutations of, or options on, swaps or security-based swaps; and (ii) contracts for differences ("CFDs").

Proposed rule 1.3(xxx)(2) under the CEA and proposed rule 3a69–2 under the Exchange Act would explicitly define the term "swap" to include certain foreign exchange-related products and FRAs unless such products would be excluded by the list of exclusions in subparagraph (B) of the swap definition.[117] In proposing these rules, the Commissions do not mean to suggest that any other agreement, contract, or transaction not mentioned in the proposed rules or specifically enumerated in the statutory definition would not be covered by the swap or security-based swap definitions in the Dodd-Frank Act.

2. Foreign Exchange Products

(a) Foreign Exchange Products Subject to the Secretary's Swap Determination: Foreign Exchange Forwards and Foreign Exchange Swaps

The Dodd-Frank Act provides that "foreign exchange forwards" and "foreign exchange swaps" shall be considered swaps under the swap definition unless the Secretary of the Treasury ("Secretary") issues a written determination that either foreign exchange swaps, foreign exchange forwards, 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 pursuant to section 721(c) of the Dodd-Frank Act.[118] A foreign exchange forward is defined as "a transaction that solely involves the exchange of 2 different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange."[119] A foreign exchange swap, in turn, is defined as "a transaction that solely involves—(A) An exchange of 2 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 2 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."[120]

Under the Dodd-Frank Act, if foreign exchange forwards or foreign exchange swaps are no longer considered swaps due to a determination by the Secretary, nevertheless, certain provisions of the CEA added by the Dodd-Frank Act would continue to apply to such transactions. Specifically, those transactions still would be subject to certain requirements for reporting swaps, and swap dealers and major swap participants engaging in such transactions still would be subject to certain business conduct standards.[121]

The Commissions are proposing to provide greater clarity by explicitly defining by rule the term "swap" to include foreign exchange forwards and foreign exchange swaps (as those terms are defined in the CEA).[122] The proposed rules would incorporate the provision of the Dodd-Frank Act that, if the Secretary issues the written determination described above, foreign exchange forwards and foreign exchange swaps would no longer be considered swaps. The proposed rules also would reflect the continuing applicability of certain reporting requirements and business conduct standards in the event that the Secretary makes such a determination.[123]

(b) Foreign Exchange Products Not Subject to the Secretary's Swap Determination

The Commissions also are proposing rules to provide clarity that a determination by the Secretary that foreign exchange forwards or foreign exchange swaps, or both, should not be regulated as swaps would not affect other products involving foreign currency, such as foreign currency options, NDFs, and cross-currency swaps. The Commissions are proposing rules to explicitly define the term "swap" to include such products, irrespective of whether the Secretary makes a determination to exempt foreign exchange forwards or foreign exchange swaps.[124]

(i) Foreign Currency Options[125]

As discussed above, the statutory swap definition includes options, and it expressly enumerates foreign currency options. It encompasses any agreement, contract, or transaction: " (i) that is a

[117] *See* CEA section 1a(47)(B), 7 U.S.C. 1a(47)(B).

[118] *See* CEA section 1a(47)(E)(i), 7 U.S.C. 1a(47)(E)(i). The Secretary has issued a request for comment about whether an exclusion from the swap definition for foreign exchange swaps, foreign exchange forwards, or both, is warranted, and on the application of the statutory factors that the Secretary must consider in making a determination regarding whether to exclude these products. *See* Determinations of Foreign Exchange Swaps and Forwards, 75 FR 66829, Oct. 29, 2010.

[119] *See* CEA section 1a(24), 7 U.S.C. 1a(24).

[120] *See* CEA section 1a(25), 7 U.S.C. 1a(25).

[121] *See, e.g.,* CEA sections 1a(47)(E)(iii) and (iv), 7 U.S.C. 1a(47)(E)(iii) and (iv) (reporting and business conduct standards, respectively).

[122] As noted above, the proposed rules provide that foreign exchange forwards and forward exchange swaps would not be swaps if they fall within one of the exclusions set forth in subparagraph (B) of the swap definition.

[123] The exclusion of foreign exchange forwards and foreign exchange swaps would become effective upon the Secretary's submission of the determination to the appropriate Congressional Committees. *See* CEA section 1a(47)(E)(ii), 7 U.S.C. 1a(46)(E)(ii).

[124] As discussed above, however, the proposed rules provide that none of the products discussed in this section (b) would be swaps if they fall within one of the exclusions set forth in subparagraph (B) of the swap definition.

[125] This discussion is not intended to address, and has no bearing on, the CFTC's jurisdiction over foreign currency options in other contexts. *See, e.g.,* CEA sections 2(c)(2)(A)(iii) and 2(c)(2)(B)–(C), 7 U.S.C. 2(c)(2)(A)(iii) and 2(c)(2)(B)–(C) (off-exchange options in foreign currency offered or entered into with retail customers).

put, call, cap, floor, collar, or similar option of any kind that is for the purchase or sale, or based on the value, of 1 or more interest *or other rates, currencies,* commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind." [126]

Foreign exchange options traded on a national securities exchange ("NSE"), however, are securities under the Federal securities laws and not swaps or security-based swaps.[127]

Any determination by the Secretary, discussed above, that foreign exchange forwards or foreign exchange swaps should not be regulated as swaps would not impact foreign currency options because a foreign currency option is neither a foreign exchange swap nor a foreign exchange forward, as those terms are defined in the CEA. Consequently, the Commissions are proposing rules to provide clarity by explicitly defining the term "swap" to include foreign currency options (other than foreign currency options traded on an NSE).[128] The proposed rules also would clarify that foreign currency options are not foreign exchange forwards or foreign exchange swaps under the CEA.

(ii) Non-Deliverable Forward Contracts Involving Foreign Exchange

An NDF generally is similar to a forward foreign exchange contract,[129] except that at maturity, the NDF does not require physical delivery of currencies and is typically settled in U.S. dollars. The other currency, usually an emerging market currency subject to capital controls, is therefore said to be "nondeliverable." [130] If the spot market exchange rate on the settlement date is greater (in foreign currency per dollar terms) than the previously agreed forward exchange rate, the party to the contract that is long the emerging market currency must pay its counterparty the difference between the contracted forward price and the spot market rate, multiplied by the notional amount.[131]

NDFs are not expressly enumerated in the swap definition, but they satisfy clause (A)(iii) of the definition because they provide for a future (executory) payment based on an exchange rate, which is an "interest or other rate[]" within the meaning of clause (A)(iii) of the swap definition.[132] Each party to an NDF transfers to its counterparty the risk of the exchange rate moving against the counterparty, thus satisfying the requirement that there be a transfer of financial risk associated with a future change in rate. This financial risk transfer in the context of an NDF is not accompanied by a transfer of an ownership interest in any asset or liability. Thus, an NDF is a swap under clause (A)(iii) of the swap definition.[133]

As discussed above, the Secretary may determine that foreign exchange swaps or foreign exchange forwards should not be regulated as swaps. The outcome of the Secretary's determination would not impact NDFs, however, because NDFs (like foreign currency options) do not meet the definitions of the terms foreign exchange forward or foreign exchange swap set forth in the CEA. NDFs do not involve an "exchange" of two different currencies (an element of the definition of both a foreign exchange forward and a foreign exchange swap); instead, they are settled by payment in one currency (usually U.S. dollars).

Notwithstanding their "forward" label, NDFs do not fall within the forward contract exclusion of the swap definition. Currency is outside the scope of the forward contract exclusion for nonfinancial commodities. Nor have NDFs traditionally been considered commercial merchandising transactions. Rather, the NDF markets appear to be driven in large part by speculation [134] and hedging,[135] which features are more characteristic of swap markets than forward markets.

Based on the foregoing considerations, the Commissions are proposing to provide greater clarity by explicitly defining the term "swap" to include NDFs. The proposed rules also would clarify that NDFs are not foreign exchange forwards or foreign exchange swaps as those terms are defined in the CEA.

(iii) Currency Swaps and Cross-Currency Swaps

A currency swap [136] and a cross-currency swap [137] each generally can be

[126] *See* CEA section 1a(47)(A)(i), 7 U.S.C. 1a(47)(A)(i) (emphasis added).

[127] *See* CEA section 1a(47)(B)(iv), 7 U.S.C. 1a(47)(B)(iv).

[128] The proposed rules would treat the terms foreign currency options, currency options, foreign exchange options, and foreign exchange rate options as synonymous. Moreover, for purposes of the proposed rules, foreign currency options include options to enter into or terminate, or that otherwise operate on, a foreign exchange swap or foreign exchange forward or on the terms thereof. As discussed above, foreign exchange options traded on an NSE are securities and therefore not addressed in the proposed rules.

[129] A deliverable forward foreign exchange contract is an obligation to buy or sell a specific currency on a future settlement date at a fixed price set on the trade date. *See* Laura Lipscomb, "Federal Reserve Bank of New York, An Overview of Non-Deliverable Foreign Exchange Forward Markets," 1 (May 2005) (citation omitted) ("Fed NDF Overview").

[130] *See id.* at 1–2 (citation omitted).

[131] *See id.* at 2. Being long the emerging market currency means that the holder of the NDF contract is the "buyer" of the emerging market currency and the "seller" of dollars. Conversely, if the emerging market currency appreciates relative to the previously agreed forward rate, the holder of the contract that is short the emerging market currency must pay its counterparty the difference between the spot market rate and the contracted forward price, multiplied by the notional amount. *See id.* at 2, n.4.

[132] *See* CEA section 1a(47)(A)(iii), 7 U.S.C. 1a(47)(A)(iii) (providing that a swap is an agreement, contract, or transaction "that provides on an executory basis for the exchange, on a fixed or contingent basis, of 1 or more payments based on the value or level of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind, or any interest therein or based on the value thereof, and that transfers, as between the parties to the transaction, in whole or in part, the financial risk associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset (including any enterprise or investment pool) or liability that incorporates the financial risk so transferred * * *.").

[133] It appears that at least some market participants view NDFs as swaps today. *See, e.g.,* Credit Suisse, "Non-Deliverable Forwards," at 1 (characterizing NDFs as "a derivative instrument for hedging * * * exchange-rate risk" in the absence of a forwards market), available at *https://www.credit-suisse.com/ch/unternehmen/kmugrossunternehmen/doc/nondeliverable_forward_en.pdf;* Association of Corporate Treasurers, "Glossary of Terms" (defining an NDF as "[a] foreign currency financial derivative contract"), available at *http://www.treasurers.org/glossary/N#Non-deliverableforward.* Thus, NDFs also may fall within clause (A)(iv) of the swap definition as "an agreement, contract, or transaction that is, or in the future becomes, commonly known to the trade as a swap." *See* CEA section 1a(47)(A)(iv), 7 U.S.C. 1a(47)(A)(iv). *Cf.* CFTC rule 35.1(b)(1)(i), 17 CFR 35.1(b)(1)(i) (providing that the definition of "swap agreement" includes a "forward foreign exchange agreement," without reference to convertibility or delivery).

[134] *See* "Fed NDF Overview," *supra* note 129, at 5 ("[E]stimates vary but many major market participants estimate as much as 60 to 80 percent of NDF volume is generated by speculative interest, noting growing participation from international hedge funds.") and 4 ("[D]ealers note that much of the volume in Chinese *yuan* NDFs is generated by speculative positioning based on expectations for an alteration in China's current, basically fixed exchange rate.") (italics in original).

[135] *See id.* at 4 (noting that "[much of the] Korean *won* NDF volume[,] * * * estimated to be the largest of any currency, * * * is estimated to originate with international investment portfolio managers hedging the currency risk associated with their onshore investments").

[136] A swap that exchanges a fixed rate against a fixed rate is known as a currency swap. *See* Federal Reserve System, "Trading and Capital-Markets Activities Manual," section 4335.1 (Jan. 2009).

[137] Cross-currency swaps with a fixed leg based on one rate and a floating leg based on another rate, where the two rates are denominated in different currencies, are generally referred to as cross-currency coupon swaps, while those with a floating leg based on one rate and another floating leg based on a different rate are known as cross-currency basis swaps. *Id.* Cross-currency swaps also include annuity swaps and amortizing swaps. In cross-

described as a swap in which the fixed legs or floating legs based on various interest rates are exchanged in different currencies. Such swaps can be used to reduce borrowing costs, to hedge currency exposure, and to create synthetic assets [138] and are viewed as an important tool, given that they can be used to hedge currency and interest rate risk in a single transaction.

Currency swaps and cross-currency swaps are not foreign exchange swaps as defined in the CEA because, although they may involve an exchange of foreign currencies, they also require contingent or variable payments in different currencies. Because the CEA defines a foreign exchange swap as a swap that "solely" involves an initial exchange of currencies and a reversal thereof at a later date, subject to certain parameters, currency swaps and cross-currency swaps would not be foreign exchange swaps. Similarly, currency swaps and cross-currency swaps are not foreign exchange forwards because foreign exchange forwards "solely" involve an initial exchange of currencies, subject to certain parameters, while currency swaps and cross-currency swaps contain additional elements, as discussed above.

Currency swaps are expressly enumerated in the statutory definition of the term "swap." [139] Cross-currency swaps, however, are not.[140] Accordingly, based on the foregoing considerations, the Commissions are proposing rules to provide greater clarity by explicitly defining the term "swap" to include cross-currency swaps. The proposed rules also would clarify that neither currency swaps nor cross-currency swaps are foreign exchange forwards or foreign exchange swaps as those terms are defined in the CEA.

Request for Comment

52. Should the proposed rules explicitly define the term "swap" to include foreign exchange forwards and foreign exchange swaps, unless the Secretary determines to exempt them? Should the proposed rules clarify that, if the Secretary determines to exempt foreign exchange swaps or foreign exchange forwards, those transactions remain subject to certain reporting requirements, and swap dealers and major swap participants entering into such transactions remain subject to certain business conduct standards, imposed by Title VII and CFTC regulations promulgated thereunder? Why or why not?

53. Should the proposed rules explicitly define the term "swap" to include foreign currency options and clarify that foreign currency options are not foreign exchange forwards or foreign exchange swaps? Why or why not? Should the terms foreign currency options, currency options, foreign exchange options, and foreign exchange rate options be interpreted as synonymous? Why or why not?

54. Should the proposed rules explicitly define the term "swap" to include NDFs and clarify that NDFs are not foreign exchange forwards or foreign exchange swaps? Why or why not?

55. Should the proposed rules explicitly define the term "swap" to include cross-currency swaps as swaps and clarify that currency swaps and cross-currency swaps are not foreign exchange forwards or foreign exchange swaps? Why or why not? Should the terms cross-currency swap and cross-currency rate swap be interpreted as synonymous? Why or why not?

56. Is additional detail needed within the proposed rules regarding foreign exchange-related products to provide greater clarity regarding the specific products listed in the proposed rules? If so, what additional detail would be necessary?

3. Forward Rate Agreements

In general, the Commissions understand an FRA to be an over-the-counter contract for a single cash payment, due on the settlement date of a trade, based on a spot rate (determined pursuant to a method agreed upon by the parties) and a prespecified forward rate. The single cash payment is equal to the product of the present value (discounted from a specified future date to the settlement date of the trade) of the difference between the forward rate and the spot rate on the settlement date multiplied by the notional amount. The notional amount itself is not exchanged.[141]

An FRA provides for the future (executory) payment based on the transfer of interest rate risk between the parties as opposed to transferring an ownership interest in any asset or liability.[142] Thus, the Commissions believe that an FRA satisfies clause (A)(iii) of the swap definition.[143]

Notwithstanding their "forward" label, FRAs do not fall within the forward contract exclusion from the swap definition. FRAs do not involve nonfinancial commodities and thus are outside the scope of the forward contract exclusion. Nor is an FRA a commercial merchandising transaction, as there is no physical product to be delivered in an FRA.[144] Accordingly,

currency annuity swaps, level cash flows in different currencies are exchanged with no exchange of principal; annuity swaps are priced such that the level payment cash flows in each currency have the same net present value at the inception of the transaction. An amortizing cross-currency swap is structured with a declining principal schedule, usually designed to match that of an amortizing asset or liability. *Id. See also* Derivatives ONE, "Cross Currency Swap Valuation" ("A cross currency swap is swap of an interest rate in one currency for an interest rate payment in another currency. * * * This could be considered an interest rate swap with a currency component."), available at *http://www.derivativesone.com/cross-currency-swap-valuation/;* Financial Accounting Standards Board, "Examples Illustrating Application of FASB Statement No. 138," Accounting for Certain Derivative Instruments and Certain Hedging Activities, section 2, Example 1, at 3 ("The company designates the cross-currency swap as a fair value hedge of the changes in the fair value of the loan due to both interest and exchange rates."), available at *http://www.fasb.org/derivatives/examples.pdf.*

[138] BMO Capital Markets, "Cross Currency Swaps," available at *http://www.bmocm.com/products/marketrisk/intrderiv/cross/default.aspx.*

[139] *See* CEA section 1a(47)(A)(iii)(VII), 7 U.S.C. 1a(47)(A)(iii)(VII).

[140] Clause (A)(iii) of the swap definition expressly refers to a cross-currency rate swap. *See* CEA section 1a(47)(A)(iii)(V), 7 U.S.C. 1a(47)(A)(iii)(V). Although the swap industry appears to use the term "cross-currency swap," rather than "cross-currency rate swap" (the term used in CEA section 1a(47)(A)(iii)(V)), the Commissions interpret these terms as synonymous.

[141] *See generally* "Trading and Capital-Markets Activities Manual," *supra* note 136, section 4315.1 ("For example, in a six-against-nine-month (6x9) FRA, the parties agree to a three-month rate that is to be netted in six months' time against the prevailing three-month reference rate, typically LIBOR. At settlement (after six months), the present value of the net interest rate (the difference between the spot and the contracted rate) is multiplied by the notional principal amount to determine the amount of the cash exchanged between the parties * * *. If the spot rate is higher than the contracted rate, the seller agrees to pay the buyer the differences between the prespecified forward rate and the spot rate prevailing at maturity, multiplied by a notional principal amount. If the spot rate is lower than the forward rate, the buyer pays the seller.").

[142] It appears that at least some in the trade view FRAs as swaps today. *See, e.g.,* The Globecon Group, Ltd., "Derivatives Engineering: A Guide to Structuring, Pricing and Marketing Derivatives," 45 (McGraw-Hill 1995) ("An FRA is simply a one-period interest-rate swap."); DerivActiv, Glossary of Financial Derivatives Terms ("A swap is * * * a strip of FRAs."), available at *http://www.derivactiv.com/definitions.aspx?search=forward+rate+agreements. Cf.* Don M. Chance, *et. al,* "Derivatives in Portfolio Management," 29 (AIMR 1998) ("[An FRA] involves one specific payment and is basically a one-date swap (in the sense that a swap is a combination of FRAs[,] with some variations)."). Thus, FRAs also may fall within clause (A)(iv) of the swap definition, as "an agreement, contract, or transaction that is, or in the future becomes, commonly known to the trade as a swap." *See* CEA section 1a(47)(a)(iv), 7 U.S.C. 1a(47)(a)(iv).

[143] *See* CEA section 1a(47)(A)(iii); 7 U.S.C. 1a(47)(A)(iii). CFTC regulations have defined FRAs as swap agreements. *See* CFTC rule 35.1(b)(1)(i), 17 CFR 35.1(b)(1)(i); Exemption for Certain Swap Agreements, 58 FR 5587, Jan. 22, 1993. The CFTC recently has proposed to repeal that rule in light of the enactment of Title VII of the Dodd-Frank Act. *See* Commodity Options and Agricultural Swaps, *supra* note 78.

[144] *See* Regulation of Hybrid and Related Instruments, 52 FR 47022, 47028, Dec. 11, 1987

Continued

the Commissions believe that the forward contract exclusion from the swap definition for nonfinancial commodities does not apply to FRAs.[145]

Based on the foregoing considerations, the Commissions are proposing rules to provide greater clarity by explicitly defining the term "swap" to include FRAs. As with the foreign exchange-related products discussed above, the proposed rules provide that FRAs would not be swaps if they fall within one of the exclusions set forth in subparagraph (B) of the swap definition.

Request for Comment

57. Is the description of FRAs accurate? If not, please provide a detailed description of FRAs. Are there various types of FRAs? If so, please provide an explanation of their characteristics and how they differ.

58. What types of market participants use FRAs, and for what purposes? What market (spot) and fixed rates are used in FRAs, and how are those rates determined, or on what are those rates based?

59. Should the proposed rules explicitly define the term "swap" to include FRAs? Why or why not?

60. Should the proposed rules provide a more detailed description of what FRAs are? Why or why not? If so, please explain what additional language regarding FRAs should be included in the proposed rules.

4. Combinations and Permutations of, or Options on, Swaps and Security-Based Swaps

Clause (A)(vi) of the swap definition provides that "any combination or permutation of, or option on, any agreement, contract, or transaction described in any of clauses (i) through (v)" of the definition is a swap or security-based swap.[146] As a result, clause (A)(vi) means, for example, that an option on a swap or security-based swap (commonly known as a "swaption") would itself be a swap or security-based swap, respectively. The Commissions also interpret clause (A)(vi) to mean that a "forward swap" would itself be a swap or security-based swap, respectively.[147]

Request for Comment

61. Is additional guidance regarding swaptions, necessary? Why or why not? If so, please provide a detailed explanation of what additional guidance would be necessary.

62. Is the Commissions' description of forward swaps accurate? Why or why not? If not, please provide a detailed explanation of why the description is inaccurate. Is additional guidance regarding forward swaps necessary? Why or why not? If so, please provide a detailed explanation of what additional guidance would be necessary.

63. Is additional guidance regarding other combinations or permutations of swaps or security-based swaps necessary? Why or why not? If so, please provide a detailed description of any particular agreement, contract, or transaction, including the purposes for which it is used and the market participants that use it, and what additional guidance would be necessary.

5. Contracts for Differences

The Commissions have received inquiries over the years regarding the treatment of CFDs under the CEA and the Federal securities laws. A CFD generally is an agreement to exchange the difference in value of an underlying asset between the time at which a CFD position is established and the time at which it is terminated.[148] If the value increases, the seller pays the buyer the difference; if the value decreases, the buyer pays the seller the difference. CFDs can be traded on a number of products, including treasuries, foreign exchange rates, commodities, equities, and stock indexes. Equity CFDs closely mimic the purchase of actual shares. The buyer of an equity CFD receives cash dividends and participates in stock splits.[149] In the case of a long position, a dividend adjustment is credited to the client's account. In the case of a short position, a dividend adjustment is debited from the client's account. CFDs generally are traded over-the-counter (though they also are traded on the Australian Securities Exchange) in a number of countries outside the United States.

CFDs, unless otherwise excluded, may fall within the scope of the swap and security-based swap definitions.[150] Whether a CFD is a swap or security-based swap will depend on the underlying product of that particular CFD transaction. Because CFDs are highly variable and a CFD can contain a variety of elements that would affect its characterization, the Commissions believe that market participants will need to analyze the characteristics of any particular CFD in order to determine whether it is a swap or a security-based swap. Therefore, the Commissions are not proposing rules or additional interpretive guidance at this time regarding CFDs.

Request for Comment

64. Should the Commissions provide additional guidance regarding CFDs? Why or why not? If so, please provide a detailed description of any particular CFD and what additional guidance would be necessary.

(stating "[FRAs] do not possess all of the characteristics of forward contracts heretofore delineated by the [CFTC]").

[145] Current European Union law includes FRAs in the definition of "financial instruments." *See* Markets in Financial Instruments Directive (MiFID), "Directive 2004/39/EC of the European Parliament and of the Council," Annex I(C), 4, 5, 10 (Apr. 21, 2004), available at *http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2004L0039:20070921:EN:PDF.* A European Commission legislative proposal on derivatives, central clearing, and trade repositories applies to FRAs that are traded over-the-counter and, thus, would subject such transactions to mandatory clearing, reporting and other regulatory requirements. *See Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories,* title I, art. 1(1), COM(2010) 484/5 (Sept. 15, 2010), available at *http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/20100915_proposal_en.pdf.*

[146] *See* CEA section 1a(47)(vi), 7 U.S.C. 1a(47)(vi).

[147] Forward swaps are also commonly known as forward start swaps, or deferred or delayed start swaps. A forward swap can involve two offsetting swaps that both start immediately, but one of which ends on the deferred start date of the forward swap itself. For example, if a counterparty wants to hedge its risk for four years, starting one year from today, it could enter into a one-year swap and a five-year swap, which would partially offset to create a four-year swap, starting one year forward. A forward swap also can involve a contract to enter into a swap or security-based swap at a future date or with a deferred start date. A forward swap is not a nonfinancial commodity forward contract or security forward, both of which are excluded from the swap definition and discussed elsewhere in this release.

[148] *See* Ontario Securities Commission, Staff Notice 91–702, "Offerings of Contracts for Difference and Foreign Exchange Contracts to Investors in Ontario," at part IV.1 (defining a CFD as "a derivative product that allows an investor to obtain economic exposure (for speculative, investment or hedging purposes) to an underlying asset * * * such as a share, index, market sector, currency or commodity, without acquiring ownership of the underlying asset"), available at *http://www.osc.gov.on.ca/documents/en/Securities-Category9/sn_20091030_91–702_cdf.pdf* (Oct. 30, 2009); Financial Services Authority, Consultation Paper 7/20, "Disclosure of Contracts for Difference—Consultation and draft Handbook text," at part 2.2 (defining a CFD on a share as "a derivative product that gives the holder an economic exposure, which can be long or short, to the change in price of a specific share over the life of the contract"), available at *http://www.fsa.gov.uk/pubs/cp/cp07_20.pdf* (Nov. 2007).

[149] *See, e.g.,* Int'l Swaps and Derivatives Ass'n, "2002 ISDA Equity Derivatives Definitions," art. 10 (Dividends) and 11 (Adjustments and Modifications Affecting Indices, Shares and Transactions).

[150] In some cases, depending on the facts and circumstances, the SEC may determine that a particular CFD on an equity security, for example, should be characterized as constituting a purchase or sale of the underlying equity security and, therefore, be subject to the requirements of the Federal securities laws applicable to such purchases or sales.

D. Certain Interpretive Issues

1. Agreements, Contracts, or Transactions That May Be Called, or Documented Using Form Contracts Typically Used for, Swaps or Security-Based Swaps

The Commissions are aware that individuals and companies may generally use the term "swap" to refer to certain of their agreements, contracts, or transactions. For example, the term "swap" may be used to refer to an agreement to exchange real or personal property between the parties. Or, two companies that produce fungible products may use the term "swap" to refer to an agreement to perform each other's delivery obligations—for example, if one company must deliver the product in California and the other must deliver the same product in New York, they may use the term "swap" to refer to an agreement that each company will perform the other's delivery obligation.

The name or label that the parties use to refer to a particular agreement, contract, or transaction is not determinative of whether it is a swap or security-based swap.[151] Also, it may not be relevant whether the agreement, contract, or transaction is documented using an industry standard form agreement that is typically used for swaps and security-based swaps.[152] Instead, the relevant question is whether the agreement, contract, or transaction falls within the definition of the terms "swap" or "security-based swap" (as further interpreted pursuant to the guidance proposed herein) based on its terms and other characteristics. Even if one effect of an agreement is to reduce the risk faced by the parties (*e.g.,* the "swap" of physical delivery obligations described above may reduce the risk of non-delivery), the agreement is not a swap or security-based swap unless it otherwise meets one of the statutory definitions, as further defined by the Commissions. Similarly, the fact that the parties use another name to refer to a swap or security-based swap would not be relevant in determining whether the agreement, contract, or transaction is a swap or security-based swap as those terms are defined in the CEA and the Exchange Act and the rules and regulations thereunder.

Request for Comment

65. What agreements, contracts, or transactions that are not swaps or security-based swaps are documented using industry standard form agreements that are typically used for swaps and security-based swaps? Please provide examples of such agreements, contracts, or transactions and details regarding their documentation, including why industry standard form agreements typically used for swaps and security-based swaps are used.

2. Transactions in Regional Transmission Organizations and Independent System Operators

The Commissions received a comment letter in response to the ANPR requesting clarification regarding the status of transactions in RTOs and ISOs, including financial transmission rights ("FTRs"), under the swap and security-based swap definitions.[153] Section 722 of the Dodd-Frank Act, though, specifically addresses how the CFTC should approach products regulated by FERC that also may be subject to CFTC jurisdiction. Section 722 of the Dodd-Frank Act amended CEA section 4(c)[154] to provide that, if the CFTC determines that an exemption for FERC-regulated instruments or other specified electricity transactions would be in accordance with the public interest, then it shall exempt such instruments or transactions from the requirements of the CEA. Given this specific provision regarding these FERC-related products, the CFTC believes the treatment of these products should be considered under the standards and procedures specified in section 722 of the Dodd-Frank Act for a public interest waiver, rather than through this joint rulemaking to further define the terms "swap" and "security-based swap."

Consequently, the Commissions are not addressing FTRs or other transactions in RTOs or ISOs within this joint definitional rulemaking. Instead, persons with concerns about whether FERC-regulated products may be considered swaps (or futures) should request an exemption pursuant to section 722 of the Dodd Frank Act.[155]

III. The Relationship Between the Swap Definition and the Security-Based Swap Definition

A. Introduction

Title VII of the Dodd-Frank Act defines the term "swap" under the CEA,[156] and also defines the term "security-based swap" under the Exchange Act.[157] Pursuant to the regulatory framework established in Title VII, the CFTC has regulatory authority over swaps and the SEC has regulatory authority over security-based swaps. The Commissions are proposing to further define the terms "swap" and "security-based swap" to clarify whether particular agreements, contracts, or transactions are swaps or security-based swaps based on characteristics including the specific terms and conditions of the instrument and the nature of, among other things, the prices, rates, securities, indexes, or commodities upon which the instrument is based.

Because the discussion below is focused on whether particular agreements, contracts, or transactions are swaps or security-based swaps, the Commissions use the term "Title VII instrument" in this release to refer to any agreement, contract, or transaction that is included in either the definition of the term "swap" or the definition of the term "security-based swap." Thus, the term "Title VII instrument" is synonymous with "swap or security-based swap."[158]

The determination of whether a Title VII instrument is a swap or security-

[151] *See, e.g., Haekel* v. *Refco,* 2000 WL 1460078, at * 4 (CFTC Sept. 29, 2000) ("[T]he labels that parties apply to their transactions are not necessarily controlling"); *Reves* v. *Ernst & Young,* 494 U.S. 56, 61 (1990) (stating that the purpose of the securities laws is "to regulate *investments,* in whatever form they are made and by whatever name they are called") (emphasis in original).

[152] The CFTC consistently has found that the form of a transaction is not dispositive in determining its nature. *See, e.g., Grain Land, supra* note 61, at *16 (CFTC Nov. 25, 2003) (holding that contract substance is entitled to at least as much weight as form); *In the Matter of First Nat'l Monetary Corp.,* [1984–1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,698 at 30,974 (CFTC Aug. 7, 1985) ("When instruments have been determined to constitute the functional equivalent of futures contracts neither we nor the courts have hesitated to look behind whatever self-serving labels the instruments might bear."); *Stovall, supra* note 63 (holding that the CFTC "will not hesitate to look behind whatever label the parties may give to the instrument"). Likewise, the form of a transaction is not dispositive in determining whether an agreement, contract, or transaction falls within the regulatory regime for securities. *See SEC* v. *Merch. Capital, LLC,* 483 F.3d 747, 755 (11th Cir. 2007) ("The Supreme Court has repeatedly emphasized that economic reality is to govern over form and that the definitions of the various types of securities should not hinge on exact and literal tests.") (*quoting Williamson* v. *Tucker,* 645 F.2d 404, 418 (5th Cir. 1981)); *Robinson* v. *Glynn,* 349 F.3d 166, 170 (4th Cir. 2003) ("What matters more than the form of an investment scheme is the 'economic reality' that it represents * * * .") (internal citation omitted); *Caiola* v. *Citibank, N.A., New York,* 295 F.3d 312, 325 (2d Cir. 2002) (*quoting United Housing Foundation* v. *Foreman,* 421 U.S. 837, 848 (1975) ("In searching for the meaning and scope of the word 'security' * * * the emphasis should be on economic reality")).

[153] *See* WGCEF Letter.

[154] 7 U.S.C. 6(c).

[155] This approach, however, should not be taken to suggest any findings by the Commissions as to whether or not FTRs or any other FERC-regulated products are swaps (or futures contracts).

[156] *See* CEA section 1a(47), 7 U.S.C. 1a(47).

[157] *See* section 3(a)(68) of the Exchange Act, 15 U.S.C. 78c(a)(68).

[158] In some cases, the Title VII instrument may be a mixed swap. Mixed swaps are discussed further in part IV below.

based swap should be made based on the facts and circumstances relating to the Title VII instrument at the time that the parties enter into it. If the Title VII instrument itself is not amended, modified, or otherwise adjusted during its term by the parties, its characterization as a swap or security-based swap should not change during its duration because of any changes that may occur to the factors affecting its character as a swap or security-based swap.[159]

Classifying a Title VII instrument as a swap or security-based swap is straightforward for most instruments. The Commissions, however, are proposing guidance to clarify the classification of swaps and security-based swaps in certain areas and to provide guidance regarding the use of certain terms and conditions in Title VII instruments.

B. Title VII Instruments Based on Interest Rates, Other Monetary Rates, and Yields

Parties frequently use Title VII instruments to manage risks related to, or to speculate on, changes in interest rates, other monetary rates or amounts, or the return on various types of assets. Broadly speaking, Title VII instruments based on interest or other monetary rates would be swaps, whereas Title VII instruments based on the yield or value of a single security, loan, or narrow-based security index would be security-based swaps. However, market participants and financial professionals sometimes use the terms "rate" and "yield" in different ways. The Commissions are proposing guidance regarding whether Title VII instruments that are based on interest rates, other monetary rates, or yields would be swaps or security-based swaps and requesting comment as to whether additional clarification in this area would be appropriate.[160]

1. Title VII Instruments Based on Interest Rates or Other Monetary Rates That Are Swaps

The Commissions believe that when payments exchanged under a Title VII instrument are based solely on the levels of certain interest rates or other monetary rates that are not themselves based on one or more securities, the instrument would be a swap and not a security-based swap.[161] Often swaps on interest rates or other monetary rates require the parties to make payments based on the comparison of a specified floating rate (such as the London Interbank Offered Rate ("LIBOR")) to a fixed rate of interest agreed upon by the parties. A rate swap also may require payments based on the differences between two floating rates, or it may require that the parties make such payments when any agreed-upon events with respect to interest rates or other monetary rates occur (such as when a specified interest rate crosses a threshold, or when the spread between two such rates reaches a certain point). The rates referenced for the parties' obligations are varied, and examples of such rates include the following:

- *Interbank Offered Rates:* An average of rates charged by a group of banks for lending money to each other or other banks over various periods of time, and other similar interbank rates,[162] including, but not limited to, LIBOR (regardless of currency); [163] the Euro Interbank Offered Rate ("Euribor"); the Canadian Dealer Offered Rate ("CDOR"); and the Tokyo Interbank Offered Rate ("TIBOR"); [164]

- *Money Market Rates:* A rate established or determined based on actual lending or money market transactions, including, but not limited to, the Federal Funds Effective Rate; the Euro Overnight Index Average ("EONIA" or "EURONIA") (which is the weighted average of overnight unsecured lending transactions in the Euro-area interbank market); the EONIA Swap Index; the Australian dollar RBA 30 Interbank Overnight Cash Rate; the Canadian Overnight Repo Rate Average ("CORRA"); the Mexican interbank equilibrium interest rate ("TIIE"); the NZD Official Cash Rate; the Sterling Overnight Interbank Average Rate ("SONIA") (which is the weighted average of unsecured overnight cash transactions brokered in London by the Wholesale Markets Brokers' Association); the Swiss Average Rate Overnight ("SARON"); and the Tokyo Overnight Average Rate ("TONAR") (which is based on uncollateralized overnight average call rates for interbank lending);

- *Government Target Rates:* A rate established or determined based on guidance established by a central bank including, but not limited to, the Federal Reserve discount rate, the Bank of England base rate and policy rate, the Canada Bank rate, and the Bank of Japan policy rate (also known as the Mutan rate);

- *General Lending Rates:* A general rate used for lending money, including, but not limited to, a prime rate, rate in the commercial paper market, or any similar rate provided that it is not based on any security, loan, or group or index of securities;

- *Indexes:* A rate derived from an index of any of the foregoing or following rates, averages, or indexes, including but not limited to a constant maturity rate (U.S. Treasury and certain other rates),[165] the interest rate swap rates published by the Federal Reserve in its "H.15 Selected Interest Rates" publication, the ISDAFIX rates, the ICAP Fixings, a constant maturity swap, or a rate generated as an average (geometric, arithmetic, or otherwise) of any of the foregoing, such as overnight index swaps ("OIS")—provided that such rates are not based on a specific

[159] *See* discussion *infra* part III.G.3(a) regarding Title VII instruments based on indexes.

[160] Commenters did not address these instruments specifically. A number of commenters urged clarification that various transactions or obligations, such as commercial loans, are not Title VII instruments solely because they reference an interest rate. *See* BlackRock Letter; Cleary Letter; Farm Credit Council Letter; White & Case Letter. The Commissions have proposed guidance to address such customary commercial transactions in part II.B.3 above.

[161] *See* discussion *supra* part III.F regarding the use of certain terms and conditions.

[162] Interbank lending rates are measured by surveys of the loan rates that banks offer other banks, or by other mechanisms. The periods of time for such loans may range from overnight to 12 months or longer.

The interbank offered rates listed here are frequently called either a "reference rate," the rate of "reference banks," or by a designation that is specific to the service that quotes the rate. For some of the interbank offered rates listed here, there is a similar rate that is stated as an interbank bid rate, which is the average rate at which a group of banks bid to borrow money from other banks. For example, the bid rate similar to LIBOR is called LIBID.

[163] Today, LIBOR is used as a rate of reference for the following currencies: Australian Dollar, Canadian Dollar, Danish Krone, Euro, Japanese Yen, New Zealand Dollar, Pound Sterling, Swedish Krona, Swiss Franc, and U.S. Dollar.

[164] Other interbank offered rates include the following (with the country or city component of the acronym listed in parentheses): AIDIBOR (Abu Dhabi); BAIBOR (Buenos Aires); BKIBOR (Bangkok); BRAZIBOR (Brazil); BRIBOR/BRIBID (Bratislava); BUBOR (Budapest); CHIBOR (China); CHILIBOR (Chile); CIBOR (Copenhagen); COLIBOR (Colombia); HIBOR (Hong Kong); JIBAR (Johannesburg); JIBOR (Jakarta); KAIBOR (Kazakhstan); KIBOR (Karachi); KLIBOR (Kuala Lumpur); KORIBOR ((South) Korea); MEXIBOR (Mexico); MIBOR (Mumbai); MOSIBOR (Moscow); NIBOR (Norway); PHIBOR (Philippines); PRIBOR (Prague); REIBOR/REIBID (Reykjavik); RIGIBOR/RIGIBID (Riga); SHIBOR (Shanghai); SIBOR (Singapore); SOFIBOR (Sofia); STIBOR (Stockholm); TAIBOR (Taiwan); TELBOR (Tel Aviv); TRLIBOR and TURKIBOR (Turkey); VILIBOR (Vilnius); VNIBOR (Vietnam); and WIBOR (Warsaw).

[165] A Title VII instrument based solely on the level of a constant maturity U.S. Treasury rate would be a swap because U.S. Treasuries are exempted securities that are excluded from the security-based swap definition. Conversely, a Title VII instrument based solely on the level of a constant maturity rate on a narrow-based index of non-exempted securities under the security-based swap definition would be a security-based swap.

security, loan, or narrow-based group or index of securities;

• *Other Monetary Rates:* A monetary rate including, but not limited to, the Consumer Price Index ("CPI"), the rate of change in the money supply, or an economic rate such as a payroll index; and

• *Other:* The volatility, variance, rate of change of (or the spread, correlation or difference between), or index based on any of the foregoing rates or averages of such rates, such as forward spread agreements, references used to calculate the variable payments in index amortizing swaps (whereby the notional principal amount of the agreement is amortized according to the movement of an underlying rate), or correlation swaps and basis swaps, including but not limited to, the "TED spread" [166] and the spread or correlation between LIBOR and an OIS.

As discussed above, the Commissions believe that when payments under a Title VII instrument are based solely on any of the foregoing, such Title VII instrument would be a swap.

Request for Comment

66. The Commissions request comment generally on the foregoing proposed guidance regarding Title VII instruments where the underlying reference is an interest rate or other monetary rate.

67. Does the proposed guidance in this section accurately describe the types of interest rates and other monetary rates that are used as an underlying reference of a Title VII instrument, and that should cause the instrument to be considered a swap? Are any of the rates identified in this list not used in this manner? Are there any significant interest or monetary rates that should be added to this list in order to provide additional guidance?

68. As discussed above, a Title VII instrument would be considered a security-based swap if the instrument is based on constant maturity rates that are derived from the market prices and yields of a non-exempted debt security or a narrow-based security index of debt securities (depending on the other terms of the Title VII instrument, such instrument may be a mixed swap). The Commissions request comment on this guidance. Are there certain constant maturity rates that should not be considered to be security-based, such that a Title VII instrument based on those rates would instead be a swap and not a security-based swap or mixed swap? If so, are there objective criteria to distinguish between different types of constant maturity rates in the determination of whether a Title VII instrument is a swap or security-based swap? If so, please describe any such criteria in detail.

2. Title VII Instruments Based on Yields

The Commissions also propose guidance to clarify the status of Title VII instruments in which one of the underlying references of the instrument is a "yield." In cases when a "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. For example, debt securities often are quoted and traded on a yield basis rather than on a dollar price, where the yield relates to a specific date, such as the date of maturity of the debt security (*i.e.,* yield to maturity) or the date upon which the debt security may be redeemed or called by the issuer (*e.g.,* yield to first whole issue call).[167]

Except in the case of certain exempted securities, when one of the underlying references of the Title VII instrument is the "yield" of a debt security, loan, or narrow-based security index in the sense where the term "yield" is used as a proxy for the price or value of the debt security loan, or narrow-based security index, the Title VII instrument would be a security-based swap. And, as a result, in cases where the underlying reference is a point on a "yield curve" generated from the different "yields" on debt securities in a narrow-based security index (*e.g.,* a constant maturity yield or rate), the Title VII instrument would be a security-based swap. In either case, however, where certain exempted securities, such as U.S. Treasury securities, are the only underlying reference of a Title VII instrument involving securities, the Title VII instrument would be a swap. Title VII instruments based on exempted securities are discussed further below.

The above interpretation would not apply in cases where the "yield" referenced in a Title VII instrument is not based on a debt security, loan, or narrow-based security index of debt securities but rather is being used to reference an interest rate or monetary rate as outlined above in subsection one of this section. In these cases, this "yield" reference would be considered equivalent to a reference to an interest rate or monetary rate and the Title VII instrument would be, under the guidance in this section, a swap (or mixed swap depending on other references in the instrument).

Request for Comment

69. The Commissions request comment generally on the foregoing proposed guidance regarding Title VII instruments where the underlying reference is a "yield." Please provide a detailed explanation of any uncertainty regarding the Commissions' proposed use of the terms "yield" and "yield curve" and what additional guidance would be necessary.

70. Does the proposed guidance in this section appropriately describe instruments based on the "yield" of a debt security that should be considered security-based swaps? Is additional guidance necessary regarding when the term "yield" is used as a proxy for price or value? If so, please provide a detailed explanation of any uncertainty regarding how the term "yield" is used and what additional guidance would be necessary.

71. Are there instruments where the underlying reference is a "yield" of a debt security that should be considered a swap as opposed to a security-based swap? If so, what are they, and how often are they traded? How are such instruments distinguished from instruments based on "yield" that should be considered security-based swaps?

3. Title VII Instruments Based on Government Debt Obligations

The Commissions also are providing guidance regarding instances in which the underlying reference of the Title VII instrument is a government debt obligation. The security-based swap definition specifically excludes any agreement, contract, or transaction that meets the definition of a security-based swap only because it "references, is based upon, or settles through the transfer, delivery, or receipt of an exempted security under [section 3(a)(12) of the Exchange Act], as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in [section 3(a)(29) of the Exchange Act] * * *), unless such agreement, contract, or transaction is of the character of, or

[166] The TED spread is the difference between the interest rates on interbank loans and short-term U.S. government debt (Treasury bills or "T-bills"). The latter are exempted securities that are excluded from the statutory definition of the term "security-based swap." Thus, neither any aspect of U.S. Treasuries nor interest rates on interbank loans, can form the basis of a security-based swap. For this reason, a Title VII instrument on a spread between interbank loan rates and T-bill rates also would not be a security-based swap.

[167] *See, e.g.,* Securities Confirmations, 47 FR 37920, Aug. 27, 1982.

is commonly known in the trade as, a put, call, or other option." [168]

As a result of this exclusion in the security-based swap definition for "exempted securities," [169] if the only underlying reference of a Title VII instrument involving securities is, for example, the price of a U.S. Treasury security and does not have any other underlying reference involving securities, then the instrument would be a swap. Similarly, if the Title VII instrument is based on the "yield" of a U.S. Treasury security and does not have any other underlying reference involving securities, then the instrument also would be a swap, regardless of whether the term "yield" is a proxy for the price of the security.

Foreign government securities, by contrast, were not "exempted securities" as of the date of enactment of the Futures Trading Act of 1982 [170] and thus do not explicitly fall within this exclusion from the security-based swap definition. Therefore, if the underlying reference of the Title VII instrument is the price, value, or "yield" (where "yield" is a proxy for price or value) of a foreign government security, or a point on a yield curve derived from a narrow-based security index composed of foreign government securities, then the instrument would be a security-based swap.

Request for Comment

72. The Commissions request comment generally on the foregoing proposed guidance regarding the treatment of Title VII instruments in which the underlying reference is a government debt obligation.

General Request for Comment: In addition to the particular requests for comment set forth on the issues discussed above, the Commissions also request comment generally on the following:

73. Does the proposed guidance in this part III.B accurately describe market practices and terminology? Will the proposed guidance be useful in determining whether Title VII instruments are swaps or security-based swaps?

C. Total Return Swaps

A TRS is a Title VII instrument in which one counterparty, the seller of the TRS, makes a payment that is based on the price appreciation and income from an underlying security or security index.[171] The other counterparty, the buyer of the TRS, makes a financing payment that is often based on a variable interest rate, such as LIBOR (or other interbank offered rate or money market rate, as described above), as well as a payment based on the price depreciation of the underlying reference. The "total return" consists of the price appreciation or depreciation, plus any interest or income payments.[172] Accordingly, where a TRS is based on a single security or loan, or a narrow-based security index, the TRS would be a security-based swap.[173]

Generally, the use of a variable interest rate in the TRS buyer's payment obligations to the seller is incidental to the purpose of, and the risk that the counterparties assume in, entering into the TRS. These payments are a form of financing that reflects the security-based swap dealer's cost of financing the position or a related hedge, allowing the TRS buyer to receive payments based on the price appreciation and income of a security or security index without purchasing the security or security index. The Commissions believe that when such interest rate payments act merely as a financing component in a TRS, or in any other security-based swap, the inclusion of such interest rate terms would not cause the security-based swap to be characterized as a mixed swap.[174] Financing terms may also involve adding or subtracting a spread to or from the financing rate,[175] or calculating the financing rate in a currency other than that of the underlying reference security or security index.[176] However, the Commissions note that where such payments incorporate additional elements that create additional interest rate or currency 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, those additional elements may cause the security-based swap to be a mixed swap.

For example, where the counterparties embed interest-rate optionality (*e.g.,* a cap, collar, call, or put) into the terms of a security-based swap in a manner designed to shift or limit interest rate exposure, the inclusion of these terms would cause

[168] Section 3(a)(68)(C) of the Exchange Act, 15 U.S.C. 76c(a)(68)(C).

[169] As of January 11, 1983, the date of enactment of the Futures Trading Act of 1982, Public Law 97–444, 96 Stat. 2294, section 3(a)(12) of the Exchange Act, 15 U.S.C. 78c(a)(12), provided that, among other securities, "exempted securities" include: (i) "securities which are direct obligations of, or obligations guaranteed as to principal or interest by, the United States;" (ii) certain securities issued or guaranteed by corporations in which the United States has a direct or indirect interest as designated by the Secretary of the Treasury; and (iii) certain other securities as designated by the SEC in rules and regulations.

[170] Public Law 97–444, 96 Stat. 2294 (1983).

[171] Where the underlying security is an equity, a TRS is also known as an "equity swap."

[172] If the total return is negative, the seller receives this amount from the buyer. TRS can be used to synthetically reproduce the payoffs of a position. For example, two counterparties may enter into a 3-year TRS where the buyer of the TRS receives the positive total return on XYZ security, if any, and the seller of the TRS receives LIBOR plus 30 basis points and the absolute value of the negative total return on XYZ security, if any.

[173] If the underlying reference of the TRS is a broad-based equity security index, however, the Commissions believe that it would be a swap (and an SBSA) and not a security-based swap. In addition, a TRS on an exempted security, such as a U.S. Treasury, under section 3(a)(12) of the Exchange Act, 15 U.S.C. 78c(a)(12), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Exchange Act, 15 U.S.C. 78c(a)(29), as in effect on the date of enactment of the Futures Trading Act of 1982) would be a swap (and an SBSA) and not a security-based swap.

[174] Several commenters noted that such instruments should not be characterized as mixed swaps. *See* Cleary Letter (expressing the view that such Title VII instruments should not be characterized as mixed swaps because "the floating rate payment obligation is not the principal driver of the security-based swap and, in that sense, the security-based swap is not 'based on' the level of an interest rate within the meaning of [the Dodd-Frank Act]"); Deutsche Bank Letter (explaining that such Title VII instruments in which the party that is "synthetically short" the underlying security makes payments based on the value of the underlying security to the party that is "synthetically long," and the synthetically long party pays the synthetically short party an amount that may be based on LIBOR or another interest rate, should not be treated as mixed swaps because the payments to the synthetically short party are generally intended only for financing costs incurred in establishing or maintaining the transaction or its hedge); ISDA Letter (noting that variable interest rate-based payments in connection with a typical Title VII instrument of this type are "incidental to what is essentially a security-based transaction and should not yield mixed swap status"); Morgan Stanley Letter (noting that the interest rate-based payments in such Title VII instruments "reflect compensation for the financing costs associated" with the instrument and "are not at the core of what is being 'swapped' under the contract"); Letter from Timothy W. Cameron, Esq., Managing Director, Asset Management Group, Securities Industry and Financial Markets Association, Sept. 20, 2010 (expressing the view that such a financing component is incidental to the Title VII instrument and should not cause it to be viewed as a mixed swap).

[175] *See, e.g.,* Moorad Chowdry, "Total Return Swaps: Credit Derivatives and Synthetic Funding Instruments," at 3–4 (noting that the spread to the TRS financing rate is a function of: the credit rating of the counterparty paying the financing rate; the amount, value, and credit quality of the reference asset; the dealer's funding costs; a profit margin; and the capital charge associated with the TRS), available at *http://www.yieldcurve.com/Mktresearch/LearningCurve/TRS.pdf.*

[176] For example, a security-based swap on an equity security priced in U.S. dollars in which payments are made in Euros based on the U.S. dollar/Euro spot rate at the time the payment is made would not be a mixed swap. Under these circumstances, the currency is merely referenced in connection with the method of payment, and the counterparties are not hedging the risk of changes in currency exchange rates during the term of the security-based swap.

the TRS to be both be a swap and a security-based swap (*i.e.,* a mixed swap). Similarly, if a TRS is also based on non-security-based components (such as the price of oil, or a currency), the security-based swap would also be a swap.[177]

Request for Comment

74. Is the proposed guidance regarding TRS and other security-based swaps for which the use of a variable interest rate in a counterparty's payment obligations is incidental to the risk that counterparties assume in entering into a TRS or other security-based swap appropriate? Why or why not? If not, please provide a detailed explanation of what guidance would be appropriate.

75. How often do market participants use rates, other than interbank offered rates or money market rates, in TRS to recoup their financing costs? If so, which rates and what portion of the market (broken down by product, country, counterparty type, and/or whatever data are available to commenters), in percentage and/or dollar terms do TRS with such financing rates constitute? What factors influence the financing rates that market participants incorporate into their security-based swaps?

76. Do market participants embed optionality, such a cap, collar, put, or call, into the payment component of a TRS? If so, how frequently and for what purpose?

77. Do market participants embed nonfinancial commodity components into the payment component that directly affect the payments on a TRS rather than operating as a mere financing component? If so, how frequently and for what purpose?

78. Do market participants embed foreign currency swaps into a foreign currency payment component of a TRS? If so, how frequently and for what purpose?

79. Are there other circumstances under which a TRS should be treated as a mixed swap rather than a security-based swap or swap? If so, please provide a detailed description of such circumstances and explain why.

D. Security-Based Swaps Based on a Single Security or Loan and Single-Name Credit Default Swaps

The second prong of the security-based swap definition includes a swap that is based on "a single security or loan, including any interest therein or on the value thereof." [178] The Commissions believe that, under this prong of the definition of security-based swap, a single-name CDS that is based on a single reference obligation would be a security-based swap because it would be based on a single security or loan (or any interest therein or on the value thereof).

In addition, the third prong of the security-based swap definition includes a swap that is based on the occurrence of an event relating to a "single issuer of a security," provided that such event "directly affects the financial statements, financial condition, or financial obligations of the issuer." [179] This provision applies generally to event-triggered swap contracts. With respect to a CDS, such events could include the bankruptcy of an issuer, a default on one of an issuer's debt securities, or the default on a non-security loan of an issuer.[180] Therefore, the Commissions believe that if the payout on a CDS on a single issuer of a security is triggered by the occurrence of an event relating to that issuer, the CDS would be a security-based swap under the third prong.[181]

In this regard, the Commissions note that each transaction under an ISDA Master Agreement would need to be analyzed to determine whether it is a swap or security-based swap. For example, the Commissions believe that a number of single-name CDS that are executed at the same time and that are documented under one ISDA Master Agreement, but in which a separate confirmation is sent for each CDS, should be treated as an aggregation of security-based swaps. As a practical and economic matter, the Commissions believe that each such CDS would be a separate and independent transaction. Thus, such an aggregation of single-name CDS would not constitute a "group or index" under the security-based swap definition but instead would constitute multiple single-name CDS.

E. Title VII Instruments Based on Futures Contracts

A Title VII instrument that is based on a futures contract will either be a swap or a security-based swap, or both (*i.e.,* a mixed swap), depending on the nature of the futures contract, including the underlying reference of the futures contract. The Commissions believe that a Title VII instrument where the underlying reference is a security future would be a security-based swap.[182] The Commissions believe that, except with respect to certain futures on foreign government debt securities discussed below, a Title VII instrument where the underlying reference is a futures contract that is not a security future would be a swap.[183]

Title VII instruments involving futures contracts on foreign government debt securities present a unique circumstance. Rule 3a12–8 under the Exchange Act exempts certain foreign government debt securities, for purposes only of the offer, sale, or confirmation of sale of futures contracts on such foreign government debt securities, from all provisions of the Exchange Act which by their terms do not apply to an "exempted security," subject to certain conditions.[184] To date, the SEC has

[177] *See* Mixed Swaps, *infra* part IV.

[178] Section 3(a)(68)(A)(ii)(II) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(II). The first prong of the security-based swap definition is discussed below.

[179] Section 3(a)(68)(A)(ii)(III) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(III).

[180] The Commissions understand that in the context of credit derivatives on asset-backed securities or MBS, the events include principal writedowns, failure to pay principal and interest shortfalls.

[181] The Commissions understand that some single-name CDS now trade with fixed coupon payments expressed as a percentage of the notional amount of the transaction and payable on a periodic basis during the term of the transaction. *See* Markit, "The CDS Big Bang: Understanding the Changes to the Global CDS Contract and North American Conventions," 3, available at *http://www.markit.com/cds/announcements/resource/cds_big_bang.pdf.* The Commissions believe the existence of such single-name CDS does not change their interpretation.

[182] A security future is specifically defined in both the CEA and the Exchange Act as a futures contract on a single security or a narrow-based security index, including any interest therein or based on the value thereof, except an exempted security under section 3(a)(12) of the Exchange Act, 15 U.S.C. 78c(a)(12), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Exchange Act, 15 U.S.C. 78c(a)(29), as in effect on the date of enactment of the Futures Trading Act of 1982).

The term security future does not include any agreement, contract, or transaction excluded from the CEA under CEA sections 2(c), 2(d), 2(f), or 2(g), 7 U.S.C. 2(c), 2(d), 2(f), or 2(g), (as in effect on the date of enactment of the Commodity Futures Modernization Act of 2000 ("CFMA") or Title IV of the CFMA). *See* CEA section 1a(44), 7 U.S.C. 1a(44); section 3(a)(55) of the Exchange Act, 15 U.S.C. 78c(a)(55).

[183] Depending on the underlying reference of the futures contract, though, such swaps could be security-based swap agreements. For example, a swap on a future on the S&P 500 index would be a security-based swap agreement.

[184] Specifically, rule 3a12–8 under the Exchange Act requires as a condition to the exemption that the foreign government debt securities not be registered under the Securities Act (or the subject of any American depositary receipt registered under the Securities Act) and that futures contracts on such foreign government debt securities "require delivery outside the United States, [and] any of its possessions or territories, and are traded on or through a board of trade, as defined in [CEA section 2, 7 U.S.C. 2]." *See* rules 3a12–8(b), 3a12–8(a)(2) under the Exchange Act, 17 CFR 240.3a12–8(b) and 240.3a12–8(a)(2).These conditions were "designed to minimize the impact of the exemption on securities distribution and trading in the United States . . . ." *See* Exemption for Certain Foreign

Continued

enumerated within rule 3a12–8 debt securities of 21 identified foreign governments solely for purposes of futures trading.[185]

The Commissions are evaluating the appropriate characterization of Title VII instruments based on futures on such foreign government debt securities that are traded in reliance on rule 3a12–8. The Commissions recognize that as a result of the rule 3a12–8 exemption, futures on foreign government debt securities of 21 foreign countries trade pursuant to the CFTC's exclusive jurisdiction and without the futures being considered security futures. Because futures contracts on the 21 foreign government debt securities designated in rule 3a12–8 are not security futures, applying the above interpretive guidance to a Title VII instrument on a futures contract on these foreign government debt securities would mean that such Title VII instrument would be a swap.[186] The Commissions note, however, that the conditions in the rule 3a12–8 exemption were established specifically for trading futures contracts on these foreign sovereign debt obligations, not Title VII instruments based on futures contracts on foreign government debt securities. Furthermore, the Commissions note that the Dodd-Frank Act did not exclude debt securities of foreign governments from the definition of security-based swap. Therefore, a Title VII instrument based on such debt securities would be a security-based swap. Relying on rule 3a12–8 for the treatment of Title VII instruments on such futures would therefore result in different treatments depending on whether the Title VII instrument is based on a foreign government debt security or on a future that is in turn based on a foreign government debt security.[187] On the other hand, to do otherwise would create different regulators for a future and Title VII instruments based on that future.

The SEC believes that the characterization of a Title VII instrument involving a foreign government debt security may affect Federal securities law provisions relating to the distribution of the underlying foreign debt security. Specifically, the Dodd-Frank Act included provisions that would not permit issuers, affiliates of issuers, or underwriters to use security-based swaps to offer or sell the issuers' securities underlying a security-based swap without complying with the requirements of the Securities Act.[188] In addition, the Dodd-Frank Act provided that any offer and sale of security-based swaps to non-ECPs would have to be registered under the Securities Act.[189] Thus, for example, if a Title VII instrument on a future on foreign government debt security is characterized as a swap, and not a security-based swap, then the provisions of the Dodd-Frank Act enacted to ensure that there could not be offers and sales of securities made without compliance with the Securities Act, either by issuers, their affiliates, or underwriters or to non-ECPs, would not apply to such swap transactions.

On the other hand, the CFTC believes that characterizing Title VII instruments based on a future on a foreign government debt security designated in rule 3a12–8 as security-based swaps could undermine the regulatory scheme that Congress established in the CEA. As noted above, the Commissions generally would treat Title VII instruments based on futures that are not security futures as swaps. Many of the futures on the 21 foreign government debt securities designated in rule 3a12–8 trade with substantial volume. Section 753 of the Dodd-Frank Act provided the CFTC with additional antifraud and anti-manipulation authorities patterned on those provided to the SEC in the Federal securities laws. The CFTC believes that treating Title VII instruments based on these futures as security-based swaps, while the underlying futures come under the CEA, may undermine those authorities.

In sum, depending on how a Title VII instrument on such a future on a foreign government debt security is characterized, there is potential for such an instrument: (i) to be used to avoid the application of the Federal securities laws, including the Dodd-Frank Act provisions, that otherwise would apply if the Title VII instrument was instead based on the foreign government debt security directly; or (ii) to be used to avoid the application of the CEA, including the Dodd-Frank Act provisions, that otherwise would apply if the Title VII instrument was instead based on any other futures contract that is not a security future. Accordingly, the Commissions also are evaluating whether a Title VII instrument on such a futures contract on a foreign government debt security should be characterized as a mixed swap.

Request for Comment

80. The Commissions request comment generally on the foregoing discussion regarding Title VII instruments based on futures contracts and security futures.

81. What types of such products are traded in the market today? How often, and where are such products traded?

82. The Commissions are requesting comment on how to characterize a Title VII instrument where the underlying reference is a futures contract on one of the 21 foreign government debt securities that have been designated as "exempted securities" under rule 3a12–8 only for the offer, sale, or confirmation of sale of futures contracts on such securities and only where the conditions of such exemption are satisfied. When should a Title VII instrument on a futures contract on a foreign government debt security being traded in reliance on the exemption under rule 3a12–8 be treated as a swap, a security-based swap or a mixed swap? Is there any economic reason why the treatment of a Title VII instrument on a future on a foreign government debt security should be different than the treatment of a Title VII instrument on the foreign government debt security directly? Is there any economic reason why the treatment of a Title VII instrument on a future on a designated foreign government debt security should be different than the treatment of a Title VII instrument on any other futures contract that is not a security future? If the answer to either of the two preceding questions is yes, please explain and provide empirical analysis. If the Title VII instrument is able to be entered into by the issuer, affiliate of the issuer, or an underwriter, or if the Title VII instrument is being offered and sold to non-ECPs, should the Title VII instrument be viewed as a security-based swap or a mixed swap so that market participants cannot chose

Government Securities for Purposes of Futures Trading, 49 FR 8595, 8596–97, Mar. 8, 1984 (*citing* Futures Trading Act of 1982).

[185] *See* rule 3a12–8(a)(1) under the Exchange Act (designating the debt securities of the governments of the United Kingdom, Canada, Japan, Australia, France, New Zealand, Austria, Denmark, Finland, the Netherlands, Switzerland, Germany, Ireland, Italy, Spain, Mexico, Brazil, Argentina, Venezuela, Belgium, and Sweden).

[186] The Commissions note, by contrast, that a Title VII instrument that is based on the price or value of, or settlement into, a futures contract on one of the 21 foreign government debt securities designated in rule 3a12–8 and that is also based on the price or value of, or had the potential to settle directly into, the foreign debt security, would be a security-based swap and, depending on other features of the Title VII instrument, possibly a mixed swap.

[187] This is the case today (*i.e.,* different treatments) with respect to, for example, options on broad-based security indexes and options on futures on broad-based security indexes.

[188] *See* section 2(a)(3) of the Securities Act as amended by the Dodd-Frank Act, 15 U.S.C. 77b(a)(3). This provision applies regardless of whether the Title VII instrument allows the parties to physically settle any such security-based swap.

[189] *See* section 5 of the Securities Act as amended by the Dodd-Frank Act. 15 U.S.C. 77e.

whether to comply with the registration requirements of the Securities Act with respect to the foreign government debt securities? Should such an instrument be viewed as a swap or a mixed swap so that market participants cannot choose whether to comply with the requirements of the Dodd-Frank Act concerning clearing, trade execution, reporting, and standards applicable to dealers and major participants that apply to Title VII instruments on futures contracts that are not security futures? Are there other suggested approaches to the treatment of Title VII instruments on futures on foreign government debt securities that would preserve the application of the Securities Act as contemplated by the Dodd-Frank Act to Title VII instruments involving foreign government debt securities? Are there other suggested approaches to the treatment of Title VII instruments on futures on foreign government debt securities that would preserve the application of the CEA as contemplated by the Dodd-Frank Act to Title VII instruments involving futures contracts that are not security futures? If the answer to either of the two preceding questions is yes, please provide detail and analysis.

F. Use of Certain Terms and Conditions in Title VII Instruments

The Commissions are aware that market participants' setting of certain fixed terms or conditions of Title VII instruments may be informed by the value or level of a security, rate, or other commodity at the time of the execution of the instrument. The Commissions believe that, in evaluating whether such a Title VII instrument is a swap or security-based swap, the nature of the security, rate, or other commodity that informed the setting of such fixed term or condition should not itself impact the determination of whether the Title VII instrument is a swap or a security-based swap, provided that the fixed term or condition is set at the time of execution of the Title VII instrument and the value or level of that fixed term or condition may not vary over the life of the Title VII instrument.

For example, a Title VII instrument, such as an interest rate swap, in which floating payments based on 3-month LIBOR are exchanged for fixed rate payments of 5% would be a swap, and not a security-based swap, even if the 5% fixed rate was informed by, or quoted based on, the yield of a security, provided that the 5% fixed rate was set at the time of execution and may not vary over the life of the Title VII instrument.[190] Another example would be where a private sector or government borrower that issues a 5-year, amortizing $100 million debt security with a semi-annual coupon of LIBOR plus 250 basis points also, at the same time, chooses to enter into a 5-year interest rate swap on $100 million notional in which this same borrower, using the same amortization schedule as the debt security, receives semi-annual payments of LIBOR plus 250 basis points in exchange for 5% fixed rate payments. The fact that the specific terms of the interest rate swap (*e.g.,* 5-year, LIBOR plus 250 basis point, $100 million notional, fixed amortization schedule) were set at the time of execution to match related terms of a debt security does not cause the interest rate swap to become a security-based swap. However, if the interest rate swap contained additional terms that were in fact contingent on a characteristic of the debt security that may change in the future, such as an adjustment to future interest rate swap payments based on the future price or yield of the debt security, then this Title VII instrument would be a security-based swap that would be a mixed swap.

Request for Comment

83. Is the guidance provided by the Commissions regarding the relevance of the nature of a security, rate, or other commodity that informs the determination of a fixed term or condition of a Title VII instrument appropriate? Why or why not? If not, what guidance would be appropriate?

84. The Commissions are aware that quoting conventions are used in the context of setting the fixed terms of certain Title VII instruments, such as interest rate swaps that exchange LIBOR for a fixed rate that is set at the time of execution by reference to U.S. Treasury securities.[191] Are there other Title VII instruments that use such quoting conventions? If so, please provide a detailed explanation of such Title VII instruments and the references they use.

G. The Term "Narrow-Based Security Index" in the Security-Based Swap Definition

1. Introduction[192]

As noted above, a Title VII instrument in which the underlying reference of the instrument is a "narrow-based security index" is considered a security-based swap subject to regulation by the SEC, whereas a Title VII instrument in which the underlying reference of the instrument is a security index that is not a narrow-based security index (*i.e.,* the index is broad-based), the instrument is considered a swap subject to regulation by the CFTC. In this section, the Commissions propose rules and guidance regarding several issues regarding the term "narrow-based security index" in the security-based swap definition, including: (i) The existing criteria for determining whether a security index is a narrow-based security index and the applicability of past guidance of the Commissions regarding those criteria to Title VII instruments; (ii) new criteria for determining whether a CDS where the underlying reference is a group or index of entities or obligations of entities (typically referred to as an "index CDS") is based on an index that is a narrow-based security index; (iii) the meaning of the term "index"; (iv) a rule governing the tolerance period for Title VII instruments on security indexes traded on DCMs, SEFs, foreign boards of trade ("FBOTs"), security-based SEFs, or NSEs, where the security index temporarily moves from broad-based to narrow-based or from narrow-based to broad-based; and (v) a rule governing the grace period for Title VII instruments on security indexes traded on DCMs, SEFs, FBOTs, security-based SEFs, or NSEs, where the security index moves from broad-based to narrow-based or from narrow-based to broad-based and the move is not temporary.

2. Applicability of the Statutory Narrow-Based Security Index Definition and Past Guidance of the Commissions to Title VII Instruments

As defined in the CEA and Exchange Act,[193] an index is a "narrow-based

[190] However, to the extent the fixed term or condition is set at a future date or at a future value or level of a security, rate, or other commodity rather than the value or level of such security, rate, or other commodity at the time of execution of the Title VII instrument, the discussion above would not apply, and the nature of the security, rate, or other commodity used in determining the terms or conditions would be considered in evaluating whether the Title VII instrument is a swap or security-based swap.

[191] The Commissions note that such Title VII instruments would be swaps in any event because U.S. Treasury securities are exempted securities that are excluded from the security-based swap definition in Title VII but understand that such swaps use the reference or quoting convention described above in setting the terms or conditions of the Title VII instrument at the time of execution.

[192] Four commenters referred to the definition of the term "narrow-based security index," each in the context of CDS. *See infra* notes 209 and 211.

[193] Sections 3(a)(55)(B) and (C) of the Exchange Act, 15 U.S.C. 78c(a)(55)(B) and (C), include a definition of "narrow-based security index" in the same paragraph as the definition of security future. *See also* CEA sections 1a(35)(A) and (B), 7 U.S.C. 1a(35)(A) and (B). A security future is a contract for

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security index" if, among other things, it meets any one of the following four criteria:

- It has nine or fewer component securities;
- A component security comprises more than 30% of the index's weighting;
- The five highest weighted component securities in the aggregate comprise more than 60% of the index's weighting; or
- The lowest weighted component securities comprising, in aggregate, 25% of the index's weighting have an aggregate dollar value of average daily trading volume of less than $50,000,000 (or in the case of an index with more than 15 component securities, $30,000,000), except that 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 percent 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.[194]

The first three criteria apply to the number and concentration of the "component securities" in the index; the fourth criterion applies to the average daily trading volume of an index's "component securities." [195]

This statutory narrow-based security index definition focuses on indexes composed of equity securities and certain aspects of the definition, in particular the evaluation of average daily trading volume, are designed to take into account the trading patterns of individual stocks.[196] However, the Commissions, pursuant to authority granted in the CEA and the Exchange Act, previously have extended the definition to other categories of indexes but modified the definition to take into account the characteristics of those other categories.[197] Specifically, the Commissions have provided guidance regarding the application of the narrow-based security index definition to futures contracts on volatility indexes [198] and debt security indexes.[199] Today, then, there exists additional guidance for determining what constitutes a narrow-based security index.

Volatility indexes are indexes composed of index options. The Commissions issued a joint order in 2004 to define when a volatility index is not a narrow-based security index. Under this joint order, a volatility index is not a narrow-based security index if the index meets all of the following criteria:

- The index measures the magnitude of changes (as calculated in accordance with the order) in the level of an underlying index that is not a narrow-based security index pursuant to the statutory criteria for equity indexes discussed above;
- The index has more than nine component securities, all of which are options on the underlying index;
- No component security of the index comprises more than 30 percent of the index's weighting;
- The five highest weighted component securities of the index in the aggregate do not comprise more than 60 percent of the index's weighting;
- The average daily trading volume of the lowest weighted component securities in the underlying index (those comprising, in the aggregate, 25 percent of the underlying index's weighting) have a dollar value of more than $50,000,000 (or $30,000,000 in the case of an underlying index with 15 or more component securities), except if there are 2 or more securities with equal weighting that could be included in the calculation of the lowest weighted component securities comprising, in the aggregate, 25 percent of the underlying 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;
- Options on the underlying index are listed and traded on an NSE registered under section 6(a) of the Exchange Act; [200] and
- The aggregate average daily trading volume in options on the underlying index is at least 10,000 contracts calculated as of the preceding 6 full calendar months.[201]

With regard to debt security indexes, the Commissions issued joint rules in 2006 ("July 2006 Rules") to define when an index of debt securities [202] is not a narrow-based security index. The first three criteria of that definition were similar to the statutory definition for equities and the order regarding volatility indexes in that a debt security index would not be narrow based if: (i) It had more than 9 debt securities issued by more than 9 non-affiliated issuers; (ii) the securities of any issuer included in the index did not comprise more than 30 percent of the index's weighting; and (iii) the securities of any five non-affiliated issuers in the index did not comprise more than 60 percent of the index's weighting.

In the July 2006 Rules, instead of the statutory average daily trading volume test, however, the Commissions adopted a public information availability requirement. Under this requirement, assuming the aforementioned number and concentration limits were satisfied, a debt security index would not be a narrow-based security index if the debt securities or the issuers of debt securities in the index met any one of the following criteria:

- The issuer of the debt security is required to file reports pursuant to section 13 or section 15(d) of the Securities Exchange Act of 1934; [203]
- The issuer of the debt security has a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more;
- The issuer of the debt security has outstanding securities that are notes, bonds, debentures, or evidence of indebtedness having a total remaining principal amount of at least $1 billion;

future delivery on a single security or narrow-based security index (including any interest therein or based on the value thereof). *See* section 3(a)(55) of the Exchange Act, 15 U.S.C. 78c(a)(55), and CEA section 1a(44), 7 U.S.C. 1a(44).

[194] *See* section 3(a)(55)(B) of the Exchange Act, 15 U.S.C. 78c(a)(55)(B). *See also* CEA sections 1a(35)(A) and (B), 7 U.S.C. 1a(35)(A) and (B).

[195] The narrow-based security index definition in the CEA and Exchange Act also excludes from its scope security indexes that satisfy certain specified criteria. *See* sections 3(a)(55)(C)(i)—(vi) of the Exchange Act, 15 U.S.C. 78c(a)(55)(C)(i)—(vi), and CEA sections 1a(35)(B)(i)—(vi), 7 U.S.C. 1a(35)(B)(i)—(vi).

[196] *See* Joint Order Excluding Indexes Comprised of Certain Index Options From the Definition of Narrow-Based Security Index, 69 FR 16900, Mar. 31, 2004 ("March 2004 Joint Order").

[197] *See* CEA section 1a(35)(B)(vi), 7 U.S.C. 1a(35)(B)(vi), and section 3(a)(55)(C)(vi) of the Exchange Act, 15 U.S.C. 78c(a)(55)(C)(vi).

[198] *See* March 2004 Joint Order, *supra* note 196.

[199] *See* Joint Final Rules: Application of the Definition of Narrow-Based Security Index to Debt Securities Indexes and Security Futures on Debt Securities, 71 FR 39434, July 13, 2006 ("July 2006 Rules").

[200] 15 U.S.C. 78f(a).

[201] *See* March 2004 Joint Order, *supra* note 196. In 2009, the Commissions issued a joint order that provided that, instead of the index options having to be listed on an NSE, the index options must be listed on an exchange and pricing information for the index options, and the underlying index, must be computed and disseminated in real time through major market data vendors. *See* Joint Order To Exclude Indexes Composed of Certain Index Options From the Definition of Narrow-Based Security Index, 74 FR 61116, Nov. 23, 2009 (expanding the criteria necessary for exclusion under the March 2004 Joint Order to apply to volatility indexes for which pricing information for the underlying broad-based security index, and the options that compose such index, is current, accurate, and publicly available).

[202] Under the rules, debt securities include notes, bonds, debentures or evidence of indebtedness. *See* CFTC rule 41.15(a)(1)(i), 17 CFR 41.15(a)(1)(i) and rule 3a55–4(a)(1)(i) under the Exchange Act, 17 CFR 240.3a55–4(a)(1)(i).

[203] 15 U.S.C. 78m or 78o(d).

• The security is an exempted security as defined in section 3(a)(12) of the Securities Exchange Act of 1934 [204] and the rules promulgated thereunder; or

• The issuer of the security is a government of a foreign country or a political subdivision of a foreign country.[205]

The statutory definition of the term "narrow-based security index" for equities, and the Commissions' subsequent guidance as to what constitutes a narrow-based security index with respect to volatility and debt indexes, is applicable in the context of distinguishing between futures contracts and security futures products. In the Dodd-Frank Act, Congress included the term "narrow-based security index" in the security-based swap definition, and thus the statutory definition of the term "narrow-based security index" also applies in distinguishing swaps (on security indexes that are not narrow-based, also known as "broad-based") and security-based swaps (on narrow-based security indexes). Further, the Commissions believe that their prior guidance with respect to what constitutes a narrow-based security index in the context of volatility and debt security indexes should apply in determining whether a Title VII instrument is a swap or a security-based swap.

To clarify that the Commissions are applying the prior guidance and rules to Title VII instruments, the Commissions are proposing rules to further define the term "narrow-based security index" in the security-based swap definition. Under paragraph (1) of proposed rule 1.3(yyy) under the CEA and paragraph (a) of proposed rule 3a68–3 under the Exchange Act, for purposes of the security-based swap definition, the term "narrow-based security index" would have the same meaning as the statutory definition set forth in section 1a(35) of the CEA and section 3(a)(55) of the Exchange Act,[206] and the rules, regulations, and orders issued by the Commissions relating to such definition. As a result, except as the new rules the Commissions are proposing provide for other treatment, market participants generally will be able to use the Commissions' past guidance in determining whether certain Title VII instruments based on a security index are swaps or security-based swaps.

However, the Commissions are proposing interpretive guidance and additional rules regarding Title VII instruments based on a security index. The additional rules and interpretive guidance set forth new narrow-based security index criteria with respect to indexes composed of securities, loans, or issuers of securities referenced by an index CDS. The proposed interpretive guidance and rules also address the definition of an "index" and the treatment of broad-based security indexes that become narrow-based and narrow-based indexes that become broad-based, including rule provisions regarding tolerance and grace periods for swaps on security indexes that are traded on CFTC-regulated trading platforms and security-based swaps on security indexes that are traded on SEC-regulated trading platforms. These rules and interpretive guidance are discussed in turn below.

3. Narrow-Based Security Index Criteria for Index Credit Default Swaps

(a) In General

A CDS is a Title VII instrument in which the "protection buyer" makes a series of payments to the "protection seller" and, in return, the "protection seller" is obligated to make a payment to the "protection buyer" if an obligation or obligations (typically bonds, but in some cases loans) of an entity or entities referenced in the contract, or the entity or entities themselves, experience a "credit event." [207] While the Commissions understand that the underlying reference for most cleared CDS is a single entity or an index of entities rather than a single security or an index of securities, the underlying reference for CDS also could be a single security or an index of securities.[208] A CDS where the underlying reference is a single entity (*i.e.*, a single-name CDS), a single obligation of a single entity (*e.g.*, a CDS on a specific bond, loan, or asset-backed security, or any tranche or series of any bond, loan, or asset-backed security), or an index CDS where the underlying reference is a narrow-based security index or the issuers of securities in a narrow-based security index would be a security-based swap.[209] An index CDS where the underlying reference is not a narrow-based security index or the issuers of securities in a narrow-based security index (*i.e.*, a broad-based index) would be a swap.[210]

The statutory definition of the term "narrow-based security index," as explained above, was designed with the U.S. equity markets in mind. Thus, the statutory definition is not appropriate for determining whether an index underlying an index CDS is broad or narrow-based. Nor is the further guidance that the Commissions have previously issued with respect to the narrow-based security index definition discussed above necessarily appropriate, because that guidance was designed to address and was uniquely tailored to the characteristics of volatility indexes and debt security indexes in the context of futures. Accordingly, the Commissions are proposing rules that would adopt criteria for determining whether an index is a narrow-based security index within the context of index CDS.[211]

[204] 15 U.S.C. 78c(a)(12).

[205] The July 2006 Rules also provided that debt securities in the index must satisfy certain minimum outstanding principal balance criteria, established certain exceptions to these criteria and the public information availability requirement, and provided for the treatment of indexes that include exempted securities (other than municipal securities).

[206] 7 U.S.C. 1a(35) and 15 U.S.C. 78c(a)(55).

[207] *See supra* note 180 and accompanying text.

[208] *See, e.g.,* Markit, "Markit CDX" (describing the Markit CDX indexes and the number of "names" included in each index), available at *http://www.markit.com/en/products/data/indices/credit-and-loan-indices/cdx/cdx.page?;* Markit, "Markit iTraxx Indices," (stating that the "Markit iTraxx indices are comprised of the most liquid *names* in the European and Asian markets") (emphasis added), available at *http://www.markit.com/en/products/data/indices/credit-and-loan-indices/itraxx/itraxx.page?*]. Examples of indexes based on securities include the Markit ABX.HE and CMBX indexes. *See* Markit, "Markit ABX.HE," (describing the Markit ABX.HE index as "a synthetic tradeable index referencing a basket of 20 subprime mortgage-backed securities"), available at *http://www.markit.com/en/products/data/indices/structured-finance-indices/abx/abx.page;* Markit, "Markit CMBX," (describing the Markit CMBX index as "a synthetic tradeable index referencing a basket of 25 commercial mortgage-backed securities"), available at *http://www.markit.com/en/products/data/indices/structured-finance-indices/cmbx/cmbx.page.*

[209] Two commenters made suggestions relating to the effect of the jurisdictional consequences of the definition of the term "narrow-based security index," but neither commented on the meaning of the term itself. One of the two commenters, recognizing that a jurisdictional line would exist for CDS, stressed the need for "substantially identical" regulations applicable to CDS. *See* Deutsche Bank Letter. The other commenter also noted that a line for CDS would exist and urged the Commissions to adopt a regulation stating that a derivatives clearing organization ("DCO") may be a clearing agency and a clearing agency may be a DCO, in order to facilitate portfolio margining and cross-margining. *See* White & Case Letter. The Commissions are sensitive to the requirement in section 712(a)(7) of the Dodd-Frank Act to treat functionally or economically similar products or entities in a similar manner.

[210] Similarly, an option to enter into a single-name CDS or a CDS referencing a narrow-based security index as described above would be a security-based swap, while an option to enter into a CDS on a broad-based security index or the issuers of securities in a broad-based security index would be a swap. Index CDS where the underlying reference is a broad-based security index would be SBSAs. The SEC has enforcement authority with respect to swaps that are SBSAs, as discussed further in part V below.

[211] Two commenters urged clarification of the definition of the term "narrow-based security index"

Continued

The Commissions are further defining the term "security-based swap," and the use of the term "narrow-based security index" within that definition to modify the criteria applied in the context of index CDS in assessing whether the index is a narrow-based security index. The third prong of the security-based swap definition includes a Title VII instrument based on the occurrence of an event relating to the "issuers of securities in a narrow-based security index," provided that such event directly affects the "financial statements, financial condition, or financial obligations of the issuer." [212] The first prong of the security-based swap definition includes a Title VII instrument that is based on a "narrow-based security-index." [213] Because the third prong of the security-based swap definition relates to issuers of securities, while the first prong of such definition relates to securities, the Commissions are proposing to further define both the term "narrow-based security index" and the term "issuers of securities in a narrow-based security index" in the context of the definition of security-based swap as applied to index CDS. The Commissions believe it is important to further define both terms in order to ensure consistent analysis of index CDS.[214] While the wording of the two proposed definitions differs slightly, the Commissions expect that they would yield the same substantive results in distinguishing narrow-based and broad-based index CDS.

(b) Proposed Rules Regarding the Definitions of "Issuers of Securities in a Narrow-Based Security Index" and "Narrow-Based Security Index" for Index Credit Default Swaps

The Commissions are considering how to further define the terms "issuers of securities in a narrow-based security index" and "narrow-based security index" in order to provide for appropriate criteria for determining whether an index composed of issuers of securities referenced by an index CDS and an index composed of securities referenced by an index CDS are narrow-based security indexes. In formulating these criteria, and consistent with the guidance and rules the Commissions have previously issued and adopted regarding narrow-based security indexes in the context of security futures, the Commissions believe that there should be public information available about a predominant percentage of the reference entities underlying the index, or, in the case of an index CDS, on an index of securities, about the issuers of the securities or the securities underlying the index, in order to reduce the likelihood that non-narrow-based indexes referenced in index CDS or the component securities or issuers of securities in that index would be readily susceptible to manipulation, as well as to help prevent the misuse of material non-public information through the use of CDS based on such indexes.

To satisfy these objectives, the Commissions intend to use the criteria developed for debt indexes discussed above [215] but tailor the criteria specifically to address index CDS.[216] These criteria would be used solely for the purpose of defining the terms "narrow-based security index" and "issuers of securities in a narrow-based security index" in the first and third prongs of the security-based swap definition with respect to index CDS and would not be interpreted to affect any other interpretation or use of the term "narrow-based security index" or any other provision of the Dodd-Frank Act, CEA, or Exchange Act.

(i) Number and Concentration Percentages of Reference Entities or Securities

The Commissions believe that the first three criteria of the debt security index test discussed above (*i.e.,* the number and concentration weighting requirements) are appropriate to apply to index CDS, whether CDS on indexes of securities or indexes of issuers of securities.

Accordingly, proposed rules 1.3(zzz) under the CEA and proposed rule 3a68–1a under the Exchange Act would provide that, for purposes of determining whether an index CDS is a security-based swap under section 3(a)(68)(A)(ii)(III) of the Exchange Act,[217] the term "issuers of securities in a narrow-based security index" would include issuers of securities identified in an index in which:

• *Number:* There are 9 or fewer non-affiliated issuers of securities that are reference entities [218] in the index, provided that an issuer of securities shall not be deemed a reference entity in the index unless (i) a credit event with respect to such reference entity would result in a payment by the credit protection seller to the credit protection buyer under the CDS based on the related notional amount allocated to such reference entity, or (ii) the fact of such credit event or the calculation in accordance with clause (i) above of the amount owed with respect to such credit event is taken into account in determining whether to make any future payments under the CDS with respect to any future credit events;

• *Single Component Concentration:* The effective notional amount allocated to any reference entity included in the index comprises more than 30 percent of the index's weighting; or

• *Largest Five Component Concentration:* The effective notional amount allocated to any 5 non-affiliated reference entities included in the index comprises more than 60 percent of the index's weighting.[219]

in the context of CDS to ensure that it reflects "the letter and the spirit" of the existing definition. *See* Letter from Thomas W. Jasper, Chief Executive Officer, Primus Guaranty Ltd., and Gene Park, Chief Executive Officer, Quadrant Structured Investment Advisers, LLC, Sept. 20, 2010 ("Primus and Quadrant Letter").

[212] Section 3(a)(68)(A)(ii)(III) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(III).

[213] Section 3(a)(68)(A)(ii)(I) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(I).

[214] Because it applies only with respect to index CDS, the proposed definitions of "issuers of securities in a narrow-based security index" and "narrow-based security index" would not apply with respect to other types of event contracts, whether analyzed under the first or third prong.

[215] *See* discussion of July 2006 Rules, *supra* note 199.

[216] The Commissions note that the language of the proposed rules is intended, in general, to track the criteria developed for debt indexes discussed above. Certain changes from the criteria developed for debt indexes are necessary to address differences between futures on debt indexes and index CDS. Certain other changes are necessary because the rules for debt indexes define under what conditions an index is *not* a narrow-based security index, whereas the proposed rules define what *is* a narrow-based security index. For example, an index is not a narrow-based security index under the rule for debt indexes if it is not a narrow-based security index under *either* subparagraph (a)(1) *or* paragraph (a)(2) of the rule. Under the proposed rules for index CDS, however, an index *is* a narrow-based security index if it meets the requirements of *both* of the counterpart paragraphs in the proposed rules regarding index CDS (paragraphs (1)(i) and (1)(ii) of proposed rules 1.3(xxx) and 1.3(aaaa) under the CEA and paragraphs (a)(1) and paragraph (a)(2) of proposed rules 3a68–1a and 3a68–1b under the Exchange Act), even though the criteria in the debt index rules and the proposed rules for index CDS include generally the same criteria and structure.

[217] 15 U.S.C. 78c(a)(68)(A)(ii)(III).

[218] For purposes of proposed rules 1.3(zzz) and 3a68–1a: (i) A reference entity would be affiliated with another entity if it controls, is controlled by, or is under common control with, that entity; (ii) control would mean ownership of 20 percent or more of an entity's equity, or the ability to direct the voting of 20 percent or more of the entity's voting equity; and (iii) the term "reference entity" would include an issuer of securities, an issuing entity of asset-backed securities, and a single reference entity or group of affiliated entities; provided that an issuing entity of an asset-backed security shall not be affiliated with any other issuing entity or issuer under this proposed definition.

[219] These proposed rules refer to the "effective notional amount" allocated to reference entities or securities in order to address potential situations in which the means of calculating payout across the reference entities or securities is not uniform. Thus, if one or more payouts is leveraged or enhanced by the structure of the transaction (*i.e.*, 2x recovery rate), that amount would be the "effective notional amount" for purposes of the 30% and 60% tests in

Similarly, proposed rules 1.3(aaaa) under the CEA and proposed rule 3a68–1b under the Exchange Act would provide that, for purposes of determining whether an index CDS is a security-based swap under section 3(a)(68)(A)(ii)(I) of the Exchange Act,[220] the term "narrow-based security index" would include an index in which essentially the same criteria apply, substituting securities for issuers. Under these proposed criteria, the term "narrow-based security index" would mean an index in which:

- *Number:* There are 9 or fewer securities, or securities that are issued by 9 or fewer non-affiliated issuers,[221] in the index, provided that a security shall not be deemed a component of the index unless (i) a credit event with respect to the issuer of such security or a credit event with respect to such security would result in a payment by the credit protection seller to the credit protection buyer under the CDS based on the related notional amount allocated to such security, or (ii) the fact of such credit event or the calculation in accordance with clause (i) above of the amount owed with respect to such credit event is taken into account in determining whether to make any future payments under the CDS with respect to any future credit events;
- *Single Component Concentration:* The effective notional amount allocated to the securities of any issuer included in the index comprises more than 30 percent of the index's weighting; or
- *Largest Five Component Concentration:* The effective notional amount allocated to the securities of any 5 non-affiliated issuers included in the index comprises more than 60 percent of the index's weighting.

Thus, the applicability of the proposed rules would depend on conditions relating to the number of non-affiliated reference entities, issuers of securities, or securities, as applicable, included in an index and the weighting of notional amounts allocated to the reference entities or securities in the index, as applicable. These first three criteria of the proposed rules would evaluate the number and concentration of the issuers or securities in the index, as applicable, and ensure that an index with a small number of issuers or securities or concentrated in only a few issuers or securities would be narrow-based, and thus where such index is the underlying reference of an index CDS, the index CDS would be a security-based swap.

Specifically, the proposed rules would provide that an index meeting any one of certain identified conditions would be a narrow-based security index. The first condition in paragraph (1)(i)(A) of proposed rule 1.3(zzz) under the CEA and paragraph (a)(1)(i) of proposed rule 3a68–1a under the Exchange Act is that there are 9 or fewer non-affiliated issuers of securities that are reference entities in the index. An issuer of securities would count toward this total only if a credit event with respect to such entity would result in a payment by the credit protection seller to the credit protection buyer under the CDS based on the notional amount allocated to such entity, or if the fact of such a credit event or the calculation of the payment with respect to such credit event is taken into account when determining whether to make any future payments under the CDS with respect to any future credit events.

Similarly, the first condition in paragraph (1)(i)(A) of proposed rules 1.3(aaaa) under the CEA and paragraph (a)(1)(i) of proposed rule 3a68–1b under the Exchange Act would provide that a security would count toward the total number of securities in the index only if a credit event with respect to such security, or the issuer of such security, would result in a payment by the credit protection seller to the credit protection buyer under the CDS based on the notional amount allocated to such security, or if the fact of such a credit event or the calculation of the payment with respect to such credit event is taken into account when determining whether to make any future payments under the CDS with respect to any future credit events. These provisions are intended to ensure that an index concentrated in a few reference entities or securities, or a few reference entities that are affiliated or a few securities issued by a few issuers that are affiliated, are within the "narrow-based" definition and that an entity is not counted as a reference entity in the index, and a security is not counted as a security in the index, unless a credit event with respect to the entity, issuer, or security affects payout under a CDS on the index.[222]

In addition, the proposed rules would provide that a reference entity or issuer of a security in an index and any of that reference entity's or issuer's affiliated entities are deemed to be a single reference entity or issuer in the index.[223] For purposes of the narrow-based security index definition for index CDS under the third prong and first prong, a reference entity or issuer would be affiliated with another entity if it controls, is controlled by, or is under common control with, that other entity or issuer. The proposed rules would define control, solely for purposes of this provision, to mean ownership of 20% or more of an entity's or issuer's equity or the ability to direct the voting of 20% or more of an entity's or issuer's voting equity.[224] This definition of control is designed to provide a clear standard for determining affiliation for purposes of the narrow-based security index criteria with respect to index CDS. Determining whether a reference entity or issuer is affiliated with another entity or issuer is important in assessing whether an index meets the criteria in the proposed rules because the notional amounts allocated to all affiliated reference entities, or all securities issued by affiliated issuers, included in an index must be aggregated in order to prevent a concentration of the index in reference entities or securities issued by issuers that are affiliated and because a reference entity's and issuer's affiliates must be considered when determining whether the reference entity or security meets the public information availability test discussed below. In addition, in order to ensure application of the criteria regarding index CDS to indexes of

paragraphs (1)(i)(B) and (1)(i)(C) of proposed rules 1.3(zzz) and 1.3(aaaa) and paragraphs (a)(1)(ii) and (a)(1)(iii) of proposed rules 3a68–1a and 3a68–1b. Similarly, if the aggregate notional amount under a CDS is not uniformly allocated to each reference entity or security, then the portion of the notional amount allocated to each reference entity or security (which may be by reference to the product of the aggregate notional amount and an applicable percentage) would be the "effective notional amount."

[220] 15 U.S.C. 78c(a)(68)(A)(ii)(I).

[221] This language is intended to be consistent with the language in the rule for debt indexes but the specific language is different to deal with the differences in structure between the rule for debt indexes and proposed rules 1.3(aaaa) and 3a68–1b. *See* discussion *supra* note 216.

For purposes of proposed rules 1.3(aaaa) and 3a68–1b: (i) An issuer would be affiliated with another issuer if it controls, is controlled by, or is under common control with, that issuer; (ii) control would mean ownership of 20 percent or more of an issuer's equity, or the ability to direct the voting of 20 percent or more of the issuer's voting equity; and (iii) the term "issuer" would include an issuer of securities, an issuing entity of asset-backed securities, and a single issuer or group of affiliated issuers; provided that an issuing entity of an asset-backed security shall not be deemed affiliated with any other issuing entity or issuer under this proposed definition.

[222] This requirement is generally consistent with the definition of "narrow-based security index" in CEA section 1a(35)(A), 7 U.S.C. 1a(35)(A), and section 3(a)(55)(B) of the Exchange Act, 15 U.S.C. 78c(a)(55)(B), and the July 2006 Rules, *supra* note 199.

[223] *See* proposed rule 1.3(zzz)(4) under the CEA and proposed rule 3a68–1a(d) under the Exchange Act.

[224] The affiliate issue under the Federal securities laws is generally a facts and circumstances determination based on the definition of the term "affiliate" contained in such laws. *See, e.g.,* rule 405 under the Securities Act, 17 CFR 230.405; rule 12b–2 under the Exchange Act, 17 CFR 240.12b–2.

reference entities that have issued asset-backed securities as defined in section 3(a)(77) of the Exchange Act,[225] as well as indexes of such asset-backed securities, the term reference entity and the term issuer under the proposed rules includes issuing entities of asset-backed securities. The proposed rules also would provide that each issuing entity of an asset-backed security is considered a separate reference entity or issuer, as applicable.

The second condition, in paragraphs (1)(i)(B) of proposed rules 1.3(zzz) and 1.3(aaaa) under the CEA and paragraphs (a)(1)(ii) of proposed rules 3a68–1a and 3a68–1b under the Exchange Act, is that the effective notional amount allocated to any reference entity or security included in the index comprises more than 30 percent of the index's weighting.

The third condition, in paragraphs (1)(i)(C) of proposed rules 1.3(zzz) and 1.3(aaaa) under the CEA and paragraphs (a)(1)(iii) of proposed rules 3a68–1a and 3a68–1b under the Exchange Act, is that the effective notional amount allocated to any 5 non-affiliated reference entities, or to the securities of any 5 non-affiliated issuers, included in the index that are the underlying reference entities or securities, respectively, comprises more than 60 percent of the index's weighting.

Given that Congress determined that these concentration percentages are appropriate to characterize an index as a narrow-based security index, and the Commissions have determined they are appropriate for debt security indexes in the security futures context, the Commissions believe that these concentration percentages are appropriate to apply to the notional amount allocated to reference entities and securities in order to apply similar standards to indexes that are the underlying references of index CDS. Moreover, with respect to both the numerical and concentration percentage criteria, the markets have had experience with these criteria with respect to futures on equity indexes, volatility indexes, and debt security indexes.

(ii) Public Information Availability Regarding Reference Entities and Securities

In addition to the numerical and concentration percentage criteria, the debt security index test also included, as discussed above, a public information availability test. This test was designed to reduce the likelihood that broad-based debt security indexes or the component securities or issuers of securities in that index would be readily susceptible to manipulation. The fourth condition in the proposed rules includes a similar public information availability test that is intended solely for purposes of determining whether an index underlying a CDS is narrow-based. Except as discussed below, under the proposed rules, an index CDS would be considered narrow-based if a reference entity or security included in the index does not meet any one of the following criteria:

- The reference entity or the issuer of the security is required to file reports pursuant to the Exchange Act or the regulations thereunder;
- The reference entity or the issuer of the security is eligible to rely on the exemption provided in rule 12g3–2(b) under the Exchange Act;[226]
- The reference entity or the issuer of the security has a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more;[227]
- The reference entity or the issuer of the security (other than an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Exchange Act[228]) has outstanding securities that are notes, bonds, debentures, or evidences of indebtedness having a total remaining principal amount of at least $1 billion;
- The reference entity is an issuer of an exempted security, or the security is an exempted security, each as defined in section 3(a)(12) of the Exchange Act[229] and the rules promulgated thereunder (except a municipal security);
- The reference entity or the issuer of the security is a government of a foreign country or a political subdivision of a foreign country; or
- If the reference entity or the issuer of the security is an issuing entity of asset-backed securities as defined in section 3(a)(77) of the Exchange Act,[230] such asset-backed securities were issued in a transaction registered under the Securities Act and have publicly available distribution reports.

However, so long as the effective notional amounts allocated to reference entities or securities that satisfy the public information availability test comprise at least 80 percent of the index's weighting, failure by a reference entity or security included in the index to satisfy the public information availability test would be disregarded if the effective notional amounts allocated to that reference entity or security comprise less than 5 percent of the index's weighting.

These issuer eligibility criteria are intended to condition the characterization of an index as "narrow-based" on the likelihood that information about a predominant percentage of the reference entities or securities included in the index is publicly available.[231] For example, a reference entity or issuer of securities that is required to file reports pursuant to the Exchange Act or the regulations thereunder makes regular and public disclosure through those filings. Moreover, reference entities and issuers of securities that do not file reports with the SEC but that are eligible to rely on the exemption in rule 12g3–2(b) under the Exchange Act (*i.e.,* foreign private issuers) are required to make certain types of financial information publicly available in English on their Web sites or through an electronic information delivery system generally available to the public in their primary trading markets.[232] The Commissions believe that other reference entities or issuers of securities that do not file reports with the SEC, but that have worldwide equity market capitalization of $700 million, have $1 billion in outstanding debt (other than in the case of issuing entities of asset-backed securities), issue exempted securities (other than municipal securities), or are foreign

[225] 15 U.S.C. 78c(a)(77). The Commissions note that section 941 of the Dodd-Frank Act added the definition of the term "asset-backed security" as section 3(a)(77) of the Exchange Act, 15 U.S.C. 78c(a)(77). However, section 761(a)(6) of the Dodd-Frank Act also added the definition of the term "security-based swap execution facility" as section 3(a)(77) of the Exchange Act, 15 U.S.C. 78c(a)(77). References to the definition of the term "asset-backed security" in this release are to the definition added by section 941 of the Dodd-Frank Act.

[226] 17 CFR 240.12g3–2(b).

[227] *See* July 2006 Rules, *supra* note 199, at 39537 (noting that issuers having worldwide equity market capitalization of $700 million are likely to have public information available about them).

[228] 15 U.S.C. 78c(a)(77).

[229] 15 U.S.C. 78c(a)12.

[230] 15 U.S.C. 78c(a)(77).

[231] *See* discussion *supra* part III.G.3(b). Most of the thresholds in the public information availability test are similar to those the Commissions adopted in their joint rules regarding the application of the definition of the term "narrow-based security index" to debt security indexes and security futures on debt securities. *See* July 2006 Rules, *supra* note 199. The July 2006 Rules also included an additional requirement regarding the minimum principal amount outstanding for each security in the index. The Commissions have not included this requirement in proposed rule 1.3(zzz) under the CEA and proposed rule 3a68–1a under the Exchange Act. The numerical thresholds also are similar to those the SEC adopted in its securities offering reform rules, which were based on data analysis conducted by the SEC's Office of Economic Analysis. *See* Securities Offering Reform, 70 FR 44722, Aug. 3, 2005.

[232] 17 CFR 240.12g3–2(b).

sovereign entities either are required to or are otherwise sufficiently likely, solely for purposes of the proposed "narrow-based security-index" and "issuers of securities in a narrow-based security index" definitions, to have public information available about them.[233]

In the case of indexes including asset-backed securities, or reference entities that are issuing entities of asset-backed securities, information about the reference entity or issuing entity of the asset-backed security would not alone be sufficient and, consequently, the proposed rules provide that the public information availability test would be satisfied only if certain information also is available about the asset-backed securities. An issuing entity (whether or not a reference entity) of asset-backed securities may meet the public information availability test if such asset-backed securities were issued in a transaction registered under the Securities Act and distribution reports about such asset-backed securities are publicly available. In addition, because of the lack of public information regarding many asset-backed securities, despite the size of the outstanding amount of securities,[234] the proposed rules would not permit such reference entities and issuers to satisfy the public information availability test by having $1 billion in outstanding debt. Characterizing an index with reference entities or securities for which public information is not likely to be available as "narrow-based," and thus index CDS where the underlying references or securities are such indexes as security-based swaps, should help to ensure the transparency of the index components.

In sum, an index that is not narrow-based under the number and weighting requirements would be characterized as broad-based (and thus an index CDS, where the underlying reference is that index, would be characterized as a swap and not a security-based swap) unless one of the reference entities or securities in the index fails to meet one of the criteria in the public information availability test set forth in the proposed rules. Yet, even if one or more of the reference entities or securities included in the index fail the public information availability test, the proposed rules would provide that the terms "issuers of securities in a narrow-based security index" and "narrow-based security index" would not include such an index, so long as the applicable reference entity or security that failed the test represents less than 5 percent of the index's weighting, and so long as reference entities or securities comprising at least 80 percent of the index's weighting do satisfy the public information availability test.

An index that includes a very small proportion of reference entities or securities that do not satisfy this public information availability test should nevertheless be treated as a broad-based security index. This would be achieved where the index satisfies both of the requirements at the time the parties enter into the index CDS. The 5-percent weighting threshold is designed to provide that reference entities or securities not satisfying the public information availability test comprise only a very small portion of the index, and the 80-percent weighting threshold is designed to provide that a predominant percentage of the reference entities or securities in the index satisfy the public information availability test. As a result, these thresholds would provide market participants with flexibility in constructing an index. The Commissions believe that this provision is appropriate and that providing such flexibility is not likely to increase the likelihood that an index that satisfies these provisions would be readily susceptible to manipulation or the likelihood that the component securities or issuers of securities in that index also would be subject to manipulation or that there would be misuse of material non-public information about them through the use of CDS based on such indexes.

The Commissions also are proposing that, for index CDS entered into solely between ECPs, the public information availability test may instead be satisfied other than in the manner discussed above. Accordingly, solely for index CDS entered into between ECPs, an index would be considered narrow-based if a reference entity or security included in the index does not meet any one of the criteria enumerated above or any one of the following criteria:

- The reference entity or the issuer of the security (other than issuing entities of asset-backed securities) provides to the public or to such eligible contract participant information about such reference entity or issuer pursuant to rule 144A(d)(4) under the Securities Act;[235]
- Financial information about the reference entity (other than an issuing entity of asset-backed securities) is otherwise publicly available; or
- In the case of an asset-backed security, or a reference entity that is an issuing entity of asset-backed securities, information of the type and level included in public distribution reports for similar asset-backed securities is publicly available about both the reference entity or issuing entity as well as such asset-backed securities.

Reference entities or reference securities that meet alternative public information criteria currently may underlie CDS that are entered into by ECPs and that are cleared by central counterparties operating pursuant to exemptive orders granted by the SEC.[236] In addition, solely with respect to index CDS entered into by ECPs, so long as the effective notional amounts allocated to reference entities or securities that satisfy this expanded public information availability test comprise at least 80 percent of the index's weighting, a reference entity or security included in the index that fails to satisfy this expanded public information availability test would be disregarded if the effective notional amounts allocated to that reference entity or security comprise less than 5 percent of the index's weighting.

The Commissions are also seeking comment as to whether the public information availability test should apply to the extent that an index is compiled by an index provider that is not a party to an index CDS ("third-party index provider") and makes publicly available general information about the construction of the index, index rules, identity of components, and predetermined adjustments, and which index is referenced by an index CDS that is offered on or subject to the rules of a DCM or SEF, or by direct access in

[233] It is important to note that the public information availability test is designed solely for purposes of distinguishing between index CDS that are swaps and index CDS that are security-based swaps. The proposed criteria are not intended to provide any assurance that there is any particular level of information actually available regarding a particular reference entity or issuer of securities. Meeting one or more of the proposed criteria for the limited purpose here—defining the terms "narrow-based security index" and "issuers of securities in a narrow-based security index" in the first and third prongs of the security-based swap definition with respect to index CDS—would not substitute for or satisfy any other requirement for public disclosure of information or public availability of information for purposes of the Federal securities laws.

[234] *See generally* Asset-Backed Securities, 75 FR 23328, May 3, 2010.

[235] 17 CFR 230.144A(d)(4).

[236] *See, e.g.,* Order Granting Temporary Exemptions Under the Securities Exchange Act of 1934 in Connection With Request of Chicago Mercantile Exchange Inc. and Citadel Investment Group, L.L.C. Related to Central Clearing of Credit Default Swaps, and Request for Comments, Exchange Act Release No. 34–59578 (Mar. 13, 2009). This order has been extended a number of times, most recently on November 29, 2010. *See* Order Extending Temporary Conditional Exemptions Under the Securities Exchange Act of 1934 in Connection With Request of Chicago Mercantile Exchange Inc. Related to Central Clearing of Credit Default Swaps and Request for Comment, Exchange Act Release No. 34–63388 (Nov. 29, 2010).

the U.S. from an FBOT that is registered with the CFTC.

The CFTC believes that the requirement that the index be compiled by a third-party index provider may help to ensure that information is publicly available because such index providers generally employ a variety of selection criteria for inclusion of reference entities or securities in the indexes for index CDS, including liquidity thresholds. The CFTC believes that requiring that such index providers make publicly available general information about the construction of the index, index rules, components, and predetermined adjustments may help ensure transparency regarding the index and its components. In addition, the CFTC believes that the requirement that the index be the underlying reference of an index CDS that is offered for trading on or subject to the rules of a DCM or SEF, or by direct access in the U.S. from a registered FBOT, helps to ensure that information about the index is publicly available and that the index is not readily susceptible to manipulation. The CEA prohibits DCMs and SEFs from offering for trading contracts that are readily susceptible to manipulation.[237] Similarly, under rules recently proposed by the CFTC, FBOTs only may offer contracts by direct access from the U.S. that are not readily susceptible to manipulation.[238] The CFTC believes that CFTC oversight of DCMs, SEFs and registered FBOTs for compliance with these requirements[239] will help ensure that information about an index that is the underlying reference of an index CDS traded on these platforms is publicly available and is not readily susceptible to manipulation.[240]

The SEC believes that a third-party index provider that simply provides general information about the construction of an index, index rules, components, and predetermined adjustments is not a substitute for the public availability of information about the issuers of the securities or the securities in the index; nor does such a third-party index provider indicate a likelihood that such public information is available, which the SEC believes, for purposes of index CDS, is important to market integrity and to investors in engaging in transactions based on such indexes. If a third-party index provider does not require, as a condition of inclusion in an index it compiles, that information likely is publicly available regarding the component issuers or securities in the index, the SEC does not believe investors will have adequate information regarding such component issuers or securities. In addition, the SEC notes that, absent specified standards regarding what persons constitute a third-party index provider for purposes of the proposed rules, any person that compiles an index at the behest of another person could constitute a “third-party index provider.” Moreover, the SEC does not believe that requiring an index CDS to be offered on or subject to the rules of a DCM or SEF, or by an FBOT, addresses whether public information likely is available about the issuers of securities or securities in an index compiled by a third-party index provider. As a result, the SEC does not believe that an index compiled by a third-party index provider that makes publicly available general information about the construction of the index, index rules, components, and index adjustments, and that is referenced by an index CDS that is offered for trading on or subject to the rules of a DCM or SEF, or by direct access in the U.S. from a registered FBOT, should substitute for the public information availability test under the proposed rules for index CDS.

Accordingly, the Commissions seek comment as to whether the public information availability test should apply to indexes compiled by a third-party index provider that makes publicly available general information about the construction of the index, index rules, identity of components, and predetermined adjustments, and which index is referenced by an index CDS that is offered on or subject to the rules of a DCM or SEF, or by direct access in the U.S. from an FBOT that is registered with the CFTC.

(iii) Treatment of Indexes Including Reference Entities That Are Issuers of Exempted Securities or Including Exempted Securities

In addition, the proposed rules provide for alternative treatment of indexes that include exempted securities or reference entities that are issuers of exempted securities.[241] The Commissions believe such treatment is consistent with the objective and intent of the definition of the term “security-based swap,” as well as the approach taken in the context of security futures.[242] Accordingly, paragraph (1)(ii) of proposed rules 1.3(zzz) and 1.3(aaaa) under the CEA and paragraph (a)(2) of proposed rules 3a68–1a and 3a68–1b under the Exchange Act would provide that, in the case of an index that includes exempted securities, or reference entities that are issuers of exempted securities, in each case as defined as of the date of enactment of the Futures Trading Act of 1982 (other than municipal securities), such securities or reference entities are excluded from the index when determining whether the securities or reference entities in the index constitute a “narrow-based security index” or “issuers of securities in a narrow-based security index” under the proposed rules.

Under paragraph (1)(ii) of proposed rules 1.3(zzz) and 1.3(aaaa) under the CEA and paragraph (a)(2) of proposed rules 3a68–1a and 3a68–1b under the Exchange Act, an index composed solely of securities that are, or reference entities that are issuers of, exempted securities (other than municipal securities) would not be a “narrow-based security index” or an index composed of “issuers of securities in a narrow-based security index.” In the case of an index where some, but not all, of the securities or reference entities are exempted securities (other than municipal securities) or issuers of exempted securities (other than municipal securities), the index would be a “narrow-based security index” or an index composed of “issuers of securities in a narrow-based security index” only if the index is narrow-based when the securities that are, or reference entities that are issuers of, exempted securities (other than municipal securities) are

[237] *See* CEA sections 5(d)(3), 7 U.S.C. 7(d)(3) (a DCM “shall list on the contract market only contracts that are not readily susceptible to manipulation.”); 5h(f)(3), 7 U.S.C. 7b–3(f)(3) (same requirement for SEFs).

[238] *See* Registration of Foreign Boards of Trade, 75 FR 70973, Nov. 19, 2010.

[239] CFTC oversight in evaluating compliance with the requirement that a swap not be readily susceptible to manipulation for cash settled contracts includes consideration of whether cash settlement is at a price reflecting the underlying cash market, will not be subject to manipulation or distortion, and is based on a cash price series that is reliable, acceptable, publicly available, and timely. *See* 17 CFR Part 40, Appendix A—Guideline No. 1.

[240] Such indexes also would be SBSAs, providing the SEC with antifraud and anti-manipulation authority.

[241] *See* proposed rules 1.3(zzz)(1)(i) and 1.3(aaaa)(1)(i) under the CEA and proposed rules 3a68–1a(a)(2) and 3a68–1b(a)(2) under the Exchange Act; July 2006 Rules, *supra* note 199.

[242] *See* section 3(a)(68)(C) of the Exchange Act, 15 U.S.C. 78c(a)(68)(C) (providing that “[t]he term ‘security-based swap’ does not include any agreement, contract, or transaction that meets the definition of a security-based swap only because such agreement, contract, or transaction references, is based upon, or settles through the transfer, delivery, or receipt of an exempted security under paragraph (12) [of the Exchange Act], as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in paragraph (29) [of the Exchange Act] as in effect on the date of enactment of the Futures Trading Act of 1982), unless such agreement, contract, or transaction is of the character of, or is commonly known in the trade as, a put, call, or other option”).

disregarded. The Commissions believe this approach would result in consistent treatment for indexes regardless of whether they include securities that are, or issuers of securities that are, exempted securities (other than municipal securities) while ensuring that exempted securities (other than municipal securities) and issuers of exempted securities (other than municipal securities) are not included in an index merely to make the index either broad-based or narrow-based under the proposed rules.

Request for Comment

The Commissions request comment on all aspects of proposed rules 1.3(zzz) and 1.3(aaaa) under the CEA and proposed rules 3a68–1a and 3a68–1b under the Exchange Act, as applied to CDS, including the following:

85. Do the proposed criteria for identifying when an index of reference entities constitutes "issuers of securities in a narrow-based security index" and when an index of securities constitutes a "narrow-based security index" effectively encompass the key elements of a narrow-based security index as it pertains to paragraph (A)(ii)(III) (*i.e.,* the third prong) and paragraph (A)(ii)(I) (*i.e.,* the first prong) of the security-based swap definition? Why or why not?

86. Should an index with 9 or fewer non-affiliated issuers of securities or 9 or fewer securities be "narrow-based?" Why or why not?

87. Should an index in which the effective notional amounts allocated to any reference entity or security included in the index comprise more than 30 percent of the index's weighting be "narrow-based"? Why or why not?

88. Should an index in which the effective notional amounts allocated to any 5 non-affiliated reference entities or securities included in the index comprise more than 60 percent of the index's weighting be "narrow-based"? Why or why not?

89. Should an index in which publicly available information is not available for a predominant percentage of reference entities or securities included in the index be "narrow-based" for purposes of index CDS? Why or why not? The Commissions note that the criteria for the public information availability test do not necessarily ensure that there is in fact public information available regarding the relevant entities or securities, or that the criteria act in any way as a substitute for the actual availability of public information; instead, the criteria, taken as a whole, are intended to capture, for purposes of the definition of the term "narrow-based security index" for index CDS, those entities or securities, that on average, are likely to have public information available, and that the relevant index would therefore not be treated as "narrow-based." Do the proposed criteria appropriately achieve this objective? Are the criteria for the public information availability test under the proposed rules appropriate to result in a sufficient likelihood that public information about the component securities or issuers of securities in an index CDS would be available to properly address the regulatory interests of the Federal securities laws? Are the $700 million and $1 billion thresholds discussed above appropriate tests for the likelihood of publicly available information in this context? These thresholds are similar to those in the SEC securities offering reform rules used to determine, in part, whether a particular issuer was a "well-known seasoned issuer," in order to streamline registration requirements under the Securities Act.[243] Are there companies that have less than $700 million in worldwide equity capitalization, or less than $1 billion in outstanding debt (other than asset-backed securities), and that do not otherwise satisfy the public information availability test, that have public information available about them for purposes of determining whether an index CDS that includes such a company as a reference entity or such a security is broad or narrow-based? The Commissions request comment on the appropriate thresholds for determining whether there likely is public information available for purposes of the proposed definition of narrow-based security index and issuers of securities in a narrow-based security index for purposes of index CDS, in particular whether these thresholds should be modified higher or lower, and request empirical data to support the response.

90. Is it appropriate to treat an issuer eligible to rely on rule 12g3–2(b) under the Exchange Act as meeting the public information availability test under the proposed rules? Why or why not? Would such a provision include issuers that otherwise would not satisfy the information condition in the proposed rules? Why or why not? Please provide a detailed explanation and include empirical data to support any suggested modification.

91. With respect to asset-backed securities, is the proposed criterion for meeting the public information availability test, that the asset-backed securities were issued in a transaction registered under the Securities Act and have publicly available distribution reports, the correct approach? Why or why not? Should such a provision explicitly also apply to include asset-backed securities issued by Fannie Mae and Freddie Mac? Why or why not? Please provide a detailed explanation of whether and why such a condition is necessary and include empirical data to support any suggested modification.

92. Should the proposed rules exclude a reference entity or security in the index from the public information availability test, so long as the reference entity or security included in the index represents less than five percent of the index's weighting? Why or why not?

93. Should the proposed rules exclude a reference entity or security in the index from the public information availability test, so long as the reference entities or securities comprising at least 80 percent of the index's weighting satisfy the provisions of those paragraphs? Why or why not?

94. The Commissions are considering whether the public information availability test in proposed rules 1.3(zzz) and 1.3(aaaa) under the CEA and proposed rules 3a68–1a and 3a68–1b under the Exchange Act should apply to an index of issuers of securities or securities that is created and published by a third-party index provider that is not a party to an index CDS and makes publicly available general information about the construction of the index, index rules, components, and predetermined adjustments, and which index is referenced by an index CDS that is offered on or subject to the rules of a DCM or SEF, or by direct access in the U.S. from an FBOT that is registered with the CFTC. How are indexes created by such a third-party index provider and what type of compensation do they receive? What role do parties to a swap or security-based swap play in determining the constituents or index criteria? What type of information does a third-party index provider ensure is publicly available on an ongoing basis about each of the constituent issuers of securities or securities identified in the index and what actions does the third-party index provider take to ensure the accuracy of information about the issuers of securities or securities in any index compiled by such third-party index provider? How would a third-party index provider take steps to ensure that the indexes it creates are composed of issuers of securities or securities for which there likely is public information available? Please provide detailed examples.

95. If the Commissions determine to use, as an alternative to the public

[243] *See supra* note 231.

information availability test in the proposed rules relating to index CDS, the existence of a third-party index provider that is not a party to an index CDS and makes publicly available general information about the construction of the index, index rules, components, and predetermined adjustments, and which index is referenced by an index CDS that is offered on or subject to the rules of a DCM or SEF, or by direct access in the U.S. from an FBOT that is registered with the CFTC, what requirements, if any, should the Commissions impose on the DCM, SEF, or FBOT to ensure that public information likely will be available in this context regarding the issuers of securities or securities in the index? What specified standards, if any, should the Commissions require the DCM, SEF, or FBOT to meet for purposes of the proposed rules?

96. Should index CDS based on an index compiled by a third-party index provider as described in this section be considered a "mixed swap" rather than a swap in order to ensure that the protections of the Federal securities laws apply with respect to index constituents about which public information about the constituent issuers of securities or securities in the index (subject to the de minimis provisions of the proposed rules) may not be available?

97. Are there other criteria that the Commissions should adopt as alternative means of satisfying the public information availability test in the proposed rules? If so, please explain what they are and what requirements the Commissions should impose to ensure the public availability of information regarding issuers of securities or securities in index CDS.

98. Should the proposed rules provide, solely with respect to CDS that may be entered into only between eligible contract participants, that the information availability test could be satisfied if the reference entity or the issuer of the security (i) except in the case of issuing entities of asset-backed securities, provides information to the public or to such eligible contract participant pursuant to rule 144A(d)(4) of the Securities Act; (ii) except in the case of issuing entities of asset-backed securities, financial information is otherwise publicly available about the reference entity or the issuer of the security; or (iii) in the case of asset-backed securities and issuing entities of asset-backed securities, financial information of the type and level included in public distribution reports for similar asset-backed securities about both the issuing entity and such asset-backed securities is publicly available? Why or why not? Please provide a detailed explanation and empirical data, to the extent feasible.

99. Should the proposed rules include additional or other criteria to determine whether an index is "narrow-based" with respect to index CDS? If so, what criteria should be included, and why?

100. Does the proposed treatment of index CDS whereby a payment is contemplated based on the default of a particular entity in the index rather than solely on the value of the index adequately address the Federal regulatory interests under the Federal securities laws and the Commodity Exchange Act?

101. Does the definition of "control" for purposes of identifying whether a reference entity or issuer is affiliated with another entity (ownership of 20 percent or more of an entity's or issuer's equity, or the ability to direct the voting of 20 percent or more of the entity's or issuer's voting equity) appropriately identify when affiliates are in a control relationship for these purposes? Why or why not? Should these thresholds be higher or lower? Please provide supporting data and/or analysis. Should issuing entities of asset-backed securities be considered separate reference entities or issuers for purposes of the proposed criteria? If not, why not? Are there circumstances under which issuing entities of asset-backed securities should not be considered separate reference entities or issuers for purposes of the proposed criteria? Why or why not?

102. Are there other categories or types of CDS that proposed rules 1.3(zzz) and (aaaa) and proposed rules 3a68–1a and 3a68–1b do not address or that require additional clarification regarding their treatment under the Dodd-Frank Act? If so, please provide a detailed description of any such categories or types of CDS, as well as any analysis, supported by empirical data to the extent feasible, of what clarification is necessary.

103. Are there other categories of event-type contracts relating to issuers of securities that require additional clarification regarding their treatment under the Dodd-Frank Act? If so, please provide a detailed explanation of the types of contracts and why the proposed rules should apply to such other event-type contracts.

4. Security Indexes

The Dodd-Frank Act defines the term "index" as "an index or group of securities, including any interest therein or based on the value thereof." [244] The Commissions are proposing guidance as to how to determine when a portfolio of securities is a narrow-based or broad-based security index and the circumstances in which changes to the composition of a security index (including a portfolio of securities) [245] underlying a Title VII instrument would affect the characterization of such Title VII instrument.[246]

In most cases, a security index is designed to reflect the performance of a market or sector by reference to representative securities or interests in securities. There are a number of well-known security indexes established and maintained by recognized index providers currently in the market.[247] The Commissions understand, however, that instead of using these established indexes, market participants may enter into a Title VII instrument where the underlying reference of the Title VII instrument is a portfolio of securities selected by the counterparties or created by a third-party index provider at the behest of one or both counterparties. In some cases, the Title VII instrument may give one or both of the counterparties, either directly or indirectly (*e.g.,* through an investment adviser or through the third-party index provider), discretionary authority to change the composition of the security portfolio, including, for example, by adding or removing securities in the security portfolio on an "at-will" basis during the term of the Title VII instrument.[248] The Commissions believe that where the counterparties, either directly or indirectly (*e.g.,* through an investment adviser or through the third-party index provider), have this discretionary authority to change the

[244] *See* section 3(a)(68)(E) of the Exchange Act, 15 U.S.C. 78c(a)(68)(E).

[245] A "portfolio" of securities could be a group of securities and therefore an "index" for purposes of the Dodd-Frank Act. To the extent that changes are made to the securities underlying the Title VII instrument and each such change is individually confirmed, then those substituted securities would not be part of a security index as defined in the Dodd-Frank Act, and therefore a Title VII instrument on each of those substituted securities would be a security-based swap.

[246] Solely for purposes of the discussion in this section, the terms "security index" and "security portfolio" are intended to include either securities or the issuers of securities.

[247] For instance, the S&P 500® is an index that gauges the large cap U.S. equities market.

[248] Alternatively, counterparties may enter into Title VII instruments where a third-party investment manager selects an initial portfolio of securities and has discretionary authority to change the composition of the security portfolio in accordance with guidelines agreed upon with the counterparties. Such security portfolios would be treated as narrow-based security indexes with Title VII instruments on those security portfolios being security-based swaps.

composition or weighting of securities in a security portfolio, that security portfolio should be treated as a narrow-based security index, and that therefore a Title VII instrument on that security portfolio would be a security-based swap.[249]

The Commissions believe, however, that not all changes that occur to the composition or weighting of a security index underlying a Title VII instrument will always result in that security index being treated as a narrow-based security index. Many security indexes are constructed and maintained by an index provider pursuant to a published methodology.[250] For instance, the various Standard & Poor's security indexes are reconstituted and rebalanced as needed and on a periodic basis pursuant to published index criteria.[251]

In addition, counterparties to a Title VII instrument frequently agree to use as the underlying reference of a Title VII instrument a security index based on predetermined criteria where the security index composition or weighting may change as a result of the occurrence of certain events specified in the Title VII instrument at execution, such as "succession events." Counterparties to a Title VII instrument also may use a predetermined self-executing formula to make other changes to the composition or weighting of a security index underlying a Title VII instrument. In either of these situations, the composition of a security index may change pursuant to predetermined criteria or predetermined self-executing formulas without the Title VII instrument counterparties, their agents, or third-party index providers having any direct or indirect discretionary authority to change the security index.

In general, and by contrast to Title VII instruments in which the counterparties, either directly or indirectly (*e.g.,* through an investment adviser or through the third-party index provider), have the discretion to change the composition or weighting of the referenced security index, where there is an underlying security index for which there are predetermined criteria or a predetermined self-executing formula for adjusting the security index that are not subject to change or modification through the life of the Title VII instrument and that are set forth in the Title VII instrument at execution (regardless of who establishes the criteria or formula), a Title VII instrument on such underlying security index would be on a broad-based or narrow-based security index, depending on the composition and weighting of the underlying security index. Subject to the interpretation discussed below regarding security indexes that may shift from being a narrow-based security index or broad-based security index during the life of an existing Title VII instrument,[252] the characterization of a Title VII instrument based on a security index as either a swap or a security-based swap would depend on the characterization of the security index using the above interpretation.[253]

Request for Comment

104. The Commissions request comment on whether there are additional or other criteria that would be appropriate in determining whether a security index or security portfolio would constitute a narrow-based security index for purposes of the definitions of the terms "swap" and "security-based swap." Please discuss any criteria in detail and provide any supporting data where relevant.

105. What are the ways in which Title VII instruments involving security portfolios are structured, including changes in security portfolio composition?

106. Should "discretionary authority to change" by the counterparties, either directly or indirectly (*e.g.,* through an investment adviser or through the third-party index provider), be a determinative factor for whether a security portfolio should be treated as a narrow-based security index? Why or why not? Are there Title VII instruments where the underlying reference is a security portfolio where counterparties may directly or indirectly (*e.g.,* through an investment manager or the third-party provider) exercise discretionary authority to change the composition of the security portfolio that should not be considered security-based swaps? Why or why not? Please provide a detailed explanation of such Title VII instruments, the means by which, and why, the composition of the underlying security portfolio are established and subsequently changed, and for what purpose such Title VII instruments are used.

107. Should a security index, where changes to the composition are not subject to discretionary authority but instead may be made pursuant to predetermined criteria or a predetermined self-executing formula set forth in the Title VII instrument at execution, be considered either a broad-based security index or a narrow-based security index, depending on its constitution? Why or why not? Are changes pursuant to such predetermined criteria or formulas common? How frequently do such changes occur? What sorts of events trigger such changes? Please provide a detailed explanation and empirical data, to the extent feasible.

108. Are the terms "predetermined criteria" and "predetermined self-executing formula" clear? Why or why not? If not, what alternative or additional guidance should be provided to clarify under what circumstances changes to the composition of a security index underlying a Title VII instrument may be made without being considered "at will" or discretionary changes by the counterparties, either directly or indirectly (*e.g.,* through an investment adviser or through the third-party index provider), that would result in the security index being treated as a narrow-based security index and the Title VII instrument being a security-based swap? Are there specific additional criteria, restrictions, or parameters that should be considered? If so, please provide a detailed explanation regarding such criteria, restrictions, or parameters, including the types of changes that should or should not be permitted.

109. Are there specific methodologies or criteria, agreed to at or prior to the

[249] The Commissions understand that a security portfolio could be labeled as such or could just be an aggregate of individual Title VII instruments documented, for example, under a master agreement or by amending an annex of securities attached to a master trade confirmation. If the security portfolio were created by aggregating individual Title VII instruments, each Title VII instrument would need to be evaluated in accordance with the proposed guidance to determine whether it is a swap or a security-based swap. For the avoidance of doubt, if the counterparties to a Title VII instrument exchanged payments under that Title VII instrument based on a security index that was itself created by aggregating individual security-based swaps, such Title VII instrument would be a security-based swap. *See* discussion *supra* part III.D.

[250] *See, e.g.,* NASDAQ, "NASDAQ–100 Index" ("The NASDAQ–100 Index is calculated under a modified capitalization-weighted methodology. The methodology is expected to retain in general the economic attributes of capitalization-weighting while providing enhanced diversification. To accomplish this, NASDAQ will review the composition of the NASDAQ–100 Index on a quarterly basis and adjust the weightings of Index components using a proprietary algorithm, if certain pre-established weight distribution requirements are not met."), available at *http://dynamic.nasdaq.com/dynamic/nasdaq100_activity.stm*

[251] Information regarding security indexes and their related methodologies may be widely available to the general public or restricted to licensees in the case of proprietary or "private label" security indexes. Both public and private label security indexes are frequently subject to intellectual property protection.

[252] As discussed further below, the Commissions are concerned about the potential use of security indexes to game the narrow-based security index definition.

[253] *See supra* note 249 regarding the aggregation of separate trades.

execution of a Title VII instrument, for changing the composition of an underlying security index, that should be explicitly addressed by the Commissions in providing the proposed guidance regarding security indexes? If so, please provide a detailed explanation of those methodologies or criteria and what additional guidance is necessary.

110. Would restrictions on the frequency of changes to the composition of a security index underlying a Title VII instrument be useful in determining whether the underlying security index should be treated as a narrow-based security index? If so, please provide a detailed explanation of what restrictions should apply and why, as well as empirical data to the extent feasible.

5. Evaluation of Title VII Instruments on Security Indexes That Move From Broad-Based to Narrow-Based or Narrow-Based to Broad-Based

(a) In General

As discussed above, the determination of whether a Title VII instrument is a swap, a security-based swap, or both (*i.e.,* a mixed swap), is made at the execution of the Title VII instrument.[254] If the security index underlying a Title VII instrument migrates from being broad-based to being narrow-based, or vice versa, during the life of a Title VII instrument, the characterization of that Title VII instrument would not change from its initial characterization regardless of whether the Title VII instrument was entered into bilaterally or was executed through a trade on or subject to the rules of a DCM, SEF, FBOT, security-based SEF, or NSE. For example, if two counterparties enter into a swap based on a broad-based security index, and three months into the life of the swap the security index underlying that Title VII instrument migrates from being broad-based to being narrow-based, the Title VII instrument would remain a swap for the duration of its life and would not be recharacterized as a security-based swap.

If the material terms of a Title VII instrument are amended or modified during its life, the Commissions would view the amended or modified Title VII instrument as a new Title VII instrument.[255] As a result, the characteristics of the underlying security index must be reassessed at the time of such an amendment or modification to determine whether the security index has migrated from broad-based to narrow-based or vice versa. If the security index has migrated, then the characterization of the amended or modified Title VII instrument would be determined by evaluating the characterization of the underlying security index at the time the Title VII instrument is amended or modified. Similarly, if a security index has migrated from broad-based to narrow-based or vice versa, any new Title VII instrument based on that security index would be characterized pursuant to an evaluation of the underlying security index at the execution of that new Title VII instrument.

The Commissions are proposing guidance regarding circumstances in which the character of a security index on which a Title VII instrument is based changes according to predetermined criteria or a predetermined self-executing formula set forth in the Title VII instrument (or in a related or other agreement entered into by the counterparties or a third-party index provider to the Title VII instrument) at execution. Where at the time of execution such criteria or such formula would cause the underlying broad-based security index to become or assume the characteristics of a narrow-based security index or vice versa during the duration of the instrument,[256] then the characterization of the Title VII instrument based on such security index would be a mixed swap during the entire life of the Title VII instrument.[257] Although at certain points during the life of the Title VII instrument the underlying security index would be broad-based and at other points the underlying security index would be narrow-based, the Commissions believe that regulating such a Title VII instrument as a mixed swap from the execution of the Title VII instrument and throughout its life reflects the appropriate characterization of a Title VII instrument based on a security index that migrates pursuant to predetermined criteria or a predetermined self-executing formula.

The Commissions believe that this guidance regarding the use of predetermined criteria or a predetermined self-executing formula would prevent potential gaming of the Commissions' guidance regarding security indexes and prevent potential regulatory arbitrage based on the migration of a security index from broad-based to narrow-based or vice versa. In particular, the Commissions note that predetermined criteria and predetermined self-executing formulas can be constructed in ways that take into account the characteristics of a narrow-based security index and prevent a narrow-based security index from becoming broad-based and vice versa.

(b) Title VII Instruments on Security Indexes Traded on Designated Contract Markets, Swap Execution Facilities, Foreign Boards of Trade, Security-Based Swap Execution Facilities, and National Securities Exchanges

The Commissions recognize that security indexes underlying Title VII instruments that are traded on DCMs, SEFs, FBOTs, security-based SEFs, or NSEs raise particular issues if an underlying security index migrates from broad-based to narrow-based or vice versa. The characterization of an exchange-traded Title VII instrument at its execution, as explained above, would not change through the life of the Title VII instrument, regardless of whether the underlying security index migrates from broad-based to narrow-based or vice versa. Accordingly, a market participant who enters into a swap on a broad-based security index traded on or subject to the rules of a DCM, SEF or FBOT that migrates from broad-based to narrow-based may hold that position until the swap's expiration without any change in regulatory responsibilities, requirements, or obligations, and

[254] *See* discussion *supra* part III.A.

[255] For example, if, on its effective date, a Title VII instrument tracks the performance of an index of 12 securities but is amended during its term to track the performance of only 8 of those 12 securities, the Commissions would view the amended or modified Title VII instrument as a new Title VII instrument. Conversely, if, on its effective date, a Title VII instrument tracks the performance of an index of 12 securities but is amended during its term to reflect the replacement of a departing "key person" of a hedge fund that is a counterparty to the Title VII instrument with a new "key person," the Commissions would not view the amended or modified Title VII instrument as a new Title VII instrument because the amendment or modification is not to a material term of the Title VII instrument. Because it would be a new Title VII instrument, any regulatory requirements regarding new Title VII instruments would apply.

[256] Thus, for example, if a predetermined self-executing formula agreed to by the counterparties of a Title VII instrument at or prior to the execution of the Title VII instrument provided that the security index underlying the Title VII instrument would decrease from 20 to 5 securities after six months, such that the security index would become narrow-based as a result of the reduced number of securities, then the Title VII instrument would be a mixed swap at its execution. The characterization of the Title VII instrument as a mixed swap would not change during the life of the Title VII instrument.

[257] As discussed above in part III.G.4, to the extent a Title VII instrument permits "at will" substitution of an underlying security index, however, as opposed to the use of predetermined criteria or a predetermined self-executing formula, the Title VII instrument would be a security-based swap at its execution and throughout its life regardless of whether the underlying security index was narrow-based at the execution of the Title VII instrument.

similarly a market participant who enters into a security-based swap on a narrow-based security index traded on a security-based SEF or NSE may hold that position until the security-based swap's expiration without any change in regulatory responsibilities, requirements, or obligations.

However, in the absence of any action by the Commissions, if the market participant wants to offset the swap or enter into a new swap on the DCM, SEF or FBOT where the underlying security index has migrated from broad-based to narrow-based, or to offset the security-based swap or enter into a new security-based swap on a security-based SEF or NSE where the underlying security index has migrated from narrow-based to broad-based, the participant would be prohibited from doing so. That is because swaps may trade only on DCMs, SEFs, and FBOTs, and security-based swaps may trade only on registered NSEs and security-based SEFs.[258] The Commissions believe it is important to address how to treat Title VII instruments traded on trading platforms where the underlying security index migrates from broad-based to narrow-based or narrow-based to broad-based so that market participants will know where such Title VII instruments may be traded and can avoid potential disruption of their ability to offset or enter into new Title VII instruments on trading platforms when such migration occurs. The Commissions are proposing rules accordingly.[259]

Congress and the Commissions addressed a similar issue in the context of security futures, where the security index on which a future is based may migrate from broad-based to narrow-based or vice versa. Congress provided in the definition of "narrow-based security index" in both the CEA and the Exchange Act[260] for a tolerance period ensuring that, under certain conditions, a futures contract on a broad-based security index traded on a DCM may continue to trade, even when the index temporarily assumes characteristics that would render it a narrow-based security index under the statutory definition.[261] In general, an index is subject to this tolerance period, and therefore is not a narrow-based security index, if: (i) a futures contract on the index traded on a DCM for at least 30 days as a futures contract on a broad-based security index before the index assumed the characteristics of a narrow-based security index and (ii) the index does not retain the characteristics of a narrow-based security index for more than 45 business days over 3 consecutive calendar months. Pursuant to these statutory provisions, if the index becomes narrow-based for more than 45 business days over 3 consecutive calendar months, the index is excluded from the definition of the term "narrow-based security index" for the following 3 calendar months as a grace period.

The Commissions believe a similar tolerance period should apply to swaps traded on DCMs, SEFs, and FBOTs and security-based swaps traded on security-based SEFs and NSEs. Accordingly, the Commissions are proposing rules providing for tolerance periods for swaps that are traded on DCMs, SEFs, or FBOTs and for security-based swaps traded on security-based SEFs and NSEs.

Under paragraph (2)(i)(A) of proposed rule 1.3(yyy) under the CEA and paragraph (b)(1)(i) of proposed rule 3a68–3 under the Exchange Act, to be subject to the tolerance period, a security index underlying a swap executed on or subject to the rules of a DCM, SEF, or FBOT must not have been a narrow-based security index[262] during the first 30 days of trading.[263] If the index becomes narrow-based during the first 30 days of trading, paragraph (2)(i)(B) of proposed rule 1.3(yyy) under the CEA and paragraph (b)(1)(ii) of proposed rule 3a68–3 under the Exchange Act provide that the index must not have been a narrow-based security index during every trading day of the 6 full calendar months preceding a date no earlier than 30 days prior to the commencement of trading of a swap on such index.[264] If either of these alternatives are met, paragraph (2)(ii) of proposed rule 1.3(yyy) under the CEA and paragraph (b)(2) of proposed rule 3a68–3 under the Exchange Act provide that the index will not be a narrow-based security index if it has been a narrow-based security index for no more than 45 business days over 3 consecutive calendar months. Paragraph (2) of proposed rule 1.3(yyy) under the CEA and paragraph (b) of proposed rule 3a68–3 under the Exchange Act apply solely for purposes of swaps traded on or subject to the rules of a DCM, SEF, or FBOT.

Similarly, paragraph (3) of proposed rule 1.3(yyy) under the CEA and paragraph (c) of proposed rule 3a68–3 under the Exchange Act provide a tolerance period for security-based swaps traded on security-based SEFs or NSEs. Under paragraph (3)(i)(A) of proposed rule 1.3(yyy) under the CEA and paragraph (c)(1)(i) of proposed rule 3a68–3 under the Exchange Act, to be subject to the tolerance period, a security index underlying a security-based swap executed on a security-based SEF or NSE must have been a narrow-based security index during the first 30 days of trading. If the index becomes broad-based during the first 30 days of trading, paragraph (3)(i)(B) of proposed rule 1.3(yyy) under the CEA and paragraph (c)(1)(ii) of proposed rule 3a68–3 under the Exchange Act provide that the index must have been a non-narrow-based security index during every trading day of the 6 full calendar months preceding a date no earlier than 30 days prior to the commencement of trading of a security-based swap on such index. If either of these alternatives are met, paragraph (3)(ii) of proposed rule 1.3(yyy) under the CEA and paragraph (c)(2) of proposed rule 3a68–3 under the Exchange Act provide that the index will be a narrow-based security index if it has been a security index that is not narrow-based for no more than 45 business days over 3 consecutive

[258] If a swap were based on a security index that migrated from broad-based to narrow-based, a DCM, SEF, or FBOT could no longer offer the Title VII instrument because it would be a security-based swap. Similarly, if a security-based swap were based on a security index that migrated from narrow-based to broad-based, a security-based SEF or NSE could no longer offer the Title VII instrument because it would be a swap.

[259] The proposed rules apply only to the particular Title VII instrument that is traded on or subject to the rules of a DCM, SEF, FBOT, security-based SEF, or NSE. To the extent that a particular Title VII instrument is not traded on such a trading platform (even if another Title VII instrument of the same class or type is traded on such a trading platform) the proposed rules would not apply to that particular Title VII instrument.

[260] CEA section 1a(35)(B)(iii), 7 U.S.C. 1a(35)(B)(iii); section 3(a)(55)(C)(iii) of the Exchange Act, 15 U.S.C. 78c(a)(55)(C)(iii).

[261] By joint rules, the Commissions have provided that "[w]hen a contract of sale for future delivery on a security index is traded on or subject to the rules of a foreign board of trade, such index shall not be a narrow-based security index if it would not be a narrow-based security index if a futures contract on such index were traded on a designated contract market * * *." *See* CFTC rule 41.13, 17 CFR 41.13, and rule 3a55–3 under the Exchange Act, 17 CFR 240.3a55–3. Accordingly, the statutory tolerance period rules applicable to futures on security indexes traded on DCMs apply to futures traded on FBOTs as well.

[262] For purposes of the proposed rules, the term "narrow-based security index" shall also mean "issuers of securities in a narrow-based security index." *See supra* part III.G.3(b) (discussing the proposed rules defining "issuers of securities in a narrow-based security index").

[263] This provision is consistent with the provisions of the CEA and the Exchange Act applicable to futures contracts on security indexes. CEA section 1a(35)(B)(iii)(I), 7 U.S.C. 1a(35)(B)(iii)(I); section 3(a)(55)(C)(iii)(I) of the Exchange Act, 15 U.S.C. 78c(a)(55)(C)(iii)(I).

[264] This alternative test is the same as the alternative test applicable to futures contracts in CEA rule 41.12, 17 CFR 41.12 and rule 3a55–2 under the Exchange Act, 17 CFR 240.3a55–2.

calendar months.[265] Paragraph (3) of proposed rule 1.3(yyy) under the CEA and paragraph (c) of proposed rule 3a68–3 under the Exchange Act apply solely for purposes of security-based swaps traded on security-based SEFs or NSEs.

The Commissions are proposing that, once the tolerance period under the proposed rules has ended, there would be a grace period during which a Title VII instrument based on a security index that has migrated from broad-based to narrow-based or vice versa would be able to trade on the platform on which Title VII instruments based on such security index were trading before the security index migrated and can also, during such period, be cleared. Paragraph (4)(i) of proposed rule 1.3(yyy) under the CEA and paragraph (d)(1) of proposed rule3a68–3 under the Exchange Act would provide for an additional 3-month grace period applicable to a security index that becomes narrow-based for more than 45 business days over 3 consecutive calendar months, solely with respect to swaps that are traded on or subject to the rules of DCMs, SEFs, or FBOTs. During the grace period, such an index would not be considered a narrow-based security index. Paragraph (4)(ii) of proposed rule 1.3(yyy) under the CEA and paragraph (d)(2) of proposed rule3a68–3 under the Exchange Act would apply the same grace period to a security-based swap on a security index that becomes broad-based for more than 45 business days over 3 consecutive calendar months, solely with respect to security-based swaps that are traded on a security-based SEF or NSE. During the grace period, such an index would not be considered a broad-based security index.[266] As a result, this proposed rule would provide sufficient time for the migrated Title VII instrument to satisfy listing and clearing requirements applicable to swaps or security-based swaps, as appropriate.

There would be no overlap between the tolerance and the grace periods under the proposed rules and no "re-triggering" of the tolerance period. For example, if a security index becomes narrow-based for more than 45 business days over 3 consecutive calendar months, solely with respect to swaps that are traded on or subject to the rules of DCMs, SEFs, or FBOTs, but as a result of the proposed rules is not considered a narrow-based security index during the grace period, the tolerance period provisions would not apply, even if the security-index migrated temporarily during the grace period. After the grace period has ended, a security index would need to satisfy anew the requirements under the proposed rules regarding the tolerance period in order to trigger a new tolerance period.

The Commissions note that the proposed rules would not result in the recharacterization of any outstanding Title VII instruments. In addition, the proposed tolerance and grace periods would apply only to Title VII instruments that are traded on or subject to the rules of DCMs, SEFs, FBOTs, security-based SEFs, and NSEs.

Request for Comment

The Commissions request comment on all aspects of proposed rules 1.3(yyy) under the CEA and proposed rule 3a68–3 under the Exchange Act, including the following:

111. The Commissions request comment regarding whether the term "narrow-based security index" as defined in the CEA and the Exchange Act[267] requires further definition solely in the context of Title VII instruments.

112. Are there particular types of Title VII instruments that require additional guidance as to how the narrow-based security index definition applies? If so, which types of Title VII instruments? How should the definition apply to them? Please provide a detailed explanation of such Title VII instruments and the additional guidance that would be appropriate.

113. Does the proposed guidance effectively address security indexes that migrate from broad-based to narrow-based and vice versa? Why or why not? If not, what additional or alternative requirements would be appropriate, and why?

114. Will the proposed limitations regarding the use of predetermined criteria or predetermined self-executing formulas for Title VII instruments effectively prevent gaming of the proposed rules and potential regulatory arbitrage based on the migration of a security index or security portfolio from broad-based to narrow-based or vice versa? Why or why not? If not, please provide a detailed explanation of why not, and what additional or alternative limitations would do so.

115. Should the standard pursuant to which a Title VII instrument would be a mixed swap during the entire life of the Title VII instrument require instead that the predetermined criteria or predetermined self-executing formula be constructed in such a manner that a broad-based security index or security portfolio would be reasonably likely to become or assume the characteristics of a narrow-based security index or security portfolio, or vice versa? Why or why not? Are there additional or alternative standards that should be used in determining when a Title VII instrument would be a mixed swap during the entire life of the Title VII instrument? If so, please provide a detailed explanation of such standards and why they would be effective.

116. Do the proposed tolerance period rules appropriately address security indexes that temporarily change from broad-based to narrow-based, and from narrow-based to broad-based, in the context of Title VII instruments that are executed on or subject to the rules of a DCM, SEF, FBOT, security-based SEF, or NSE? Why or why not? If not, how should the proposed tolerance period rules be modified?

117. Should the "grace period" applicable to Title VII instruments executed on or subject to the rules of a DCM, SEF, FBOT, security-based SEF, or NSE regarding a security index that becomes narrow-based or broad-based, respectively, for more than 45 business days over 3 consecutive calendar months be modified? Why or why not? If so, what modifications should be made?

118. What would be the impact of the proposed rules on market participants with open swap or security-based swap positions if the security index underlying a swap were to become narrow-based or if the security index underlying a security-based swap were to become broad-based? Should market participants be allowed to liquidate their swaps or security-based swaps prior to expiration but after the grace period? If so, how would the listing market restrict trading for liquidation only?

H. Method of Settlement of Index CDS

The method that the parties have chosen or use to settle an index CDS following the occurrence of a credit event under such index CDS also can affect whether such index CDS would be a swap, a security-based swap, or both (*i.e.,* a mixed swap). The Commissions believe that if an index CDS that is not based on a narrow-based

[265] These provisions are consistent with the parallel provisions in the CEA and the Exchange Act applicable to futures contracts on security indexes traded on DCMs. CEA section 1a(35)(B)(iii)(II), 7 U.S.C. 1a(35)(B)(iii)(II); section 3(a)(55)(C)(iii)(II) of the Exchange Act, 15 U.S.C. 78c(a)(55)(C)(iii)(II).

[266] These provisions are consistent with the parallel provisions in the CEA and the Exchange Act applicable to futures contracts on security indexes traded on DCMs. *See* CEA section 1a(35)(D), 7 U.S.C. 1a(35)(D); section 3(a)(55)(E) of the Exchange Act, 15 U.S.C. 78c(a)(55)(E).

[267] CEA sections 1a(35)(A) and (B), 7 U.S.C. 1a(35)(A) and (B); section 3(a)(55)(B) and (C) of the Exchange Act, 15 U.S.C. 78c(a)(55)(B) and (C).

security index under the Commissions' proposed rules includes a mandatory physical settlement provision that would require the delivery of, and therefore the purchase and sale of, a non-exempted security [268] or a loan in the event of a credit event, such an index CDS would be a mixed swap.[269] Conversely, the Commissions believe that if an index CDS that is not based on a narrow-based security index under the Commissions' proposed rules includes a mandatory cash settlement [270] provision, such index CDS would be a swap, and not a security-based swap or a mixed swap, even if the cash settlement were based on the value of a non-exempted security or a loan.

The Commissions believe that an index CDS that is not based on a narrow-based security index under the Commissions' proposed rules and that provides for cash settlement in accordance with the 2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement Supplement to the 2003 Definitions (the "Auction Supplement") or with the 2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement CDS Protocol ("Big Bang Protocol") [271] would be a swap, and would not be considered a security-based swap or a mixed swap solely because the determination of the cash price to be paid is established through a securities or loan auction.[272] In 2009, auction settlement, rather than physical settlement, became the default method of settlement for, among other types of CDS, index CDS on corporate issuers of securities.[273] The amount of the cash settlement is determined through an auction triggered by the occurrence of a credit event.[274] The Auction Supplement "hard wired" the mechanics of credit event auctions into the 2003 Definitions.[275] The Commissions understand that the credit event auction process that is part of the ISDA terms works as follows:

Following the occurrence of a credit event under a CDS, a determinations committee ("DC") established by ISDA, following a request by any party to a credit derivatives transaction that is subject to the Big Bang Protocol or Auction Supplement, will determine, among other matters: (i) Whether and when a credit event occurred; (ii) whether or not to hold an auction to enable market participants to settle those of their credit derivatives transactions covered by the auction; (iii) the list of deliverable obligations of the relevant reference entity; and (iv) the necessary auction specific terms. The credit event auction takes place in two parts. In the first part of the auction, dealers submit physical settlement requests, which are requests to buy or sell any of the deliverable obligations (based on the dealer's needs and those of its counterparties), and an initial market midpoint price is created based on dealers' initial bids and offers. Following the establishment of the initial market midpoint, the physical settlement requests are then calculated to determine the amount of open interest.

The aggregate amount of open interest is the basis for the second part of the auction. In the second part of the auction, dealers and investors can determine whether to submit limit orders and the levels of such limit orders. The limit orders, which are irrevocable, have a firm price in addition to size and whether it is a buy or sell order. The auction is conducted as a "dutch" auction, in which the open buy interests and open sell interests are matched.[276] The final price of the auction is the last limit order used to match against the open interest. The final price in the auction is the cash price used for purposes of calculating the settlement payments in respect of the orders to buy and sell the deliverable obligations and it is also used to determine the cash settlement payment under the CDS.

I. Security-Based Swaps as Securities Under the Exchange Act and Securities Act

Pursuant to the Dodd-Frank Act, a security-based swap is defined as a "security" under the Exchange Act [277] and Securities Act.[278] As a result, security-based swaps are subject to the Exchange Act and the Securities Act and the rules and regulations promulgated thereunder.[279] To the

[268] The Commissions note that section 3(a)(68)(C) of the Exchange Act, 15 U.S.C. 78c(a)(68)(C), provides that "[t]he term "security-based swap" does not include any agreement, contract, or transaction that meets the definition of a security-based swap only because such agreement, contract, or transaction references, is based upon, or settles through the transfer, delivery, or receipt of an exempted security under paragraph (12) [of the Exchange Act], as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in paragraph (29) [of the Exchange Act] as in effect on the date of enactment of the Futures Trading Act of 1982), unless such agreement, contract, or transaction is of the character of, or is commonly known in the trade as, a put, call, or other option."

[269] The Commissions' views as to the legal basis for such a conclusion differ. The SEC also notes that there must either be an effective registration statement covering the transaction or an exemption under the Securities Act would need to be available for such physical delivery of securities and compliance issues under the Exchange Act would also need to be considered.

[270] The Commissions are aware that the 2003 Definitions *supra* note 35, include "Cash Settlement" as a defined term and that such "Settlement Method" (also a defined term in the 2003 Definitions) works differently than auction settlement pursuant to the "Big Bang Protocol" or "Auction Supplement" (each as defined below). The Commissions' use of the term "cash settlement" in this section includes "Cash Settlement," as defined in the 2003 Definitions, and auction settlement, as described in the "Big Bang Protocol" or "Auction Supplement."

[271] *See* Int'l Swaps and Derivatives Ass'n, Inc., "2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement CDS Protocol," available at *http://www.isda.org/bigbangprot/docs/Big-Bang-Protocol.pdf.*

[272] The possibility that such index CDS may, in fact, be physically settled if an auction is not held or if the auction fails would not affect the characterization of the index CDS.

[273] The Commissions understand that the Big Bang Protocol is followed for index CDS involving corporate debt obligations but is not followed for index CDS based on asset-backed securities, loan-only CDS, and certain other types of CDS contracts. To the extent that such other index CDS contain auction procedures similar to the auction procedures for corporate debt to establish the cash price to be paid, the Commissions also would not consider such other index CDS that are not based on narrow-based security indexes under the Commissions' proposed rules to be mixed swaps.

[274] The Commissions understand that other conditions may need to be satisfied as well for an auction to be held.

[275] *See supra* note 35.

[276] The second part of the credit event auction process involves offers and sales of securities that must be made in compliance with the provisions of the Securities Act and the Exchange Act. First, the submission of a physical settlement request constitutes an offer by the counterparty to either buy or sell any one of the deliverable obligations in the auction. Second, the submission of the irrevocable limit orders by dealers or investors are sales or purchases by such persons at the time of submission of the irrevocable limit order. Through the auction mechanism, where the open interest (which represents physical settlement requests) is matched with limit orders, buyers and sellers are matched. Finally, following the auction and determination of the final price, the counterparty who has submitted the physical delivery request decides which of the deliverable obligations will be delivered to satisfy the limit order in exchange for the final price. The sale of the securities in the auction occurs at the time the limit order is submitted, even though the identification of the specific deliverable obligation does not occur until the auction is completed.

[277] *See* section 761(a)(2) of the Dodd-Frank Act (inserting the term "security-based swap" into the definition of "security" in section 3a(10) of the Exchange Act, 15 U.S.C. 78c(a)(10)).

[278] *See* section 768(a)(1) of the Dodd-Frank Act (inserting the term "security-based swap" into the definition of "security" in section 2(a)(1) of the Securities Act, 15 U.S.C. 77b(a)(1)).

[279] Sections 761(a)(3) and (4) of the Dodd-Frank Act amend sections 3(a)(13) and (14) of the Exchange Act, 15 U.S.C. 78c(a)(13) and (14), and section 768(a)(3) of the Dodd-Frank Act adds section 2(a)(18) to the Securities Act, 15 U.S.C. 77b(a)(18), to provide that the terms "purchase" and "sale" of a security-based swap shall mean the "the execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing of rights or obligations under, a security-based swap, as the context may require."

extent that security-based swaps differ from more traditional securities products, however, the SEC is soliciting comment on whether additional guidance may be necessary regarding the application of certain provisions of the Exchange Act and the Securities Act, and the rules and regulations promulgated thereunder, to security-based swaps.

Request for Comment

119. Are there Exchange Act or Securities Act provisions, or rules and regulations promulgated thereunder, that contemplate application to cash market securities products or other securities products for which additional guidance may be necessary when applied to security-based swaps? If so, which provisions, and why? Please provide detailed analysis and empirical data, to the extent feasible.

120. What additional guidance or modifications would be necessary to any such provisions in order to address the application of these provisions to security-based swaps while still achieving the regulatory purposes of those provisions?

IV. Mixed Swaps

A. Scope of the Category of Mixed Swap

The category of mixed swap is described, in both the definition of the term "security-based swap" in the Exchange Act and the definition of the term "swap" in the CEA, 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 (other than an event described in subparagraph (A)(ii)(III) [of section 3(a)(68) of the Exchange Act]).[280]

A mixed swap, therefore, is both a security-based swap and a swap.[281]

The Commissions believe that the scope of mixed swaps is, and is intended to be, narrow. Title VII establishes robust and largely parallel regulatory regimes for both swaps and security-based swaps and directs the Commissions to jointly prescribe such regulations regarding mixed swaps as may be necessary to carry out the purposes of the Dodd-Frank Act.[282] More generally, the Commissions believe the category of mixed swap was designed so that there would be no gaps in the regulation of swaps and security-based swaps. Therefore, in light of the statutory scheme created by the Dodd-Frank Act for swaps and security-based swaps, the Commissions believe the category of mixed swap covers only a small subset of Title VII instruments.[283]

For example, a Title VII instrument in which the underlying references are the value of an oil corporation stock and the price of oil would be a mixed swap. Similarly, a Title VII instrument in which the underlying reference is a portfolio of both securities (assuming the portfolio is not an index or, if it is an index, that the index is narrow-based) and commodities would be a mixed swap. Mixed swaps also would include certain Title VII instruments called "best of" or "out performance" swaps that require a payment based on the higher of the performance of a security and a commodity (other than a security).[284] As discussed elsewhere in this release, the Commissions also believe that certain Title VII instruments may be mixed swaps if they meet specified conditions.

The Commissions also believe that the use of certain market standard agreements in the documentation of Title VII instruments should not in and of itself transform a Title VII instrument into a mixed swap. For example, many instruments are documented by incorporating by reference market standard agreements. Such agreements typically set out the basis of establishing a trading relationship with another party but are not, taken separately, a swap or security-based swap. These agreements also include termination and default events relating to one or both of the counterparties; such counterparties may or may not be entities that issue securities.[285] The Commissions believe that the term "any agreement * * * based on * * * the occurrence of an event relating to a single issuer of a security," as provided in the definition of the term "security-based swap," was not intended to include such termination and default events relating to counterparties included in standard agreements that are incorporated by reference into a Title VII instrument.[286] Therefore, an instrument would not be simultaneously a swap and a security-based swap (and thus not a mixed swap) simply by virtue of having incorporated by reference a standard agreement, including default and termination events relating to counterparties to the Title VII instrument.

Request for Comment

The Commissions request comment on the following:

121. Are there other examples of Title VII instruments that should, or should not, be included within the mixed swap category?

122. How frequently, and for what purposes, do market participants use mixed swaps?

123. Can, and should, the economic goals of mixed swaps be accomplished using a combination of separate Title VII instruments, none of which would need to constitute a mixed swap? What problems, if any, would arise from the "disaggregation" of mixed swaps?

B. Regulation of Mixed Swaps

1. Introduction

Paragraph (a) of proposed rule 1.9 under the CEA and proposed rule 3a68–4 under the Exchange Act would define a "mixed swap" in the same manner as the term is defined in both the CEA and the Exchange Act. The Commissions are proposing two rules to address the regulation of mixed swaps. First, paragraph (b) of proposed rule 1.9 under the CEA and proposed rule 3a68–4 under the Exchange Act would provide a regulatory framework with which parties to bilateral uncleared mixed swaps (*i.e.,* mixed swaps that are neither executed on or subject to the rules of a DCM, NSE, SEF, security-based SEF, or FBOT nor cleared through a DCO or clearing agency), as to which at least

[280] Section 3(a)(68)(D) of the Exchange Act, 15 U.S.C. 78c(a)(68)(D); CEA section 1a(47)(D), 7 U.S.C. 1a(47)(D).

[281] *Id.* The exclusion from the definition of the term "swap" for security-based swaps does not include security-based swaps that are mixed swaps. *See* CEA section 1a(47)(B)(x), 7 U.S.C. 1a(47)(B)(x).

[282] *See* section 712(a)(8) of the Dodd-Frank Act.

[283] *See* Morgan Stanley Letter (expressing the view that "the universe of mixed swaps should be relatively small"); Letter from Timothy W. Cameron, Esq., Managing Director, Asset Management Group, Securities Industry and Financial Markets Association ("SIFMA Letter") (suggesting that the scope of products included in the mixed swap category should be limited to "avoid unnecessary and duplicative regulation").

[284] *See* Cleary Letter (providing as examples of mixed swaps, "a swap based on the out-performance of gold, oil or another commodity relative to a security or narrow-based security index," "a security-based swap with knock-out/knock-in events tied to the value of gold, oil or another commodity," and "[s]waps on indices or baskets that include narrow-based security index and physical commodity components"); Deutsche Bank Letter (indicating that "best-of" swaps should be treated as mixed swaps); Morgan Stanley Letter ("An example of a mixed swap might be a contract under which one party takes long exposure to the common stock of a U.S. corporation while simultaneously taking short exposure to the price of gold.").

[285] Those standard events include inter alia bankruptcy, breach of agreement, cross default to other indebtedness, and misrepresentations.

[286] *See* section 3(a)(68)(A)(ii)(III) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(III).

one of the parties is dually registered with both Commissions, would need to comply. Second, paragraph (c) of the proposed rules would establish a process for persons to request that the Commissions issue a joint order permitting such persons (and any other person or persons that subsequently lists, trades, or clears that class of mixed swap) [287] to comply, as to parallel provisions [288] only, with specified parallel provisions of either the CEA or the Exchange Act, and related rules and regulations (collectively "specified parallel provisions"), instead of being required to comply with parallel provisions of both the CEA and the Exchange Act.

2. Bilateral Uncleared Mixed Swaps Entered Into by Dually-Registered Dealers or Major Participants

Swap dealers and major swap participants will be comprehensively regulated by the CFTC and security-based swap dealers and major security-based swap participants will be comprehensively regulated by the SEC.[289] The Commissions recognize that there may be differences in the requirements applicable to swap dealers and security-based swap dealers, or major swap participants and major security-based swap participants, such that dually-registered market participants may be subject to potentially conflicting or duplicative regulatory requirements when they engage in mixed swap transactions. In order to assist market participants in addressing such potentially conflicting or duplicative requirements, the Commissions are proposing rules that would permit dually-registered swap dealers and security-based swap dealers and dually-registered major swap participants and major security-based swap participants to comply with an alternative regulatory regime when they enter into certain mixed swaps under specified circumstances.

Accordingly, paragraph (b) of proposed rule 1.9 under the CEA and rule 3a68–4 under the Exchange Act would provide that a bilateral uncleared mixed swap,[290] where at least one party 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, would be subject to all applicable provisions of the Federal securities laws (and SEC rules and regulations promulgated thereunder). The proposed rules also would provide that such mixed swaps would be subject to only the following provisions of the CEA (and CFTC rules and regulations promulgated thereunder):

- Examinations and information sharing: CEA sections 4s(f) and 8; [291]
- Enforcement: CEA sections 2(a)(1)(B), 4(b), 4b, 4c, 6(c), 6(d), 6c, 6d, 9, 13(a), 13(b) and 23; [292]
- Reporting to an SDR: CEA section 4r; [293]
- Real-time reporting: CEA section 2(a)(13); [294]
- Capital: CEA section 4s(e); [295] and
- Position Limits: CEA section 4a.[296]

The Commissions believe that paragraph (b) of the proposed rules would address potentially conflicting or duplicative regulatory requirements for dually-registered dealers and major participants that are subject to regulation by both the CFTC and the SEC, while requiring dual registrants to comply with the regulatory requirements the Commissions believe are necessary to provide sufficient regulatory oversight for mixed swaps transactions entered into by such dual registrants. The CFTC also believes that paragraph (b) of the proposed rules would provide clarity to dually-registered dealers and major participants, who are subject to regulation by both the CFTC and the SEC, as to the requirements of each Commission that will apply to their bilateral uncleared mixed swaps.

Request for Comment

124. The Commissions request comment generally on the foregoing proposed rules regarding the regulation of mixed swaps entered into by dually-registered swap or security-based swap dealers and major swap or security-based swap participants.

125. Does paragraph (b) of proposed rule 1.9 under the CEA and proposed rule 3a68–4 under the Exchange Act provide effective regulatory treatment for bilateral uncleared mixed swaps entered into by persons that are dually registered both as swap dealers or major swap participants with the CFTC and security-based swap dealers or major security-based swap participants with the SEC? If not, how should the proposed regulatory treatment be modified?

126. Are the enumerated sections of the CEA (and the regulations promulgated thereunder) that are reserved in paragraph (b) appropriate? Are there sections that should be withdrawn? Why or why not? Are there sections that should be added? Why or why not?

3. Regulatory Treatment for Other Mixed Swaps

Because mixed swaps are both security-based swaps and swaps,[297] 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 (or class thereof) would be required to comply with all the statutory provisions in the CEA and the Exchange Act (including all the rules and regulations thereunder) that were added or amended by Title VII with respect to swaps or security-based swaps.[298] Such dual regulation may not be appropriate in every instance and may result in potentially conflicting or duplicative regulatory requirements. However, before the Commissions can determine the appropriate regulatory treatment for mixed swaps (other than the treatment discussed above), the Commissions would need to understand better the nature of the mixed swaps that parties want to trade. Paragraph (c) of proposed rule 1.9 under the CEA and proposed

[287] All references to Title VII instruments in this part IV and in part VI shall include a class of such Title VII instruments as well. For example, a "class" of Title VII instrument would include instruments that are of similar character and provide substantially similar rights and privileges.

[288] For purposes of paragraph (c) of proposed rule 1.9 under the CEA and rule 3a68–4 under the Exchange Act, "parallel provisions" means comparable provisions of the CEA and the Exchange Act that were added or amended by Title VII with respect to security-based swaps and swaps, and the rules and regulations thereunder.

[289] Section 712(a)(7)(A) of the Dodd-Frank Act requires the Commissions to treat functionally or economically similar entities in a similar manner.

[290] For purposes of the proposed rules, a "bilateral uncleared mixed swap" would be a mixed swap that: (i) Is neither executed on nor subject to the rules of a DCM, NSE, SEF, security-based SEF, or FBOT; and (ii) will not be submitted to a DCO or registered or exempt clearing agency to be cleared. To the extent that a mixed swap is subject to the mandatory clearing requirement (*see* CEA section 2(h)(1)(A), 7 U.S.C. 2(h)(1)(A), and section 3C(a)(1) of the Exchange Act) (and where a counterparty is not eligible to rely on the end-user exclusion from mandatory clearing requirement (*see* CEA section 2(h)(7), 7 U.S.C. 2(h)(7), and section 3C(g) of the Exchange Act)), this alternative regulatory treatment would not be available.

[291] 7 U.S.C. 6s(f) and 12, respectively.

[292] 7 U.S.C. 2(a)(1)(B), 6(b), 6b, 6c, 9 and 15, 13b, 13a–1, 13a–2, 13, 13c(a), 13c(b), and 26, respectively.

[293] 7 U.S.C. 6r.

[294] 7 U.S.C. 2(a)(13).

[295] 7 U.S.C. 6s(e).

[296] 7 U.S.C. 6a.

[297] *See supra* note 10.

[298] Because security-based swaps are also securities, compliance with the Federal securities laws and rules and regulations thereunder (in addition to the provisions of the Dodd-Frank Act and the rules and regulations thereunder) would also be required. To the extent one of the Commissions has exemptive authority with respect to other provisions of the CEA or the Federal securities laws and the rules and regulations thereunder, persons may submit separate exemptive requests or rulemaking petitions regarding those provisions to the relevant Commission.

rule 3a68–4 under the Exchange Act would establish a process pursuant to which any person who desires or intends to list, trade, or clear a mixed swap (or class thereof) that is not subject to the provisions of paragraph (b) (*i.e.,* bilateral uncleared mixed swaps entered into by at least one dual registrant) may request the Commissions to publicly issue a joint order permitting such person (and any other person or persons that subsequently lists, trades, or clears that class of mixed swap) to comply, as to parallel provisions only, with the specified parallel provisions, instead of being required to comply with parallel provisions of both the CEA and the Exchange Act.[299]

Paragraph (c) of the proposed rules would further provide that a person submitting such a request to the Commissions must provide the Commissions with:

(i) All material information regarding the terms of the specified, or specified class of, mixed swap;

(ii) the economic characteristics and purpose of the specified, or specified class of, mixed swap;

(iii) the specified parallel provisions, and the reasons the person believes such specified parallel provisions would be appropriate for the mixed swap (or class thereof);

(iv) an analysis of (1) the nature and purposes of the parallel provisions that are the subject of the request; (2) the comparability of such parallel provisions; and (3) the extent of any conflicts or differences between such parallel provisions; and

(v) such other information as may be requested by either of the Commissions.

This provision is intended to provide the Commissions with sufficient information regarding the mixed swap (or class thereof) and the proposed regulatory approach to make an informed determination regarding the appropriate regulatory treatment of the mixed swap (or class thereof).

Paragraph (c) of the proposed rules also would allow a person to withdraw a request regarding the regulation of a mixed swap at any time prior to the issuance of a joint order by the Commissions. This provision is intended to permit persons to withdraw requests that they no longer need. This, in turn, would save the Commissions time and staff resources.

Paragraph (c) would further provide that in response to a request pursuant to the proposed rules, the Commissions may jointly issue an order, after public notice and opportunity for comment, permitting the requesting person (and any other person or persons that subsequently lists, trades, or clears that class of mixed swap) to comply, as to parallel provisions only, with the specified parallel provisions (or another subset of the parallel provisions that are the subject of the request, as the Commissions determine is appropriate), instead of being required to comply with parallel provisions of both the CEA and the Exchange Act. In determining the contents of such a joint order, the Commissions could consider, among other things, (i) the nature and purposes of the parallel provisions that are the subject of the request; (ii) the comparability of such parallel provisions; and (iii) the extent of any conflicts or differences between such parallel provisions.

Finally, paragraph (c) of the proposed rules would require the Commissions, if they determine to issue a joint order pursuant to these rules, to do so within 120 days of receipt of a complete request (with such 120-day period being tolled during the pendency of a request for public comment on the proposed interpretation). If the Commissions do not issue a joint order within the prescribed time period, the proposed rules require that each Commission publicly provide the reasons for not having done so. Paragraph (c) makes clear that nothing in the proposed rules requires either Commission to issue a requested joint order regarding the regulation of a particular mixed swap (or class thereof).

These provisions are intended to provide market participants with a prompt review of requests for a joint order regarding the regulation of a particular mixed swap (or class thereof). The proposed rules also would provide transparency and accountability by requiring that at the end of the review period, the Commissions issue the requested order or publicly state the reasons for not doing so.

Request for Comment

127. Is the proposed procedure set forth in paragraph (c) appropriate? Should paragraph (c) of the proposed rules include a more detailed process for persons to request that the Commissions issue a joint order permitting such persons to comply, as to parallel provisions only, with specified parallel provisions, instead of being required to comply with parallel provisions of both the CEA and the Exchange Act? If so, please provide a detailed explanation of what that process should include.

128. Is the information required by paragraph (c) in support of a request for a joint order appropriate? Are there specific economic characteristics that should be required? In particular, should requesting persons be required to provide the specified parallel provisions, and the reasons the person believes it would be appropriate to request that regulatory treatment, as well as an analysis of (i) the nature and purposes of the parallel provisions that are the subject of the request; (ii) the comparability of such parallel provisions; and (iii) the extent of any conflicts or differences between such parallel provisions? Why or why not? If not, please provide a detailed explanation, including what information requesting persons should be required to provide.

129. Is there additional or alternative information that the Commissions should require persons to submit in connection with a request regarding the regulation of particular mixed swaps (or class thereof)? If so, what additional or alternative information should be required?

130. Should persons be able to withdraw a request for a joint order regarding the regulation of a particular mixed swap (or class thereof)? Why or why not? Should there be additional requirements regarding such withdrawals? If so, what should they be?

131. Is the 120-day timeframe for issuance of a requested joint order provided for in paragraph (c) of proposed rule 1.9 under the CEA and proposed rule 3a68–4 under the Exchange Act appropriate? Is it too short or too long? Are the provisions for tolling this timeframe during a public comment period appropriate? Why or why not? Where the Commissions do not issue a joint order, is it appropriate that they each publicly provide the reasons for not doing so within the applicable timeframe? Why or why not?

V. Security-Based Swap Agreements

A. Introduction

SBSAs are swaps over which the CFTC has regulatory and enforcement authority but for which the SEC also has antifraud and certain other authority.[300]

[299] Other than with respect to the specified parallel provisions with which such persons may be permitted to comply instead of complying with parallel provisions of both the CEA and the Exchange Act, any other provision of either the CEA or the Federal securities laws that applies to swaps or security-based swaps will continue to apply.

[300] *See* section 3(a)(78) of the Exchange Act, 15 U.S.C. 78c(a)(78); CEA section 1a(47)(A)(v), 7 U.S.C. 1a(47)(A)(v). The Dodd-Frank Act provides that certain CFTC registrants, such as DCOs and SEFs, will keep records regarding SBSAs open to inspection and examination by the SEC upon request. *See, e.g.,* sections 725(e) and 733 of the Dodd-Frank Act. The Commissions are committed

The term "security-based swap agreement" is defined as a "swap agreement" (as defined in section 206A of the GLBA [301]) of which "a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, including any interest therein" but does not include a security-based swap.[302] The Dodd-Frank Act amended the definition of "swap agreement" in section 206A of the GLBA [303] to eliminate the requirements that a swap agreement be between ECPs, as defined in 1a(12)(C) of the CEA,[304] and subject to individual negotiation.[305]

B. Swaps That Are Security-Based Swap Agreements

Although the Commissions believe it is not possible to provide a bright line test to define an SBSA, the Commissions believe that it is possible to clarify that certain types of swaps clearly fall within the definition of SBSA. For example, a swap based on an index of securities that is not a narrow-based security index (*i.e.,* a broad-based security index) would fall within the definition of an SBSA under the Dodd-Frank Act.[306] Similarly, an index CDS that is not based on a narrow-based security index or on the "issuers of securities in a narrow-based security index," as defined in proposed rule 1.3(zzz) under the CEA and proposed rule 3a68–1a under the Exchange Act, would be an SBSA. In addition, a swap based on a U.S. Treasury security or on certain other exempted securities other than municipal securities would fall within the definition of an SBSA under the Dodd-Frank Act.[307] The Commissions have received no comments regarding the definition of SBSA in the Dodd-Frank Act in response to the ANPR, and have not been made aware of any significant market confusion regarding what constitutes an SBSA since the definition of SBSA was enacted as part of the CFMA in 2000. Accordingly, the Commissions are not proposing to further define SBSA at this time beyond providing the examples above.[308]

Request for Comment

132. The Commissions request comment on whether further clarification of the definition of SBSA is necessary or appropriate. Commenters should provide a detailed analysis regarding what further guidance should be provided and how that guidance would affect what constitutes an SBSA.

133. The Commissions also request comment on whether there are other examples of swap transactions that the Commissions should clarify meet the definition of SBSA.

C. Books and Records Requirements for Security-Based Swap Agreements

The Dodd-Frank Act requires the Commissions to adopt rules regarding the books and records required to be kept for SBSAs. Specifically, section 712(d)(2)(B) of the Dodd-Frank Act requires the Commissions, in consultation with the Board, to jointly adopt rules governing books and records requirements for SBSAs by persons registered as SDRs under the CEA, including uniform rules that specify the data elements that shall be collected and maintained by each SDR. Similarly, section 712(d)(2)(C) of the Dodd-Frank Act requires the Commissions, in consultation with the Board, to jointly adopt rules governing books and records for SBSAs, including daily trading records, for swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants.

As discussed above, SBSAs are swaps over which the CFTC has primary regulatory authority, but for which the SEC has antifraud, anti-manipulation, and certain other authority. The CFTC has proposed rules governing books and records for swaps, which would apply to swaps that also are SBSAs.[309] The Commissions believe that the proposed rules would provide sufficient books and records regarding SBSAs and do not believe that additional books and records requirements are necessary for SBSAs. The Commissions therefore are proposing rules to clarify that there would not be additional books and records requirements regarding SBSAs other than those proposed for swaps. Specifically, proposed rule 1.7 under the CEA and proposed rule 3a69–3 under the Exchange Act would not require persons registered as SDRs under the CEA and the rules and regulations thereunder to (i) keep and maintain additional books and records regarding SBSAs other than the books and records regarding swaps that SDRs would be required to keep and maintain pursuant to the CEA and rules and regulations thereunder; and (ii) collect and maintain additional data regarding SBSAs other than the data regarding swaps that SDRs would be required to collect and maintain pursuant to the CEA and rules and regulations thereunder.

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to working cooperatively together regarding their dual enforcement authority over SBSAs.

[301] 15 U.S.C. 78c note.

[302] *See* section 3(a)(78) of the Exchange Act, 15 U.S.C. 78c(a)(78). The CFMA amended the Exchange Act and the Securities Act to exclude swap agreements from the definitions of security in those Acts but subjected "security-based swap agreements," as defined in section 206B of the GLBA, 15 U.S.C. 78c note, to the antifraud, anti-manipulation, and anti-insider trading provisions of the Exchange Act and Securities Act. *See* CFMA, *supra* note 182, title III.

The CEA does not contain a stand-alone definition of "security-based swap agreement" but includes the definition instead in subparagraph (A)(v) of the swap definition in CEA section 1a(47), 7 U.S.C. 1a(47). The only difference between these definitions is that the definition of SBSA in the Exchange Act specifically excludes security-based swaps (*see* section 3(a)(78)(B) of the Exchange Act, 15 U.S.C. 78c(a)(78)(B)), while the definition of SBSA in the CEA does not contain a similar exclusion. Instead, the exclusion for security-based swaps is placed in the general exclusions from the definition of swap in the CEA (*see* CEA section 1a(47)(B)(x), 7 U.S.C. 1a(47)(B)(x)).

[303] 15 U.S.C. 78c note.

[304] 7 U.S.C. 1a(12)(C).

[305] *See* section 762(b) of the Dodd-Frank Act. Sections 762(c) and (d) of the Dodd-Frank Act also made conforming amendments to the Exchange Act and the Securities Act to reflect the changes to the regulation of "swap agreements" that are either "security-based swaps" or "security-based swap agreements" under the Dodd-Frank Act.

[306] Swaps based on indexes that are not narrow-based security indexes are not included within the definition of the term security-based swap under the Dodd-Frank Act. *See* section 3(a)(68)(A)(ii)(I) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(I), and discussion *supra* part III.G. However, such swaps have a material term that is "based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein," and therefore such swaps fall within the SBSA definition.

[307] Swaps on U.S. Treasury securities that do not have any other underlying references involving securities are expressly excluded from the definition of the term "security-based swap" under the Dodd-Frank Act. *See* section 3(a)(68)(C) of the Exchange Act, 15 U.S.C. 78c(a)(68)(C) (providing that an agreement, contract, or transaction that would be a security-based swap solely because it references, is based on, or settles through the delivery of one or more U.S. Treasury securities (or certain other exempted securities) is excluded from the security-based swap definition). However, swaps on U.S. Treasury securities or on other exempted securities covered by subparagraph (C) of the security-based swap definition have a material term that is "based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein," and therefore they fall within the SBSA definition.

[308] The Commissions note that certain transactions that were not "security-based swap agreements" under the CFMA are nevertheless included in the definition of security-based swap under the Dodd-Frank Act—including, for example, a CDS on a single loan. Accordingly, although such transactions were not subject to insider trading restrictions under the CFMA, under the Dodd-Frank Act they are subject to the Federal securities laws, including insider trading restrictions.

[309] *See* Swap Data Recordkeeping and Reporting Requirements, *supra* note 6 (proposed rules regarding swap data recordkeeping and reporting requirements for SDRs, DCOs, DCMs, SEFs, swap dealers, major swap participants, and swap counterparties who are neither swap dealers nor major swap participants); Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants, *supra* note 7 (proposed rules regarding reporting and recordkeeping requirements and daily trading records requirements for swap dealers and major swap participants).

In addition, the proposed rules would not require persons registered as swap dealers or major swap participants under the CEA and rules and regulations thereunder, or registered as security-based swap dealers or major security-based swap participants under the Exchange Act and rules and regulations thereunder, to keep and maintain additional books and records, including daily trading records, regarding SBSAs other than the books and records regarding swaps those persons would be required to keep and maintain pursuant to the CEA and the rules and regulations thereunder.[310]

Request for Comment

134. The Commissions request comment on the proposed rules regarding books and records requirements for SBSAs. Will requiring the same recordkeeping information for SBSAs that will be required for swaps under the CFTC's recordkeeping rules be sufficient? Should the Commissions impose additional recordkeeping requirements for SBSAs? If so, why, and what additional recordkeeping should be required?

VI. Process for Requesting Interpretations of the Characterization of a Title VII Instrument

As discussed above, there may be Title VII instruments (or classes of Title VII instruments) that may be difficult to categorize definitively as swaps or security-based swaps. Further, because mixed swaps are both swaps and security-based swaps, identifying a mixed swap may not always be straightforward.

Section 712(d)(4) of the Dodd-Frank Act provides that any interpretation of, or guidance by, either the CFTC or SEC regarding a provision of Title VII shall be effective only if issued jointly by the Commissions (after consultation with the Board) on issues where Title VII requires the CFTC and SEC to issue joint regulations to implement the provision. The Commissions believe that any interpretation or guidance regarding whether a Title VII instrument is a swap, a security-based swap, or both (*i.e.,* a mixed swap), must be issued jointly pursuant to this requirement. Consequently, the Commissions are proposing a process for interested persons to request a joint interpretation by the Commissions regarding whether a particular Title VII instrument (or class of Title VII instruments) is a swap, a security-based swap, or both (*i.e.,* a mixed swap).

Section 718 of the Dodd-Frank Act establishes a process for determining the status of "novel derivative products" that may have elements of both securities and futures contracts. Section 718 of the Dodd-Frank Act provides a useful model for a joint Commission review process to appropriately categorize Title VII instruments. As a result, the Commissions' proposed process rules regarding swaps, security-based swaps, and mixed swaps include various attributes of the process established in section 718 of the Dodd-Frank Act. In particular, to permit an appropriate review period that provides sufficient time to ensure Federal regulatory interests are satisfied that also does not unduly delay the introduction of new financial products, the proposed process, like the process established in section 718, would include a deadline for responding to a request for a joint interpretation.[311]

Proposed rule 1.8 under the CEA and proposed rule 3a68–2 under the Exchange Act would establish a process for parties to request a joint interpretation regarding the characterization of a particular Title VII instrument (or class thereof). Specifically, paragraph (a) of the proposed rules would provide that any person may submit a request to the Commissions to provide a public joint interpretation of whether a particular Title VII instrument is a swap, a security-based swap, or both (*i.e.,* a mixed swap).

Paragraph (a) of the proposed rules is intended to afford market participants with the opportunity to obtain greater certainty from the Commissions regarding the regulatory status of particular Title VII instruments under the Dodd-Frank Act. This provision should decrease the possibility that market participants inadvertently might violate the regulatory requirements applicable to a particular Title VII instrument.

Paragraph (b) of proposed rules 1.8 under the CEA and proposed rule 3a68–2 under the Exchange Act would provide that a person requesting an interpretation as to the characterization of a Title VII instrument as a swap, a security-based swap, or both (*i.e.,* a mixed swap), must provide the Commissions with the person's determination of the characterization of the instrument and supporting analysis, along with certain other documentation. Specifically, the person must provide the Commissions with the following information:

- All material information regarding the terms of the Title VII instrument;
- A statement of the economic characteristics and purpose of the Title VII instrument;
- The requesting person's determination as to whether the Title VII instrument should be characterized as a swap, a security-based swap, or both (*i.e.,* a mixed swap), including the basis for such determination; and
- Such other information as may be requested by either Commission.

This provision is intended to provide the Commissions with sufficient information regarding the Title VII instrument at issue so that the Commissions can appropriately evaluate whether it is a swap, a security-based swap, or both (*i.e.,* a mixed swap). By requiring that requesting persons furnish a determination regarding whether they believe the Title VII instrument is a swap, a security-based swap, or both (*i.e.,* a mixed swap), including the basis for such determination, this provision also would assist the Commissions in more quickly identifying and addressing the relevant issues involved in arriving at a joint interpretation of the characterization of the instrument.

Paragraph (c) of proposed rule 1.8 under the CEA and proposed rule 3a68–2 under the Exchange Act would provide that a person may withdraw a request made pursuant to paragraph (a) at any time prior to the issuance of a joint interpretation or joint notice of proposed rulemaking by the Commissions. Notwithstanding any such withdrawal, the Commissions may provide an interpretation regarding the characterization of the Title VII instrument that was the subject of a withdrawn request.

This provision is intended to permit parties to withdraw requests for which the party no longer needs an interpretation. This, in turn, would save the Commissions time and staff resources. If the Commissions believe such an interpretation is necessary regardless of a particular request for interpretation, however, the Commissions may provide such a joint interpretation of their own accord.

Paragraph (d) of proposed rule 1.8 under the CEA and proposed rule 3a68–2 under the Exchange Act would

[310] Proposed rule 1.7 under the CEA and proposed rule 3a69–3 under the Exchange Act would provide that the term "security-based swap agreement" has the meaning set forth in CEA section 1a(47)(A)(v), 7 U.S.C. 1a(47)(A)(v), and section 3(a)(78) of the Exchange Act, 15 U.S.C. 78c(a)(78), respectively.

[311] The Commissions note that section 718 of the Dodd-Frank Act is a separate process from the process the Commissions are proposing, and that any future interpretation involving the process under section 718 would not affect the process being proposed here, nor would any future interpretation involving the process proposed here affect the process under section 718.

provide that if either Commission receives a proposal to list, trade, or clear an agreement, contract, or transaction (or class thereof) that raises questions as to the appropriate characterization of such agreement, contract, or transaction (or class thereof) as a swap, security-based swap, or both (*i.e.,* a mixed swap), the receiving Commission promptly shall notify the other. This provision of the proposed rules would further provide that either Commission, or their Chairmen jointly, may submit a request for a joint interpretation as to the characterization of the Title VII instrument where no external request has been received.

This provision is intended to ensure that Title VII instruments do not fall into regulatory gaps and will help the Commissions to fulfill their responsibility to oversee the regulatory regime established by Title VII of the Dodd-Frank Act by making sure that Title VII instruments are appropriately characterized, and thus appropriately regulated. An agency, or their Chairmen jointly, submitting a request for an interpretation as to the characterization of a Title VII instrument under this paragraph would be required to submit the same information as, and could withdraw a request in the same manner as, a person submitting a request to the Commissions. The bases for these provisions are set forth above with respect to paragraphs (b) and (c) of these proposed rules.

Paragraph (e) of proposed rule 1.8 under the CEA and proposed rule 3a68–2 under the Exchange Act would require the Commissions, if they determine to issue a joint interpretation as to the characterization of a Title VII instrument, to do so within 120 days of receipt of the complete external or agency submission (unless such 120-day period is tolled during the pendency of a request for public comment on the proposed interpretation).[312] If the Commissions do not issue a joint interpretation within the prescribed time period, the proposed rules require that each Commission publicly provide the reasons for not having done so. This provision of the proposed rules also incorporates the mandate of the Dodd-Frank Act that any joint interpretation by the Commissions be issued only after consultation with the Board of Governors of the Federal Reserve System.[313] Finally, paragraph (e) makes clear that nothing in the proposed rules requires either Commission to issue a requested joint interpretation regarding the characterization of a particular instrument.

These provisions are intended to guarantee market participants a prompt review of submissions requesting a joint interpretation of whether a Title VII instrument is a swap, a security-based swap, or both (*i.e.,* a mixed swap). The proposed rules also would provide transparency and accountability by requiring that at the end of the review period, the Commissions issue the requested interpretation or publicly state the reasons for not doing so.

Paragraph (f) of proposed rule 1.8 under the CEA and proposed rule 3a68–2 under the Exchange Act would permit the Commissions, in lieu of issuing a requested interpretation, to issue (within the timeframe for issuing a joint interpretation) a joint notice of proposed rulemaking to further define one or more of the terms "swap," "security-based swap," or "mixed swap." Such a rulemaking, as required by Title VII, would be required to be done in consultation with the Board of Governors of the Federal Reserve System. This paragraph is intended to provide the Commissions with needed flexibility to address issues that may be of broader applicability than the particular Title VII instrument that is the subject of a request for a joint interpretation.

Request for Comment

135. The Commissions request comment generally on all aspects of proposed rule 1.8 under the CEA and proposed rule 3a68–2 under the Exchange Act.

136. Should proposed rule 1.8(a) under the CEA and proposed rule 3a68–2(a) under the Exchange Act include a more specific process for persons to request a joint interpretation of whether a Title VII instrument is a swap, a security-based swap, or both (*i.e.,* a mixed swap)? If so, what additional specificity would be appropriate?

137. Would the information required by paragraph (b) of the proposed rules be sufficient for the Commissions to consider a request? Should requesting persons have to provide a statement regarding the economic characteristics and purpose of the Title VII instrument? Should requesting persons have to provide a determination regarding whether such instrument should be characterized as a swap, a security-based swap, or both (*i.e.,* a mixed swap), along with reasons therefor?

138. Is there additional or alternative information that the Commissions should require persons to submit in connection with a request for an interpretation regarding whether a Title VII instrument is a swap, a security-based swap, or both (*i.e.,* a mixed swap)? If so, what additional or alternative information should be required?

139. Should persons be able to withdraw a request for an interpretation pursuant to paragraph (c) of proposed rule 1.8 under the CEA and proposed rule 3a68–2 under the Exchange Act? Why or why not? Should there be additional parameters around or requirements regarding such withdrawals? If so, what should they be?

140. Is the 120-day timeframe for issuance of a requested joint interpretation provided for in paragraph (e) of proposed rule 1.8 under the CEA and proposed rule 3a68–2 under the Exchange Act appropriate? Is it too short or too long? Are the provisions for tolling this timeframe during a public comment period, and for permitting the Commissions to proceed with a joint notice of proposed rulemaking instead of issuing a joint interpretation, appropriate? Why or why not? Where the Commissions do not issue a joint interpretation, is it helpful that they each publicly provide the reasons for not doing so within the applicable timeframe? Why or why not?

141. Title VII requires that certain persons that are registered with the CFTC keep books and records relating to SBSAs open to inspection and examination by the SEC. As discussed in part V above, the Commissions are not proposing additional recordkeeping or other regulatory requirements for SBSAs that would require pre-transaction identification of a swap as an SBSA by market participants. Under these circumstances, is it appropriate to include SBSAs in the interpretation process set forth in proposed rule 1.8 under the CEA and proposed rule 3a68–2 under the Exchange Act? Why or why not?

142. Would it be appropriate to include SBSAs in the interpretation process, if their inclusion required the Commissions to extend the 120-day timeframe for issuance of a requested joint interpretation to, for example, 180 days for all products in order to address a potential increase in requests? Why or why not?

VII. Anti-Evasion

A. CFTC Proposed Anti-Evasion Rules

Section 721(c) of the Dodd-Frank Act requires the CFTC to adopt a rule to further define the terms "swap," "swap dealer," "major swap participant," and "eligible contract participant," in order "[t]o include transactions and entities

[312] This 120-day period is based on the timeframe set forth in section 718(a)(3) of the Dodd-Frank Act.

[313] *See* section 712(d)(4) of the Dodd-Frank Act.

that have been structured to evade" subtitle A of Title VII (or an amendment made by subtitle A). Section 761(b)(3) of the Dodd-Frank Act, in turn, grants discretionary authority to the SEC to define the terms "security-based swap," "security-based swap dealer," "security-based major swap participant," and "eligible contract participant," with regard to security-based swaps, "for the purpose of including transactions and entities that have been structured to evade subtitle B of Title VII (or amendments made by subtitle B). The CFTC notes that several provisions of Title VII reference the promulgation of anti-evasion rules:

- Subparagraph (E) of the definition of "swap" provides that foreign exchange swaps and foreign exchange forwards shall be considered swaps unless the Secretary of the Treasury makes a written determination that either foreign exchange swaps or foreign exchange forwards, or both, among other things, "are not structured to evade the [Dodd-Frank Act] in violation of any rule promulgated by the [CFTC] pursuant to section 721(c) of that Act;" [314]
- Section 722(d) of the Dodd-Frank Act provides that the provisions of the CEA relating to swaps shall not apply to activities outside the United States unless those activities, among other things, "contravene such rules or regulations as the [CFTC] may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of [the CEA] that was enacted by the [Title VII];" [315] and
- Section 725(g) of the Dodd-Frank Act amends the Legal Certainty for Bank Products Act of 2000 to provide that, although identified banking products generally are excluded from the CEA, that exclusion shall not apply to an identified banking product that is a product of a bank that is not under the regulatory jurisdiction of an appropriate Federal banking agency,[316] meets the definition of "swap" or "security-based swap," and "has been structured as an identified banking product for the purpose of evading the provisions of the [CEA], the [Securities Act], or the [Exchange Act]." [317]

The CFTC has determined to exercise its anti-evasion rulemaking authority under the Dodd-Frank Act.[318]

Structuring transactions and entities to evade the requirements of the Dodd-Frank Act could take any number of forms. As with the law of manipulation, the "methods and techniques" of evasion are "limited only by the ingenuity of man." [319] In light of the myriad methods of potential evasion, any attempt to comprehensively determine what constitutes evasion, or to provide a bright-line test of evasion by rule, would likely not be effective as would-be evaders could simply restructure their transactions or entities to fall outside any rigid boundary. Accordingly, proposed rule 1.3(xxx)(6) under the CEA generally would define as swaps those transactions that are willfully structured to evade the provisions of Title VII governing the regulation of swaps. Specific provisions would apply in similar fashion to currency and interest rate swaps that are willfully structured as foreign exchange forwards or foreign exchange swaps, and to transactions of a bank that is not under the regulatory jurisdiction of an appropriate Federal banking agency where the transactions are willfully structured as identified banking products to evade the new regulatory regime for swaps that was enacted in Title VII. These proposed rules would not apply to any agreement, contract, or transaction structured as a security (including a security-based swap) under the securities laws (as defined in section 3(a)(47) of the Exchange Act).

The Dodd-Frank Act also gives the CFTC general authority to prevent evasion of Title VII that occurs outside of the United States. Specifically, as noted above, section 722(d) of the Dodd-Frank Act states that the provisions of the CEA relating to swaps that were enacted by Title VII (including any rule prescribed or regulation promulgated thereunder) shall not apply to activities outside the United States unless, among other things, those activities "contravene such rules or regulations as the [CFTC] may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of [the CEA] that was enacted by [Title VII]." The CFTC is proposing rules to address potential evasion of Title VII under this provision of the Dodd-Frank Act.

Proposed rule 1.6 under the CEA would prohibit activities conducted outside the United States, including entering into transactions and structuring entities, to willfully evade or attempt to evade any provision of the CEA as enacted under Title VII or the rules and regulations promulgated thereunder. No activity, however, conducted outside of the United States with respect to a security (including a security-based swap) under the securities laws (as defined in section 3(a)(47) of the Exchange Act) and that is subject to the jurisdiction of the SEC would be prohibited pursuant to proposed rule 1.6.

The CFTC's proposed rule 1.3(xxx)(6) further defining the term "swap" would further provide that transactions, other than transactions structured as securities, willfully structured to evade shall be considered in determining whether a person is a swap dealer or major swap participant. Proposed rule 1.6 would further provide that an activity conducted outside the United States, other than an activity with respect to a security (including a security-based swap), to willfully evade or attempt to evade, shall be subject to the swap provisions of the CEA enacted under Title VII of the Dodd-Frank Act. The CFTC believes that these provisions are necessary to fully prevent those who seek to willfully evade the regulatory requirements established by Congress in Title VII relating to swaps from enjoying any benefits from their efforts to evade.

Finally, the CFTC's proposed rules would provide that in determining whether a transaction has been willfully structured to evade, neither the form, label, nor written documentation of the transaction shall be dispositive. The CFTC believes that looking beyond the form of the transaction to examine its actual substance is necessary to prevent evasion through clever draftsmanship. Such an approach is consistent with the CFTC's case law in the context of determining whether a contract is a futures contract.[320]

[314] CEA section 1a(47)(E), 7 U.S.C. 1a(47)(E).

[315] CEA section 2(i), 7 U.S.C. 2(i). New CEA section 2(i), as added by section 722(d) of the Dodd-Frank Act, also provides that the provisions of Title VII relating to swaps shall not apply to activities outside the United State unless those activities "have a direct and significant connection with activities in, or effect on, commerce of the United States."

[316] The term "identified banking product" is defined in section 402 of the Legal Certainty for Bank Products Act of 2000, 7 U.S.C. 27. The term "appropriate Federal banking agency" is defined in CEA section 1a(2), 7 U.S.C. 1a(2), and section 3(a)(72) of the Exchange Act, 15 U.S.C. 78c(a)(72), which were added by sections 721(a) and 761(a) of the Dodd-Frank Act, respectively.

[317] Section 741(b) of the Dodd-Frank Act amends section 6(e) of the CEA, 7 U.S.C. 9a, to provide that any DCO, swap dealer, or major swap participant "that knowingly or recklessly evades or participates in or facilitates an evasion of the requirements of section 2(h) [of the CEA] shall be liable for a civil monetary penalty in twice the amount otherwise available for a violation of section 2(h) [of the CEA]." This anti-evasion provision is not dependent upon the promulgation of a rule under section 721(c) of the Dodd-Frank Act, and hence this release does not apply to the anti-evasion authority regarding CEA section 2(h), 7 U.S.C. 2(h).

[318] No comments were received in response to the ANPR that specifically addressed anti-evasion authority. One commenter, however, noted that evasion is a concern. *See* Letter from David A. Berg, Esq., Vice President & General Counsel, Air Transport Association (Sept. 20, 1010).

[319] *Cargill* v. *Hardin*, 452 F.2d 1154, 1163 (8th Cir. 1971).

[320] *See, e.g., Grain Land, supra* note 61, at 55748 (holding that contract substance is entitled to at

In order to provide clarity concerning the anti-evasion rules, the CFTC also proposes to provide interpretive guidance as to certain types of circumstances that may constitute an evasion of the requirements of Title VII, while at the same time preserving the CFTC's ability to determine, on a case-by-case basis, that particular or other types of transactions or actions constitute an evasion of the requirements of the statute or the regulations promulgate thereunder. In developing this guidance, the CFTC has considered legislative, administrative, and judicial precedent with respect to the anti-evasion provisions in other Federal statutes. For example, the CFTC has examined the anti-evasion provisions in the Truth in Lending Act,[321] the Bank Secrecy Act,[322] and the Internal Revenue Code.[323] Based on these other statutory anti-evasion provisions, as well as the CFTC's authority under the Dodd-Frank Act to define terms and promulgate rules and regulations to prevent evasion, the CFTC is proposing this interpretive guidance as to what may constitute evasion of the requirements of the Dodd-Frank Act with respect to swaps. The CFTC emphasizes, however, that it would examine each individual case on a case-by-case basis, and additional practices or circumstances may warrant a finding that particular conduct or transactions constitute an evasion of the requirements of the Dodd-Frank Act with respect to swaps.

Business Purpose. The CFTC recognizes that transactions may be structured, and entities may be formed, in particular ways for legitimate business purposes, without any intention of circumventing the requirements of the Dodd-Frank Act with respect to swaps. In evaluating whether a person is evading or attempting to evade the requirements with respect to a particular instrument, entity, or transaction, the CFTC would consider the extent to which a person has a legitimate business purpose for structuring the instrument or entity or entering into the transaction in that particular manner. Although different means of structuring a transaction or entity may have differing regulatory implications and attendant requirements, absent other indicia of evasion, the CFTC would not consider transactions, entities, or instruments structured in a manner solely motivated by a legitimate business purpose to constitute evasion. However, to the extent a purpose in structuring an entity or instrument or entering into a transaction is to evade the requirements of Title VII with respect to swaps, the structuring of such instrument, entity, or transaction may be found to constitute evasion.[324]

Fraud, deceit, or unlawful activity. The CFTC believes that the Internal Revenue Service's delineation of what constitutes tax evasion, as elaborated upon by the courts, provides a useful guidepost for determining which types of activities should be considered to constitute an evasion of the Dodd-Frank Act. The Internal Revenue Service distinguished between tax evasion and legitimate means for citizens to minimize, reduce, avoid or alleviate the tax that they pay under the Internal Revenue Code. Whereas permissible means of reducing tax (or "tax avoidance," as the Internal Revenue Service refers to the practice) is associated with full disclosure and explanation of why the tax should be reduced under law, tax evasion consists of the willful attempt to evade tax liability, and generally involves "deceit, subterfuge, camouflage, concealment, or some attempt to color or obscure events or to make things seem other than they are."[325] Similarly, persons that craft derivative transactions, structure entities, or conduct themselves in a deceptive or other illegitimate manner in order to avoid regulatory requirements should not be permitted to enjoy the fruits of their deceptive or illegitimate conduct. In determining whether particular conduct is an evasion of the Dodd-Frank Act, the CFTC will consider the extent to which the conduct involves deceit, deception, or other unlawful or illegitimate activity.[326]

Request for Comment

The CFTC requests comment on all aspects of the proposed anti-evasion rules, including the following:

143. Are the CFTC's proposed rules and interpretive guidance set forth in this section sufficient to address the evasion concerns in Title VII? Is further guidance necessary? If so, what further guidance would be appropriate?

least as much weight as form); *First Nat'l Monetary Corp., supra* note 152, at 30974; *Stovall, supra* note 152, at 23779 (holding that the CFTC "will not hesitate to look behind whatever label the parties may give to the instrument").

[321] 15 U.S.C. 1604(a) provides, in relevant part, that the Federal Reserve Board:

Shall prescribe regulations to carry out the purposes of this subchapter * * *. [T]hese regulations may contain such classifications, differentiations, or other provisions, and may provide for such adjustments and exceptions for any class of transactions, as in the judgment of the Board are necessary or proper to effectuate the purposes of this subchapter, to prevent circumvention or evasion thereof, or to facilitate compliance therewith.

In affirming the Board's promulgation of Regulation Z, the Supreme Court noted that anti-evasion provisions such as section 1604(a) evince Congress's intent to "stress[] the agency's power to counteract attempts to evade the purposes of a statute." *Mourning* v. *Family Publ'ns Serv., Inc.,* 411 U.S. 356, 370 (1973) (*citing Gemsco* v. *Walling,* 324 U.S. 244 (1945) (giving great deference to a regulation promulgated under similar prevention-of-evasion rulemaking authority in the Fair Labor Standards Act)).

[322] 31 U.S.C. 5324 (stating, in pertinent part, that "[n]o person shall, for the purpose of evading the reporting requirements of [the Bank Secrecy Act (BSA) or any regulation prescribed thereunder].* * * structure or assist in structuring, or attempt to structure or assist in structuring, any transaction with one or more domestic financial institutions"). The Federal Deposit Insurance Corporation regulations implementing the BSA require banks to report transactions that ""the bank knows, suspects, or has reason to suspect" are "designed to evade any regulations promulgated under the Bank Secrecy Act." 12 CFR 353.3 (2010).

[323] The Internal Revenue Code makes it unlawful for any person willfully to attempt "in any manner to evade or defeat any tax * * *." 26 U.S.C. 7201. While a considerable body of case law has developed under the tax evasion provision, the statute itself does not define the term, but generally prohibits willful attempts to evade tax.

[324] A similar concept applies with respect to tax evasion. A transaction that is structured to avoid the payment of taxes but that lacks a valid business purpose may be found to constitute tax evasion. *See, e.g., Gregory* v. *Helvering,* 293 U.S. 465, 469 (1935) (favorable tax treatment disallowed because transaction lacked any business or corporate purpose). Under the "sham-transaction" doctrine, "a transaction is not entitled to tax respect if it lacks economic effects or substance other than the generation of tax benefits, or if the transaction serves no business purpose." *Winn-Dixie Stores, Inc.* v. *Comm'r,* 254 F.3d 1313, 1316 (11th Cir. 2001) (*citing Knetsch* v. *United States,* 364 U.S. 361 (1960)). "The doctrine has few bright lines, but 'it is clear that transactions whose sole function is to produce tax deductions are substantive shams.'" *Id.* (*quoting United Parcel Serv. of Am., Inc.* v. *Comm'r,* 254 F.3d 1014, 1018 (11th Cir 2001)).

[325] The Internal Revenue Service explains:

Avoidance of taxes is not a criminal offense. Any attempt to reduce, avoid, minimize, or alleviate taxes by legitimate means is permissible. The distinction between avoidance and evasion is fine, yet definite. One who avoids tax does not conceal or misrepresent. He/she shapes events to reduce or eliminate tax liability and, upon the happening of the events, makes a complete disclosure. Evasion, on the other hand, involves deceit, subterfuge, camouflage, concealment, some attempt to color or obscure events or to make things seem other than they are. For example, the creation of a bona fide partnership to reduce the tax liability of a business by dividing the income among several individual partners is tax avoidance. However, the facts of a particular investigation may show that an alleged partnership was not, in fact, established and that one or more of the alleged partners secretly returned his/her share of the profits to the real owner of the business, who, in turn, did not report this income. This would be an instance of attempted evasion.

Internal Revenue Service, *Internal Revenue Manual,* part 9.1.3.3.2.1, available at *http://www.irs.gov/irm/part9/irm_09–001–003.html#d0e169.*

[326] Although deceitful, deceptive, or illegitimate conduct may be sufficient to find that evasion has occurred, such conduct is not a prerequisite for a finding of evasion, particularly when other indicia of evasion are present, such as, for example, when the transaction lacks any business purpose.

144. Is further definition of the term "swap" necessary to address transactions that have been structured to evade subtitle A of Title VII? If so, what further definition is appropriate, and why? Please provide specific examples or scenarios, and a detailed analysis of any such transactions and the guidance that would be appropriate.

145. In addition to defining the term "swap" to address evasion generally, and with respect to certain foreign exchange products and identified banking products in particular, are CFTC rules prohibiting transactions from being willfully structured to evade or attempt to evade (similar to the proposed rules regarding activities conducted outside the United States) subtitle A of Title VII appropriate?

B. SEC Request for Comment Regarding Anti-Evasion

Section 761(b)(3) of the Dodd-Frank Act grants discretionary authority to the SEC to define the terms "security-based swap," "security-based swap dealer," "security-based major swap participant," and "eligible contract participant," with regard to security-based swaps, "for the purpose of including transactions and entities that have been structured to evade subtitle B of Title VII (or amendments made by subtitle B). Section 772(b) of the Dodd-Frank Act states that the provisions of the Exchange Act that were added by Title VII (including any rule or regulation thereunder) shall not apply to any person insofar as that person transacts a business in security-based swaps outside the jurisdiction of the United States, unless such person transacts such business "in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate to prevent evasion of any provision of [the Exchange Act] that was added by [Title VII]." [327]

The SEC is not proposing specific rules regarding anti-evasion at this time. The SEC may consider whether to propose anti-evasion rules based on comments received or after having experience with the new regulatory regime under subtitle B of Title VII.

Request for Comment

146. The SEC requests comment on whether SEC rules or interpretive guidance addressing anti-evasion regarding security-based swaps, security-based swap dealers, major security-based swap participants, or ECPs are necessary. Why or why not? Should the SEC adopt rules and interpretive guidance modeled on the CFTC's proposals? If other rules or interpretive guidance are necessary, please provide a detailed description of what rules or interpretative guidance would be necessary.

147. Are SEC rules or interpretive guidance addressing evasion in the context of activities conducted outside the United States necessary? Why or why not? Should the SEC adopt rules and interpretive guidance modeled on the CFTC's proposals? If other rules or interpretive guidance are necessary, please provide a detailed description of what rules or interpretative guidance would be necessary.

VIII. Administrative Law Matters—CEA Revisions

A. Regulatory Flexibility Act

The Regulatory Flexibility Act ("RFA") requires that agencies consider whether the rules they propose will have a significant economic impact on a substantial number of small entities and, if so, provide a regulatory flexibility analysis respecting the impact.[328] Most of the entities that will be impacted by this proposed rulemaking have previously been determined to not be small entities. In addition, this proposed rulemaking, which provides interpretive guidance, general rules of construction and definitions that will largely be used in other rulemakings will, by itself, not impose a significant economic impact on market participants or entities.

1. Effect of the Proposed Rulemaking

The proposed rulemaking in this release further defines, and clarifies, the statutory terms "swap," "security-based swap," "security-based swap agreement," and "mixed swap." It also provides a process for requesting joint interpretations from the Commissions as to whether agreements, contracts, and transactions are swaps, security-based swaps, or mixed swaps, as well as a process for requesting alternative regulatory treatment for certain mixed swaps. This proposed rulemaking also includes books and records, and data, requirements for SDRs, swap dealers, and major swap participants with respect to SBSAs, and implements the anti-evasion rulemaking authority granted to the CFTC under several provisions of the Dodd-Frank Act.

Additionally, this release proposes interpretive guidance that the forward contract exclusion from the swap definition in the Dodd-Frank Act with respect to nonfinancial commodities should be read consistently with the forward contract exclusion from the CEA definition of the term "future delivery." In that regard, the CFTC is proposing to retain the Brent Interpretation and extend it to apply to all nonfinancial commodities, and as a result, to withdraw the Energy Exemption,[329] which had extended the Brent Interpretation regarding the forward contract exclusion from the term "future delivery" to energy commodities other than oil. The Energy Exemption listed certain "appropriate persons" that could rely on the exemption.

The CFTC anticipates that this proposed rulemaking will affect primarily the following entities: DCMs, DCOs, ECPs, swap dealers, major swap participants, SEFs, SDRs, FBOTs, and those "appropriate persons" who previously relied on the Energy Exemption.

2. Specific Entities That Are Not Small Entities

The vast majority of entities impacted by this proposed rulemaking previously have been determined to not be small entities by the CFTC. Prior to the enactment of the Dodd-Frank Act, the following entities had been determined by the CFTC to not be small entities for purposes of the RFA: DCMs, DCOs, and ECPs. Other entities that will be affected by this rulemaking, including swap dealers, major swap participants, SEFs, SDRs, and FBOTs, have been certified by the CFTC not to be small entities in other proposed recent CFTC rulemaking implementing requirements of the Dodd-Frank Act. Specifically:

i. Swap Dealers, Major Swap Participants, SEFs, SDRs, and FBOTs. The CFTC previously has certified that swap dealers, major swap participants, SEFs, SDRs, and FBOTs are not small entities for purposes of the RFA.[330] Nevertheless, because these are new categories of registrants under the Dodd-Frank Act, the CFTC is, again, hereby determining that these entities are not small entities.

a. Swap Dealers: As noted above, the CFTC previously has determined that FCMs are not small entities for the purpose of the RFA based upon, among

[327] *See* section 30(c) of the Exchange Act, 15 U.S.C. 78dd(c).

[328] 5 U.S.C. 601 *et seq.*

[329] Energy Exemption, *supra* note 72.

[330] *See* respectively, Registration of Swap Dealers and Major Swap Participants, 75 FR 71379, 71385, Nov. 23, 2010 (swap dealers and major swap participants); Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 FR 63732, 63745, Oct. 18, 2010 (SEFs); Swap Data Repositories, 75 FR 80898, 80926, Dec. 23, 2010 (SDRs); Registration of Foreign Boards of Trade, 75 FR 70974, 70987, Nov. 19, 2010 (FBOTs).

other things, the requirements that FCMs must meet, including certain minimum financial requirements that enhance the protection of customers' segregated funds and protect the financial condition of FCMs generally. Swap dealers similarly will be subject to minimum capital and margin requirements, and are expected to comprise the largest global financial firms. Entities that engage in a de minimis quantity of swap dealing in connection with transactions with or on behalf of customers will be exempt from designation as a swap dealer. For purposes of the RFA, the CFTC is hereby determining that swap dealers not be considered to be "small entities" for essentially the same reasons that FCMs previously have been determined not to be small entities.

b. Major Swap Participants: The CFTC also previously has determined that large traders are not small entities for the purpose of the RFA. Major swap participants, among other things, maintain substantial positions in swaps, creating substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets. For purposes of the RFA, the CFTC is hereby determining that major swap participants not be considered to be "small entities" for essentially the same reasons that large traders previously have been determined not to be small entities.

c. SEFs: The Dodd-Frank Act defines a SEF to mean a trading system or platform in which multiple participants have the ability to accept bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility that facilitates the execution of swaps between persons and is not a DCM. The CFTC previously has determined that DCMs are not small entities because, among other things, they may be designated only when they meet specific criteria, including expenditure of sufficient resources to establish and maintain adequate self-regulatory programs. Likewise, the CFTC will register an entity as a SEF only after it has met specific criteria, including the expenditure of sufficient resources to establish and maintain an adequate self-regulatory program. For purposes of the RFA, the CFTC is hereby determining that SEFs not be considered to be "small entities" for essentially the same reasons that DCMs previously have been determined to be small entities.

d. SDRs: The CFTC previously has determined that DCMs and DCOs are not small entities because, among other things, of "the central role" they play in "the regulatory scheme concerning futures trading." [331] Because of the "importance of futures trading in the national economy," to be designated as a contract market or registered as a DCO, the respective entity must meet stringent requirements set forth in the CEA. Similarly, swap positions that are recorded, reported and disseminated by SDRs will be an important part of the national economy. SDRs will receive data from market participants and will be obligated to facilitate swap execution by reporting real-time data. Similar to DCMs and DCOs, SDRs will play a central role both in the regulatory scheme concerning swap trading. Additionally, the Dodd-Frank Act permits DCOs to register as SDRs. For purposes of the RFA, the CFTC is hereby determining that SDRs not be considered to be "small entities" for essentially the same reasons that DCMs and DCOs previously have been determined not to be small entities.

e. FBOTs. The term "foreign board of trade" has been used in the CEA and in the CFTC's Regulations to refer to a board of trade "located outside the U.S." [332] The term "board of trade" is defined in the CEA as "any organized exchange or trading facility." [333] An "organized exchange," in turn, includes designated or registered exchanges, such as DCMs.[334] The CFTC previously has determined that DCMs are not "small entities." As noted above, because of DCMs' importance to the economy, they must meet stringent requirements set forth in the CEA. Similarly, the CFTC will register an FBOT only after it has met criteria similar to those required of a DCM. Critically, an FBOT will be registered only after demonstrating, among other things, that it possesses the attributes of an organized exchange, adheres to appropriate rules prohibiting abusive trading practices, and enforces appropriate rules to maintain market and financial integrity. Because FBOTs and DCMs are functionally equivalent entities, for purposes of the RFA, the CFTC hereby is determining that FBOTs not be considered to be small entities for essentially the same reasons that DCMs previously have been determined not to be small entities.

ii. DCMs, DCOs, and ECPs. The CFTC previously has determined that DCMs, DCOs, and ECPs, are not small entities for purposes of the Regulatory Flexibility Act.[335] The Dodd-Frank Act requires that counterparties to swaps that are traded on a bilateral basis not on or subject to the rules of a DCM be ECPs. Prior to the enactment of the Dodd-Frank Act, ECPs trading swaps were generally outside the scope of CFTC oversight under the CEA. The CFTC cannot estimate with precision the number of non-ECPs that will, as permitted by the Dodd-Frank Act, trade swaps on DCMs. Nevertheless, this proposed rulemaking by the CFTC provides proposed further definitions of the terms "swap," "security-based swap," "mixed swap" and "security-based swap agreement," and proposes rules of construction and interpretive guidance (including guidance as to agreements, contracts, and transactions that are not included within the scope of the swap definition), that will largely be used in other rulemakings and which, by themselves, do not impose significant new regulatory requirements on market participants.

iii. "Appropriate Persons" who relied on the Energy Exemption. The Energy Exemption listed certain "appropriate persons" that could rely on the exemption and also required that, to be eligible for this exemption, an "appropriate person" must have a demonstrable capacity or ability to make or take delivery. The Energy Exemption stated: "in light of the general nature of the current participants in the market, the CFTC believes that smaller commercial firms, which cannot meet [certain] financial criteria, should not be included." [336] Therefore, the CFTC does not believe that the "appropriate persons" eligible for the Energy Exemption, and who may be affected by its withdrawal, are "small entities" for purposes of RFA.

Accordingly, the Chairman, on behalf of the CFTC, hereby certifies pursuant to 5 U.S.C. 605(b) that the proposed rules will not have a significant impact on a substantial number of small entities. Nonetheless, the CFTC specifically requests comment on the impact that this proposed rulemaking may have on small entities.

[331] Policy Statement and Establishment of Definitions of "Small Entities" for Purposes of the Regulatory Flexibility Act, 47 FR 18618, Apr. 30, 1982.

[332] *See* CEA section 4(a), 7 U.S.C. 6(a); CFTC rule 1.33(ss), 17 C.F.R. 1.33(ss).

[333] CEA section 1a(2), 7 U.S.C. 1a(2).

[334] CEA section 1a(27), 7 U.S.C. 1a(27).

[335] *See* respectively, Policy Statement and Establishment of Definitions of "Small Entities" for Purposes of the Regulatory Flexibility Act, *supra* note 331, at 18619 (DCMs); A New Regulatory Framework for Clearing Organizations, 66 FR 45604, 45609, Aug. 29, 2001 (DCOs); Opting Out of Segregation. 66 FR 20740, 20743, Apr. 25, 2001 (ECPs).

[336] Energy Exemption, *supra* note 72.

B. Paperwork Reduction Act

1. Introduction

Proposed CFTC rules 1.8 and 1.9 would result in new "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA"). An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid Office of Management and Budget (OMB) control number.

2. Summary of the Proposed Requirements

Proposed rule 1.8 of the CEA would allow persons to submit a request for a joint interpretation from the Commissions regarding whether an agreement, contract or transaction (or a class thereof) is a swap, security-based swap, or mixed swap. Proposed rule 1.8 provides that a person requesting an interpretation as to the nature of an agreement, contract, or transaction as a swap, security-based swap, or mixed swap must provide the Commissions with the person's determination of the nature of the instrument and supporting analysis, along with certain other documentation, including a statement of the economic purpose for, and a copy of all material information regarding the terms of, each relevant agreement, contract, or transaction (or class thereof). The Commissions also may request the submitting person to provide additional information. In response to the submission, the Commissions may issue a joint interpretation regarding the status of that agreement, contract, or transaction (or class of agreements, contracts, or transactions) as a swap, security-based swap, or mixed swap.

Proposed rule 1.9 enables persons to submit requests to the Commissions for joint orders providing an alternative regulatory treatment for particular mixed swaps. Under proposed rule 1.9, a person would provide to the Commissions a statement of the economic purpose for, and a copy of all material information regarding, the relevant mixed swap. In addition, the person would provide the specific alternative provisions that the person believes should apply to the mixed swap, the reasons the person believes it would be appropriate to request an alternative regulatory treatment, and an analysis of: (i) The nature and purposes of the specified provisions; (ii) the comparability of the specified provisions to other statutory provisions of Title VII of the Dodd-Frank Act and the rules and regulations thereunder; and (iii) the extent of any conflicting or incompatible requirements of the specified provisions and other statutory provisions of Title VII and the rules and regulations thereunder. The Commissions also may request the submitting person to provide additional information.

3. Information Provided by Reporting Entities

The burdens imposed by proposed CFTC rules 1.8 and 1.9 are the same as the burdens imposed by the SEC's proposed rules 3a68–2 and 3a68–4. Therefore, the burdens that would be imposed on market participants under CFTC rules 1.8 and 1.9 already have been accounted for within the SEC's calculations regarding the impact of this collection of information under the PRA and the request for a control number that will be submitted by the SEC to OMB.[337]

4. Information Collection Comments

The CFTC invites public comment on any aspect of the reporting and recordkeeping burdens discussed above. Pursuant to 44 U.S.C. 3506(c)(2)(B), the CFTC solicits comments in order to: (i) Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the CFTC, including whether the information will have practical utility; (ii) evaluate the accuracy of the CFTC's estimate of the burden of the proposed collections of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Comments may be submitted directly to the OMB's Office of Information and Regulatory Affairs, by fax at (202) 395–6566 or by e-mail at *OIRAsubmissions@omb.eop.gov.* Please provide the CFTC with a copy of submitted comments so that all comments can be summarized and addressed in the preamble to the final rulemaking. Please refer to the Addresses section of this notice of proposed rulemaking for comment submission instructions to the CFTC. A copy of the supporting statements for the collections of information discussed above may be obtained by visiting RegInfo.gov. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this release in the **Federal Register**. Consequently, a comment to OMB is most ensured of being fully effective if received by OMB (and the CFTC) within 30 days after publication of this release. Nothing in the foregoing affects the deadline enumerated above for public comment to the CFTC on the rules and interpretive guidance proposed herein.

C. Cost-Benefit Analysis

CEA section 15(a)[338] requires the CFTC to consider the costs and benefits of its actions before issuing a rulemaking under the CEA. By its terms, section 15(a) does not require the CFTC to quantify the costs and benefits of a rule or to determine whether the benefits of the rulemaking outweigh its costs; rather, it requires that the CFTC "consider" the costs and benefits of its actions. Section 15(a) further specifies that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (i) Protection of market participants and the public; (ii) efficiency, competitiveness, and financial integrity of futures markets; (iii) price discovery; (iv) sound risk management practices; and (v) other public interest considerations. The CFTC may in its discretion give greater weight to any one of the five enumerated areas and could in its discretion determine that, notwithstanding its costs, a particular rule is necessary or appropriate to protect the public interest or to effectuate any of the provisions or accomplish any of the purposes of the CEA.

1. Costs and Benefits of the Proposed Definitions

The proposed rulemaking and interpretive guidance would further define the terms "swap," "security-based swap," "security-based swap agreement," and "mixed swap." The scope of the definitions of the terms "swap," "security-based swap," "security-based swap agreement," and "mixed swap" will be an important factor in determining the scope of activities and entities that will be subject to various requirements set forth in the Dodd-Frank Act, such as reporting, registration, business conduct, and capital requirements. Those requirements, which will be implemented in rules proposed or to be proposed by the CFTC, will likely lead to compliance costs, capital holding costs, and other costs, which have been or will be addressed in the CFTC's proposals to implement those requirements.

[337] 44 U.S.C. 3501–3521. *See also* 44 U.S.C. 3509 and 3510.

[338] 7 U.S.C. 19(a).

Yet, the CFTC believes that the proposal to further define the terms "swap," "security-based swap," "security-based swap agreement," and "mixed swap" is, for the most part, in line with the expectations of market participants and does not depart significantly from how market participants would interpret the statutory definitions of these terms set forth in Title VII of the Dodd-Frank Act. Thus, the CFTC does not believe that the proposed rules and interpretive guidance further defining these terms impose any significant incremental costs beyond the costs associated with the statutory definitions.

The CFTC also believes that the proposed rules and guidance regarding the definitions will lead to benefits in the form of increased market transparency, reduced systemic risk, and a lower incidence of market-wide crises and other market failures. Further, the proposed rules and guidance can be consistently applied by substantially all market participants to determine which agreements, contracts, or transactions are, and which are not, swaps, security-based swaps, security-based swap agreements, or mixed swaps. Thus, the proposed rules and interpretive guidance will help to create a level playing field. Market participants will be able to use Title VII instruments more efficiently and the swap markets will operate more effectively because all market participants will be relying on consistent and clear definitions. The clarity provided by the proposed rules and interpretive guidance relating to the definitions is in the public interest because this clarity will permit the public to better evaluate information about Title VII instruments made available under the Dodd-Frank Act. In particular, they will allow market participants to better understand publicly-available price data. The clarity of the definitions also has the potential to ease the negotiation of Title VII instruments and reduce other transaction costs. These factors are expected to permit the public to make a more extensive use of Title VII instruments for risk management and other purposes.

The CFTC requests comment as to the costs and benefits of the proposed rules and interpretive guidance regarding the definitions for market participants, markets, and the public. In particular, comment is requested as to whether there are any aspects of the proposed rules and interpretive guidance regarding the definitions that are both burdensome to apply and not helpful to achieving clarity as to the scope of the defined terms. In addition, are there less burdensome means of providing clarity as to the scope of the defined terms?

2. Costs and Benefits of Proposed Rules and Interpretive Guidance Regarding Insurance

Proposed CFTC rule 1.3(xxx)(4) under the CEA would clarify that insurance products that meet certain requirements, that are provided by state or Federally regulated insurance companies, and that are regulated as insurance products, would not be swaps. Specifically, proposed rule 1.3(xxx)(4) would define the term "swap" so that it would not include an agreement, contract, or transaction that, by its terms or by law, as a condition of performance on the agreement, contract, or transaction: (i) Requires the beneficiary to have an insurable interest that is the subject of the agreement, contract, or transaction and thereby carry the risk of loss with respect to that interest continuously throughout the duration of the agreement, contract, or transaction; (ii) requires that loss to occur and to be proved, and that any payment or indemnification therefore be limited to the value of the insurable interest, separately from the insured interest; (iii) is not traded, separately from the insured interest, on an organized market or over-the-counter; and (iv) with respect to financial guarantee insurance only, in the event of payment default or insolvency of the obligor, any acceleration of payments under the policy is at the sole discretion of the insurer.

Proposed rule 1.3(xxx)(4) also would require that the agreement, contract, or transaction: (i) Be provided by a person or entity that is organized as an insurance company whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies and that is subject to supervision by the insurance commissioner, or similar official or agency, of a state (as defined under section 3(a)(16) of the Exchange Act [339]) or by the United States or an agency or instrumentality thereof, and be regulated as insurance under the laws of such state or the United States; (ii) be provided by the United States or any of its agents or instrumentalities, or pursuant to a statutorily authorized program thereof; or (iii) in the case of reinsurance only, be provided by a person located outside the United States to an insurance company that meets the above requirements, provided that such person is not prohibited by the law of any state or the United States from offering such agreement, contract, or transaction to such insurance company, the product to be reinsured meets the requirements above for insurance products, and the total amount reimbursable by all reinsurers for such insurance product cannot exceed the claims or losses paid by the cedant.

An agreement, contract, or transaction would have to meet all of these criteria in order to qualify as an insurance product that falls outside of the swap and security-based swap definitions pursuant to the proposed rules. The Commissions also are proposing interpretative guidance to clarify that certain enumerated types of traditional insurance products, such as life insurance, health insurance, and property and casualty insurance, are outside the scope of the statutory swap and security-based swap definitions.

(a) Costs

In complying with proposed rule 1.3(xxx)(4), a market participant will need to ascertain whether an agreement, contract, or transaction is an insurance product according to the criteria set forth in the definition. This analysis will have to be performed upon entering into the agreement, contract, or transaction to ensure compliance with the proposed rule. Absent this analysis, however, the cost associated with the uncertainty cited by commenters as to whether an agreement, contract, or transaction that the participants consider to be insurance could instead be regulated as a swap is expected to be greater than the cost of the analysis proposed herein.

To the extent that the criteria under proposed rule 1.3(xxx)(4) inadvertently fail to exclude certain types of insurance products from the proposed definitions, these failures could lead to costs for market participants entering into agreements, contracts, or transactions that might be improperly regulated as swaps and not as insurance products. Similarly, to the extent that the criteria under the proposed rule lead to the inadvertent treatment of certain types of swaps as insurance, costs for market participants entering into agreements, contracts, or transactions that are improperly regulated as insurance products and not as swaps may increase.

(b) Benefits

The proposed rule and interpretative guidance regarding insurance will help to assure that traditional insurance products remain subject to the current regulatory scheme for insurance and not to the regulatory regime established by the Dodd-Frank Act for swaps. Market

[339] 15 U.S.C. 78c(a)(16).

participants, therefore, will be able to continue to rely on their previous understanding of insurance regulations without any additional burden that may have resulted if they had to instead comply with regulations under the Dodd-Frank Act.

Without the proposed rule and interpretative guidance herein, market participants may be uncertain about whether an agreement, contract, or transaction is an insurance product that is subject to regulation as a swap. Proposed rule 1.3(xxx)(4) is intended to eliminate the potential uncertainty of what constitutes an insurance product by setting forth clear and objective criteria for determining that an agreement, contract, or transaction is an insurance product that is not subject to regulation as a swap. Providing such an objective rule and guidance alleviates additional costs of inquiring with the Commissions, or obtaining an opinion of counsel, about whether an agreement, contract, or transaction is an insurance product or a swap. The added clarity provided by the rule and guidance proposed herein will enhance the efficiency of the swaps market and also allow market participants to engage in sound risk management practices because they will be readily able to consider whether a particular agreement, contract, or transaction is insurance or a swap at the outset.

The CFTC requests comment as to the costs and benefits of proposed rule 1.3(xxx)(4) and interpretive guidance contained herein to distinguish between insurance products and swaps for market participants, markets, and the public.

3. Costs and Benefits of Proposed Rule Regarding Foreign Exchange Products and Forward Rate Agreements

Proposed CFTC rule 1.3(xxx)(2) under the CEA would explicitly define the term “swap” to include an agreement, contract, or transaction that is a cross-currency swap, currency option, foreign currency option, foreign exchange option, foreign exchange rate option, foreign exchange forward, foreign exchange swap, forward rate agreement, and non-deliverable forward involving foreign exchange, unless such agreement, contract, or transaction is otherwise excluded by section 1a(47)(B) of the CEA. Proposed rule 1.3(xxx)(2) also provides that: (i) A foreign exchange forward or a foreign exchange swap shall not be considered a swap if the Secretary of the Treasury makes the determination described in CEA section 1a(47)(E)(i); and (ii) notwithstanding any such determination, certain provisions of the CEA will apply to such foreign exchange forward or foreign exchange swap (specifically, the reporting requirements in section 4r of the CEA and regulations thereunder and, in the case of a swap dealer or major swap participant that is a party to a foreign exchange swap or foreign exchange forward, the business conduct standards in section 4s of the CEA and regulations thereunder). Proposed rule 1.3(xxx)(2) further clarifies that a currency swap, cross-currency swap, currency option, foreign currency option, foreign exchange option, foreign exchange rate option, or non-deliverable forward involving foreign exchange is not a foreign exchange forward or foreign exchange swap subject to a determination by the Secretary of the Treasury as described above.

(a) Costs

In complying with proposed rule 1.3(xxx)(2), a market participant will need to ascertain whether an agreement, contract, or transaction is a swap under the definition. This analysis will have to be performed upon entering into the agreement, contract, or transaction to ensure compliance with the proposed rule. However, any costs associated with this analysis are expected to be less than the costs of doing the same analysis absent the proposed rule, particularly given potential confusion in the event of a determination by the Secretary of the Treasury that foreign exchange forwards and/or foreign exchange swaps not be considered swaps. To the extent that proposed rule 1.3(xxx)(2) leads to the improper inclusion of certain types of agreements, contracts, and transactions in the swap definition, and therefore the imposition of additional requirements and obligations, these requirements and obligations could lead to costs for market participants entering into such agreements, contracts, or transactions.

(b) Benefits

Because the statutory definition of the term “swap” includes a process by which the Secretary of the Treasury may determine that certain agreements, contracts, and transactions that meet the statutory definition of a “foreign exchange forward” or “foreign exchange swap,” respectively,[340] shall not be considered a swap, the CFTC is concerned that application of the definition, without further clarification, may cause uncertainty about whether, if the Secretary of the Treasury makes such a determination, certain agreements, contracts, or transactions would be swaps. Proposed rule 1.3(xxx)(2) would clarify that a currency swap, cross-currency swap, currency option, foreign currency option, foreign exchange option, foreign exchange rate option, or non-deliverable forward involving foreign exchange is a swap (unless it is otherwise excluded by the statutory definition of the term “swap”). The proposed rule also would clarify that reporting requirements, and business conduct requirements for swap dealers and major swap participants, are applicable to foreign exchange forwards and foreign exchange swaps even if the Secretary of the Treasury determines that they should not be considered swaps. The CFTC also is concerned that confusion could be generated by the “forward” label of non-deliverable forwards involving foreign exchange, and forward rate agreements. Proposed rule 1.3(xxx)(2) would clarify that these types of agreements, contracts, and transactions are swaps.

Providing a clarifying rule to market participants to determine whether certain types of agreements, contracts, or transactions are swaps alleviates additional costs to persons of inquiring with the Commissions, or obtaining an opinion of counsel, about whether such agreements, contracts, or transactions are swaps. In addition, a clarifying rule regarding the requirements that apply to foreign exchange forwards and foreign exchange swaps that are subject to a determination by the Secretary of the Treasury similarly alleviates additional costs to persons of inquiring with the Commissions, or obtaining an opinion of counsel, to determine the requirements that are applicable to such foreign exchange forwards and foreign exchange swaps. As with the other rules related to product definitions, added clarity will increase the efficiency of the swaps market and also will enable market participants to engage in sound risk management practices, which will benefit both market participants and the public.

The CFTC requests comment as to the costs and benefits of proposed rule 1.3(xxx)(2) for market participants, markets, and the public.

4. Costs and Benefits of Proposed Rules and Interpretive Guidance Regarding Title VII Instruments Where the Underlying Reference Is a Security Index

Proposed CFTC rule 1.3(yyy)(1) provides that, for purposes of the security-based swap definition, the term “narrow-based security index” would have the same meaning as the statutory definition set forth in CEA section

[340] CEA section 1a(24), 7 U.S.C. 1a(24)(definition of a “foreign exchange forward”); CEA section 1a(25), 7 U.S.C. 1a(25)(definition of a “foreign exchange swap”).

1a(35), and the rules, regulations, and orders issued by the Commissions relating to such definition. As a result, except as the new rules the Commissions are proposing provide for other treatment, market participants generally will be able to use the Commissions' past guidance in determining whether certain Title VII instruments based on a security index are swaps or security-based swaps.

The Commissions also are proposing interpretive guidance and additional rules regarding Title VII instruments based on a security index. The interpretive guidance and additional rules set forth new narrow-based security index criteria with respect to indexes composed of securities, loans, or issuers of securities referenced by an index CDS. The proposed interpretive guidance and rules also address the definition of an "index" and the treatment of broad-based security indexes that become narrow-based and narrow-based indexes that become broad-based, including rule provisions regarding tolerance and grace periods for swaps on security indexes that are traded on CFTC-regulated trading platforms.

(a) Costs

In complying with the proposed rules, a market participant will need to ascertain whether an index CDS is a swap or a security-based swap according to the criteria set forth in the definitions of the terms "issuers of securities in a narrow-based security index" and "narrow-based security index" as used in the security-based swap definition. This analysis will have to be performed upon entering into an index CDS, and when the material terms of an index CDS are amended or modified, to ensure compliance with proposed rules 1.3(zzz) or 1.3(aaaa). However, any such costs are expected to be less than the costs of doing the same analysis absent the proposed rules, which the CFTC believes would be more difficult and lead to greater uncertainty. Proposed rules 1.3(zzz) and 1.3(aaaa) allow market participants to minimize the costs of determining whether an index CDS is a swap or a security-based swap by providing a test with objective criteria that is similar to a test with which they already are familiar in the security futures context, yet tailored to index CDS in particular.

Additionally, absent proposed rule 1.3(yyy), which applies the tolerance period rules, if a security index underlying a Title VII instrument traded on a trading platform migrated from being broad-based to being narrow-based, market participants may suffer disruption of their ability to offset or enter into new Title VII instruments, and incur additional costs as a result.

(b) Benefits

Proposed rules 1.3(zzz) and 1.3(aaaa) would clarify the treatment of an index CDS as either a swap or a security-based swap by setting forth objective criteria for meeting the definition of the terms "issuers of securities in a narrow-based security index" and "narrow-based security index," respectively. These objective rules will alleviate additional costs to persons trading index CDS of inquiring with the Commissions, or obtaining an opinion of counsel, to make complex determinations regarding whether an index is broad- or narrow-based, and whether an index CDS based on such an underlying index is a swap or security-based swap.

Also, proposed rules 1.3(zzz) and 1.3(aaaa) should reduce the potential for market participants to use an index CDS to evade regulations, because they set objective requirements relating to the concentration of the notional amount allocated to each reference entity or security included in the index, as well as the eligibility conditions for reference entities and securities. Finally, these proposed rules benefit the public by requiring that the providers of index CDS make publicly available sufficient information regarding the reference entities in an index underlying the index CDS. By requiring that such information be made publicly available, proposed rules 1.3(zzz) and 1.3(aaaa) seek to assure the transparency of the index components that will be beneficial to market participants who trade such instruments and to the public.

Separately, proposed rule 1.3(yyy) addresses exchange-traded swaps based on security indexes where the underlying index migrates from broad-based to narrow-based. The proposed rule includes provisions that many market participants are familiar with from security futures trading. The CFTC believes that by using a familiar regulatory scheme, market participants will be able to more readily understand the proposed rule as compared to a wholly new regulatory scheme. Also, the proposal of a "tolerance period" for swaps on security indexes that migrate from broad-based to narrow-based also creates greater clarity by establishing a 45-day timeframe (and subsequent grace period) on which market participants may rely. This tolerance period results in cost savings when compared to the alternative scenario where no tolerance period is provided and a migration of an index from broad-based to narrow-based would result in potential impediments to the ability of market participants to offset their swap positions.

Finally, the Commissions are proposing interpretive guidance that the determination of whether a Title VII instrument is a swap, a security-based swap, or both (*i.e.,* a mixed swap), is made at the execution of the Title VII instrument. If the security index underlying a Title VII instrument migrates from being broad-based to being narrow-based, or vice versa, during the life of a Title VII instrument, the characterization of that Title VII instrument would not change from its initial characterization regardless of whether the Title VII instrument was entered into bilaterally or was executed through a trade on or subject to the rules of a DCM, SEF, FBOT, security-based SEF, or NSE. Absent this guidance, market participants may need to expend additional resources to continually monitor their swaps to see if the indexes on which they are based have migrated from broad-based to narrow-based. Since the proposal provides that the initial determination prevails regardless of whether the underlying index migrates from broad-based to narrow-based, market participants do not need to expend these monitoring costs.

The CFTC requests comment as to the costs and benefits of proposed rules 1.3(yyy), 1.3(zzz), and 1.3(aaaa), and the proposed guidance contained herein, regarding Title VII instruments where the underlying reference is a security index, and regarding index CDS, for market participants, markets, and the public.

5. Costs and Benefits of Processes To Determine Whether a Title VII Instrument Is a Swap, Security-Based Swap, or Mixed Swap, and To Determine Regulatory Treatment for Mixed Swaps

(a) Costs

Proposed rule 1.8 under the CEA would allow persons to submit a request for a joint interpretation from the Commissions regarding whether an agreement, contract or transaction (or a class of agreements, contracts, or transactions) is a swap, security-based swap, or mixed swap. The CFTC estimates the cost of submitting a request for a joint interpretation pursuant to rule 1.8 would be approximately 20 hours of internal company or individual time and a cost of $9,480 for the services of outside professionals. Once such a joint interpretation is made, however, other market participants that seek to transact in the same agreement, contract, or transaction (or class thereof) would have regulatory clarity about whether it is a swap, security-based swap, or mixed swap.

Separately, proposed CFTC rule 1.9 under the CEA allows persons to submit a request for a joint order from the Commissions regarding an alternative regulatory treatment for particular mixed swaps. This process applies except with respect to bilateral, uncleared mixed swaps where one of the parties to the 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. With respect to bilateral uncleared mixed swaps where one of the parties is a dual registrant, the proposed rule provides that such mixed swaps would be subject to a regulatory scheme set forth in rule 1.9 in order to provide clarity as to the regulatory treatment of such mixed swaps.

The CFTC estimates that the cost of submitting a request for a joint order seeking an alternative regulatory treatment for a particular mixed swap would be approximately 30 hours of internal company or individual time and a cost of approximately $15,800 for the services of outside professionals. Absent such a process, though, market participants that desire or intend to enter into such a mixed swap (or class thereof) would be required pursuant to Title VII of the Dodd-Frank Act to comply with all regulatory requirements applicable to both swaps and security-based swaps. The CFTC believes that the cost of such dual regulation would likely be at least as great, if not greater, than the costs of the process set forth in proposed rule 1.9 to request an alternative regulatory treatment for such the mixed swap. The proposed rule regarding bilateral uncleared mixed swaps where at least one party is a dual registrant does not entail any additional costs, and may reduce costs for dual registrants that enter into such mixed swaps by eliminating potentially duplicative or inconsistent regulation.

(b) Benefits

The CFTC believes that the proposed rules that enable market participants to submit requests for joint interpretations regarding the nature of various agreements, contracts, or transactions, and requests for joint orders regarding the regulatory treatment of mixed swaps, will help to create a level playing field (since the joint interpretations and joint orders will be available to all market participants) regarding which agreements, contracts, or transactions constitute swaps, security-based swaps, or mixed swaps, and the regulatory treatment applicable to particular mixed swaps. The availability of such joint interpretations and joint orders regarding the scope of the definitions and the regulatory treatment of mixed swaps will reduce transaction costs and thereby promote the use of Title VII instruments and the efficient operation of the swap markets. This, in turn, is expected to encourage the use of Title VII instruments for risk management and other purposes. The separate proposed rule for bilateral uncleared mixed swaps where at least one party is dually registered should eliminate potentially duplicative and inconsistent regulation.

The CFTC requests comment as to the costs and benefits of the processes for seeking joint interpretations and joint orders in proposed rules 1.8 and 1.9, respectively, for market participants, markets, and the public.

6. Costs and Benefits of SBSA Books and Records, and Data, Requirements

Proposed CFTC rule 1.7 under the CEA would clarify that there would not be books and records, or data, requirements regarding SBSAs other than those that would exist for swaps. The proposed rule alleviates any additional books and records or information costs to persons who are required to keep and maintain books and records regarding, or collect and maintain data regarding, SBSAs because the proposed rule does not require such persons to keep or maintain any books and records, or collect and maintain any data, regarding, SBSAs that differs from the books, records, and data required regarding swaps.

Specifically, proposed rule 1.7 would require persons registered as SDRs to: (i) keep and maintain books and records regarding SBSAs only to the extent that SDRs are required to keep and maintain books and records regarding swaps; and (ii) collect and maintain data regarding SBSAs only to the extent that SDRs are required to collect and maintain data regarding swaps. In addition, proposed rule 1.7 would require persons registered as swap dealers or major swap participants to keep and maintain books and records, including daily trading records, regarding SBSAs only to the extent that those persons would be required to keep and maintain books and records regarding swaps.

Because proposed rule 1.7 imposes no requirements with respect to SBSAs other than those that exist for swaps, proposed rule 1.7 would impose no costs other than those that are required with respect to swaps in the absence of proposed rule 1.7. Proposed rule 1.7 provides clarity by establishing uniform requirements regarding books and records, and data collection, requirements for swaps and for SBSAs.

The CFTC requests comment as to the costs and benefits of proposed rule 1.7 for market participants, markets, and the public.

7. Costs and Benefits of the Proposed Interpretive Guidance Regarding the Forward Contract Exclusion From the Swap Definition

The CFTC is proposing interpretive guidance that the forward contract exclusion from the swap definition for nonfinancial commodities should be read consistently with the forward contract exclusion from the CEA definition of the term "future delivery." In that regard, the CFTC is proposing to retain the Brent Interpretation and extend it to apply to all nonfinancial commodities, and to withdraw the Energy Exemption which had extended the Brent Interpretation regarding the forward contract exclusion from the term "future delivery" to energy commodities other than oil. The CFTC also is proposing that its prior guidance regarding commodity options embedded in forward contracts should be applied as well to the treatment of forward contracts in nonfinancial commodities that contain embedded options under the Dodd-Frank Act.

The CFTC anticipates that its proposed interpretive guidance construing the forward contract exclusion consistently with respect to the definitions of the terms "swap" and "future delivery" in this manner will not impose any material costs on market participants. It also will establish a uniform interpretation of the forward contract exclusion for the definitions of both statutory terms, which will avoid the significant costs that some commenters stated would result if the forward contract exclusion were construed differently in these two contexts.[341]

The CFTC requests comment as to the costs and benefits of the proposed interpretative guidance regarding the

[341] *See* EEI Letter ("Without legal certainty as to the regulatory treatment of their forward contracts, EEI's members and other end users who rely on the forward contract exclusion likely will face higher transaction costs due to greater uncertainty. These increased transaction costs may include: (i) More volatile or higher commodity prices; and (ii) increased credit costs, in each case caused by changes in market liquidity as end users change the way they transact in the commodity markets. A single regulatory approach that uses the same criteria to confirm that a forward contract is excluded from the Commission's jurisdiction over swaps and futures will reduce this uncertainty and the associated costs to end users." (footnote omitted)).

forward contract exclusion from the swap definition, including the retention of the Brent Interpretation and its extension to all nonfinancial commodities and the withdrawal of the Energy Exemption, for market participant, markets, and the public.

8. Costs and Benefits of the Proposed Anti-Evasion Rules and Interpretive Guidance

The CFTC is proposing to exercise the anti-evasion rulemaking authority granted to it by the Dodd-Frank Act. Generally, proposed CFTC rule 1.3(xxx)(6) under the CEA would define as a swap any agreement, contract, or transaction that is willfully structured to evade (or as an attempt to evade) the provisions of Title VII governing the regulation of swaps. Further, proposed CFTC rule 1.6 under the CEA would prohibit activities conducted outside the United States, including entering into agreements, contracts, and transactions and structuring entities, to willfully evade any provision of the CEA as enacted by Title VII or the rules and regulations promulgated thereunder.

As opposed to providing a bright-line test, proposed rule 1.3(xxx)(6) would apply to agreements, contracts, and transactions, and proposed rule 1.6 would apply to agreements, contracts, transactions and entities, that are willfully structured to evade (or as an attempt to evade) the provisions of Title VII governing the regulation of swaps. Although this test does not provide a bright line, it helps ensure that would-be evaders cannot intentionally structure their transactions or entities for the sole purpose of evading the requirements of Title VII. The CFTC also is proposing interpretive guidance as to certain types of circumstances that may constitute an evasion of the requirements of Title VII, while at the same time preserving the CFTC's ability to determine, on a case-by-case basis, that other types of transactions or actions constitute an evasion of the requirements of the statute or the regulations promulgated thereunder. This will promote the enforcement of the anti-evasion rules in a manner that does not inappropriately interfere with activities undertaken for legitimate business purposes.

Absent the proposed anti-evasion rules and interpretive guidance, price discovery would be impaired because markets would not be informed about those transactions. Additionally, systemic risk could increase in a manner that the CFTC would not be able to measure accurately. The proposed anti-evasion rules and interpretive guidance will bring the appropriate scope of transactions and entities within the regulatory framework established by the Dodd-Frank Act, which will better allow the CFTC to assure transparency and address systemic risk.

Request for Comment

148. After considering the costs and benefits of the proposed rules and interpretive guidance as discussed in this section, the CFTC has determined to issue the proposal. The CFTC invites public comment on all of its cost-benefit considerations. Commenters are requested to submit empirical data or other factual information quantifying or qualifying the costs and benefits of the proposed rules and interpretive guidance with their comments, to the extent possible.

D. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 ("SBREFA") [342] the CFTC must advise the Office of Management and Budget as to whether the proposed rules constitute a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in: (i) An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease); (ii) a major increase in costs or prices for consumers or individual industries; or (iii) significant adverse effect on competition, investment or innovation. If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review. The CFTC does not believe that any of the proposed rules in this release, in their current form, would constitute a major rule.

The CFTC requests comment on the potential impact of the proposed rules on the economy on an annual basis, on the costs or prices for consumers or individual industries, and on competition, investment or innovation. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

IX. Administrative Law Matters—Exchange Act Revisions

A. Paperwork Reduction Act

1. Background

Proposed rules 3a68–2 and 3a68–4(c) would contain new "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995.[343] The SEC is submitting them to the Office of Management and Budget ("OMB") for review in accordance with the PRA.[344] An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. OMB has not yet assigned a control number to the new collection of information.

These proposed rules contain collections and are being proposed pursuant to the Exchange Act. The proposed rules would establish a process through which a person could submit a request to the Commissions that the Commissions provide a joint interpretation of whether an agreement, contract, or transaction (or class thereof) is a swap, security-based swap, or both (*i.e.,* a mixed swap). The rules also would establish a process with respect to mixed swaps through which a person could submit a request to the Commissions that the Commissions issue a joint order permitting the requesting person (and any other person or persons that subsequently lists, trades, or clears that class of mixed swap) to comply, as to parallel provisions only, with the specified parallel provisions, instead of being required to comply with parallel provisions of both the CEA and the Exchange Act. The hours and costs associated with preparing and sending these requests would constitute reporting and cost burdens imposed by each collection of information.

2. Summary of Collection of Information Under Proposed Rules 3a68–2 and 3a68–4(c)

The SEC is proposing new rules that would allow persons to submit requests to the Commissions for joint interpretations regarding whether a particular agreement, contract, or transaction (or class thereof) is a swap, security-based swap, or both (*i.e.,* a mixed swap), and for joint orders permitting alternative regulatory treatment for particular mixed swaps.

First, the SEC is proposing new rule 3a68–2, which would allow persons to submit a request for a joint interpretation from the Commissions regarding whether an agreement, contract, or transaction (or a class thereof) is a swap, security-based swap, or both (*i.e.,* a mixed swap). Under proposed rule 3a68–2, a person would provide to the Commissions a copy of all material information regarding the terms of, and a statement of the economic characteristics and purpose of, each relevant agreement, contract, or

[342] Public Law 104–121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

[343] 44 U.S.C. 3501 *et seq.*

[344] 44 U.S.C. 3507(d) and 5 CFR 1320.11.

transaction (or class thereof), along with that person's determination as to whether each such agreement, contract, or transaction (or class thereof) should be characterized as a swap, security-based swap, or both (*i.e.,* a mixed swap). The Commissions also may request the submitting person to provide additional information.

The Commissions may issue in response a joint interpretation or joint notice of proposed rulemaking regarding the status of that agreement, contract, or transaction (or class thereof) as a swap, security-based swap, or both (*i.e.,* a mixed swap). Any joint interpretation, like any joint notice of proposed rulemaking, will be public and may discuss the material information regarding the terms of the relevant agreement, contract, or transaction (or class thereof), as well as any other information the Commissions deem material to the interpretation.

Requesting persons also would be permitted to withdraw a request made pursuant to proposed rule 3a68–2 at any time before the Commissions have issued a joint interpretation or joint notice of proposed rulemaking in response to the request. Regardless of a particular request for interpretation, however, the Commissions could provide such a joint interpretation or joint notice of proposed rulemaking of their own accord.

Persons would submit requests pursuant to proposed rule 3a68–2 on a voluntary basis. However, if a person submits a request, all of the information required under the proposed rule, including any additional information requested by the Commissions, must be submitted to the Commission, except to the extent a person withdraws the request pursuant to the proposed rule.

For purposes of the PRA, the SEC estimates that the total annual paperwork burden resulting from proposed rule 3a68–2 would be approximately 20 hours of internal company or individual time and a cost of approximately $9,480 for the services of outside professionals that the SEC believes would consist of services provided by attorneys.[345] As discussed further below, these total costs include all collection burdens associated with the proposed rules, including burdens related to the initial determination requirements.

Second, the SEC is proposing new rule 3a68–4(c), which would allow persons to submit requests to the Commissions for joint orders regarding the regulation of a particular mixed swap (or class thereof). Under proposed rule 3a68–4(c), a person would provide to the Commissions a copy of all material information regarding the terms of, and the economic characteristics and purpose of, the specified (or specified class of) mixed swap. In addition, a person would provide the specified parallel provisions, and the reasons the person believes such specified parallel provisions would be appropriate for relevant mixed swap (or class thereof), and an analysis of: (i) The nature and purposes of the parallel provisions that are the subject of the request; (ii) the comparability of such parallel provision; and (iii) the extent of any conflicts or differences between such parallel provisions. The Commissions also may request the submitting person to provide additional information.

The Commissions may issue in response a joint order, after public notice and opportunity for comment, providing that the requesting person (and any other person or persons that subsequently lists, trades, or clears that mixed swap (or class thereof)) is permitted to comply, as to parallel provisions only, with the specified parallel provisions (or another subset of the parallel provisions that are the subject of the request, as the Commissions determine is appropriate), instead of being required to comply with parallel provisions of both the CEA and the Exchange Act. Any joint order will be public and may discuss the material information regarding the terms of the mixed swap (or class thereof), as well as any other information the Commissions deem material to the order. Requesting persons also would be permitted to withdraw a request made pursuant to proposed rule 3a68–4(c) at any time before the Commissions have issued a joint order in response to the request.

Persons would submit requests pursuant to proposed rule 3a68–4(c) on a voluntary basis. However, if a person submits a request, all of the information required under the proposed rule, including any additional information requested by the Commissions, must be submitted to the Commission, except to the extent a person withdraws the request pursuant to the proposed rule.

For purposes of the PRA, the SEC estimates that the total annual incremental paperwork burden resulting from proposed rule 3a68–4(c) would be approximately 30 hours of internal company or individual time and a cost of approximately $15,800 for the services of outside professionals, which the SEC believes would consist of services provided by attorneys.[346] As discussed further below, these total costs include all collection burdens associated with the proposed rules, including burdens related to the initial determination requirements.

3. Proposed Use of Information

The SEC would use the information collected pursuant to proposed rule 3a68–2 to evaluate an agreement, contract, or transaction (or class thereof) in order to provide joint interpretations or joint notices of proposed rulemaking with the CFTC regarding whether these agreements, contracts, or transactions (or classes thereof) are swaps, security-based swaps, or both (*i.e.,* mixed swaps) as defined in the Dodd-Frank Act. The SEC would use the information collected pursuant to proposed rule 3a68–4(c) to evaluate a specified, or a specified class of, mixed swaps in order to provide joint orders or joint notices of proposed rulemaking with the CFTC regarding the regulation of that particular mixed swap or class of mixed swap. The information provided to the SEC pursuant to proposed rules 3a68–2 and 3a68–4(c) also would allow the SEC to monitor the development of new OTC derivatives products in the marketplace and determine whether additional rulemaking or interpretive guidance is necessary or appropriate.

4. Respondents

It is difficult to calculate the precise number of requests that would be submitted to the Commissions under proposed rules 3a68–2 and 3a68–4(c), given the historical unregulated state of the OTC derivatives market. Although any person could submit a request under proposed rule 3a68–2, the SEC believes as a practical matter that the relevant categories of such persons would be swap dealers and security-based swap dealers, major swap participants and major security-based swap participants, SEFs, security-based SEFs, DCOs clearing swaps, DCMs trading swaps, SDRs, SBSDRs, and clearing agencies clearing security-based swaps, and the total number of persons could be 475.[347] Similarly, although any

[345] For convenience, the estimated PRA hour burdens have been rounded to the nearest whole dollar. Data from SIFMA's "Management & Professional Earnings in the Securities Industry 2009," modified by SEC staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead, suggest that that the cost of an attorney is $316 per hour.

[346] *See supra* note 345.

[347] This total number includes an estimated 250 swap dealers, 50 major swap participants, 50 security-based swap dealers, 10 major security-based swap participants, 35 SEFs, 20 security-based SEFs, 12 DCOs, 17 DCMs, 15 SDRs, 10 SBSDRs, and 6 clearing agencies, as set forth by the CFTC and SEC, respectively, in their other Dodd-Frank Act

person could submit a request under proposed rule 3a68–4(c), the SEC believes as a practical matter that the relevant categories of such persons would be SEFs, security-based SEFs, and DCMs trading swaps, and the total number of persons could be 72.[348]

However, based on the SEC's experience and information received from commenters to the ANPR[349] and during meetings with the public to discuss the Product Definitions generally, including the interpretation of whether a transaction is a swap, security-based swap, or both (*i.e.,* a mixed swap), and taking into consideration the certainty provided by the proposed rules and interpretive guidance in this release, the SEC believes that the number of requests that would be submitted by such persons to the Commissions to provide joint interpretations as to whether a given agreement, contract, or transaction is a swap, security-based swap, or both (*i.e.,* a mixed swap), would be small, and therefore expects that only a small number of requests would be submitted pursuant to proposed rule 3a68–2. With respect to proposed rule 3a68–4(c), the SEC also estimates the number of requests for joint orders would be small.[350] Pursuant to the Commissions' proposed rules and interpretive guidance, a number of persons that engage in agreements, contracts, or transactions that are swaps, security-based swaps, or both (*i.e.,* a mixed swap) would be certain that their transactions are, indeed, swaps, security-based swaps, or both, (*i.e.,* a mixed swap) and would not request an interpretation pursuant to proposed rule 3a68–2. Also, as the Commissions provide joint interpretations regarding whether agreements, contracts, or transactions (or classes thereof) are or are not swaps, security-based swaps, or both (*i.e.,* mixed swaps), the SEC expects that the number of requests for interpretation will decrease over time. The SEC believes that the rules and interpretive regarding swaps, security-based swaps, and mixed swaps the Commissions are proposing, as well as the additional guidance issues pursuant to joint interpretations and orders under proposed rules 3a68–2 and 3a68–4 will result in a narrow pool of potential respondents, approximately 50,[351] to the collection of information requirements of proposed rule 3a68–2.

Similarly, because the SEC believes that both the category of mixed swap transactions and the number of market participants that engage in mixed swap transactions are small, the SEC believes that the pool of potential persons requesting a joint order regarding the regulation of a specified, or specified class of, mixed swap pursuant to proposed rule 3a68–4(c) would be small (approximately 10[352]). Also, those requests submitted pursuant to proposed rule 3a68–2 that result in an interpretation that the agreement, contract, or transaction (or class thereof) is not a mixed swap would reduce the pool of possible persons submitting a request regarding the regulation of particular mixed swaps (or class thereof) pursuant to proposed rule 3a68–4(c). In addition, not only the requesting party, but also any other person or persons that subsequently lists, trades, or clears that mixed swap, would be subject to, and must comply with, the joint order regarding the regulation of the specified, or specified class of, mixed swap, as issued by the Commissions. Therefore, the SEC believes that the number of requests for a joint order regarding the regulation of mixed swaps, particularly involving specified classes of mixed would decrease over time.

The SEC seeks comment on the number of persons that potentially would submit requests pursuant to rules 3a68–2 and 3a68–4(c).

5. Paperwork Reduction Act Burden Estimates

Proposed rules 3a68–2 and 3a68–4(c) would, if adopted, require submission of certain information to the Commissions to the extent persons elect to request an interpretation and/or alternative regulatory treatment. Proposed rules 3a68–2 and 3a68–4(c) each require the information that a requesting party must include in its request to the Commissions in order to receive a joint interpretation or order, as applicable.

(a) Proposed Rule 3a68–2

Proposed rule 3a68–2 would require any party requesting a joint interpretation under the rule to include disclosures about the agreement, contract, or transaction (or class thereof) in question as well as a statement of economic purpose and the requesting party's initial determination regarding whether the agreement, contract, or transaction (or class thereof) is a swap, security-based swap, or both (*i.e.,* a mixed swap). The proposed rule would apply only to requests made by persons that desire an interpretation from the Commissions. For each agreement, contract, or transaction (or class thereof) for which a person requests the Commissions' joint interpretation, the requesting person would be required to provide a copy of all material information regarding the applicable terms; a statement of the economic characteristics and purpose; and the requesting person's determination as to whether such agreement, contract, or transaction (or class thereof) is a swap, security-based swap, or both (*i.e.,* a mixed swap), including the basis for the requesting person's determination. The requesting person also would be required to provide such other information as the Commissions may request.

As discussed above, the SEC believes the number of persons that would submit requests pursuant to proposed rule 3a68–2 is quite small given the proposed rules and interpretive guidance regarding swaps, security-based swaps, and mixed swaps the Commissions are providing.[353] Although the SEC does not have precise figures for the number of requests that persons would submit, the SEC believes it is reasonable to estimate that it likely

rulemaking proposals. *See* Entity Definitions, *supra* note 12 (regarding security-based swap dealers and major security-based swap participants); Registration of Swap Dealers and Major Swap Participants, *supra* note 330 (regarding swap dealers and major security-based swap participants); Security-Based Swap Data Repository Registration, Duties, and Core Principles, *supra* note 6 (regarding SBSDRs); Swap Data Repositories, *supra* note 330 (regarding SDRs); Core Principles and Other Requirements for Swap Execution Facilities, 76 FR 1214, Jan. 7, 2011 (regarding SEFs); Registration and Regulation of Security-Based Swap Execution Facilities, 76 FR 10948, Feb. 28, 2011 (regarding security-based SEFs); Financial Resources Requirements for Derivatives Clearing Organizations, 75 FR 63113, Oct. 14, 2010 (regarding DCOs); Information Management Requirements for Derivatives Clearing Organizations, 75 FR 78185, Dec. 15, 2010 (regarding DCOs); Risk Management Requirements for Derivatives Clearing Organizations, 76 FR 3698, Jan. 20, 2011 (regarding DCOs); Core Principles and Other Requirements for Designated Contract Markets, 75 FR 80572, Dec. 22, 2010 (regarding DCMs); Clearing Agency Standards for Operation and Governance, 76 FR 14472, Mar. 16, 2011 (regarding clearing agencies).

[348] *Id.*

[349] *See supra* note 283 and accompanying text.

[350] *See* discussion *supra* part IV.A.

[351] The SEC believes that there would be approximately 50 requests in the first year. *See* discussion *infra* part IX.A.5. The SEC recognizes that one person might submit more than one request, but for purposes of the PRA is considering each such request as one person in order to provide a more conservative estimate of the number of persons that would be subject to paperwork burdens.

[352] *See id.*

[353] This estimate is based on comments from and discussions with market participants regarding uncertainty concerning whether certain contracts might be considered swaps, security-based swaps, or both, *i.e.,* mixed swaps, and the size of the mixed swaps category, although the SEC has not received data regarding the specific number of potential transaction types for which there is uncertainty or that are mixed swaps.

would be fewer than 50 requests in the first year. For purposes of the PRA, the SEC estimates the total paperwork burden associated with preparing and submitting a person's request to the Commissions pursuant to proposed rule 3a68–2 would be 20 hours per request and associated costs of $9,480.[354] Assuming 50 requests in the first year, the SEC estimates that this would result in an aggregate burden for the first year of 1000 hours of company time (50 requests × 20 hours/request) and $474,000 for the services of outside professionals (*e.g.,* attorneys) (50 requests × 30 hours/request × $316).

As discussed above, the SEC believes that as the Commissions provide joint interpretations or joint notices of proposed rulemaking, the number of requests received will decrease over time. Although the SEC does not have precise figures for the number of requests that persons would submit after the first year, the SEC believes it is reasonable to estimate that it likely would be fewer than 10 requests on average in ensuing years. Assuming 10 requests in ensuing years, the SEC estimates that this would result in an aggregate burden in each ensuing year of 200 hours of company time (10 requests × 20 hours/request) and $94,800 for the services of outside professionals (*e.g.,* attorneys) (10 requests × 30 hours/request × $316).

(b) Proposed Rule 3a68–4(c)

Proposed rule 3a68–4(c) would require any party requesting a joint order regarding the regulation of a specified, or specified class of, mixed swap under the rule to include disclosure about the agreement, contract, or transaction (or class thereof) that is a mixed swap as well as a statement of economic purpose for the mixed swap (class thereof). In addition, a person would provide the specified parallel provisions that the person believes should apply to the mixed swap (or class thereof), the reasons the person believes the specified parallel provisions would be appropriate for the mixed swap, and an analysis of: (i) The nature and purposes of the parallel provisions that are the subject of the request; (ii) the comparability of such parallel provisions; and (iii) the extent of any conflicts or differences between such parallel provisions. The requesting person also would be required to provide such other information as the Commissions may request.

As discussed above, the SEC believes the number of requests that persons would submit pursuant to proposed rule 3a68–4(c) is quite small given the limited types of agreements, contracts, or transactions (or class thereof) the Commissions believe would constitute mixed swaps.[355] In addition, depending on the characteristics of a mixed swap (or class thereof), a person may choose not to submit a request pursuant to proposed rule 3a68–4(c). The SEC also notes that any joint order issued by the Commissions would apply to any person that subsequently lists, trades, or clears that specified, or specified class of, mixed swap, so that requests for joint orders could diminish over time. Also, persons may submit requests for an interpretation under proposed rule 3a68–4(c) that do not result in an interpretation that the agreement, contract, or transaction (or class thereof) is a mixed swap. Therefore, although the SEC does not have precise figures for the number of requests that persons would submit, the SEC believes it is reasonable to estimate that it likely would be fewer than 20 requests in the first year. For purposes of the PRA, the SEC estimates the total paperwork burden associated with preparing and submitting a party's request to the Commissions pursuant to proposed rule 3a68–4(c) would be 30 hours and associated costs of $15,800 per request for mixed swaps for which a request for a joint interpretation pursuant to proposed rule 3a68–4(c) was not previously made.[356] Assuming 20 requests in the first year, the SEC estimates that this would result in an aggregate burden for the first year of 600 hours of company time (20 requests × 30 hours/request) and $316,000 for the services of outside professionals (20 requests × 50 hours/request × $316).

For mixed swaps for which a request for a joint interpretation pursuant to proposed rule 3a68–2 was previously made, the SEC estimates the total paperwork burden under the PRA associated with preparing and submitting a party's request to the Commissions pursuant to proposed rule 3a68–4(c) would be 10 hours fewer and $4,740 less per request than for mixed swaps for which a request for a joint interpretation pursuant to proposed rule 3a68–2 was not previously made because certain, although not all, of the information required to be submitted and necessary to prepare pursuant to proposed rule 3a68–4(c) would have been required to be submitted and necessary to prepare pursuant to proposed rule 3a68–2.[357] Although certain requests made pursuant to proposed rule 3a68–4(c) may be made without a previous request for a joint interpretation pursuant to proposed rule 3a68–2, the SEC believes that most requests under proposed rule 3a68–2 that result in the interpretation that an agreement, contract, or transaction (or class thereof) is a mixed swap will result in a subsequent request for alternative regulatory treatment pursuant to proposed rule 3a68–4(c). Assuming, therefore, that 90 percent, or 18 of the estimated 20 requests pursuant to proposed rule 3a68–4(c) in the first year, as discussed above, would be such "follow-on" requests, the SEC estimates that this would result in an aggregate burden in the first year of 360 hours of company time (18 requests × 20 hours/request) and $199,080 for the services of outside professionals (18 requests × 35 hours/request × $316).

As discussed above, the SEC believes that as the Commissions provide joint orders regarding alternative regulatory treatment, the number of requests received will decrease over time. The SEC believes it is reasonable to estimate that it likely would be fewer than 5 requests on average in ensuing years. Assuming 5 requests in ensuing years, the SEC estimates that this would result in an aggregate burden in each ensuing year of 150 hours of company time (5 requests × 30 hours/request) and $79,000 for the services of outside professionals (5 requests × 50 hours/request × $316). As discussed above, assuming that approximately 90 percent, or 4 of the estimated 5 requests pursuant to proposed rule 3a68–4(c) in

[354] This estimate is based on information indicating that the average burden associated with preparing and submitting a no-action request to the SEC staff in connection with the identification of whether certain products were securities, which the SEC believes is a process similar to the process under proposed rule 3a68–2, was approximately 20 hours and associated costs of $9,480. Assuming these costs correspond to legal fees, which we estimate at an hourly cost of $316, we estimate that this cost is equivalent to approximately 30 hours ($9,480/$316).

[355] *See supra* note 283 and accompanying text.

[356] This estimate is based on information indicating that the average burden associated with preparing and submitting a no-action request to the SEC staff in connection with the regulatory treatment of certain securities products which the SEC believes is a process similar to the process under proposed rule 3a68–4(c), was approximately 30 hours and associated costs of $15,800. Assuming these costs correspond to legal fees, which we estimate at an hourly cost of $316, we estimate that this cost is equivalent to approximately 50 hours ($15,800/$316).

[357] This estimate takes into account that certain information regarding the mixed swap (or class thereof), namely the material terms and the economic purpose, will have already been gathered and prepared as part of the request submitted pursuant to proposed rule 3a68–2. The SEC estimates that these items constitute approximately 10 hours fewer and a reduction in associated costs of $4,740. Assuming these costs correspond to legal fees, which we estimate at an hourly cost of $316, we estimate that this cost is equivalent to approximately 15 hours ($4,740/$316).

ensuing years would be "follow-on" requests to requests for joint interpretation from the Commissions under proposed rule 3a68–4(c), the SEC estimates that this would result in an aggregate burden in each ensuing year of 80 hours of company time (4 requests × 20 hours/request) and $44,240 for the services of outside professionals (4 requests × 35 hours/request × $316).

Request for Comment

Pursuant to 44 U.S.C. 3506(c)(2)(B), the SEC solicits comments to: (i) Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (ii) evaluate the accuracy of the SEC's estimate of burden of the proposed collection of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) evaluate whether there are ways to minimize the burden of the collection of information on those that are to respond, including through the use of automated collection techniques or other forms of information technology. In addition, the SEC requests comment on the accuracy of the estimates regarding the total paperwork burden.

In particular, the SEC requests comment for purposes of the PRA on the following:

149. How many requests for a joint interpretation from the Commissions would be submitted pursuant to rule 3a68–2?

150. How many requests for a joint order from the Commissions would be submitted pursuant to rule 3a68–4(c)?

151. How many requests for a joint order from the Commissions would be submitted pursuant to rule 3a68–4(c) regarding the same agreement, contract, or transaction (or class thereof) that was the subject of a request for a joint interpretation from the Commissions submitted pursuant to rule 3a68–2?

152. Are the paperwork burden estimates, for both company time and outside services, as discussed above accurate? Do these estimates reflect the paperwork burdens and costs associated with requests made pursuant to proposed rules 3a68–2 and 3a68–4(c)?

Commenters should, when possible, provide empirical data to support their views.

Any member of the public may direct to us or to OMB any comments concerning the accuracy of these burden estimates and any suggestions for reducing these burdens. Persons submitting comments on the collection of information requirements should direct the comments to the Office of Management and Budget, Attention Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should send a copy to Secretary, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549–1090, with reference to File No. S7–16–11. Requests for materials submitted to OMB by the SEC with regard to these collections of information should be in writing, refer to File No. S7–16–11, and be submitted to the Securities and Exchange Commission, Office of Investor Education and Advocacy, 100 F Street NE., Washington, DC 20549–0213. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this release. Consequently, a comment to OMB is best ensured of having its full effect if OMB receives it within 30 days of publication.

B. Cost-Benefit Analysis

1. Background

Title VII establishes a regulatory framework for OTC derivatives. As part of that framework, Title VII amends the CEA and the Exchange Act to broadly categorize covered derivative products as swaps, security-based swaps, SBSAs, and/or mixed swaps. In particular, section 712(d)(1) of the Dodd-Frank Act provides that the Commissions, in consultation with the Board, shall jointly further define, among other things, the terms "swap," "security-based swap," and "security-based swap agreement." Section 712(a)(8) of the Dodd-Frank Act provides further that the Commissions shall jointly prescribe such regulations regarding "mixed swaps" as may be necessary to carry out the purposes of Title VII. In addition, sections 712(d)(2)(B) and (C) of the Dodd-Frank Act require the Commissions, in consultation with the Board, to jointly adopt rules governing books and records for SBSAs for SDRs that are registered under the CEA, swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants.

The Product Definitions and the regulation of mixed swaps are part of the Dodd-Frank Act's comprehensive framework for regulating the swaps markets whereby the CFTC is given regulatory authority over "swaps," [358] the SEC is given regulatory authority over "security-based swaps," [359] and the Commissions shall jointly prescribe such regulations regarding mixed swaps as may be necessary to carry out the purposes of Title VII.[360] In addition, the SEC is given antifraud authority over, and access to information from certain CFTC-regulated entities (*e.g.,* DCOs, SEFs, and swap dealers) regarding, SBSAs.[361]

In most instances, the Commissions' proposed rules and guidance merely clarify the application of the Product Definitions to specific products as is required by the relevant provisions of the CEA and Exchange Act, as modified by the Dodd-Frank Act and the regulation of mixed swaps. However, for some of the rules the Commissions are proposing, the Commissions are exercising their discretion to further define the Product Definitions and to regulate mixed swaps, which would generate costs and benefits to market participants. The Commissions also are fulfilling the requirement in Dodd-Frank that they establish requirements regarding books and records with respect to SBSAs, which also would generate costs and benefits to market participants. The costs and benefits regarding these rules are discussed below.

2. Proposed Rule 3a68–1a

(a) Benefits

A security-based swap includes a swap that is based on the "occurrence, nonoccurrence, or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition, or financial obligations of the issuer" (the "Event Provision").[362] Proposed rule 3a68–1a would provide that, solely for purposes of determining whether a CDS is a security-based swap under the Event Provision, the term "issuers of securities in a narrow-based security index" would have the meaning as set forth in proposed rule 3a68–1a.

Because index CDS typically are written on indexes of entity names, not on indexes of the specific securities of those entities, the Commissions are

[358] *See* CEA section 1a(47), 7 U.S.C. 1a(47) (cross-referenced in section 3(a)(69) of the Exchange Act, 15 U.S.C. 78c(a)(69)).

[359] *See* section 3(a)(68) of the Exchange Act, 15 U.S.C. 78c(a)(68) (cross-referenced in CEA section 1a(42), 7 U.S.C. 1a(42)).

[360] *See* CEA section 1a(47)(D), 7 U.S.C. 1a(47)(D); section 3(a)(68)(D) of the Exchange Act, 15 U.S.C. 78c(68)(D).

[361] *See* section 3(a)(78) of the Exchange Act, 15 U.S.C. 78c(a)(78); CEA section 1a(47)(A)(v), 7 U.S.C. 1a(47)(A)(v).

[362] Section 3(a)(68)(A)(ii)(III) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(III).

concerned that the application of the Event Provision, without further clarification, may cause uncertainty about whether certain index CDS would be security-based swaps or swaps. Therefore, proposed rule 3a68–1a would eliminate the potential uncertainty of the treatment of index CDS as either security-based swaps or swaps by setting forth clear and objective criteria for meeting the definition of "issuers of securities in a narrow-based security index" and therefore being a security-based swap.

The SEC requests comments, data, and estimates regarding the benefits associated with proposed rule 3a68–1a. The SEC also requests comments, data, and estimates regarding any additional benefits that could be realized with proposed rule 3a68–1a.

(b) Costs

In complying with proposed rule 3a68–1a, a market participant will need to ascertain whether an index CDS is a security-based swap or swap according to the criteria set forth for meeting the definition of "issuers of securities in a narrow-based security index." This analysis will have to be performed by market participants upon entering into an index CDS to determine whether the index CDS is subject to the SEC's regulatory regime for security-based swaps or the CFTC's regulatory regime for swaps. The SEC notes, however, that any such costs would be in lieu of the costs of doing the same analysis under the statutory security-based swap definition. Because the statutory security-based swap definition lacks the specificity provided by proposed rule 3a68–1a, the SEC believes analysis of an index CDS would under proposed rule 3a68–1a would lead to less uncertainty than would the same analysis under the statutory security-based swap definition. Providing a clear rule to persons to determine whether an index CDS is a security-based swap under section 3(a)(68)(A)(ii)(III) of the Exchange Act [363] could alleviate additional costs to persons of inquiring with the Commissions about whether an index CDS is a swap or security-based swap under that provision, as well as costs of obtaining an opinion of counsel regarding the applicability of that provision to a particular index CDS.

In addition, proposed rule 3a68–1a is generally consistent with the definition of "narrow-based security index" that exists in section 3(a)(55)(B) of the Exchange Act, as modified to address debt securities in the context of security futures.[364] Because some market participants are familiar with this definition, as well as with performing analyses of products in the security futures context based on this definition, the SEC believes that the proposed definition of "issuers of securities in a narrow-based security index" will mitigate uncertainty for those market participants regarding the treatment of index CDS. In addition, because such market participants would be familiar with many of the criteria in proposed rule 3a68–1a, such market participants would require less time and effort, and thus incur less cost, in determining the scope and applicability of such criteria to the determination of whether an index CDS is a swap or security-based swap.

The SEC requests comment as to the costs that determinations under proposed rule 3a68–1a would impose on market participants, as well as estimates and empirical data to support these costs. In addition, the SEC requests comment on any other costs associated with proposed rule 3a68–1a that have not been considered and what the extent of those costs would be.

3. Proposed Rule 3a68–1b

(a) Benefits

A security-based swap includes a swap that is based on "an index that is a narrow-based security index, including any interest therein or on the value thereof." [365] Proposed rule 3a68–1b would provide that, solely for purposes of determining whether a CDS is a security-based swap under section 3(a)(68)(A)(ii)(I) of the Exchange Act,[366] the term "narrow-based security index" would have the meaning as set forth in proposed rule 3a68–1b.

Because index CDS may be written in indexes of the specific securities of entities as well as on indexes of entity names, the Commissions are concerned that the application of section 3(a)(68)(A)(ii)(I) of the Exchange Act,[367] without further clarification, may cause uncertainty about whether certain index CDS would be security-based swaps or swaps. Therefore, proposed rule 3a68–1b would eliminate the potential uncertainty of the treatment of index CDS as either security-based swaps or swaps by setting forth clear and objective criteria for meeting the definition of "narrow-based security index" and therefore being a security-based swap.

The SEC requests comments, data, and estimates regarding the benefits associated with proposed rule 3a68–1b. The SEC also requests comments, data, and estimates regarding any additional benefits that could be realized with proposed rule 3a68–1b.

(b) Costs

In complying with proposed rule 3a68–1b, a market participant will need to ascertain whether an index CDS is a security-based swap or swap according to the criteria set forth for meeting the definition of "narrow-based security index." This analysis will have to be performed by market participants upon entering into an index CDS to determine whether the index CDS is subject to the SEC's regulatory regime for security-based swaps or the CFTC's regulatory regime for swaps. The SEC notes, however, that any such costs would be in lieu of the costs of doing the same analysis under the statutory security-based swap definition. Because the statutory security-based swap definition lacks the specificity provided by proposed rule 3a68–1b, the SEC believes analysis of an index CDS would under proposed rule 3a68–1b lead to less uncertainty than would the same analysis under the statutory security-based swap definition. Providing a clear rule to persons to determine whether an index CDS is a security-based swap under section 3(a)(68)(A)(ii)(I) of the Exchange Act [368] could alleviate additional costs to persons of inquiring with the Commissions about whether an index CDS is a swap or security-based swap under that provision, as well as costs of obtaining an opinion of counsel regarding the applicability of that provision to a particular index CDS.

In addition, proposed rule 3a68–1b is generally consistent with the definition of "narrow-based security index" that exists in section 3(a)(55)(B) of the Exchange Act, as modified to address debt securities in the context of security futures.[369] Because some market participants are familiar with this definition, as well as with performing analyses of products in the security futures context based on this definition, the SEC believes that the proposed definition of "narrow-based security index" will mitigate uncertainty for those market participants regarding the treatment of index CDS. In addition, because such market participants would be familiar with many of the criteria in proposed rule 3a68–1b, such market

[363] 15 U.S.C. 78c(a)(68)(A)(ii)(III).

[364] *See* July 2006 Rules, *supra* note 199.

[365] Section 3(a)(68)(A)(ii)(I) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(I).

[366] 15 U.S.C. 78c(a)(68)(A)(ii)(I).

[367] 15 U.S.C. 78c(a)(68)(A)(ii)(I).

[368] 15 U.S.C. 78c(a)(68)(A)(ii)(I).

[369] *See* July 2006 Rules, *supra* note 199.

participants would require less time and effort, and thus incur less cost, in determining the scope and applicability of such criteria to the determination of whether an index CDS is a swap or security-based swap.

The SEC requests comment as to the costs that determinations under proposed rule 3a68–1a would impose on market participants, as well as estimates and empirical data to support these costs. In addition, the SEC requests comment on any other costs associated with proposed rule 3a68–1a that have not been considered and what the extent of those costs would be.

4. Proposed Rule 3a68–2

(a) Benefits

Proposed rule 3a68–2 would establish a process for persons to request an interpretation of whether an agreement, contract, or transaction (or class of agreements, contracts, or transactions) is a swap, security-based swap, or both (*i.e.,* a mixed swap).

Proposed rule 3a68–2 would afford persons with the opportunity to obtain greater certainty from the Commissions regarding whether certain products are swaps, security-based swaps, or both, *i.e.,* mixed swaps. The SEC believes that this provision would decrease the possibility that market participants inadvertently might violate regulatory requirements regarding products that may constitute swaps, security-based swaps, or mixed swaps, which could lead to enforcement action. It also would decrease the likelihood that products might fall into regulatory gaps by providing a method for market participants to seek interpretations regarding the status of products for which the applicable regulatory regime might otherwise remain uncertain. In addition, the SEC believes the proposed rule will provide the opportunity for financial innovation by providing a flexible structure that will allow for the development of new products that otherwise might be hindered by the lack of regulatory certainty.

(b) Costs

Under proposed rule 3a68–2, a person could request the Commissions to provide an interpretation of whether an agreement, contract, or transaction (or class thereof) is a swap, security-based swap, or mixed swap. The SEC estimates that the cost of requesting this interpretation for a particular agreement, contract, or transaction (or class thereof) would be approximately 20 hours of internal company or individual time and a cost of approximately $9,480 for the services of outside professionals.[370] The SEC notes, however, that any such costs are in lieu of the costs of doing the same analysis without requesting the Commissions to provide an interpretation. In addition, as noted above, if the Commissions provide an interpretation pursuant to a request under proposed rule 3a68–2, a market participant, and other market participants that desire to transact in the same (or same class of) agreement, contract, or transaction, would have regulatory certainty about whether that agreement, contract, or transaction (or class thereof) is a swap, security-based swap, or both (*i.e.,* a mixed swap).

Also, the SEC believes that as persons make requests for interpretations about whether agreements, contracts, or transactions (or classes thereof agreements) are swaps, security-based swaps, or both, *i.e.,* mixed swaps, pursuant to proposed rule 3a68–2, the subsequent costs for persons transacting in those products for which the Commissions have provided interpretations should be reduced.

The SEC requests comment as to the costs that proposed rule 3a68–2 would impose on market participants, as well as estimates and empirical data to support these costs. In addition, the SEC requests comment on any other costs associated with proposed rule 3a68–2 that have not been considered herein and what the extent of those costs would be.

5. Proposed Rule 3a68–3

(a) Benefits

Proposed rule 3a68–3 would provide that, except as otherwise provided in proposed rule 3a68–3, for purposes of section 3(a)(68) of the Exchange Act,[371] the term "narrow-based security index" has the meaning set forth in section 3(a)(55) of the Exchange Act,[372] and the rules, regulations, and orders of the SEC thereunder. This definition would eliminate potential uncertainty regarding the treatment of a narrow-based security index to which section 3(a)(55) of the Exchange Act also applies.[373]

Proposed rule 3a68–3 also would provide a tolerance period for the definition of "narrow-based security index" to ensure that, under certain conditions, a security index underlying a swap will not be considered a narrow-based security index and a security index underlying a security-based swap will be considered a narrow-based security index, even when the security index underlying the swap or security-based swap temporarily assumes characteristics that would render it a narrow-based security index or not a narrow-based security index, respectively. In addition, proposed rule 3a68–3 would provide for an additional 3-month grace period applicable to a security index that becomes narrow-based, or broad-based, as applicable, for more than 45 business days over 3 consecutive calendar months.

Because security indexes underlying Title VII instruments may migrate from narrow-based to broad-based, or vice versa, the Commissions are concerned that application of the narrow-based security index definition, without further clarification, may cause uncertainty regarding treatment of Title VII instruments traded on trading platforms when such migration has occurred. Therefore, proposed rule 3a68–3 would eliminate the potential uncertainty of the treatment of such Title VII instruments by setting forth clear and objective criteria regarding the application of the narrow-based security index definition to security indexes that have migrated from narrow-based to broad-based or from broad-based to narrow-based.

The SEC requests comments, data, and estimates regarding the benefits associated with proposed rule 3a68–3. The SEC also requests comments, data, and estimates regarding any additional benefits that could be realized with proposed rule 3a68–3.

(b) Costs

In complying with proposed rule 3a68–3, a market participant will need to ascertain whether a security index underlying a Title VII instrument is narrow-based or broad-based according to the criteria set forth for the tolerance periods and grace periods in the proposed rule. This analysis would be performed upon entering into Title VII instrument on a security index to ensure compliance with proposed rule 3a68–3. The SEC notes, however, that any such costs would be in lieu of the costs of doing the same analysis under the narrow-based security index definition, which the SEC believes would be more difficult and lead to greater uncertainty, rather than the clarity provided under proposed rule 3a68–3. Providing a clear rule to market participants to determine whether a Title VII instrument traded on a trading platform where the underlying security index has so migrated could alleviate additional costs to persons of inquiring with the Commissions about whether a Title VII instrument is a swap or a security-based swap, as well as costs of obtaining an opinion of counsel

[370] *See* discussion *supra* part VIII.

[371] 15 U.S.C. 78c(a)(68).

[372] 15 U.S.C. 78c(a)(55).

[373] 15 U.S.C. 78c(a)(55).

regarding a particular Title VII instrument.

In addition, proposed rule 3a68–3 is generally consistent with the tolerance period and grace period that exist in section 3(a)(55) of the Exchange Act for futures contracts.[374] Because market participants are familiar with such tolerance period and grace period as well as with performing analyses of products in the futures context based on these provisions, the SEC believes that the proposed tolerance period and grace period in proposed rule 3a68–3 will mitigate uncertainty for market participants regarding the treatment of these Title VII instruments. Proposed rule 3a68–3 also would allow market participants to minimize the costs of determining whether a security index underlying a Title VII instrument is considered narrow-based or not by providing a test that is substantially similar to a test with which they are familiar in the futures context. In addition, the tolerance period under proposed rule 3a68–3 mitigates uncertainty for market participants trading Title VII instruments on trading platforms by allowing temporary migration of an underlying security index within certain specifications without disrupting the status of Title VII instruments based on that security index. Similarly, the grace period under proposed rule 3a68–3 mitigates uncertainty for market participants trading Title VII instruments on trading platforms by allowing time for any necessary actions to be made to accommodate the non-temporary migration of a security index underlying Title VII instruments.

The SEC requests comment as to the costs that determinations under proposed rule 3a68–3 would impose on market participants, as well as estimates and empirical data to support these costs. In addition, the SEC requests comment on any other costs associated with proposed rule 3a68–3 that have not been considered, and what the extent of those costs would be.

6. Proposed Rule 3a68–4

(a) Benefits

A mixed swap is both a security-based swap and a swap, subject to dual regulation by the Commissions, and proposed rule 3a68–4 would define the term "mixed swap" in the same manner as the term is defined in both the Exchange Act.[375] Proposed rule 3a68–4 would also provide that a mixed swap that is not executed on or subject to the rules of a DCM, SEF, FBOT, NSE, or security-based SEF and that will not be submitted to a DCO or registered or exempt clearing agency to be cleared ("bilateral uncleared mixed swap"), and where at least one party to the mixed swap is registered with the SEC as a security-based swap dealer or major security-based swap participant and also with the CFTC as a swap dealer or major swap participant, shall be subject to the provisions of the Securities Act and the rules and regulations promulgated thereunder and only to certain provisions of the CEA and the rules and regulations promulgated thereunder. In addition, proposed rule 3a68–4 would establish a process for persons to request that such persons be permitted to comply, as to parallel provisions only, with the specified parallel provisions, instead of being required to comply with parallel provisions of both the CEA and the Exchange Act.

Because, as noted above, mixed swaps are both swaps and security-based swaps, and thus are subject to regulation as both swaps and security-based swaps, the Commissions are concerned that, without further clarification, there may be uncertainty as to the scope of, and the requirements applicable to, transactions that fall within the definition of the term "mixed swap."

Proposed rule 3a68–4(a) would define the term "mixed swap" in the same manner as the term is defined in the Exchange Act. This rule, coupled with guidance regarding mixed swaps provided by the Commissions, further clarifies whether a security-based swap is a mixed swap and could eliminate the need to obtain an opinion of counsel regarding a particular security-based swap.

The Commissions are proposing rule 3a68–4(b) to eliminate potentially duplicative and conflicting regulation in the context of mixed swaps by providing that a bilateral uncleared mixed swap, where at least one party to the mixed swap is dually-registered with the SEC as a security-based swap dealer or major security-based swap participant and also with the CFTC as a swap dealer or major swap participant, would be subject to all applicable provisions of the securities laws (and SEC rules and regulations promulgated thereunder) but would be subject only to certain CEA provisions (and CFTC rules and regulations promulgated thereunder). Therefore, proposed rule 3a68–4(a) would reduce both the number of and potential uncertainty regarding which requirements of each Commission will apply to bilateral uncleared mixed swaps entered into by dually-registered dealers and major participants.

Proposed rule 3a68–4(c) also would afford persons with an opportunity to seek alternative regulatory treatment of a specified, or specified class of, mixed swap. Absent such alternative regulatory treatment, a person that desires or intends to list, trade, or clear a mixed swap would be required to comply with all the statutory provisions of Title VII, including all the rules and regulations thereunder, that are applicable to both security-based swaps and swaps. The SEC believes that such a requirement could pose practical difficulties for mixed swap transactions[376] and that permitting persons to request alternative regulatory treatment of a specified, or specified class of, mixed swaps would allow the Commissions to address the potential for duplicative or contradictory regulatory requirements regarding a particular mixed swap.

The information submitted by persons pursuant to proposed rule 3a68–4(c) would assist the Commissions in more quickly identifying and addressing the relevant issues involved in providing alternative regulatory treatment.

The SEC requests comments, data, and estimates regarding the benefits associated with proposed rule 3a68–4. The SEC also requests comments, data, and estimates regarding any additional benefits that could be realized with proposed rule 3a68–4.

(b) Costs

Providing a clear rule for persons who engage in bilateral uncleared mixed swaps would reduce the potential for duplicative or contradictory regulatory requirements that apply to such bilateral uncleared mixed swaps.

Under proposed rule 3a68–4(c), a person also could request the Commissions to provide alternative regulatory treatment of a specified, or specified class of, mixed swap. The SEC estimates that the cost of requesting alternative regulatory treatment for a particular mixed swap (or class thereof) would be approximately 30 hours of internal company or individual time and a cost of approximately $15,800 for the services of outside professionals.[377] The SEC notes, however, that any such costs are in lieu of the costs of complying with all the statutory provisions in Title VII, including all the rules and regulations thereunder, that are applicable to both security-based swaps and swaps, which the SEC

[374] *See supra* note 261 and accompanying text.

[375] Section 3(a)(68)(D) of the Exchange Act, 15 U.S.C. 78c(a)(68)(D); CEA section 1(a)(47)(D), 7 U.S.C. 1(a)(47)(D).

[376] *See* discussion *supra* part IV.

[377] *See* discussion *supra* part VIII.

believes would be more costly than requesting alternative regulatory treatment, and which potentially could pose practical difficulties.[378]

Also, the SEC believes that as persons make requests for alternative regulatory treatment of specified, or specified classes of, mixed swaps pursuant to proposed rule 3a68–4, the subsequent costs for persons transacting in those products for which the Commissions have provided for alternative regulatory treatment should be reduced.

The SEC requests comment as to the costs that proposed rule 3a68–4 would impose on market participants, as well as estimates and empirical data to support these costs. In addition, the SEC requests comment on any other costs associated with proposed rule 3a68–4 that have not been considered herein, and what the extent of those costs would be.

7. Proposed Rule 3a69–1

(a) Benefits

Proposed rule 3a69–1 would clarify that state or Federally regulated insurance products provided by state or Federally regulated insurance companies, or by certain reinsurers, provided such insurance products meet certain other requirements, would not be swaps. Specifically, proposed rule 3a69–1 would define the term "swap" so that it would not include an agreement, contract, or transaction that, by its terms or by law, as a condition of performance on the agreement, contract, or transaction: (i) Requires the beneficiary of the agreement, contract, or transaction to have an insurable interest that is the subject of the agreement, contract, or transaction and thereby carry the risk of loss with respect to that interest continuously throughout the duration of the agreement, contract, or transaction; (ii) requires that loss to occur and to be proved, and that any payment or indemnification therefor be limited to the value of the insurable interest; (iii) is not traded, separately from the insured interest, on an organized market or over-the-counter; and (iv) with respect to financial guarantee insurance only, in the event of payment default or insolvency of the obligor, any acceleration of payments under the policy is at the sole discretion of the insurer. Proposed rule 3a69–1 also would require that the agreement, contract, or transaction: (i) Be provided by a company that is organized as an insurance company whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies and that is subject to supervision by the insurance commissioner, or similar official or agency, of a state, as defined under section 3(a)(16) of the Exchange Act,[379] or by the United States or an agency or instrumentality thereof, and be regulated as insurance under the laws of such state or the United States; (ii) be provided by the United States or any of its agents or instrumentalities, or pursuant to a statutorily authorized program thereof; or (iii) in the case of reinsurance only, be provided by a person located outside the United States to an insurance company that meets the above requirements, provided that such person is not prohibited by the law of any state or the United States from offering such agreement, contract, or transaction to such insurance company, the product to be reinsured meets the requirements above for insurance products, and the total amount reimbursable by all reinsurers for such insurance product cannot exceed the claims or losses paid by the cedant. An agreement, contract, or transaction would have to meet all of these criteria in order to qualify as an insurance product that falls outside of the swap and security-based swap definitions pursuant to the proposed rules.

The SEC is concerned that, without further clarification, market participants may be uncertain about whether an agreement, contract, or transaction is an insurance product that is not subject to regulation as a swap or security-based swap. Therefore, proposed rule 3a69–1 would eliminate the potential uncertainty of what constitutes an insurance product by setting forth clear and objective criteria for meeting the definition of an insurance product that is not subject to regulation as a swap or security-based swap.

The SEC requests comments, data, and estimates regarding the benefits associated with proposed rule 3a69–1. The SEC also requests comments, data, and estimates regarding any additional benefits that could be realized with proposed rule 3a69–1.

(b) Costs

In complying with proposed rule 3a69–1, a market participant will need to analyze its agreements, contracts, and transactions that are insurance products under the provisions of the proposed rule to determine whether such insurance products fall outside the definitions of the terms "swaps" and "security-based swap." This analysis will have to be performed upon entering into the agreement, contract, or transaction to ensure compliance with proposed rule 3a69–1. The SEC notes, however, that any such costs would be in lieu of the costs of doing the same analysis absent proposed rule 3a69–1, which the SEC believes would be more difficult and lead to greater uncertainty than if the analysis were done under proposed rule 3a69–1. Providing an objective rule to determine whether an agreement, contract, or transaction is an insurance product could alleviate additional costs of inquiring with the Commissions about whether an agreement, contract, or transaction is an insurance product or a swap, or costs of obtaining an opinion of counsel regarding a particular agreement, contract, or transaction.

To the extent that the criteria under proposed rule 3a69–1 lead to the inadvertent omission of certain types of insurance products, these omissions could lead to costs for market participants entering into agreements, contracts, or transactions that might be omitted because these agreements, contracts, or transactions would be regulated as swaps and not as insurance products. Similarly, to the extent that the criteria under proposed rule 3a69–1 lead to the inadvertent inclusion of certain types of swaps or security-based swaps, these inclusions could lead to costs for market participants entering into agreements, contracts, or transactions that are regulated as insurance products and not as swaps or security-based swaps. The SEC has requested comment on whether the criteria under proposed rule 3a69–1 inadvertently omits certain types of insurance products or includes certain types of swaps in order to minimize these potential costs. The SEC believes that, pursuant to comments on the proposed criteria, any subsequent modifications the Commissions make to proposed rule 3a69–1 would significantly curtail the potential for inadvertent omissions or inclusions.

The SEC requests comment as to the costs that determinations under proposed rule 3a69–1 would impose on market participants, as well as estimates and empirical data to support these costs. In addition, the SEC requests comment on any other costs associated with proposed rule 3a69–1 that have not been considered, and what the extent of those costs would be.

8. Proposed Rule 3a69–2

(a) Benefits

Proposed rule 3a69–2 provides that the term "swap" has the meaning set forth in section 3(a)(69) of the Exchange

[378] *See* discussion *supra* part IV.B.

[379] 15 U.S.C. 78c(a)(16).

Act and that, without limiting the definition of "swap" in section 3(a)(69) of the Exchange Act, an agreement, contract, or transaction that is a cross-currency swap, currency option, foreign currency option, foreign exchange option, foreign exchange rate option, foreign exchange forward, foreign exchange swap, FRA, or NDF would fall within the meaning of the term "swap", unless such agreement, contract, or transaction is otherwise excluded by section 1a(47)(B) of the CEA.[380] Proposed rule 3a69–2 also provides that a foreign exchange forward or a foreign exchange swap shall not be considered a swap if the Secretary of the Treasury makes a determination described in section 1a(47)(E)(i) of the CEA[381] and that, notwithstanding such provision, certain provisions of the CEA will apply to such foreign exchange forward or foreign exchange swap, namely the reporting requirements in section 4r of the CEA,[382] and regulations thereunder, and, in the case of a swap dealer or major swap participant that is a party to a foreign exchange swap or foreign exchange forward, the business conduct standards in section 4s of the CEA,[383] and regulations thereunder. In addition, proposed rule 3a69–2 provides that the terms "foreign exchange forward" and "foreign exchange swap" have the meanings set forth in the CEA and that a currency swap, cross-currency swap, currency option, foreign currency option, foreign exchange option, foreign exchange rate option, and NDF is not a foreign exchange forward or foreign exchange swap for purposes of sections 1a(24) and 1a(25) of the CEA.[384]

Proposed rule 3a69–2 would restate portions of the statutory definition of "swap" and enumerate certain types of agreements, contracts, and transactions that are swaps in order to consolidate parts of the definition and related interpretations for ease of reference. Proposed rule 3a69–2 would also specify certain reporting and business conduct requirements that are applicable to foreign exchange forwards and foreign exchange swaps, and provide definitions for such terms.

Because the statutory definition of the term "swap," though broadly worded and specific regarding the status of certain agreements, contracts, and transactions, does not explicitly mention every agreement, contract, or transaction that would fall within the definition, the Commissions are concerned that application of the definition, without further clarification, may cause uncertainty about whether certain agreements, contracts, or transactions would be swaps. Proposed rule 3a69–2 would eliminate the potential uncertainty of the treatment of such agreements, contracts, and transactions as swaps by setting forth clear and objective criteria for certain agreements, contracts, and transactions without limiting the scope of the statutory definition of the term "swap." Proposed rule 3a69–2 also would eliminate the potential uncertainty regarding the reporting and business conduct requirements applicable to foreign exchange forwards and foreign exchange swaps by specifying the provisions for which compliance is required.

(b) Costs

In complying with proposed rule 3a69–2, a market participant will need to analyze its agreements, contracts, and transactions under the provisions of the proposed rule to determine whether such agreements, contracts, and transactions are swaps according to the criteria set forth in the proposed rule. This analysis will have to be performed upon entering into the agreement, contract, or transaction to ensure compliance with proposed rule 3a69–2. The SEC notes, however, that any such costs would be in lieu of the costs of doing the same analysis absent proposed rule 3a69–2, which the SEC believes would be more difficult and lead to greater uncertainty than if the analysis were done under proposed rule 3a69–2.

Providing an objective rule to market participants to determine whether certain types of agreements, contracts, or transactions are swaps could alleviate additional costs to persons of inquiring with the Commissions about whether such agreements, contracts, or transactions are swaps, as well as costs of obtaining an opinion of counsel regarding a particular agreement, contract, or transaction. In addition, an objective rule regarding reporting and business conduct requirements could alleviate additional costs to persons of inquiring with the Commissions about which reporting and business conduct requirements are applicable to foreign exchange forwards and foreign exchange swaps, and could reduce the costs of obtaining an opinion of counsel regarding a particular foreign exchange forward or foreign exchange swap.

To the extent that the criteria under proposed rule 3a69–2 lead to the inadvertent inclusion of certain types of agreements, contracts, and transactions or additional reporting or business conduct obligations for certain swaps, these inclusions and additional requirements could lead to costs for market participants entering into agreements, contracts, or transactions to which proposed rule 3a69–2 applies. The SEC has requested comment on whether the criteria under proposed rule 3a69–2 provide sufficient clarity regarding the specific products included in the rule and whether the criteria should clarify the applicability of reporting and business conduct requirements in order to minimize these potential costs. The SEC believes that, pursuant to comments on the proposed criteria, any subsequent modifications the Commissions make to proposed rule 3a69–2 would significantly curtail the potential for inadvertent inclusions or additional reporting or business conduct requirements.

The SEC requests comment as to the costs that determinations under and compliance with proposed rule 3a69–2 would impose on market participants, as well as estimates and empirical data to support these costs. In addition, the SEC requests comment on any other costs associated with proposed rule 3a69–2 that have not been considered, and what the extent of those costs would be.

9. Proposed Rule 3a69–3

(a) Benefits

Proposed rule 3a69–3 would provide that the term "security-based swap agreement" has the meaning set forth in section 3(a)(78) of the Exchange Act.[385] Proposed rule 3a69–3 also would provide that registered SDRs, swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants are not required to maintain additional books and records, or, in the case of registered SDRs, collect and maintain additional information regarding, SBSAs other than the books and records (and, in the case of registered SDRs, information) required to be kept (or collected) and maintained regarding swaps pursuant to the CEA and the CFTC rules and regulations promulgated thereunder.

Because, as noted above, security-based swap agreements are subject the CFTC's regulatory and enforcement authority and the SEC's antifraud and certain other authority, the Commissions are concerned that, without further clarification, there may be uncertainty as to the scope of transactions that fall within the definition of the term "security-based

[380] 15 U.S.C. 78c(a)(69); 7 U.S.C. 1a(47)(B).

[381] 7 U.S.C. 1a(47)(E)(i).

[382] 7 U.S.C. 6r.

[383] 7 U.S.C. 6s.

[384] 7 U.S.C. 1a(24) and 1a(25).

[385] 15 U.S.C. 78c(a)(78).

swap agreement.” Proposed rule 3a69–3(c) would define the term “security-based swap agreement” in the same manner as the term is defined in the Exchange Act. This rule, coupled with guidance regarding security-based swap agreements provided by the Commissions, further clarifies whether a swap is a security-based swap agreement and could eliminate the need to obtain an opinion of counsel regarding a particular security-based swap agreement.

Section 712(d)(2)(B) and (C) of the Dodd-Frank Act requires the Commissions to engage in joint rulemaking regarding books and records requirements for SBSAs. Providing that persons required to keep and maintain books and records regarding, or collect and maintain data regarding, swaps are not required to keep or maintain additional books and records regarding, or collect and maintain additional data regarding, SBSAs alleviates any additional books and records or information costs to such persons.

(b) Costs

The SEC believes that, because proposed rule 3a69–3 includes within the definition of SBSA no agreements, contracts, or transactions that would not be an SBSA in the absence of the proposed rule, proposed rule 3a69–3 would impose no costs other than those that are required with respect to swaps in the absence of proposed rule 3a69–3. In addition, the SEC believes that, because proposed rule 3a69–3 imposes no requirements with respect to SBSAs other than those that exist for swaps, proposed rule 3a69–3 would impose no costs other than those that are required with respect to swaps in the absence of proposed rule 3a69–3.

To the extent that the criteria under proposed rule 3a69–3 inadvertently lead to additional requirements with respect to SBSAs, these additional requirements could lead to costs for market participants entering into the SBSAs to which proposed rule 3a69–3 applies. The SEC has requested comment regarding whether the requirements under proposed rule 3a69–3 are sufficient. The SEC believes that, pursuant to comments on the proposed rule, any subsequent modifications the Commissions make to proposed rule 3a69–3 would significantly curtail the potential for inadvertent additional requirements.

The SEC requests comment as to the costs that compliance with proposed rule 3a69–3 would impose on market participants, as well as estimates and empirical data to support these costs. In addition, the SEC requests comment on any other costs associated with proposed rule 3a69–3 that have not been considered, and what the extent of those costs would be.

Request for Comment

153. The SEC has considered the costs and benefits of the proposed rules and clarifications regarding the Product Definitions, the regulation of mixed swaps, and the books and records requirements for SBSAs. The SEC is sensitive to these costs and benefits, and encourages commenters to discuss any additional costs or benefits beyond those discussed here, as well as any reductions in costs. In particular, the SEC requests comment on the potential costs, as well as any potential benefits, resulting from the proposed rules and clarifications regarding the Product Definitions, the regulation of mixed swaps, and the books and records requirements for SBSAs for issuers, investors, broker-dealers, security-based swap dealers, major security-based swap participants, persons associated with a security-based swap dealer or a major security-based swap participant, other security-based swap industry professionals, regulators, and other market participants. The SEC also seeks comment on the accuracy of any of the benefits identified and also welcomes comment on any of the costs identified here. In addition, the SEC encourages commenters to identify, discuss, analyze, and supply relevant data, information, or statistics regarding any such costs or benefits, including estimates and views regarding these costs and benefits for particular types of market participants, as well as any other costs or benefits that may result from the adoption of the proposed rules, as well as the clarifications provided.

C. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act [386] requires the SEC, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation. In addition, section 23(a)(2) of the Exchange Act [387] requires the SEC, when adopting rules under the Exchange Act, to consider the impact such rules would have on competition. Section 23(a)(2) of the Exchange Act also prohibits the SEC from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.[388]

1. Proposed Rule 3a68–1a

The SEC believes that proposed rule 3a68–1a would create an efficient process for a market participant to determine whether an index CDS is a swap or a security-based swap by setting forth clear methods and guidelines, thereby reducing potential uncertainty. Because swaps and security-based swaps both are regulated pursuant to the Dodd-Frank Act by either the CFTC or the SEC, and an index CDS would be either a swap or a security-based swap, regardless of whether the SEC proposed rule 3a68–1a, the SEC believes that the proposed rule would not have an adverse effect on capital formation.

Similarly, the SEC believes that proposed rule 3a68–1a would not impose any significant burdens on competition because an index CDS would be regulated as a swap or security-based swap regardless of whether the SEC proposed rule 3a68–1a. The proposed rule is a means of providing greater clarity for market participants on whether a specific index CDS is a swap or a security-based swap.

2. Proposed Rule 3a68–1b

The SEC believes that proposed rule 3a68–1b would create an efficient process for a market participant to determine whether an index CDS is a swap or a security-based swap by setting forth clear methods and guidelines, thereby reducing potential uncertainty. Because swaps and security-based swaps both are regulated pursuant to the Dodd-Frank Act by either the CFTC or the SEC, and an index CDS would be either a swap or a security-based swap, regardless of whether the SEC proposed rule 3a68–1b, the SEC believes that the proposed rule would not have an adverse effect on capital formation.

Similarly, the SEC believes that proposed rule 3a68–1b would not impose any significant burdens on competition because an index CDS would be regulated as a swap or security-based swap regardless of whether the SEC proposed rule 3a68–1b. The proposed rule is a means of providing greater clarity for market participants on whether a specific index CDS is a swap or a security-based swap.

3. Proposed Rule 3a68–2

The SEC believes that proposed rule 3a68–2 would create an efficient process for a market participant to request the Commissions to determine whether an

[386] 15 U.S.C. 78c(f).

[387] 15 U.S.C. 78w(a)(2).

[388] *Id.*

agreement, contract, or transaction (or class thereof) is a swap, security-based swap, or both (*i.e.,* a mixed swap) by setting forth clear methods and guidelines, thereby reducing potential uncertainty. Because swaps, security-based swaps, and mixed swaps all are regulated pursuant to the Dodd-Frank Act by either the CFTC, the SEC, or both the CFTC and SEC, and because market participants still would need to determine whether an agreement, contract, or transaction (or class thereof) is a swap, security-based swap, or mixed swap regardless of whether the SEC proposed rule 3a68–2, the SEC believes that the proposed rule would not have an adverse effect on capital formation.

In addition, the SEC believes the proposed rule will provide the opportunity for financial innovation by providing a flexible structure that will allow for the development of new products, which may promote capital formation.

Similarly, the SEC believes that proposed rule 3a68–2 would not impose any significant burdens on competition because, to the extent an agreement, contract, or transaction (or class thereof) is a swap, security-based swap, or both (*i.e.,* a mixed swap), that agreement, contract, or transaction (or class thereof) would be regulated as a swap, security-based swap, or mixed swap regardless of whether the SEC proposed rule 3a68–2. The proposed rule is a means of providing a process for market participants to request clarity regarding whether a specific agreement, contract, or transaction (or class thereof) is a swap, security-based swap, or mixed swap.

4. Proposed Rule 3a68–3

The SEC believes that proposed rule 3a68–3 would create an efficient process for a market participant to determine whether a security index underlying a Title VII instrument is narrow-based or broad-based, and therefore whether the Title VII instrument is a swap or a security-based swap, by setting forth clear methods and guidelines, thereby reducing potential uncertainty. Because swaps and security-based swaps both are regulated pursuant to the Dodd-Frank Act by either the CFTC or the SEC, and a Title VII instrument on a security index would be either a swap or a security-based swap regardless of whether the SEC proposed rule 3a68–3, the SEC believes that the proposed rule would not have an adverse effect on capital formation.

Similarly, the SEC believes that proposed rule 3a68–3 would not impose any significant burdens on competition because a Title VII instrument on a security index would be regulated as a swap or security-based swap regardless of whether the SEC proposed rule 3a68–3. The proposed rule is a means of providing greater clarity for market participants regarding whether a specific Title VII instrument on a security index is a swap or a security-based swap.

5. Proposed Rule 3a68–4

The SEC believes that proposed rule 3a68–4 would create an efficient process for a market participant to request alternative regulatory treatment regarding a specified, or specified class of, mixed swap by setting forth clear methods and guidelines, thereby reducing potential uncertainty and dual regulatory requirements. Because a mixed swap is regulated pursuant to the Dodd-Frank Act, and, absent proposed rule 3a68–4, persons that desire or intend to list, trade, or clear a mixed swap would be required to comply with all the statutory provisions in Title VII, including all the rules and regulations thereunder, that are applicable to both swaps and security-based swaps, the SEC believes that the proposed rule would not have an adverse effect on capital formation. Proposed rule 3a68–4 would permit such persons to request a joint order permitting themto comply with an alternative regulatory regime that would address the potential dual regulatory requirements applicable to transactions in mixed swaps under Title VII.

Similarly, the SEC believes that proposed rule 3a68–4 would not impose any significant burdens on competition because to the extent an agreement, contract, or transaction (or class thereof) is a mixed swap, transactions in that mixed swap would be subject to all of the statutory provisions of Title VII, including all the rules and regulations thereunder, that are applicable to both swaps and security-based swaps, if the Commissions were not to provide alternative regulatory treatment pursuant to proposed rule 3a68–4.

6. Proposed Rule 3a69–1

The SEC believes that proposed rule 3a69–1 would create an efficient process for a market participant to determine whether an agreement, contract, or transaction is an insurance product and is not a swap by setting forth clear methods and guidelines, thereby reducing potential uncertainty. Because insurance products and insurance companies currently are regulated pursuant to state insurance law, and would continue to be so regardless of whether the SEC proposed rule 3a69–1, the SEC believes that the proposed rule would not have an adverse effect on capital formation.

Similarly, the SEC believes that proposed rule 3a69–1 would not impose any significant burdens on competition because insurance products and insurance companies currently are regulated pursuant to state insurance law and would continue to be so regardless of whether the SEC proposed rule 3a69–1. The proposed rule is a means of providing greater clarity for market participants on whether a specific agreement, contract, or transaction is an insurance product and is not a swap.

7. Proposed Rule 3a69–2

The SEC believes that proposed rule 3a69–2 would create an efficient process for a market participant to determine whether an agreement, contract, or transaction is a swap, a foreign exchange forward, or a foreign exchange swap or is subject to certain reporting and business conduct requirements, by setting forth clear methods and guidelines, thereby reducing potential uncertainty. Because agreements, contracts, and transactions that are swaps, foreign exchange forwards, or foreign exchange swaps under proposed rule 3a69–2 would be swaps, foreign exchange forwards, or foreign exchange swaps and, in the case of foreign exchange forwards and foreign exchange swaps, would be subject to reporting and business conduct requirements under the CEA, in the absence of proposed rule 3a69–2, the SEC believes that the proposed rule would not have an adverse effect on capital formation.

Similarly, the SEC believes that proposed rule 3a69–2 would not impose any significant burdens on competition because swaps, foreign exchange swaps, and foreign exchange forwards continue to be regulated as such regardless of whether the SEC proposed rule 3a69–2. The proposed rule is a means of providing greater clarity for market participants on whether a specific agreement, contract, or transaction is a swap, foreign exchange forward, or foreign exchange swap and whether certain reporting and business conduct requirements apply in the case of foreign exchange forwards and foreign exchange swaps.

8. Proposed Rule 3a69–3

The SEC believes that proposed rule 3a69–3 would create an efficient process for registered SDRs, SDs, MSPs, security-based swap dealers, and major security-based swap participants to determine the books and records requirements for SBSAs by setting forth clear guidelines, thereby reducing potential uncertainty. Proposed rule 3a69–3(c) also would define the term “security-based swap agreement” in the same manner as the term is defined in the Exchange Act. Because SBSAs are swaps, they are subject to certain books and records requirements under the CEA (and CFTC rules and regulations promulgated thereunder) that are applicable to swaps and would continue to be so regardless of whether the SEC proposed rule 3a69–3. The SEC believes that the proposed rule would thus not have an adverse effect on capital formation.

Similarly, the SEC believes that proposed rule 3a69–3 would not impose any significant burdens on competition because SBSAs would be regulated as swaps regardless of whether the SEC proposed rule 3a69–3. The proposed rule is a means of providing greater clarity for market participants regarding SBSAs, including the books and records requirements for SBSAs.

Request for Comment

154. The SEC requests comment on the possible effects of the proposed rules under the Exchange Act regarding efficiency, competition, and capital formation. The SEC requests that commenters provide views and supporting information regarding any such effects. The SEC notes that such effects are difficult to quantify. The SEC seeks comment on possible anti-competitive effects of the proposed rules under the Exchange Act not already identified. The SEC also requests comment regarding the competitive effects of pursuing alternative regulatory approaches that are consistent with section 712(a) and 712(d) of the Dodd-Frank Act. In addition, the SEC requests comment on how the other provisions of the Dodd-Frank Act for which SEC rulemaking is required will interact with and influence the competitive effects of the proposed rules and clarifications under the Exchange Act.

D. Consideration of Impact on the Economy

For purposes of SBREFA the SEC must advise the OMB as to whether the proposed rules and interpretive guidance under the Exchange Act constitute “major” rules. Under SBREFA, a rule is considered “major” where, if adopted, it results or is likely to result in: (1) An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease); (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effect on competition, investment or innovation. If a rule is “major,” its effectiveness will generally be delayed for 60 days pending Congressional review.

The SEC requests comment on the potential impact of the proposed rules and interpretive guidance under the Exchange Act on the economy on an annual basis, on the costs or prices for consumers or individual industries, and on competition, investment, or innovation. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

E. Initial Regulatory Flexibility Act Certification

The RFA requires Federal agencies, in promulgating rules, to consider the impact of those rules on small entities. Section 603(a) [389] of the Administrative Procedure Act,[390] as amended by the RFA, generally requires the SEC to undertake a regulatory flexibility analysis of all proposed rules, or proposed rule amendments, to determine the impact of such rulemaking on “small entities.” [391] Section 605(b) of the RFA states that this requirement shall not apply to any proposed rule or proposed rule amendment, that, if adopted, would not have a significant economic impact on a substantial number of small entities.[392]

For purposes of SEC rulemaking in connection with the RFA, a small entity includes: (i) When used with reference to an “issuer” or a “person,” other than an investment company, an “issuer” or “person” that, on the last day of its most recent fiscal year, had total assets of $5 million or less,[393] or (ii) a broker-dealer with total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to rule 17a–5(d) under the Exchange Act,[394] or, if not required to file such statements, a broker-dealer with total capital (net worth plus subordinated liabilities) of less than $500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and is not affiliated with any person (other than a natural person) that is not a small business or small organization.[395] Under the standards adopted by the Small Business Administration, small entities in the finance and insurance industry include the following: (i) For entities in credit intermediation and related activities, entities with $175 million or less in assets or, for non-depository credit intermediation and certain other activities, $7 million or less in annual receipts; (ii) for entities in financial investments and related activities, entities with $7 million or less in annual receipts; (iii) for insurance carriers and entities in related activities, entities with $7 million or less in annual receipts; and (iv) for funds, trusts, and other financial vehicles, entities with $7 million or less in annual receipts.[396]

Based on the SEC’s existing information about the swap markets, the SEC believes that the swap markets, while broad in scope, are largely dominated by entities such as those that would be covered by the “swap dealer,” “security-based swap dealer,” “major swap participant,” and “major security-based swap participant” definitions.[397] The SEC believes that such entities exceed the thresholds defining “small entities” set out above. Moreover, although it is possible that other persons may engage in swap and security-based swap transactions, the SEC does not believe that any of these entities would be “small entities” as defined in rule 0–10 under the Exchange Act.[398] Feedback from industry participants about the swap markets indicates that only persons or entities with assets significantly in excess of $5 million (or with annual receipts significantly in excess of $7 million) participate in the swap markets.

To the extent that a small number of transactions did have a counterparty that was defined as a “small entity” under SEC rule 0–10, the SEC believes it is unlikely that the proposed rules and clarifications regarding the Product Definitions, the regulation of mixed swaps, and the books and records requirements for SBSAs would have a significant economic impact on that

[389] 5 U.S.C. 603(a).

[390] 5 U.S.C. 551 *et seq.*

[391] Although section 601(b) of the RFA defines the term “small entity,” the statute permits agencies to formulate their own definitions. The SEC has adopted definitions for the term small entity for the purposes of SEC rulemaking in accordance with the RFA. Those definitions, as relevant to this proposed rulemaking, are set forth in rule 0–10, 17 CFR 240.0–10. *See* Statement of Management on Internal Accounting Control, 47 FR 5215, Feb. 4, 1982.

[392] *See* 5 U.S.C. 605(b).

[393] *See* 17 CFR 240.0–10(a).

[394] *See* 17 CFR 240.17a–5(d).

[395] *See* 17 CFR 240.0–10(c).

[396] *See* 13 CFR 121.201.

[397] *See, e.g.,* CEA section 1a(49), 7 U.S.C. 1a(49) (defining “swap dealer”); section 3(a)(71)(A) of the Exchange Act, 15 U.S.C. 78c(a)(71)(A) (defining “security-based swap dealer”); CEA section 1a(33), 7 U.S.C. 1a(33) (defining “major swap participant”); section 3(a)(67)(A) of the Exchange Act, 15 U.S.C. 78c(a)(67)(A) (defining “major security-based swap participant”). Such entities also would include commercial entities that may use swaps to hedge or mitigate commercial risk.

[398] *See* 17 CFR 240.0–10(a).

entity. The proposed rules and clarifications simply would address whether certain products fall within the swap definition, address whether certain products are swaps, security-based swaps, SBSAs, or mixed swaps, provide a process for requesting interpretations of whether agreements, contracts, and transactions are swaps, security-based swaps, and mixed swaps, provide a process for requesting alternative regulatory treatment for mixed swaps, and establish books and records requirements for SBSAs, which are applicable to all entities.

For the foregoing reasons, the SEC certifies that the proposed rules and clarifications regarding the Product Definitions, the regulation of mixed swaps, and the books and records requirements for SBSAs would not have a significant economic impact on a substantial number of small entities for purposes of the RFA. The SEC encourages written comments regarding this certification. The SEC requests that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of the impact.

X. Statutory Basis and Rule Text

List of Subjects

17 CFR Part 1

Definitions, General swap provisions.

17 CFR Part 240

Reporting and recordkeeping requirements, Securities.

Commodity Futures Trading Commission

Pursuant to the Commodity Exchange Act, 7 U.S.C. 1 *et seq.,* as amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010) ("Dodd-Frank Act"), and sections 712(a)(8), 712(d), 721(a), 721(b), 721(c), 722(d), and 725(g) of the Dodd-Frank Act, the CFTC is proposing to adopt rules 1.3(xxx) through 1.3(aaaa) and 1.6 through 1.9 under the Commodity Exchange Act.

Text of Proposed Rules

For the reasons stated in the preamble, the CFTC is proposing to further amend Title 17, Chapter I, of the Code of Federal Regulations, as amended at 75 FR 63732, October 18, 2010, 75 FR 65586, Oct. 26, 2010, 75 FR 77576, Dec. 13, 2010, 75 FR 80174, Dec. 21, 2010, and 76 FR 722, Jan. 6, 2011, as follows:

PART 1—GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

1. The authority citation for part 1 is revised to read as follows:

Authority: 7 U.S.C. 1a, 2, 5, 6, 6a, 6b, 6c, 6c, 6e, 6f, 6g, 6h, 6i, 6j, 6k, 6l, 6m, 6n, 6o, 6p, 6r, 7, 7a, 7b, 8, 9, 10, 12, 12a, 12c, 13a, 13a–1, 16, 16a, 21, 23, and 24.

2. Amend § 1.3 by adding paragraphs (xxx), (yyy), (zzz), and (aaaa) to read as follows:

§ 1.3 Definitions.

* * * * *

(xxx) *Swap.* (1) *In general.* The term *swap* has the meaning set forth in section 1a(47) of the Commodity Exchange Act.

(2) *Inclusion of particular products.* (i) The term *swap* includes, without limiting the meaning set forth in section 1a(47) of the Commodity Exchange Act, the following agreements, contracts, and transactions:

(A) A cross-currency swap;

(B) A currency option, foreign currency option, foreign exchange option and foreign exchange rate option;

(C) A foreign exchange forward;

(D) A foreign exchange swap;

(E) A forward rate agreement; and

(F) A non-deliverable forward involving foreign exchange.

(ii) The term *swap* does not include an agreement, contract, or transaction described in paragraph (xxx)(2)(i) of this section that is otherwise excluded by section 1a(47)(B) of the Commodity Exchange Act.

(3) *Foreign exchange forwards and foreign exchange swaps.* Notwithstanding paragraph (xxx)(2) of this section:

(i) A foreign exchange forward or a foreign exchange swap shall not be considered a swap if the Secretary of the Treasury makes a determination described in section 1a(47)(E)(i) of the Commodity Exchange Act.

(ii) Notwithstanding paragraph (xxx)(3)(i) of this section:

(A) The reporting requirements set forth in section 4r of the Commodity Exchange Act and regulations promulgated thereunder shall apply to a foreign exchange forward or foreign exchange swap; and

(B) The business conduct standards set forth in section 4s of the Commodity Exchange Act and regulations promulgated thereunder shall apply to a swap dealer or major swap participant that is a party to a foreign exchange forward or foreign exchange swap.

(iii) For purposes of section 1a(47)(E) of the Commodity Exchange Act and this § 1.3(xxx), the term *foreign exchange forward* has the meaning set forth in section 1a(24) of the Commodity Exchange Act.

(iv) For purposes of section 1a(47)(E) of the Commodity Exchange Act and this § 1.3(xxx), the term *foreign exchange swap* has the meaning set forth in section 1a(25) of the Commodity Exchange Act.

(v) For purposes of sections 1a(24) and 1a(25) of the Commodity Exchange Act and this § 1.3(xxx), the following transactions are not foreign exchange forwards or foreign exchange swaps:

(A) A currency swap or a cross-currency swap;

(B) A currency option, foreign currency option, foreign exchange option, or foreign exchange rate option; and

(C) A non-deliverable forward involving foreign exchange.

(4) *Insurance.* The term *swap* as used in section 1a(47) of the Commodity Exchange Act does not include an agreement, contract, or transaction that:

(i) By its terms or by law, as a condition of performance on the agreement, contract, or transaction:

(A) Requires the beneficiary of the agreement, contract, or transaction to have an insurable interest that is the subject of the agreement, contract, or transaction and thereby carry the risk of loss with respect to that interest continuously throughout the duration of the agreement, contract, or transaction;

(B) Requires that loss to occur and to be proved, and that any payment or indemnification therefor be limited to the value of the insurable interest;

(C) Is not traded, separately from the insured interest, on an organized market or over-the-counter; and

(D) With respect to financial guaranty insurance only, in the event of payment default or insolvency of the obligor, any acceleration of payments under the policy is at the sole discretion of the insurer; and

(ii) Is provided:

(A) By a company that is organized as an insurance company whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies and that is subject to supervision by the insurance commissioner (or similar official or agency) of any State or by the United States or an agency or instrumentality thereof, and such agreement, contract, or transaction is regulated as insurance under the laws of such State or of the United States;

(B) By the United States or any of its agencies or instrumentalities, or pursuant to a statutorily authorized program thereof; or

(C) In the case of reinsurance only, by a person located outside the United States to an insurance company that is eligible under paragraph (xxx)(4)(ii) of this section, provided that:

(*1*) Such person is not prohibited by any law of any State or of the United States from offering such agreement, contract, or transaction to such an insurance company;

(*2*) The product to be reinsured meets the requirements under paragraph (xxx)(4)(i) of this section to be insurance; and

(*3*) The total amount reimbursable by all reinsurers for such insurance product cannot exceed the claims or losses paid by the cedant.

(5) *State.* For purposes of paragraph (xxx)(4) of this section, the term *State* means any state of the United States, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, or any other possession of the United States.

(6) *Anti-evasion.* (i) An agreement, contract, or transaction that is willfully structured to evade any provision of Subtitle A of the Wall Street Transparency and Accountability Act of 2010, including any amendments made to the Commodity Exchange Act thereby (*Subtitle A*), shall be deemed a swap for purposes of Subtitle A and the rules, regulations, and orders of the Commission promulgated thereunder.

(ii) An interest rate swap or currency swap, including but not limited to a transaction identified in paragraph (xxx)(3)(v) of this section, that is willfully structured as a foreign exchange forward or foreign exchange swap to evade any provision of Subtitle A shall be deemed a swap for purposes of Subtitle A and the rules, regulations, and orders of the Commission promulgated thereunder.

(iii) An agreement, contract, or transaction of a bank that is not under the regulatory jurisdiction of an appropriate Federal banking agency (as defined in section 1a(2) of the Commodity Exchange Act), where the agreement, contract, or transaction is willfully structured as an identified banking product (as defined in section 402 of the Legal Certainty for Bank Products Act of 2000) to evade the provisions of the Commodity Exchange Act, shall be deemed a swap for purposes of the Commodity Exchange Act and the rules, regulations, and orders of the Commission promulgated thereunder.

(iv) The form, label, and written documentation of an agreement, contract, or transaction shall not be dispositive in determining whether the agreement, contract, or transaction has been willfully structured to evade as provided in paragraphs (xxx)(6)(i) through (xxx)(6)(iii) of this section.

(v) An agreement, contract, or transaction that has been willfully structured to evade as provided in paragraphs (xxx)(6)(i) through (xxx)(6)(iii) of this section shall be considered in determining whether a person is a swap dealer or major swap participant.

(vi) Notwithstanding the foregoing, no agreement, contract, or transaction structured as a security (including a security-based swap) under the securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47))) shall be deemed a swap pursuant to this § 1.3(xxx)(6) or shall be considered for purposes of paragraph (xxx)(6)(v) of this section.

(yyy) *Narrow-based security index as used in the definition of "security-based swap."*

(1) *In general.* Except as otherwise provided in paragraphs (zzz) and (aaaa) of this section, for purposes of section 1a(42) of the Commodity Exchange Act, the term *narrow-based security index* has the meaning set forth in section 1a(35) of the Commodity Exchange Act, and the rules, regulations and orders of the Commission thereunder.

(2) *Tolerance period for swaps traded on designated contract markets, swap execution facilities, and foreign boards of trade.* Notwithstanding paragraph (yyy)(1) of this section, solely for purposes of swaps traded on or subject to the rules of a designated contract market, swap execution facility, or foreign board of trade, a security index underlying such swaps shall not be considered a narrow-based security index if:

(i)(A) A swap on the index is traded on or subject to the rules of a designated contract market, swap execution facility, or foreign board of trade for at least 30 days as a swap on an index that was not a narrow-based security index; or

(B) Such index was not a narrow-based security index during every trading day of the six full calendar months preceding a date no earlier than 30 days prior to the commencement of trading of a swap on such index on a market described in paragraph (yyy)(2)(i)(A) of this section; and

(ii) The index has been a narrow-based security index for no more than 45 business days over three consecutive calendar months.

(3) *Tolerance period for security-based swaps traded on national securities exchanges or security-based swap execution facilities.* Notwithstanding paragraph (yyy)(1) of this section, solely for purposes of security-based swaps traded on a national securities exchange or security-based swap execution facility, a security index underlying such security-based swaps shall be considered a narrow-based security index if:

(i)(A) A security-based swap on the index is traded on a national securities exchange or security-based swap execution facility for at least 30 days as a security-based swap on a narrow-based security index; or

(B) Such index was a narrow-based security index during every trading day of the six full calendar months preceding a date no earlier than 30 days prior to the commencement of trading of a security-based swap on such index on a market described in paragraph (yyy)(3)(i)(A) of this section; and

(ii) The index has been a security index that is not a narrow-based security index for no more than 45 business days over three consecutive calendar months.

(4) *Grace period.* (i) Solely with respect to a swap that is traded on or subject to the rules of a designated contract market, swap execution facility, or foreign board of trade, an index that becomes a narrow-based security index under paragraph (yyy)(2) of this section solely because it was a narrow-based security index for more than 45 business days over three consecutive calendar months shall not be a narrow-based security index for the following three calendar months.

(ii) Solely with respect to a security-based swap that is traded on a national securities exchange or security-based swap execution facility, an index that becomes a security index that is not a narrow-based security index under paragraph (yyy)(3) of this section solely because it was not a narrow-based security index for more than 45 business days over three consecutive calendar months shall be a narrow-based security index for the following three calendar months.

(zzz) *Meaning of "issuers of securities in a narrow-based security index" as used in the definition of "security-based swap" as applied to index credit default swaps.*

(1) Notwithstanding paragraph (yyy)(1) of this section, and solely for purposes of determining whether a credit default swap is a security-based swap under the definition of "security-based swap" in section 3(a)(68)(A)(ii)(III) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(68)(A)(ii)(III), as incorporated in section 1a(42) of the Commodity Exchange Act, the term *issuers of securities in a narrow-based security index* means issuers of

securities identified in an index in which:

(i)(A) There are 9 or fewer non-affiliated issuers of securities that are reference entities in the index, provided that an issuer of securities shall not be deemed a reference entity for purposes of this section unless:

(*1*) A credit event with respect to such reference entity would result in a payment by the credit protection seller to the credit protection buyer under the credit default swap based on the related notional amount allocated to such reference entity; or

(*2*) The fact of such credit event or the calculation in accordance with paragraph (zzz)(1)(i)(A)(*1*) of this section of the amount owed with respect to such credit event is taken into account in determining whether to make any future payments under the credit default swap with respect to any future credit events;

(B) The effective notional amount allocated to any reference entity included in the index comprises more than 30 percent of the index's weighting;

(C) The effective notional amount allocated to any five non-affiliated reference entities included in the index comprises more than 60 percent of the index's weighting; or

(D) Except as provided in paragraph (zzz)(2) of this section, for each reference entity included in the index, none of the following criteria is satisfied:

(*1*) The reference entity is required to file reports pursuant to section 13 or section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d));

(*2*) The reference entity is eligible to rely on the exemption provided in rule 12g3–2(b) under the Securities Exchange Act of 1934 (17 CFR 240.12g3–2(b));

(*3*) The reference entity has a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more;

(*4*) The reference entity (other than an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)) has outstanding securities that are notes, bonds, debentures, or evidences of indebtedness having a total remaining principal amount of at least $1 billion;

(*5*) The reference entity is the issuer of an exempted security as defined in section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)) (other than any municipal security as defined in section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29)));

(*6*) The reference entity is a government of a foreign country or a political subdivision of a foreign country;

(*7*) If the reference entity is an issuer of asset-backed securities as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)), such asset-based securities were issued in a transaction registered under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*) and have publicly available distribution reports; and

(*8*) For a credit default swap entered into solely between eligible contract participants as defined in section 1a(18) of the Commodity Exchange Act:

(*i*) The reference entity (other than a reference entity that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77))) provides to the public or to such eligible contract participant information about the reference entity pursuant to rule 144A(d)(4) under the Securities Act of 1933 (17 CFR 230.144A(d)(4));

(*ii*) Financial information about the reference entity (other than a reference entity that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77))) is otherwise publicly available; or

(*iii*) In the case of a reference entity that is an issuing entity of asset-backed securities as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)), information of the type and level included in public distribution reports for similar asset-backed securities is publicly available about both the reference entity and such asset-backed securities; and

(ii)(A) The index is not composed solely of reference entities that are issuers of exempted securities as defined in section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29))), as in effect on the date of enactment of the Futures Trading Act of 1982); and

(B) Without taking into account any portion of the index composed of reference entities that are issuers of exempted securities as defined in section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29))), the remaining portion of the index would be a narrow-based security index under paragraph (zzz)(1)(i) of this section.

(2) Paragraph (zzz)(1)(i)(D) of this section will not apply with respect to a reference entity included in the index if:

(i) The effective notional amounts allocated to such reference entity comprise less than five percent of the index's weighting; and

(ii) The effective notional amounts allocated to reference entities that satisfy paragraph (zzz)(1)(i)(D) of this section comprise at least 80 percent of the index's weighting.

(3) For purposes of this paragraph (zzz):

(i) A reference entity is affiliated with another entity if it controls, is controlled by, or is under common control with, that entity; provided that each reference entity that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)) will not be considered affiliated with any other issuing entity of an asset-backed security.

(ii) *Control* means ownership of 20 percent or more of an entity's equity, or the ability to direct the voting of 20 percent or more of the entity's voting equity.

(iii) The term *reference entity* includes:

(A) An issuer of securities;

(B) An issuing entity of an asset-based security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)); and

(C) A single reference entity or a group of affiliated entities; provided that each issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)) is a separate reference entity.

(aaaa) *Meaning of* "*narrow-based security index*" *as used in the definition of* "*security-based swap*" *as applied to index credit default swaps.*

(1) Notwithstanding paragraph (yyy)(1) of this section, and solely for purposes of determining whether a credit default swap is a security-based swap under the definition of "security-based swap" in section 3(a)(68)(A)(ii)(I) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(68)(A)(ii)(I), as incorporated in section 1a(42) of the Commodity Exchange Act, the term *narrow-based security index* means an index in which:

(i)(A) The index is composed of 9 or fewer securities or securities that are issued by 9 or fewer non-affiliated issuers, provided that a security shall not be deemed a component of the index for purposes of this section unless:

(*1*) A credit event with respect to the issuer of such security or a credit event with respect to such security would result in a payment by the credit protection seller to the credit protection buyer under the credit default swap based on the related notional amount allocated to such security; or

(*2*) The fact of such credit event or the calculation in accordance with paragraph (aaaa)(1)(i)(A)(*1*) of this section of the amount owed with respect to such credit event is taken into account in determining whether to make any future payments under the credit default swap with respect to any future credit events;

(B) The effective notional amount allocated to the securities of any issuer included in the index comprises more than 30 percent of the index's weighting;

(C) The effective notional amount allocated to the securities of any five non-affiliated issuers included in the index comprises more than 60 percent of the index's weighting; or

(D) Except as provided in paragraph (aaaa)(2) of this section, for each security included in the index, none of the following criteria is satisfied:

(*1*) The issuer of the security is required to file reports pursuant to section 13 or section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d));

(*2*) The issuer of the security is eligible to rely on the exemption provided in rule 12g3–2(b) under the Securities Exchange Act of 1934 (17 CFR 240.12g3–2(b));

(*3*) The issuer of the security has a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more;

(*4*) The issuer of the security (other than an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77))) has outstanding securities that are notes, bonds, debentures, or evidences of indebtedness having a total remaining principal amount of at least $1 billion;

(*5*) The security is an exempted security as defined in section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)) (other than any municipal security as defined in section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29)));

(*6*) The issuer of the security is a government of a foreign country or a political subdivision of a foreign country;

(*7*) If the security is an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)), the security was issued in a transaction registered under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*) and has publicly available distribution reports; and

(*8*) For a credit default swap entered into solely between eligible contract participants as defined in section 1a(18) of the Commodity Exchange Act:

(*i*) The issuer of the security (other than an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77))) provides to the public or to such eligible contract participant information about such issuer pursuant to rule 144A(d)(4) of the Securities Act of 1933 (17 CFR 230.144A(d)(4));

(*ii*) Financial information about the issuer of the security (other than an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77))) is otherwise publicly available; or

(*iii*) In the case of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)), information of the type and level included in public distribution reports for similar asset-backed securities is publicly available about both the issuing entity and such asset-backed security; and

(ii)(A) The index is not composed solely of exempted securities as defined in section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29))), as in effect on the date of enactment of the Futures Trading Act of 1982); and

(B) Without taking into account any portion of the index composed of exempted securities as defined in section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29))), the remaining portion of the index would be a narrow-based security index under paragraph (aaaa)(1)(i) of this section.

(2) Paragraph (aaaa)(1)(i)(D) of this section will not apply with respect to securities of an issuer included in the index if:

(i) The effective notional amounts allocated to all securities of such issuer included in the index comprise less than five percent of the index's weighting; and

(ii) The securities that satisfy paragraph (aaaa)(1)(i)(D) of this section comprise at least 80 percent of the index's weighting.

(3) For purposes of this paragraph (aaaa):

(i) An issuer is affiliated with another issuer if it controls, is controlled by, or is under common control with, that issuer; provided that each issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)) will not be considered affiliated with any other issuing entity of an asset-backed security.

(ii) *Control* means ownership of 20 percent or more of an issuer's equity, or the ability to direct the voting of 20 percent or more of the issuer's voting equity.

(iii) The term *issuer* includes:

(A) An issuer of securities;

(B) An issuing entity of an asset-based security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)); and

(C) A single issuer or a group of affiliated issuers; provided that each issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)) is a separate issuer.

3. Add §§ 1.6 through 1.9 to read as follows:

* * * * *

§ 1.6 Anti-evasion.

(a) It shall be unlawful to conduct activities outside the United States, including entering into agreements, contracts, and transactions and structuring entities, to willfully evade or attempt to evade any provision of the Commodity Exchange Act as enacted by Subtitle A of the Wall Street Transparency and Accountability Act of 2010 or the rules, regulations, and orders of the Commission promulgated thereunder (*Subtitle A*).

(b) The form, label, and written documentation of an agreement, contract, or transaction, or an entity, shall not be dispositive in determining whether the agreement, contract, or transaction, or entity, has been entered into or structured to willfully evade as provided in paragraph (a) of this section.

(c) An activity conducted outside the United States to evade as provided in paragraph (a) of this section shall be subject to the provisions of Subtitle A.

(d) Notwithstanding the foregoing, no agreement, contract, or transaction structured as a security (including a security-based swap) under the securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47))) shall be deemed a swap pursuant to this § 1.6.

5. Add § 1.7 to read as follows:

§ 1.7 Books and records requirements for security-based swap agreements.

(a) A person registered as a swap data repository under section 21 of the Commodity Exchange Act and the rules and regulations thereunder:

(1) Shall not be required to keep and maintain additional books and records regarding security-based swap agreements other than the books and records regarding swaps required to be kept and maintained pursuant to section 21 of the Commodity Exchange Act and the rules and regulations thereunder; and

(2) Shall not be required to collect and maintain additional data regarding security-based swap agreements other than the data regarding swaps required to be collected and maintained by such persons pursuant to section 21 of the Commodity Exchange Act and the rules and regulations thereunder.

(b) A person shall not be required to keep and maintain additional books and records, including daily trading records, regarding security-based swap agreements other than the books and records regarding swaps required to be kept and maintained by such persons pursuant to section 4s of the Commodity Exchange Act and the rules and regulations thereunder if such person is registered as:

(1) A swap dealer under section 4s(a)(1) of the Commodity Exchange Act and the rules and regulations thereunder;

(2) A major swap participant under section 4s(a)(2) of the Commodity Exchange Act and the rules and regulations thereunder;

(3) A security-based swap dealer under section 15F(a)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-10(a)(1)) and the rules and regulations thereunder; or

(4) A major security-based swap participant under section 15F(a)(2) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-10(a)(2)) and the rules and regulations thereunder.

(c) The term *security-based swap agreement* has the meaning set forth in section 1a(47)(A)(v) of the Commodity Exchange Act.

6. Add § 1.8 to read as follows:

§ 1.8 Interpretation of swaps, security-based swaps, and mixed swaps.

(a) *In general.* Any person may submit a request to the Commission and the Securities and Exchange Commission to provide a joint interpretation of whether a particular agreement, contract, or transaction (or class thereof) is:

(1) A swap, as that term is defined in section 1a(47) of the Commodity Exchange Act and the rules and regulations promulgated thereunder;

(2) A security-based swap, as that term is defined in section 1a(42) of the Commodity Exchange Act and the rules and regulations promulgated thereunder; or

(3) A mixed swap, as that term is defined in section 1a(47)(D) of the Commodity Exchange Act and the rules and regulations promulgated thereunder.

(b) *Request process.* In making a request pursuant to paragraph (a) of this section, the requesting person must provide the Commission and the Securities and Exchange Commission with the following:

(1) All material information regarding the terms of the agreement, contract, or transaction (or class thereof);

(2) A statement of the economic characteristics and purpose of the agreement, contract, or transaction (or class thereof);

(3) The requesting person's determination as to whether the agreement, contract, or transaction (or class thereof) should be characterized as a swap, a security-based swap, or both, (*i.e.,* a mixed swap), including the basis for such determination; and

(4) Such other information as may be requested by the Commission or the Securities and Exchange Commission.

(c) *Request withdrawal.* A person may withdraw a request made pursuant to paragraph (a) of this section at any time prior to the issuance of a joint interpretation or joint notice of proposed rulemaking by the Commission and the Securities and Exchange Commission in response to the request; provided, however, that notwithstanding such withdrawal, the Commission and the Securities and Exchange Commission may provide a joint interpretation of whether the agreement, contract, or transaction (or class thereof) is a swap, a security-based swap, or both (*i.e.,* a mixed swap).

(d) *Request by the Commission or the Securities and Exchange Commission.* In the absence of a request for a joint interpretation under paragraph (a) of this section:

(1) If the Commission or the Securities and Exchange Commission receives a proposal to list, trade, or clear an agreement, contract, or transaction (or class thereof) that raises questions as to the appropriate characterization of such agreement, contract, or transaction (or class thereof) as a swap, a security-based swap, or both (*i.e.,* a mixed swap), the Commission or the Securities and Exchange Commission, as applicable, promptly shall notify the other of the agreement, contract, or transaction (or class thereof); and

(2) The Commission or the Securities and Exchange Commission, or their Chairmen jointly, may submit a request for a joint interpretation as described in paragraph (a) of this section; such submission shall be made pursuant to paragraph (b) of this section, and may be withdrawn pursuant to paragraph (c) of this section.

(e) *Timeframe for joint interpretation.* (1) If the Commission and the Securities and Exchange Commission determine to issue a joint interpretation as described in paragraph (a) of this section, such joint interpretation shall be issued within 120 days after receipt of a complete submission requesting a joint interpretation under paragraph (a) or (d) of this section.

(2) The Commission and the Securities and Exchange Commission shall consult with the Board of Governors of the Federal Reserve System prior to issuing any joint interpretation as described in paragraph (a) of this section.

(3) If the Commission and the Securities and Exchange Commission seek public comment with respect to a joint interpretation regarding an agreement, contract, or transaction (or class thereof), the 120-day period described in paragraph (e)(1) of this section shall be stayed during the pendency of the comment period, but shall recommence with the business day after the public comment period ends.

(4) Nothing in this section shall require the Commission and the Securities and Exchange Commission to issue any joint interpretation.

(5) If the Commission and the Securities and Exchange Commission do not issue a joint interpretation within the time period described in paragraph (e)(1) or (e)(3) of this section, each of the Commission and the Securities and Exchange Commission shall publicly provide the reasons for not issuing such a joint interpretation within the applicable timeframes.

(f) *Joint notice of proposed rulemaking.* (1) Rather than issue a joint interpretation pursuant to paragraph (a) of this section, the Commission and the

Securities and Exchange Commission may issue a joint notice of proposed rulemaking, in consultation with the Board of Governors of the Federal Reserve System, to further define one or more of the terms swap, security-based swap, or mixed swap.

(2) A joint notice of proposed rulemaking described in paragraph (f)(1) of this section shall be issued within the timeframe for issuing a joint interpretation set forth in paragraph (e) of this section.

7. Add § 1.9 to read as follows:

§ 1.9 Regulation of mixed swaps.

(a) *In general.* The term mixed swap has the meaning set forth in section 1a(47)(D) of the Commodity Exchange Act.

(b) *Regulation of bilateral uncleared mixed swaps entered into by dually-registered dealers or major participants.* A mixed swap:

(1) That 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;

(2) That will not be submitted to a derivatives clearing organization or registered or exempt clearing agency to be cleared; and

(3) Where at least one party is registered with the Commission as a swap dealer or major swap participant and also with the Securities and Exchange Commission as a security-based swap dealer or major security-based swap participant, shall be subject to:

(i) The following provisions of the Commodity Exchange Act, and the rules and regulations promulgated thereunder:

(A) Examinations and information sharing: sections 4s(f) and 8 of the Commodity Exchange Act;

(B) Enforcement: sections 2(a)(1)(B), 4(b), 4b, 4c, 6(c), 6(d), 6c, 6d, 9, 13(a), 13(b), and 23 of the Commodity Exchange Act;

(C) Reporting to a swap data repository: section 4r of the Commodity Exchange Act;

(D) Real-time reporting: section 2(a)(13) of the Commodity Exchange Act;

(E) Capital: section 4s(e) of the Commodity Exchange Act; and

(F) Position Limits: section 4a of the Commodity Exchange Act; and

(ii) The provisions of the Federal securities laws, as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47)), and the rules and regulations promulgated thereunder.

(c) *Process for determining regulatory treatment for other mixed swaps*—(1) *In general.* Any person who desires or intends to list, trade, or clear a mixed swap (or class thereof) that is not subject to paragraph (b) of this section may request the Commission and the Securities and Exchange Commission to issue a joint order permitting the requesting person (and any other person or persons that subsequently lists, trades, or clears that mixed swap) to comply, as to parallel provisions only, with specified parallel provisions of either the Commodity Exchange Act or the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*), and the rules and regulations thereunder (collectively, *specified parallel provisions*), instead of being required to comply with parallel provisions of both the Commodity Exchange Act and the Securities Exchange Act of 1934. For purposes of this paragraph (c), *parallel provisions* means comparable provisions of the Commodity Exchange Act and the Securities Exchange Act of 1934 that were added or amended by the Wall Street Transparency and Accountability Act of 2010 with respect to swaps and security-based swaps, and the rules and regulations thereunder.

(2) *Request process.* A person submitting a request pursuant to paragraph (c)(1) of this section must provide the Commission and the Securities and Exchange Commission with the following:

(i) All material information regarding the terms of the specified, or specified class of, mixed swap;

(ii) The economic characteristics and purpose of the specified, or specified class of, mixed swap;

(iii) The specified parallel provisions, and the reasons the person believes such specified parallel provisions would be appropriate for the mixed swap (or class thereof); and

(iv) An analysis of:

(A) The nature and purposes of the parallel provisions that are the subject of the request;

(B) The comparability of such parallel provisions;

(C) The extent of any conflicts or differences between such parallel provisions; and

(D) Such other information as may be requested by the Commission or the Securities and Exchange Commission.

(3) *Request withdrawal.* A person may withdraw a request made pursuant to paragraph (c)(1) of this section at any time prior to the issuance of a joint order under paragraph (c)(4) of this section by the Commission and the Securities and Exchange Commission in response to the request.

(4) *Issuance of orders.* In response to a request under paragraph (c)(1) of this section, the Commission and the Securities and Exchange Commission, as necessary to carry out the purposes of the Wall Street Transparency and Accountability Act of 2010, may issue a joint order, after notice and opportunity for comment, permitting the requesting person (and any other person or persons that subsequently lists, trades, or clears that mixed swap) to comply, as to parallel provisions only, with the specified parallel provisions (or another subset of the parallel provisions that are the subject of the request, as the Commissions determine is appropriate), instead of being required to comply with parallel provisions of both the Commodity Exchange Act and the Securities Exchange Act of 1934. In determining the contents of such joint order, the Commission and the Securities and Exchange Commission may consider, among other things:

(i) The nature and purposes of the parallel provisions that are the subject of the request;

(ii) The comparability of such parallel provisions; and

(iii) The extent of any conflicts or differences between such parallel provisions.

(5) *Timeframe.* (i) If the Commission and the Securities and Exchange Commission determine to issue a joint order as described in paragraph (c)(4) of this section, such joint order shall be issued within 120 days after receipt of a complete request for a joint order under paragraph (c)(1) of this section, which time period shall be stayed during the pendency of the public comment period provided for in paragraph (c)(4) of this section and shall recommence with the business day after the public comment period ends.

(ii) Nothing in this section shall require the Commission and the Securities and Exchange Commission to issue any joint order.

(iii) If the Commission and the Securities and Exchange Commission do not issue a joint order within the time period described in paragraph (c)(5)(i) of this section, each of the Commission and the Securities and Exchange Commission shall publicly provide the reasons for not issuing such a joint order within that timeframe.

Securities and Exchange Commission

Pursuant to the Exchange Act, 15 U.S.C. 78a *et seq.,* and particularly, sections 3 and 23 thereof, and sections 712(a)(8), 712(d), 721(a), 761(a) of the Dodd-Frank Act, the SEC is proposing to adopt rules 3a68–1a through 3a68–4 and

3a69–1 through 3a69–3 under the Exchange Act.

Text of Proposed Rules

For the reasons stated in the preamble, the SEC is proposing to amend Title 17, Chapter II of the Code of the Federal Regulations as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The general authority citation for Part 240 is revised to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78*l,* 78m, 78n, 78n–1, 78o, 78o–4, 78o–8, 78p, 78q, 78s, 78u–5, 78w, 78x, 78dd(b), 78dd(c), 78*ll,* 78mm, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4, 80b–11, and 7201 *et seq.;* 18 U.S.C. 1350; and 12 U.S.C. 5221(e)(3), unless otherwise noted.

* * * * *

2. Add §§ 240.3a68–1a through 240.3a68–4 and §§ 240.3a69–1 through 240.3a69–3 to read as follows:

240.3a68–1a Meaning of "issuers of securities in a narrow-based security index" as used in section 3(a)(68)(A)(ii)(III) of the Act.
240.3a68–1b Meaning of "narrow-based security index" as used in section 3(a)(68)(A)(ii)(I) of the Act.
240.3a68–2 Interpretation of swaps, security-based swaps, and mixed swaps.
240.3a68–3 Meaning of "narrow-based security index" as used in the definition of "security-based swap".
240.3a68–4 Regulation of mixed swaps.
240.3a69–1 Definition of "swap" as used in section 3(a)(69) of the Act—insurance.
240.3a69–2 Definition of "swap" as used in section 3(a)(69) of the Act—additional products.
240.3a69–3 Books and records requirements for security-based swap agreements.

* * * * *

§ 240.3a68–1a Meaning of "issuers of securities in a narrow-based security index" as used in section 3(a)(68)(A)(ii)(III) of the Act.

(a) Notwithstanding § 240.3a68–3(a) of this chapter, and solely for purposes of determining whether a credit default swap is a security-based swap under section 3(a)(68)(A)(ii)(III) of the Act (15 U.S.C. 78c(a)(68)(A)(ii)(III)), the term *issuers of securities in a narrow-based security index* as used in section 3(a)(68)(A)(ii)(III) of the Act means issuers of securities identified in an index in which:

(1)(i) There are 9 or fewer non-affiliated issuers of securities that are reference entities in the index, provided that an issuer of securities shall not be deemed a reference entity for purposes of this section unless:

(A) A credit event with respect to such reference entity would result in a payment by the credit protection seller to the credit protection buyer under the credit default swap based on the related notional amount allocated to such reference entity; or

(B) The fact of such credit event or the calculation in accordance with paragraph (a)(1)(i)(A) of this section of the amount owed with respect to such credit event is taken into account in determining whether to make any future payments under the credit default swap with respect to any future credit events;

(ii) The effective notional amount allocated to any reference entity included in the index comprises more than 30 percent of the index's weighting;

(iii) The effective notional amount allocated to any five non-affiliated reference entities included in the index comprises more than 60 percent of the index's weighting; or

(iv) Except as provided in paragraph (b) of this section, for each reference entity included in the index, none of the following criteria is satisfied:

(A) The reference entity is required to file reports pursuant to section 13 or section 15(d) of the Act (15 U.S.C. 78m or 78o(d));

(B) The reference entity is eligible to rely on the exemption provided in § 240.12g3–2(b) of this chapter;

(C) The reference entity has a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more;

(D) The reference entity (other than an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77))) has outstanding securities that are notes, bonds, debentures, or evidences of indebtedness having a total remaining principal amount of at least $1 billion;

(E) The reference entity is the issuer of an exempted security as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)) (other than any municipal security as defined in section 3(a)(29) of the Act (15 U.S.C. 78c(a)(29)));

(F) The reference entity is a government of a foreign country or a political subdivision of a foreign country;

(G) If the reference entity is an issuer of asset-backed securities as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)), such asset-based securities were issued in a transaction registered under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*) and have publicly available distribution reports; and

(H) For a credit default swap entered into solely between eligible contract participants as defined in section 3(a)(65) of the Act (15 U.S.C. 78c(a)(65)):

(*1*) The reference entity (other than a reference entity that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77))) provides to the public or to such eligible contract participant information about the reference entity pursuant to § 230.144A(d)(4)) of this chapter;

(*2*) Financial information about the reference entity (other than a reference entity that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77))) is otherwise publicly available; or

(*3*) In the case of a reference entity that is an issuing entity of asset-backed securities as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)), information of the type and level included in public distribution reports for similar asset-backed securities is publicly available about both the reference entity and such asset-backed securities; and

(2)(i) The index is not composed solely of reference entities that are issuers of exempted securities as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Act (15 U.S.C. 78c(a)(29))), as in effect on the date of enactment of the Futures Trading Act of 1982); and

(ii) Without taking into account any portion of the index composed of reference entities that are issuers of exempted securities as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Act (15 U.S.C. 78c(a)(29))), the remaining portion of the index would be a narrow-based security index under paragraph (a)(1) of this section.

(b) Paragraph (a)(1)(iv) of this section will not apply with respect to a reference entity included in the index if:

(1) The effective notional amounts allocated to such reference entity comprise less than five percent of the index's weighting; and

(2) The effective notional amounts allocated to reference entities that satisfy paragraph (a)(1)(iv) of this section comprise at least 80 percent of the index's weighting.

(c) For purposes of this § 3a68–1a:

(1) A reference entity is affiliated with another entity if it controls, is controlled by, or is under common control with,

that entity; provided that each reference entity that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) will not be considered affiliated with any other issuing entity of an asset-backed security.

(2) *Control* means ownership of 20 percent or more of an entity's equity, or the ability to direct the voting of 20 percent or more of the entity's voting equity.

(3) The term *reference entity* includes:

(i) An issuer of securities;

(ii) An issuing entity of an asset-based security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)); and

(iii) A single reference entity or a group of affiliated entities; provided that each issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) is a separate reference entity.

§ 240.3a68–1b Meaning of "narrow-based security index" as used in section 3(a)(68)(A)(ii)(I) of the Act.

(a) Notwithstanding § 240.3a68–3(a) of this chapter, and solely for purposes of determining whether a credit default swap is a security-based swap under section 3(a)(68)(A)(ii)(I) of the Act (15 U.S.C. 78c(a)(68)(A)(ii)(I)), the term *narrow-based security index* as used in section 3(a)(68)(A)(ii)(I) of the Act means an index in which:

(1)(i) The index is composed of 9 or fewer securities or securities that are issued by 9 or fewer non-affiliated issuers, provided that a security shall not be deemed a component of the index for purposes of this section unless:

(A) A credit event with respect to the issuer of such security or a credit event with respect to such security would result in a payment by the credit protection seller to the credit protection buyer under the credit default swap based on the related notional amount allocated to such security; or

(B) The fact of such credit event or the calculation in accordance with paragraph (a)(1)(i)(A) of this section of the amount owed with respect to such credit event is taken into account in determining whether to make any future payments under the credit default swap with respect to any future credit events;

(ii) The effective notional amount allocated to the securities of any issuer included in the index comprises more than 30 percent of the index's weighting;

(iii) The effective notional amount allocated to the securities of any five non-affiliated issuers included in the index comprises more than 60 percent of the index's weighting; or

(iv) Except as provided in paragraph (b) of this section, for each security included in the index none of the following criteria is satisfied:

(A) The issuer of the security is required to file reports pursuant to section 13 or section 15(d) of the Act (15 U.S.C. 78m or 78o(d));

(B) The issuer of the security is eligible to rely on the exemption provided in § 40.12g3–2(b) of this chapter;

(C) The issuer of the security has a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more;

(D) The issuer of the security (other than an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77))) has outstanding securities that are notes, bonds, debentures, or evidences of indebtedness having a total remaining principal amount of at least $1 billion;

(E) The security is an exempted security as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)) (other than any municipal security as defined in section 3(a)(29) of the Act (15 U.S.C. 78c(a)(29)));

(F) The issuer of the security is a government of a foreign country or a political subdivision of a foreign country;

(G) If the security is an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)), the security was issued in a transaction registered under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*) and has publicly available distribution reports; and

(H) For a credit default swap entered into solely between eligible contract participants as defined in section 3(a)(65) of the Act (15 U.S.C. 78c(a)(65)):

(*1*) The issuer of the security (other than an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77))) provides to the public or to such eligible contract participant information about such issuer pursuant to § 230.144A(d)(4)) of this chapter;

(*2*) Financial information about the issuer of the security (other than an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77))) is otherwise publicly available; or

(*3*) In the case of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)), information of the type and level included in public distribution reports for similar asset-backed securities is publicly available about both the issuing entity and such asset-backed security; and

(2)(i) The index is not composed solely of exempted securities as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Act (15 U.S.C. 78c(a)(29))), as in effect on the date of enactment of the Futures Trading Act of 1982); and

(ii) Without taking into account any portion of the index composed of exempted securities as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Act (15 U.S.C. 78c(a)(29))), the remaining portion of the index would be a narrow-based security index under paragraph (a)(1) of this section.

(b) Paragraph (a)(1)(iv) of this section will not apply with respect to securities of an issuer included in the index if:

(1) The effective notional amounts allocated to all securities of such issuer included in the index comprise less than five percent of the index's weighting; and

(2) The securities that satisfy paragraph (a)(1)(iv) of this section comprise at least 80 percent of the index's weighting.

(c) For purposes of this § 240.3a68–1b:

(1) An issuer is affiliated with another issuer if it controls, is controlled by, or is under common control with, that issuer; provided that each issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) will not be considered affiliated with any other issuing entity of an asset-backed security.

(2) *Control* means ownership of 20 percent or more of an issuer's equity, or the ability to direct the voting of 20 percent or more of the issuer's voting equity.

(3) The term *issuer* includes:

(i) An issuer of securities;

(ii) An issuing entity of an asset-based security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)); and

(iii) A single issuer or a group of affiliated issuers; provided that each issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) is a separate issuer.

§ 240.3a68–2 Interpretation of swaps, security-based swaps, and mixed swaps.

(a) *In general.* Any person may submit a request to the Commission and the Commodity Futures Trading Commission to provide a joint interpretation of whether a particular agreement, contract, or transaction (or class thereof) is a swap, as that term is defined in section 3(a)(69) of the Act (15 U.S.C. 78c(a)(69)) and the rules and regulations promulgated thereunder, a security-based swap, as that term is defined in section 3(a)(68) of the Act (15 U.S.C. 78c(a)(68)) and the rules and regulations promulgated thereunder, or a mixed swap, as that term is defined in section 3(a)(68)(D) of the Act and the rules and regulations promulgated thereunder.

(b) *Request process.* In making a request pursuant to paragraph (a) of this section, the requesting person must provide the Commission and the Commodity Futures Trading Commission with the following:

(1) All material information regarding the terms of the agreement, contract, or transaction (or class thereof);

(2) A statement of the economic characteristics and purpose of the agreement, contract, or transaction (or class thereof);

(3) The requesting person's determination as to whether the agreement, contract, or transaction (or class thereof) should be characterized as a swap, a security-based swap, or both (*i.e.,* a mixed swap), including the basis for such determination; and

(4) Such other information as may be requested by the Commission or the Commodity Futures Trading Commission.

(c) *Request withdrawal.* A person may withdraw a request made pursuant to paragraph (a) of this section at any time prior to the issuance of a joint interpretation or joint notice of proposed rulemaking by the Commission and the Commodity Futures Trading Commission in response to the request; provided, however, that notwithstanding such withdrawal, the Commission and the Commodity Futures Trading Commission may provide a joint interpretation of whether the agreement, contract, or transaction (or class thereof) is a swap, a security-based swap, or both (*i.e.,* a mixed swap).

(d) *Request by the Commission or the Commodity Futures Trading Commission.* In the absence of a request for a joint interpretation under paragraph (a) of this section:

(1) If the Commission or the Commodity Futures Trading Commission receives a proposal to list, trade, or clear an agreement, contract, or transaction (or class thereof) that raises questions as to the appropriate characterization of such agreement, contract, or transaction (or class thereof) as a swap, a security-based swap, or both (*i.e.,* a mixed swap), the Commission or the Commodity Futures Trading Commission, as applicable, promptly shall notify the other of the agreement, contract, or transaction (or class thereof); and

(2) The Commission or the Commodity Futures Trading Commission, or their Chairmen jointly, may submit a request for a joint interpretation as described in paragraph (a) of this section; such submission shall be made pursuant to paragraph (b) of this section, and may be withdrawn pursuant to paragraph (c) of this section.

(e) *Timeframe for joint interpretation.*

(1) If the Commission and the Commodity Futures Trading Commission determine to issue a joint interpretation as described in paragraph (a) of this section, such joint interpretation shall be issued within 120 days after receipt of a complete submission requesting a joint interpretation under paragraph (a) or (d) of this section.

(2) The Commission and the Commodity Futures Trading Commission shall consult with the Board of Governors of the Federal Reserve System prior to issuing any joint interpretation as described in paragraph (a) of this section.

(3) If the Commission and the Commodity Futures Trading Commission seek public comment with respect to a joint interpretation regarding an agreement, contract, or transaction (or class thereof), the 120-day period described in paragraph (e)(1) of this section shall be stayed during the pendency of the comment period, but shall recommence with the business day after the public comment period ends.

(4) Nothing in this section shall require the Commission and the Commodity Futures Trading Commission to issue any joint interpretation.

(5) If the Commission and the Commodity Futures Trading Commission do not issue a joint interpretation within the time period described in paragraph (e)(1) or (e)(3) of this section, each of the Commission and the Commodity Futures Trading Commission shall publicly provide the reasons for not issuing such a joint interpretation within the applicable timeframes.

(f) *Joint notice of proposed rulemaking.*

(1) Rather than issue a joint interpretation pursuant to paragraph (a) of this section, the Commission and the Commodity Futures Trading Commission may issue a joint notice of proposed rulemaking, in consultation with the Board of Governors of the Federal Reserve System, to further define one or more of the terms swap, security-based swap, or mixed swap.

(2) A joint notice of proposed rulemaking described in paragraph (f)(1) of this section shall be issued within the timeframe for issuing a joint interpretation set forth in paragraph (e) of this section.

§ 240.3a68–3 Meaning of "narrow-based security index" as used in the definition of "security-based swap."

(a) *In general.* Except as otherwise provided in § 240.3a68–1a and § 240.3a68–1b of this chapter, for purposes of section 3(a)(68) of the Act (15 U.S.C. 78c(a)(68)), the term *narrow-based security index* has the meaning set forth in section 3(a)(55) of the Act (15 U.S.C. 78c(a)(55)), and the rules, regulations, and orders of the Commission thereunder.

(b) *Tolerance period for swaps traded on designated contract markets, swap execution facilities and foreign boards of trade.* Notwithstanding paragraph (a) of this section, solely for purposes of swaps traded on or subject to the rules of a designated contract market, swap execution facility, or foreign board of trade pursuant to the Commodity Exchange Act (7 U.S.C. 1 *et seq.*), a security index underlying such swaps shall not be considered a narrow-based security index if:

(1)(i) A swap on the index is traded on or subject to the rules of a designated contract market, swap execution facility, or foreign board of trade pursuant to the Commodity Exchange Act (7 U.S.C. 1 *et seq.*) for at least 30 days as a swap on an index that was not a narrow-based security index; or

(ii) Such index was not a narrow-based security index during every trading day of the six full calendar months preceding a date no earlier than 30 days prior to the commencement of trading of a swap on such index on a market described in paragraph (b)(1)(i) of this section; and

(2) The index has been a narrow-based security index for no more than 45 business days over three consecutive calendar months.

(c) *Tolerance period for security-based swaps traded on national securities exchanges or security-based swap execution facilities.* Notwithstanding paragraph (a) of this section, solely for purposes of security-based swaps traded on a national securities exchange or security-based swap execution facility, a security index underlying such security-based swaps shall be considered a narrow-based security index if:

(1)(i) A security-based swap on the index is traded on a national securities exchange or security-based swap execution facility for at least 30 days as a security-based swap on a narrow-based security index; or

(ii) Such index was a narrow-based security index during every trading day of the six full calendar months preceding a date no earlier than 30 days prior to the commencement of trading of a security-based swap on such index on a market described in paragraph (c)(1)(i) of this section; and

(2) The index has been a security index that is not a narrow-based security index for no more than 45 business days over three consecutive calendar months.

(d) *Grace period.*

(1) Solely with respect to a swap that is traded on or subject to the rules of a designated contract market, swap execution facility or foreign board of trade pursuant to the Commodity Exchange Act (7 U.S.C. 1 *et seq.*), an index that becomes a narrow-based security index under paragraph (b) of this section solely because it was a narrow-based security index for more than 45 business days over three consecutive calendar months shall not be a narrow-based security index for the following three calendar months.

(2) Solely with respect to a security-based swap that is traded on a national securities exchange or security-based swap execution facility, an index that becomes a security index that is not a narrow-based security index under paragraph (c) of this section solely because it was not a narrow-based security index for more than 45 business days over three consecutive calendar months shall be a narrow-based security index for the following three calendar months.

§ 240.3a68–4 Regulation of mixed swaps.

(a) *In general.* The term mixed swap has the meaning set forth in section 3(a)(68)(D) of the Act (15 U.S.C. 78c(a)(68)(D)).

(b) *Regulation of mixed swaps entered into by dually-registered dealers or major participants.* A mixed swap:

(1) That 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;

(2) That will not be submitted to a derivatives clearing organization or registered or exempt clearing agency to be cleared; and

(3) Where at least one party is registered with the Commission as a security-based swap dealer or major security-based swap participant and also with the Commodity Futures Trading Commission as a swap dealer or major swap participant, shall be subject to:

(i) The following provisions of the Commodity Exchange Act (7 U.S.C. 1 *et seq.*), and the rules and regulations promulgated thereunder, set forth in the rules and regulations of the Commodity Futures Trading Commission:

(A) Examinations and information sharing: 7 U.S.C. 6s(f) and 12;

(B) Enforcement: 7 U.S.C. 2(a)(1)(B), 6(b), 6b, 6c, 9, 13b, 13a–1, 13a–2, 13, 13c(a), 13c(b), 15 and 26;

(C) Reporting to a swap data repository: 7 U.S.C. 6r;

(D) Real-time reporting: 7 U.S.C. 2(a)(13);

(E) Capital: 7 U.S.C. 6s(e); and

(F) Position Limits: 7 U.S.C. 6a; and

(ii) The provisions of the Federal securities laws, as defined in section 3(a)(47) of the Act (15 U.S.C. 78c(a)(47)), and the rules and regulations promulgated thereunder.

(c) *Process for determining regulatory treatment for mixed swaps.*

(1) *In general.* Any person who desires or intends to list, trade, or clear a mixed swap (or class thereof) that is not subject to paragraph (b) of this section may request the Commission and the Commodity Futures Trading Commission to issue a joint order permitting the requesting person (and any other person or persons that subsequently lists, trades, or clears that mixed swap) to comply, as to parallel provisions only, with specified parallel provisions of either the Act (15 U.S.C. 78a *et seq.*) or the Commodity Exchange Act (7 U.S.C. 1 *et seq.*), and the rules and regulations thereunder (collectively, *specified parallel provisions*), instead of being required to comply with parallel provisions of both the Act and the Commodity Exchange Act. For purposes of this paragraph (c), *parallel provisions* means comparable provisions of the Act and the Commodity Exchange Act that were added or amended by the Wall Street Transparency and Accountability Act of 2010 with respect to security-based swaps and swaps, and the rules and regulations thereunder.

(2) *Request process.* A person submitting a request pursuant to paragraph (c)(1) of this section must provide the Commission and the Commodity Futures Trading Commission with the following:

(i) All material information regarding the terms of the specified, or specified class of, mixed swap;

(ii) The economic characteristics and purpose of the specified, or specified class of, mixed swap;

(iii) The specified parallel provisions, and the reasons the person believes such specified parallel provisions would be appropriate for the mixed swap (or class thereof); and

(iv) An analysis of:

(A) The nature and purposes of the parallel provisions that are the subject of the request;

(B) The comparability of such parallel provisions;

(C) The extent of any conflicts or differences between such parallel provisions; and

(D) Such other information as may be requested by the Commission or the Commodity Futures Trading Commission.

(3) *Request withdrawal.* A person may withdraw a request made pursuant to paragraph (c)(1) of this section at any time prior to the issuance of a joint order under paragraph (c)(4) of this section by the Commission and the Commodity Futures Trading Commission in response to the request.

(4) *Issuance of orders.* In response to a request under paragraph (c)(1) of this section, the Commission and the Commodity Futures Trading Commission, as necessary to carry out the purposes of the Wall Street Transparency and Accountability Act of 2010, may issue a joint order, after notice and opportunity for comment, permitting the requesting person (and any other person or persons that subsequently lists, trades, or clears that mixed swap) to comply, as to parallel provisions only, with the specified parallel provisions (or another subset of the parallel provisions that are the subject of the request, as the Commissions determine is appropriate), instead of being required to comply with parallel provisions of both the Act (15 U.S.C. 78a *et seq.*) and the Commodity Exchange Act (7 U.S.C. 1 *et seq.*). In determining the contents of such joint order, the Commission and the Commodity Futures Trading Commission may consider, among other things:

(i) The nature and purposes of the parallel provisions that are the subject of the request;

(ii) The comparability of such parallel provisions; and

(iii) The extent of any conflicts or differences between such parallel provisions.

(5) *Timeframe.*

(i) If the Commission and the Commodity Futures Trading Commission determine to issue a joint order as described in paragraph (c)(4) of this section, such joint order shall be issued within 120 days after receipt of a complete request for a joint order under paragraph (c)(1) of this section, which time period shall be stayed during the pendency of the public comment period provided for in paragraph (c)(4) of this section and shall recommence with the business day after the public comment period ends.

(ii) Nothing in this section shall require the Commission and the Commodity Futures Trading Commission to issue any joint order.

(iii) If the Commission and the Commodity Futures Trading Commission do not issue a joint order within the time period described in paragraph (c)(5)(i) of this section, each of the Commission and the Commodity Futures Trading Commission shall publicly provide the reasons for not issuing such a joint order within that timeframe.

§ 240.3a69–1 Definition of "swap" as used in section 3(a)(69) of the Act—Insurance

The term *swap* as used in section 3(a)(69) of the Act (15 U.S.C. 78c(a)(69)) does not include an agreement, contract, or transaction that:

(a) By its terms or by law, as a condition of performance on the agreement, contract, or transaction:

(1) Requires the beneficiary of the agreement, contract, or transaction to have an insurable interest that is the subject of the agreement, contract, or transaction and thereby carry the risk of loss with respect to that interest continuously throughout the duration of the agreement, contract, or transaction;

(2) Requires that loss to occur and to be proved, and that any payment or indemnification therefor be limited to the value of the insurable interest;

(3) Is not traded, separately from the insured interest, on an organized market or over-the-counter; and

(4) With respect to financial guaranty insurance only, in the event of payment default or insolvency of the obligor, any acceleration of payments under the policy is at the sole discretion of the insurer; and

(b) Is provided:

(1) By a company that is organized as an insurance company whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies and that is subject to supervision by the insurance commissioner (or similar official or agency) of any State, as defined in section 3(a)(16) of the Act (15 U.S.C. 78c(a)(16)), or by the United States or an agency or instrumentality thereof, and such agreement, contract, or transaction is regulated as insurance under the laws of such State or of the United States;

(2) By the United States or any of its agencies or instrumentalities, or pursuant to a statutorily authorized program thereof; or

(3) In the case of reinsurance only, by a person located outside the United States to an insurance company that is eligible under paragraph (b) of this section, provided that:

(i) Such person is not prohibited by any law of any State or of the United States from offering such agreement, contract, or transaction to such an insurance company;

(ii) The product to be reinsured meets the requirements under paragraph (a) of this section to be insurance; and

(iii) The total amount reimbursable by all reinsurers for such insurance product cannot exceed the claims or losses paid by the cedant.

§ 240.3a69–2 Definition of "swap" as used in section 3(a)(69) of the Act—Additional Products.

(a) *In general.* The term *swap* has the meaning set forth in section 3(a)(69) of the Act (15 U.S.C. 78c(a)(69)).

(b) *Inclusion of particular products.* (1) The term *swap* includes, without limiting the meaning set forth in section 3(a)(69) of the Act (15 U.S.C. 78c(a)(69), the following agreements, contracts, and transactions:

(i) A cross-currency swap;

(ii) A currency option, foreign currency option, foreign exchange option and foreign exchange rate option;

(iii) A foreign exchange forward;

(iv) A foreign exchange swap;

(v) A forward rate agreement; and

(vi) A non-deliverable forward involving foreign exchange.

(2) The term *swap* does not include an agreement, contract, or transaction described in paragraph (b)(1) of this section that is otherwise excluded by section 1a(47)(B) of the Commodity Exchange Act (7 U.S.C. 1a(47)(B)).

(c) *Foreign exchange forwards and foreign exchange swaps.* Notwithstanding paragraph (b)(2) of this section:

(1) A foreign exchange forward or a foreign exchange swap shall not be considered a swap if the Secretary of the Treasury makes a determination described in section 1a(47)(E)(i) of the Commodity Exchange Act (7 U.S.C. 1a(47)(E)(i)).

(2) Notwithstanding paragraph (c)(1) of this section:

(i) The reporting requirements set forth in section 4r of the Commodity Exchange Act (7 U.S.C. 6r) and regulations promulgated thereunder shall apply to a foreign exchange forward or foreign exchange swap; and

(ii) The business conduct standards set forth in section 4s of the Commodity Exchange Act (7 U.S.C. 6s) and regulations promulgated thereunder shall apply to a swap dealer or major swap participant that is a party to a foreign exchange forward or foreign exchange swap.

(3) For purposes of section 1a(47)(E) of the Commodity Exchange Act (7 U.S.C. 1a(47)(E)) and this § 240.3a69–2, the term *foreign exchange forward* has the meaning set forth in section 1a(24) of the Commodity Exchange Act (7 U.S.C. 1a(24)).

(4) For purposes of section 1a(47)(E) of the Commodity Exchange Act (7 U.S.C. 1a(47)(E)) and this § 240.3a69–2, the term *foreign exchange swap* has the meaning set forth in section 1a(25) of the Commodity Exchange Act (7 U.S.C. 1a(25)).

(5) For purposes of sections 1a(24) and 1a(25) of the Commodity Exchange Act (7 U.S.C. 1a(24) and (25)) and this § 240.3a69–2, the following transactions are not foreign exchange forwards or foreign exchange swaps:

(i) A currency swap or a cross-currency swap;

(ii) A currency option, foreign currency option, foreign exchange option, or foreign exchange rate option; and

(iii) A non-deliverable forward involving foreign exchange.

§ 240.3a69–3 Books and records requirements for security-based swap agreements.

(a) A person registered as a swap data repository under section 21 of the Commodity Exchange Act (7 U.S.C. 24a) and the rules and regulations thereunder:

(1) Shall not be required to keep and maintain additional books and records regarding security-based swap agreements other than the books and records regarding swaps required to be kept and maintained pursuant to section 21 of the Commodity Exchange Act (7 U.S.C. 24a) and the rules and regulations thereunder; and

(2) Shall not be required to collect and maintain additional data regarding security-based swap agreements other than the data regarding swaps required to be collected and maintained by such persons pursuant to section 21 of the Commodity Exchange Act (7 U.S.C. 24a) and the rules and regulations thereunder.

(b) A person shall not be required to keep and maintain additional books and records, including daily trading records, regarding security-based swap agreements other than the books and records regarding swaps required to be kept and maintained by such persons pursuant to section 4s of the Commodity Exchange Act (7 U.S.C. 6s) and the rules and regulations thereunder if such person is registered as:

(1) A swap dealer under section 4s(a)(1) of the Commodity Exchange Act (7 U.S.C. 6s(a)(1)) and the rules and regulations thereunder;

(2) A major swap participant under section 4s(a)(2) of the Commodity Exchange Act (7 U.S.C. 6s(a)(2)) and the rules and regulations thereunder;

(3) A security-based swap dealer under section 15F(a)(1) of the Act (15 U.S.C. 78o–10(a)(1)) and the rules and regulations thereunder; or

(4) A major security-based swap participant under section 15F(a)(2) of the Act (15 U.S.C. 78o–10(a)(2)) and the rules and regulations thereunder.

(c) The term *security-based swap agreement* has the meaning set forth in section 3(a)(78) of the Act (15 U.S.C. 78c(a)(78)).

Dated: April 29, 2011.

By the Commodity Futures Trading Commission.

David A. Stawick,

Secretary.

Dated: April 29, 2011.

By the Securities and Exchange Commission.

Cathy H. Ahn,

Deputy Secretary.

Product Definitions Contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act—CFTC Voting Summary and Statements of CFTC Commissioners

Note: The following will not appear in the Code of Federal Regulations.

CFTC Voting Summary

On this matter, Chairman Gensler and Commissioners Dunn, Chilton and O'Malia voted in the affirmative; Commissioner Sommers voted in the negative.

Statement of CFTC Chairman Gary Gensler

I support the proposed rulemaking to implement the Dodd-Frank Act's requirement to further define derivatives products that come under Title VII of the Act.

The CFTC worked closely with the SEC, in consultation with the Federal Reserve, on this proposed rule to further define swaps, security-based swaps, mixed swaps and security-based swap agreements. The statutory definition of swap is very detailed. This rule is consistent with that detailed definition and Congressional intent. For example, interest rate swaps, currency swaps, commodity swaps, including energy, metals and agricultural swaps, and broad-based index swaps, such as index credit default swaps, are all swaps. Consistent with Congress's definition of swaps, the rule also defines options as swaps.

In preparing the proposed rule, staff worked to address the more than 80 comments that were submitted by the public in response to the joint advance notice of proposed rulemaking on product definitions. Many of the commenters asked that the Commissions specifically provide guidance on what is not a swap or security-based swap.

For example, under the Commodity Exchange Act, the CFTC does not regulate forward contracts. Over the decades, there has been a series of orders, interpretations and cases that market participants have come to rely upon regarding the exception from futures regulation for forwards and forwards with embedded options. Consistent with that history, the Dodd-Frank Act excluded from the definition of swaps "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 proposed rule interprets that exclusion in a manner that is consistent with the Commission's previous history of the forward exclusion from futures regulation.

Further, consistent with the Dodd-Frank Act, the proposed rule clarifies that state or Federally regulated insurance products that are provided by regulated insurance companies will not be regulated under Title VII of the Act. Similarly, the proposal clarifies that certain consumer and commercial arrangements that historically have not been considered swaps, such as consumer mortgage rate locks, contracts to lock in the price of home heating oil and contracts relating to inventory or equipment, also will not be regulated under Title VII of the Act.

Statement of CFTC Commissioner Jill Sommers

I respectfully dissent from the action taken today by the Commission to issue proposed regulations relating to "Product Definitions Contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act."

I disagree with the approach taken by the Commission with regard to the proposed "Anti-Evasion" provisions. I agree that Dodd-Frank Section 721(c) directs the Commission to further define certain terms to include transactions or entities that have been structured to evade Dodd-Frank. I do not agree that Congress directed the Commission to promulgate broad "Anti-Evasion" provisions, and I point out that the Securities and Exchange Commission today has declined to promulgate such provisions in this joint rulemaking.

By promulgating a broad regulation today that essentially says that any transaction that does not fall within the definition of "swap" because it has been structured to evade Dodd-Frank nonetheless is a swap, the Commission is over-reading its Congressional mandate. The statutory definition of "swap" includes a laundry-list of transactions that Congress intended to include within the definition. If Congress intended the definition of "swap" also to include a broad statement that any transaction structured to evade Dodd-Frank is a "swap," Congress would have incorporated such a provision within the statutory definition. By directing the Commission to "further define" the term "swap" by rule, Congress is directing the Commission not to make the broad statement it declined to make, but to think through whether the definition of "swap" needs to be modified by rule to include specific transactions within the definition.

In addition to my concern about the "Anti-Evasion" provisions included within this proposal, I am concerned about an important issue that is not raised within this proposal. Multinational organizations whose statutory mission is to combat poverty and foster economic development have raised concerns about the application of Dodd-Frank to their activities. This proposal omits any discussion of their issues. In my view the following language should be included within the proposal, and I urge the public to comment upon the issues raised:

Transactions Involving Certain Foreign or Multinational Entities

The swap definition expressly excludes "any agreement, contract, or transaction a counterparty of which is a Federal Reserve bank, the Federal Government, or a Federal agency that is expressly backed by the full faith and credit of the United States." [399] Some commenters have suggested that the Commissions should exercise their authority to further define the terms "swap" and "security-based swap" to similarly exclude transactions in which a counterparty is an international public organization, a foreign central bank, a foreign sovereign, or a multi-or supra-national organization.[400] Commenters

[399] 7 U.S.C. 1a(47)(B)(ix).

[400] *See, e.g.,* letter from Gunter Pleines, Head of Banking Department, and Diego Devos, General

Continued

have advanced international comity, national treatment, limited regulatory resources, limits on the Commissions' respective extraterritorial jurisdiction, and international harmonization as rationales for such an approach.[401]

Request for Comment

• The Commissions request comment generally on the appropriate application of the Dodd-Frank Act to international public organizations, foreign central banks, foreign sovereigns (or foreign sovereign wealth funds), supranational organizations, and any other foreign or multinational entity that may be analogous to the entities excluded from the swap definition in CEA Section 1a(47)(B)(ix).

• Should the Commissions further define the terms "swap" and "security-based swap" to exclude transactions in which a counterparty is an international public organization, foreign central bank, foreign sovereign (or foreign sovereign wealth fund), supranational organization, or any other foreign or multinational entity that may be analogous to an entity excluded from the swap definition in CEA Section 1a(47)(B)(ix)? Why or why not? If so, how should the Commissions delineate the scope of entities whose transactions would be excluded? Please describe in detail the nature of the entity whose transactions would be excluded and explain the reasons for such an exclusion. Would such an exclusion inappropriately cause transactions that should be regulated as swaps or security-based swaps to fall outside of the regulatory regime established by the Dodd-Frank Act? Why or why not?

• If the Commissions further define the terms "swap" and "security-based swap" to exclude any such entity, should the exclusion be subject to any conditions, or should the exclusion be limited to particular requirements of Title VII? Why or why not? If so, what conditions would be appropriate, and/or what requirements of Title VII should the exclusion apply to, and why?

• If the Commissions further define the terms "swap" and "security-based swap" to exclude any such entity, to what extent should counterparties to such transactions be subject to the requirements of Title VII? What would be the appropriate regulatory treatment of such counterparties in these circumstances?

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Counsel, Bank for International Settlements ("BIS Letter"); Cleary Letter. The Commissions note that various other terms may be used to refer to organizations that generally: (i) Limit their membership to sovereign nations; (ii) are established by treaty; (iii) have a separate legal identity from their members; and (iv) "are usually specialized and of international or regional scope" and "formed between three or more nations to work on issues that relate to all of the countries in the organization. See, *e.g., http://portal.unesco.org/en/ev.php-URL_ID=32408&URL_DO=DO_TOPIC&URL_SECCTION=201.html; http://www.geni.org/globalenergy/library/organizations/index.shtml.* For convenience, the Commissions use the term "supranational organization" herein to refer to organizations having such characteristics.

[401] *See, e.g.,* BIS Letter (citing Article 1, paragraph 4, of the proposed EU Regulation on Central Clearing of OTC Derivatives, available at *http://register.consilium.europa.eu/pdf/en/11/st05/st05059.en11.pdf,* which excludes from its coverage the BIS, multilateral development banks, European central banks and similarly situated "other national bodies performing similar functions and other public bodies charged with or intervening in the management of the public debt").