



# Commodity Futures Trading Commission

## Office of Public Affairs

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### Final Rules and Interpretations i) Further Defining “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; ii) Regarding “Mixed Swaps”; and iii) Governing Books and Records for “Security-Based Swap Agreements”

The Commodity Futures Trading Commission (“Commission”) is proposing rules and interpretative guidance i) to further define the terms “swap,” “security-based swap,” and “security-based swap agreement”; ii) prescribing regulations regarding “mixed swaps”; and iii) governing books and records for “security-based swap agreements.” This is a joint rulemaking with the Securities and Exchange Commission (“SEC”).

#### **Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)**

Section 721 of the Dodd-Frank Act amends the Commodity Exchange Act (“CEA”) by adding definitions of the terms “swap,” “security-based swap,” and “security-based swap agreement.” Section 712(d)(1) provides that the Commission and the SEC, in consultation with the Federal Reserve Board, shall jointly further define those terms. Section 712(a)(8) 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 of the Dodd-Frank Act (“Title VII”). Section 712(d)(2) requires the Commissions, in consultation with the Federal Reserve Board, to jointly adopt rules governing books and records requirements for security-based swap agreements.

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

#### **Definition of “Swap” and “Security-Based Swap”**

The Commissions believe that the definitions of “swap” and “security-based swap” in Title VII are detailed and comprehensive. However, as the Commissions did in the Proposing Release, the Commissions are clarifying in the final rules and interpretations that certain insurance products, consumer and commercial agreements, and loan participations are not swaps or security-based swaps.

#### **Transactions that are Not Swaps or Security-Based Swaps**

- Insurance

The Commissions are issuing final rules and interpretations that would clarify that certain contracts, provided by certain entities, each meeting specified requirements would be considered insurance and not swaps or security-based swaps.

○ **Requirements for the Contract (“Product Test”)**

- The beneficiary must have an insurable interest that is the subject of the contract and thereby carry the risk of loss with respect to that interest continuously throughout the duration of the contract;
- The loss must occur and be proved, and any payment or indemnification for the loss must be limited to the value of the insurable interest;
- The contract must not be 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 a payment default or insolvency of the obligor, any acceleration of payments under the policy must be at the sole discretion of the insurer.

○ **The Person Providing the Contract Must be One of the following (“Provider Test”):**

- By a person 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 applicable state law or the laws of the United States;
- Directly or indirectly by the United States, any State or any of their respective agencies or instrumentalities, or (ii) pursuant to a statutorily authorized program thereof;
- In the case of reinsurance only, by a person to another person that satisfies the Provider Test, provided that: (i) such person is not prohibited by applicable state law or the laws of the United States from offering such agreement, contract, or transaction to such person that satisfies the Provider Test; (ii) the agreement, contract, or transaction to be reinsured satisfies the Product Test or is one of the Enumerated Products (defined below); and (iii) except as otherwise permitted under applicable state law, the total amount reimbursable by all reinsurers for such agreement, contract, or transaction may not exceed the claims or losses paid by the cedant; or
- In the case of non-admitted insurance by a person who: is located outside of the United States and listed on the Quarterly Listing of Alien Insurers as maintained by the International Insurers Department of the National Association of Insurance Commissioners or meets the eligibility criteria for non-admitted insurers under applicable State law.

○ **Enumerated Products:**

- In response to comments, the Commissions codifying in rule text their interpretation that certain enumerated types of traditional insurance products (“Enumerated Products”) are not swaps or security-based swaps and expanding and revising the list. As adopted, the rule provides that the terms “swap” and “security-based swap” will not include an agreement, contract, or transaction that is provided in accordance with the Provider Test (above) and is any one of the following: surety bonds; fidelity bonds; life insurance; health insurance; long-term care insurance; title insurance; property and casualty insurance; annuities; disability insurance; insurance against default on individual residential mortgages (commonly known as private mortgage insurance, as distinguished from financial guaranty of mortgage pools); and reinsurance (including retrocession) of any of the foregoing, so long as that reinsurance or retrocession is not accomplished by entering into swaps or security-based swaps.

○ **Safe Harbor**

- In response to comments, the Commissions are confirming that the Product Test, the Provider Test and the Enumerated Products described above represent a non-exclusive safe harbor. This means that, if a transaction does not meet any of their respective requirements, it is not

necessarily a swap or security-based swap; such a transaction would require further analysis of the facts and circumstances to determine whether the transaction is a swap or security-based swap rather than insurance.

- **Grandfather for Existing Transactions**

- In response to comments, the Commissions are including a grandfather provision in the final rules, which provides that a transaction entered into on or before the effective date of the Product Definitions will be considered insurance and not fall within the swap and security-based swap definitions, provided that, at the time it was entered into, the transaction was provided in accordance with the Provider Test.

- **Guarantees of Swaps and Security-Based Swaps**

- In the Proposing Release, the Commissions requested comment on the treatment of guarantees of swaps and security-based swaps.
- The Final Release includes an interpretation by the CFTC that a guarantee of a swap is an integral part of the swap, and therefore the term “swap” includes a guarantee of such swap, to the extent that a counterparty to a swap position would have recourse to the guarantor in connection with the position. The Commission will address the practical implications of this interpretation, including applicable reporting requirements, in a separate release.
- The SEC interprets guarantees of security-based swaps to be securities under the federal securities laws; the SEC plans to address reporting requirements for guarantees of security-based swaps in a separate rulemaking.

- **Consumer and Commercial Transactions**

The Commissions are issuing an interpretation that certain consumer and commercial transactions that have not previously been considered swaps or security-based swaps do not fall within the statutory definitions of those terms.

- **Consumer Transactions**

Transactions entered into by consumers (natural persons) as principals (or by their agents) primarily for personal, family or household purposes that would not be considered swaps or security-based swaps under the interpretation 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 for personal, family or household purposes 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 for personal use or consumption nonfinancial energy commodities, including agreements to purchase home heating fuel or agreements involving residential fuel storage, in either case, where the consumer takes delivery of and uses the fuel, and the counterparty is a merchant that delivers in the service area where the consumer resides);
- 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;
- 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;

- Service agreements, contracts, or transactions that are consumer product warranties, extended service plans, or buyer protection plans, such as those purchased with major appliances and electronics;
- Consumer options to acquire, lease, or sell real or personal property, such as options to lease apartments or purchase rugs and paintings, and purchases made through consumer layaway plans;
- Consumer agreements, contracts, or transactions where, by law or regulation, the consumer may cancel the transaction without legal cause; and
- Consumer guarantees of credit card debt, automobile loans, and mortgages of a friend or relative.

#### ○ **Commercial Transactions**

The types of commercial transactions that involve customary business arrangements (whether or not involving a for-profit entity) that would not be considered swaps or security-based swaps under the interpretation 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;
- 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);
- Mortgage or mortgage purchase commitments, or sales of installment loan agreements or contracts or receivables;
- Fixed or variable interest rate commercial loans or mortgages entered into by banks and non-banks, including the following:
  - Fixed or variable interest rate commercial loans or mortgages entered into by the Farm Credit System institutions and Federal Home Loan Banks;
  - Fixed or variable interest rate commercial loans or mortgages with embedded interest rate locks, caps, or floors, provided that such embedded interest rate locks, caps, or floors are included for the sole purpose of providing a lock, cap, or floor on the interest rate on such loan or mortgage and do not include additional provisions that would provide exposure to enhanced or inverse performance, or other risks unrelated to the interest rate risk being addressed;
  - Fixed or variable interest rate commercial loans or mortgages with embedded interest rate options, including such loans or mortgages that contain provisions causing the interest rate to change upon certain events related to the borrower, such as a higher rate of interest following a default, provided that such embedded interest rate options do not include additional provisions that would provide exposure to enhanced or inverse performance, or other risks unrelated to the primary reason the embedded interest rate option is included; 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 interpretation includes factors that the Commissions will consider in determining whether other consumer and commercial transactions that are not specifically listed should be considered swaps or security-based swaps.

#### • **Loan Participations**

Loan participations are not swaps or security-based swaps if the purchaser is acquiring a current or future direct or indirect ownership interest in the related loan or commitment and if certain other conditions are met. Please see the release for details.

- **Forward Exclusion from the Swap Definition for Nonfinancial Commodities**

The CFTC is issuing an interpretation clarifying the scope of the forward contract exclusion for nonfinancial commodities that is included in the statutory swap definition.

- The interpretation provides that the forward exclusion in nonfinancial commodities should be interpreted in a manner consistent with the CFTC's historical interpretation of the existing forward exclusion with respect to futures contracts.
- The principles underlying the CFTC's "Brent Interpretation" regarding "book-outs" transactions that apply to the forward exclusion from the definition of "future delivery" also would apply to the forward exclusion from the swap definition for nonfinancial commodities. Commercial market participants that regularly make or take delivery of the referenced commodity in the ordinary course of their business, where the book-out transaction is effectuated through a subsequent, separately negotiated agreement, should qualify for the forward exclusion from the swap definition.
- The CFTC's 1993 Energy Exemption is withdrawn as proposed because it is no longer necessary in light of the extension of the Brent Interpretation to all nonfinancial commodities; however, the CFTC is clarifying that the alternative delivery procedures (netting, etc.) mentioned in the Energy Exemption continue to apply.
- Providing guidance regarding nonfinancial commodities as commodities that may be physically delivered and are exempt or agricultural commodities, and regarding environmental commodities (e.g. offsets, allowances, and RECs) that they are nonfinancial commodities.
- Clarifying in response to commenters that oral book-outs are permissible if they are followed by a written or electronic confirmation.
- Providing guidance regarding forward with embedded volumetric optionality: Commenters in the energy industry asserted that many of their transactions contain volumetric optionality and should be considered forwards, while prior CFTC guidance restated in the proposal covered price optionality only. If among other things the volumetric optionality is due to physical factors or regulatory requirements beyond the control of the parties, the interpretation provides that the agreement, contract or transaction may qualify for the forward exclusions from the swap and future delivery definitions. The CFTC is requesting comment on its forwards with volumetric optionality interpretation.
- Providing guidance that certain contract provisions do not disqualify transactions for the forward exclusion (liquidated damages, renewal/evergreen provisions).
- Providing guidance regarding certain types of arrangements as described in the release, fuel delivery agreements and physical exchange transactions, are not swaps.
- Providing guidance regarding certain physical commercial arrangements that are similar to leases that they are not options and may qualify for the forward exclusions under the facts and circumstances.
- Providing guidance regarding energy management agreements that such agreements do not alter the nature of the transactions conducted under them.

## **Transactions That Are Swaps or Security-Based Swaps**

The Commissions are issuing final rules and interpretations clarifying that certain types of transactions are within the scope of the definitions of swap and security-based swap.

### **Final Rules**

- The final rules provide that certain transactions are swaps:

- Foreign Exchange (“FX”) Forwards and FX Swaps:
  - These products are defined as swaps, subject to a determination by the Secretary of the Treasury, as permitted under Title VII, to exempt them.
  - If exempted by Treasury, the final rules reflect the provision of the statute that certain requirements will continue to apply, including reporting and business conduct standards.
- FX Products that are outside Treasury’s determination and are swaps (unless otherwise excluded by the statute):
  - Foreign Currency Options
  - Non-Deliverable Forwards in Foreign Exchange
  - Currency Swaps and Cross-Currency Swaps
- Forward Rate Agreements, notwithstanding their “forward” label, are swaps (unless otherwise excluded in the statute).

## Interpretations

- The Commissions are issuing an interpretation provides that certain foreign exchange spot transactions are not foreign exchange forwards under the CEA. The transactions include certain foreign currency trades made in connection with a foreign securities transaction that is settled within the settlement cycle for the associated securities transaction.
- The CFTC is issuing an interpretation that retail foreign currency options that are described in Section 2(c)(2)(B) of the CEA are not swaps.
- The Commissions are issuing an interpretation that provides that options on swaps or security-based swaps, forward swaps or security-based swaps, and certain contracts for differences are swaps or security-based swaps.

## Relationship Between Swaps and Security-Based Swaps

The Commissions are issuing an interpretation to clarify whether particular agreements, contracts or transactions that are subject to Title VII of the Dodd-Frank Act (which are referred to as “Title VII Instruments” in the release) are swaps, security-based swaps or both (i.e., mixed swaps).

- **General principles**
  - The interpretation provides that the determination of whether a Title VII Instrument is a swap, security-based swap or mixed swap, is made prior to execution, but no later than when the parties offer to enter into the Title VII instrument.
  - That characterization remains the same throughout the life of the instrument (unless the instrument is amended or modified in a material respect). Thus, a Title VII Instrument on a broad-based security index that becomes narrow-based during the life of the instrument, without amendment or modification of the instrument in a material respect by the counterparties, will remain a “swap” subject to CFTC regulation. Similarly, a Title VII instrument on a narrow-based security index that becomes broad-based during the life of the instrument, without such an amendment or modification, will remain a “security-based swap” subject to SEC regulation.
- **Interest Rates, Other Monetary Rates and Yields**
  - Title VII Instruments on interest rates and other monetary rates (including interbank offered rates, money market rates, government target rates, general lending rates, rates from indexes, and other monetary rates) are swaps.

- Title VII Instruments on “yields,” where “yield” is a proxy for the price or value of a debt security, loan or narrow-based security index, are security-based swaps, except in the case of certain government debt obligations.
- Government Debt Obligations
  - Title VII Instruments on rates or yields of U.S. Treasuries and other exempted securities (other than municipal securities) are swaps and are not security-based swaps.
- **Total Return Swaps (“TRS”)**
  - A TRS on a single security, loan, or narrow-based security index generally would be a security-based swap.
  - Where counterparties embed interest-rate optionality or a non-securities component into the TRS (e.g., the price of oil, a currency hedge), it would be a mixed swap.
  - Quanto equity swaps that have certain characteristics are security-based swaps.
  - TRS based on broad-based security indexes or on two or more loans are swaps subject to CFTC regulation.
- **Title VII Instruments Based on Futures**
  - Generally, Title VII Instruments on futures are swaps; Title VII Instruments on security futures are security-based swaps.
  - Title VII instruments on futures on foreign sovereign debt exempted by the SEC for purposes of futures trading under Rule 3a12-8 are swaps subject to regulation by the CFTC if certain conditions are met. Please see the release for details.

### **The Terms “Narrow-Based Security Index” and “Issuers of Securities in a Narrow-Based Security Index” in the Security-Based Swap Definition**

The Commissions are issuing rules and interpretations to address several issues regarding the terms “narrow-based security index” and “issuers of securities in a narrow-based security index” in the security-based swap definition, including: i) the applicability of past guidance of the Commissions regarding criteria for distinguishing broad from narrow-based security indexes 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 tolerance period rule governing Title VII Instruments traded on trading platforms where the security index temporarily moves from broad-based to narrow-based or vice versa; and v) a grace period rule governing Title VII instruments on trading platforms where the security index moves from broad-based to narrow-based or vice versa and the move is not temporary. These issues are addressed as follows:

- The statutory definition, as well as past guidance of the CFTC/SEC in the context of security futures regarding volatility and debt indexes, applies to swaps and security-based swaps.
- **Index CDS**
  - The Commissions are adopting a new test for determining whether an index underlying an index CDS is broad or narrow, building on the 2006 joint SEC/CFTC rules for debt indexes, but tailored to index CDS.
  - The Commissions are clarifying in response to comments that Loan Index CDS are to be evaluated under these rules.
  - Also in response to comments, the Commissions are adjusting the definition of “control” for purposes of determining affiliation under the rules and some technical changes.

- **Security Indexes/Portfolios**

- Where parties to a Title VII Instrument directly/indirectly have discretion to change the composition/weighting of securities in a portfolio, the Title VII Instrument is a security-based swap.
- Where there is an underlying security index for which there are predetermined criteria or a self-executing formula for adjusting the security index that is not subject to change/modification, a Title VII instrument on the index would be a swap or security-based swap depending on composition/weighting of the index, unless the predetermined criteria or self-executing formula would cause the index to become narrow-based or vice-versa, in which case it would be a mixed swap. A clarification in response to a comment is made in the release with respect to indexes that may, but not necessarily, move from broad-based to narrow-based or vice versa.

- **Indexes That “Migrate” from Broad to Narrow or Vice Versa**

- The rule that the determination of a Title VII Instrument as a swap or security-based swap is made prior to execution, but no later than when the parties offer to enter into the instrument, and that its characterization does not change throughout its life, applies to Title VII Instruments based on indexes of securities, regardless of whether the Title VII Instrument was entered into bilaterally or was executed on a trading platform.
- With regard to Title VII Instruments based on indexes listed on trading platforms:
  - A market participant who enters into a Title VII Instrument on a trading platform on a broad-based or narrow-based security index that migrates from broad-based to narrow-based or vice versa may hold that position until the expiration of the instrument, without any change in regulatory responsibilities, requirements, or obligations.
  - In order to avoid market disruption, where market participants seek to offset or enter into new swaps (or security-based swaps) where the underlying index has migrated from broad to narrow (or vice versa), the tolerance period and grace period rules applicable to futures trading will apply.
- Settlement of Broad-Based Index CDS
  - If a broad-based index CDS requires mandatory physical settlement, it will be a mixed swap.
  - If a broad-based index CDS requires cash settlement or auction settlement, it will be a swap, and will 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.

## **Mixed Swaps**

Mixed swaps are both swaps and security-based swaps. In the release, the Commissions state the belief that the scope of the mixed swap definition is, and is intended to be, narrow. The Commissions also are adopting two rules regarding the regulation of mixed swaps:

- The first rule provides a regulatory framework with which parties to bilateral uncleared mixed swaps, where at least one of the parties is dually registered with both Commissions, will need to comply. Under the final rule, in order to facilitate the trading of these instruments in appropriate circumstances, certain key provisions of the CEA and related CFTC rules as well as the requirements of the federal securities laws will apply to such mixed swaps.
- For all other mixed swaps, the second rule establishes a process for persons to request that the Commissions issue a joint order permitting such persons (and any other person that subsequently lists, trades, or clears that class of mixed swap) to comply, as to parallel provisions only, with specified parallel provisions of either the CEA or the Exchange Act, and related rules and regulations, instead of being required to comply with parallel provisions of both the CEA and the Exchange Act.

## Security-Based Swap Agreements

Security-based swap agreements (“SBSAs”) are swaps involving securities over which the CFTC has regulatory and enforcement authority, but for which the SEC also has antifraud and certain other authority. The Commissions are providing guidance regarding the types of products that are SBSAs, which include:

- Swaps on broad-based security indexes; and
- Swaps on exempted securities (other than municipal securities), such as U.S. Treasury bonds.

The Dodd-Frank Act requires that the Commissions adopt rules regarding books and records requirements for SBSAs. The CFTC has adopted rules governing books and records for swaps, which would apply to swaps that also are SBSAs. The Commissions do not believe that additional books and records requirements are necessary for SBSAs. The Commissions therefore are adopting rules to clarify that there would not be additional books and records requirements regarding SBSAs other than those that the CFTC has adopted for swaps.

## Process for Requesting Interpretations Re: Swaps, Security-Based Swaps and Mixed Swaps

- The Commissions are adopting rules instituting 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 a mixed swap. The process is modeled on the statutory process for novel derivative products contained in Section 718 of the Dodd-Frank Act.
- The process includes a deadline for a decision, as well as a requirement that if the Commissions do not issue a joint interpretation within the prescribed time period, each Commission must publicly provide the reasons for not having done so.

## Anti-Evasion

- Pursuant to authority granted in the Dodd-Frank Act, the CFTC is adopting a rule that defines 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 to fall within a determination by the Secretary of Treasury to exempt such products, and to products of a bank that is not under the regulatory jurisdiction of an appropriate Federal banking agency and that are willfully structured as identified banking products to evade the new regulatory regime for swaps.
- The Dodd-Frank Act also gives the CFTC authority to prevent evasion of Title VII that occurs outside of the United States. The CFTC is adopting rule 1.6 under the CEA to address this potential evasion of Title VII as well.