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Memorandum

The New Derivatives Definitions — What Fund Managers Need to Know

August 21, 2012

Introduction

In July 2012, the Commodity Futures Trading Commission ("CFTC") and the Securities Exchange Commission ("SEC" and, together with the CFTC, the "Commissions") jointly adopted new rules and interpretations (the "Definitions Release") to define the terms "swap," "security-based swap," and "security-based swap agreement" (collectively, "Product Definitions"), to provide for the joint regulation by the Commissions of "mixed swaps" and to impose record-keeping requirements with respect to "security-based swap agreements." The Definitions Release was published in the Federal Register on Aug. 13, 2012. With certain exceptions, the effective date of the Definitions Release will be Oct. 12, 2012.

The publication of the Definitions Release will result in many of the rules previously adopted by the Commissions pursuant to Title VII ("Title VII") of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") going into effect over the next several months. The Definitions Release is an important part of this framework because it helps determine the types of transactions that will be subject to regulation by the CFTC, the SEC or both under Title VII and the regulations adopted thereunder.

In particular, the publication of the Definitions Release directly affects several areas of importance to the private funds industry:

- **CFTC Registration:** The Definitions Release provides much needed guidance on what kinds of transactions will be included or excluded as swaps for purposes of the calculations to determine the availability of the de minimis exemption to the manager of a private fund from the commodity pool operator ("CPO") registration requirements under the Commodity Exchange Act, as amended (the "CEA").
- **CFTC Regulation of Swaps:** The Definitions Release triggers the effectiveness of several new CFTC regulations governing swaps and other derivatives that will affect private funds and fund managers, including recordkeeping and disclosure requirements, anti-fraud and anti-manipulation rules, mandatory clearing of certain types of swaps, and position limits, among other new requirements.
- **SEC Regulation of Security-Based Swaps:** The SEC's inclusion of security-based swaps in the definition of "security" for purposes of both the Securities Exchange Act of 1934, as amended (the "Exchange Act") and the Securities Act of 1933, as amended (the "Securities Act") makes security-based swaps subject to regulation as securities under the federal securities laws, giving the SEC significant new regulatory and enforcement power over such derivatives.

CFTC Registration

The Product Definitions implicate a range of commodity law requirements governed by statutes and regulations enforced by the CFTC because derivatives that are "swaps" are now included in the definition of "commodity interests" for purposes of the CEA. One of the most significant effects of the Definitions Release to fund managers is its applicability to the de minimis exemptions available under Rule 4.13(a)(3) (applicable to private investment funds) and Rule 4.5 (applicable to funds registered under the Investment Company Act of 1940, as amended) from the CPO registration requirements under the CEA. As explained in greater detail in our *Alerts* of July 20, 2012 and Feb. 10, 2012 ("Update on Recent CFTC Actions Affecting Fund Managers" and "CFTC Finalizes Significant Rule Changes Affecting Fund Managers and Investment Companies," respectively), starting in Dec. 31, 2012, fund managers will not be able to claim an exemption from CPO registration pursuant to Rule 4.13(a)(4) and swaps will be considered "commodity interests" for purposes of the exemptions available under Rule 4.13(a)(3) and Rule 4.5. Therefore, most private fund managers will need to rely on the de minimis exemption available under Rule 4.13(a)(3) to avoid having to register as a CPO.

The de minimis exemption is available when a private fund engages in a de minimis level of "commodity interest" transactions. Traditionally, the exemptions required calculations that included only futures, commodity option and retail forex transactions. As of Jan. 1, 2013, these calculations will also include "swaps" regulated by the CFTC. The Definitions Release now provides clarity regarding precisely which sort of derivatives and similar transactions will be treated as swaps and must be included in the calculations related to the de minimis exemptions.

If a fund cannot qualify for the applicable de minimis exemption, the consequences to its manager can be significant.[1] For instance, if a private fund cannot qualify for the de minimis exemption under Rule 4.13(a)(3),[2] the investment manager will be required to register as a CPO,[3] an affiliated entity may be required to register as a commodity trading adviser ("CTA") and the associated persons of the CPO ("Associated Persons") must register under the CEA. A CPO must also become a member of the National Futures Association ("NFA") and its Associated Persons must become associate members of NFA and provide fingerprints to NFA on a completed fingerprint card. Associated Persons must also pass the Series 3 exam administered by the Financial Industry Regulatory Authority ("FINRA"). CPOs and CTAs will also be subject to the various reporting requirements with CFTC and NFA, including new reporting requirements under forms CPO-PQR and CTA-PR.

The release of the Product Definitions also allows for a determination of whether fund managers and other financial institutions will be required to register as swap dealers ("SDs") or major swap participants ("MSPs"),[4] since only swaps under CFTC jurisdiction need be considered for purposes of determining whether a firm is

[1] Other than the de minimis exemption under Rule 4.13(a)(3), even foreign advisors managing non-U.S. private funds that only invest in foreign commodity interest positions have no other exemptions available to them, so long as the fund has even just one U.S. investor. While there is no specific exemption for family offices, the CFTC has indicated that family offices may rely on certain CFTC no-action relief letters provided to them in the past.

[2] There is no exemption for commodity interest positions that were entered into for hedging purposes. Also, in order for a private fund to rely on Rule 4.13(a)(3), all of the investors in the fund must be either an accredited investor or a non-US person (or other "qualified eligible persons") and either (i) the aggregate of all initial margins and premiums on commodity interests and security futures positions must at all times be no more than 5 percent of the liquidation value of the fund's portfolio or (ii) the aggregate net notional value of the commodity interest positions cannot exceed at any time 100 percent of the liquidation value of the fund's portfolio, after taking into account unrealized profits and losses. The fund must also be offered in a private placement, and it cannot be marketed to the public or as a vehicle for investing in commodity futures or commodity options markets. On July 17, 2012, the Managed Funds Association ("MFA") submitted comments to the CFTC urging it to, among other things, harmonize Rule 4.13(a)(3) with the Jumpstart Our Business Startups Act (the "JOBS Act"), which eliminates the prohibition on general solicitation or advertising in connection with the non-public offering of securities. In addition, MFA requested that the CFTC grant interim temporary no-action relief to CPOs relying on Rule 4.13(a)(3) from the prohibition on marketing to the public.

[3] Certain managers may be able to take advantage of the so-called "registration lite" under Rule 4.7 promulgated under the CEA which is available to pools that are offered only to qualified eligible persons and meet certain other criteria.

[4] As detailed in SRZ's May 22, 2012 *Alert*, "SEC and CFTC Publish Entity Rule Definitions: Impact on Private Investment Funds," most private investment funds are not expected to fall within the definitions of SD or MSP, but the obligations of SDs and MSPs may affect private investment funds (for example, SDs or MSPs may be obligated to request additional collateral under derivative transactions with a private investment fund). Managers with questions regarding the SD/MSP status of their managed funds should contact their SRZ attorney.

required to register as an SD or MSP. Although it is unlikely that a private fund will be considered to be an SD or MSP, these rules are still relevant to most private funds that enter into swaps because a private fund's dealer counterparties will have to register as SDs. The publication of the Product Definitions will trigger new obligations for SDs/MSPs, including CFTC business conduct standards that require swap dealers to conduct due diligence on fund managers and private funds and to obtain certain representations from their fund counterparties and fund managers. The International Swaps and Derivatives Association, Inc. ("ISDA") has prepared documentation that will incorporate by reference into a fund's existing swap documentation the terms and conditions necessary for the fund's SD counterparties to comply with the CFTC's new business conduct standards, recordkeeping and reporting requirements. Private funds may adhere to the ISDA August 2012 DF Protocol to make certain representations and agreements to avoid intrusive due diligence and to continue trading without any interruptions.

CFTC Regulation of Swaps

The Definitions Release also triggers many CFTC requirements that apply to all swap transactions, irrespective of a swap counterparty's registration status with the CFTC, such as certain disclosure, reporting and recordkeeping requirements, position limits applicable to certain swaps,[5] the anti-manipulation and anti-fraud final rules applicable to all swaps,[6] and clearing obligations for certain swaps.

Although many of the reporting and recordkeeping requirements apply only to SDs and MSPs, a private fund may be subject to certain significant recordkeeping requirements, such as a requirement that it maintain "full, complete and systematic" records with respect to each swap to which it is a party. For example, SDs and MSPs will be required to conduct additional due diligence on managers and require the manager of a private fund counterparty to provide updated representations and on-going reports and other information (such as records that can support the accuracy of the information reported to swap data repositories). Therefore, a private fund manager will need to consider updating its record retention and recordkeeping policies to permit it to have such information accessible in a usable format.

The CFTC has adopted a Final Interim Rule imposing position limits on swaps, futures and options on 28 physical commodities, expanding the types of commodities to which position limits apply for futures and options, and including for the first time swaps that are "economically equivalent" to such futures and options. The position limits cap the maximum amount of futures, options and economically equivalent swaps that a trader may control with respect to such commodities at any given time.

The general prohibition against fraud, manipulation and deception by SDs/MSPs established by the CFTC's Business Conduct Rule prohibits an SD/MSP from engaging in "any act, practice, or course of business that is fraudulent, deceptive, or manipulative." The anti-fraud provision is identical to the general anti-fraud rule contained in CEA Section 4s(h). The CFTC has also imposed a fair dealing obligation on SDs/MSPs, requiring that an SD/MSP communicate in a "fair and balanced manner based on principles of fair dealing and good faith."

Although the CFTC has not yet required that any swap be cleared, it has proposed clearing requirements for certain credit default swaps and interest rate swaps and is expected in the future to require clearing of additional types of swaps that are currently cleared, or will be cleared, by one or more regulated clearinghouses. A private fund that enters into a cleared swap transaction will be subject to margin requirements imposed by the relevant clearinghouse as well as the member of the clearinghouse through which the private fund enters into such transaction.[7] Swaps that must be cleared must also be executed on a futures or securities exchange or a swap execution facility. Rules governing these execution facilities are not yet final.

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[5] The CFTC's Final Interim Rule and Proposed Rule relating to position limits may be found at www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-28809-1a.pdf and www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-12526a.pdf, respectively.

[6] See www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-1244a.pdf for the CFTC's Business Conduct Rule, which sets forth these rules.

[7] Private fund managers will need to prepare to negotiate and enter into futures account client agreements or similar clearing agreements with their dealer counterparties with respect to swaps that are subject to clearing requirements.

SEC Regulation of Security-Based Swaps

The Products Definitions also implicate a range of securities law requirements governed by statutes and regulations enforced by the SEC because derivatives and similar transactions that are "security-based swaps" are now included in the definition of "security" for purposes of both the Exchange Act and the Securities Act. For instance, a private fund that enters into a security-based swap referencing an equity security may be subject to a number of Section 13(d) beneficial ownership rules under the Exchange Act (including the reporting requirements thereunder) because it may be deemed to have beneficial ownership of the equity security in certain situations, including: (i) where a security-based swap, by its terms or otherwise,[8] gives a person voting or investment power over the underlying security; (ii) where a security-based swap is used with the purpose or effect of divesting or preventing the vesting of beneficial ownership as part of a plan or scheme to evade the beneficial ownership reporting requirements; and (iii) where a security-based swap, by its terms or otherwise, gives a person the right to acquire the underlying security within 60 days (or at any time if the person holds such right to acquire the underlying security with the purpose or effect of changing or influencing control of the issuer).

There are also implications under Section 16 of the Exchange Act for private fund managers to consider. Security-based swaps must be included in a private fund manager's Section 16 reporting, including: (i) Rule 16a-1(a)(1) which uses the beneficial ownership tests of Section 13(d) to determine whether a person is subject to Section 16 as a greater than 10 percent beneficial owner and (ii) Rule 16a-1(a)(2) which defines pecuniary interest for purposes of reporting obligations and related short-swing profit analysis.

Private fund managers should also be aware that security-based swaps will be treated as securities for purposes of anti-fraud and manipulation provisions of the U.S. federal securities laws.[9] However, like many of the rules related to security-based swaps, proposed antifraud Rule 9j-1 under the Exchange Act (which would apply not only to offers, purchases and sales of security-based swaps, but also to cash flows, payments, deliveries, and other ongoing obligations and rights that are specific to security-based swaps), will not go into effect until a date specified by the SEC after the publication of the Product Definitions.

The SEC stated that because of the interconnectedness of the Product Definitions with the remaining rules related to security-based swaps, the SEC is requesting comments on the sequencing of compliance dates for industry participants on proposed rules. (*See* www.sec.gov/rules/policy/2012/34-67177.pdf.) However, once the SEC publishes the compliance dates, fund managers will have to comply with similar SEC rules related to recordkeeping and reporting (including real time reporting) with respect to security-based swaps.

Dodd-Frank also requires the SEC to issue rules related to position limits for security-based swaps,[10] but the SEC has not issued a proposed rule for security-based swap position limits. The SEC will also implement the rules related to clearing security-based swaps.

Swaps and Security-Based Swaps Subject to Regulation

Swaps, Security-Based Swaps and Mixed Swaps
Each of the CFTC and SEC have certain responsibilities for administering and enforcing the regulatory regime created by Title VII. The CFTC is given regulatory authority over swaps, the SEC is given regulatory authority over security-based swaps (which are now included in the definition of "security" for purposes of both the Exchange Act and the Securities Act), and the Commissions have joint authority over mixed swaps.[11]

[8] This would include ways to exert influence in practice through consultations and other informal "handshake" agreements.

[9] These include Section 10(b) of the Exchange Act, Rule 10b-5 and Section 17(a) of the Securities Act.

[10] See Dodd-Frank § 763(h).

[11] In addition, the SEC is given antifraud authority and certain other authority over security-based swap agreements ("SBSAs"), as well as access to information disclosed by CFTC-reporting entities relating to SBSAs. SBSAs are swaps involving securities over which the CFTC has regulatory and enforcement authority and include swaps on broad-based security indexes and swaps on exempted securities (other than municipal securities), such as U.S. Treasury bonds.

Whether a Title VII Instrument[12] is a swap or a security-based swap (or both, in which case the Title VII Instrument would be a mixed swap) will be determined by "the facts and circumstances relating to the Title VII Instrument prior to execution, but no later than when the parties offer to enter into the Title VII Instrument."[13] The characterization of a Title VII Instrument as a swap or security-based swap may change over time if the Title VII Instrument is amended, modified or otherwise adjusted during its term.

The characterization of a Title VII Instrument as a swap, security-based swap or mixed swap will be determined based on the subject of the transaction embodied by such Title VII Instrument.

Generally, if the Title VII Instrument references a single security or loan, or a "narrow-based security index,"[14] the Title VII Instrument will be a security-based swap subject to regulation by the SEC but if the Title VII Instrument references commodities, assets that are not "securities" under federal law (i.e., most currency products), a group of securities (unless such group qualifies as a narrow-based securities index), an index that is not a narrow-based security index, or one or more "exempt securities" (as discussed below), the Title VII Instrument will be a swap, subject to regulation by the CFTC.

A mixed swap is a swap with both "swap" and "security-based swap" characteristics and is subject to joint regulation by the Commissions. Since mixed swaps are regulated by the CFTC, they also must be counted for purposes of all CFTC rules, including the rules related to CPO/CTA registration requirements. The Definitions Release establishes two rules with respect to mixed swaps. First, in the case of a bilateral, uncleared mixed swap,[15] where one of the parties is dually registered with both Commissions, all applicable provisions of the federal securities laws, as well as certain key provisions of the CEA, will apply to such swap. Second, where the applicable provisions of federal securities laws and the CEA (and the rules and regulations thereunder) are parallel or duplicative, a party to a mixed swap may request that the Commissions by joint order permit such party to comply with either the federal securities laws or the CEA.

The following chart contains a non-exhaustive list of Title VII Instruments and their classification under the Definitions Release. It does not contain all types of Title VII Instruments, is intended as a summary for reference purposes only and does not constitute legal advice. Private investment funds and managers should consult their SRZ attorney for an analysis of specific Title VII Instruments.

[12] As used herein (and in the Definitions Release), "Title VII Instrument" means a swap or a security-based swap.

[13] Definitions Release, p. 202.

[14] The CEA and Exchange Act both define the term "narrow-based security index" as an index satisfying, among other things, one of the following four requirements: (1) it has nine or fewer components; (2) one component comprises more than 30 percent of the index weighting; (3) the five highest weighted components comprise more than 60 percent of the index weighting or (4) the lowest weighted components comprising in the aggregate 25 percent of the index's weighting have an aggregate dollar value of the average daily volume over a six-month period of less than $50 million ($30 million if there are at least 15 component securities), subject to certain exceptions specified in the definition of narrow-based security index. Definitions Release, pp. 235-236. In addition, if (i) a Title VII Instrument is based on a portfolio of securities selected by the counterparties or created by a third-party index provider at the behest of one or both counterparties and (ii) the counterparties directly or indirectly (e.g., through an investment adviser or through a third-party index provider) have discretionary authority to change the composition or weighting of securities in the security portfolio, that security portfolio will be treated as a narrow-based security index and the Title VII Instrument will be treated as a security-based swap. Definitions Release, p. 288.

[15] A mixed swap that is not to be cleared. See Definitions Release, p. 314, footnote 950.

Swap	Security-Based Swap	Mixed Swap
Total return swaps ("TRS") referencing a broad-based security index (whether comprising debt securities or equity securities)[16]	TRS referencing a narrow-based security index (whether comprising debt securities or equity securities)	TRS referencing both a broad-based security index and a narrow-based security index
TRS referencing an exempted security[17] (other than a municipal security) or a basket of two or more securities that is not a narrow-based security index or a basket of two or more non-security loans[18]	TRS referencing a single security or a single non-security loan[19]	TRS on a single security with an embedded interest rate hedge or an embedded commodities futures or option
Credit default swaps ("CDS") referencing an exempted security (other than a municipal security) or a basket of two or more securities that is not a narrow-based security index or a basket of two or more non-security loans (whether or not such security is a narrow-based security index), including CDS whose settlement is governed by an ISDA-sponsored auction settlement protocol[20]	CDS referencing a single security or a single non-security loan or a narrow-based security index, including CDS whose settlement is governed by an ISDA-sponsored auction settlement protocol	CDS referencing both a broad-based security index and a narrow-based security index or a CDS referencing a broad-based security index and requiring physical settlement of a non-exempted security or a loan
Swaps based on rates or yield of a U.S. Treasury security or another exempt security, or of multiple U.S. Treasury securities, exempt securities or securities	Swaps based on the yield of a single security (other than U.S. Treasury securities or other exempt securities)	
Dividend swaps referencing a broad-based security index	Dividend swaps referencing a single security or narrow-based index of securities	

[16] Any index that is not a narrow-based security index is a broad-based security index.

[17] An "exempted security" is a security that is an exempted security under Section 3 of the Securities Act, such as securities issued or guaranteed by the United States, bank certificates of deposit and other securities issued or guaranteed by a bank, certain bills of exchange or banker's acceptance and certain securities issued by a savings and loan association.

[18] The Commissions determined that a TRS on a group or index of non-security loans is not a security-based swap because the definition of narrow-based security index applies only to securities and not to non-security loans.

[19] The Definitions Release defines "non-security loans" as loans that are not securities.

[20] The Definitions Release clarifies that transactions structured as securities (including a security-based swap) under the federal securities laws are not swaps under the anti-evasion rules set forth in the Definitions Release. Therefore, credit-linked notes, equity-linked notes and similar structured notes should not be considered to be swaps.

Swap	Security-Based Swap	Mixed Swap
Futures based on U.S. Treasury securities, other exempt securities (other than municipal securities) or foreign government debt securities that are exempt securities pursuant to Exchange Act Rule 3a12-8[21]	Futures based on a single security,[22] including foreign government debt securities not subject to the exemption provided by Exchange Act Rule 3a12-8	
Correlation swaps referencing a broad-based security index or any commodity or commodity index		
Interest rate swaps and basis swaps		
Cross-currency swaps, currency swaps, currency options, foreign currency options, foreign exchange ("FX") options, FX rate options, FX forwards and FX swaps[23] (but excluding foreign currency option traded on a National Securities Exchange; and spot transaction and security conversion transaction[24])		
Commodity swaps, including swaps based on agricultural commodities, metals, energy and other commodities		
Weather and emissions swaps		
Guarantee of a Title VII Instrument that is a swap	Guarantee of a Title VII Instrument that is a security-based swap	Guarantee of a Title VII Instrument that is a mixed swap

[21] The foreign governments whose debt securities are exempted by Rule 3a12-8 are 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. The Rule 3a12-8 exemption applies only to Title VII Instruments that are futures based on the exempted foreign government debt securities. A Title VII Instrument directly referencing foreign government securities (including securities issued by governments listed above) will be either a security-based swap or a swap (or a mixed swap) under the same analysis as any other Title VII Instrument referencing securities.

[22] While a swap on a security future is not considered a swap, a security future itself still must be considered for purposes of the de minimis tests. (See footnote 2 for a summary of the de minimis test under Rule 4.13(a)(3).)

[23] It is important to note, that while all FX swaps and FX forwards have been defined as swaps, the U.S. Department of the Treasury is in the process of determining whether to exempt such instruments, in which case, these instruments would no longer be considered swaps. However, a determination by the U.S. Department of the Treasury will have no effect on other FX derivatives (such as FX options, currency swaps, and non-deliverable forwards); they will still be considered swaps.

[24] While not considered security-based swaps, foreign currency options traded on a National Securities Exchange and spot transactions and security conversion transactions are excluded from the definition of a "swap."

Title VII Instruments Difficult to Categorize
To the extent that there are Title VII Instruments that are difficult to categorize as either swaps or security-based swaps, any interested person may request a joint interpretation from the Commissions regarding the categorization of such instruments by submitting a request to the Commissions (which request would include a deadline for responding to such request). The requesting party must provide certain information regarding the Title VII Instrument, including a supporting analysis and certain other documentation to the SEC and CFTC.

Anti-evasion Rules
Under the anti-evasion rules adopted by the CFTC, swaps will include agreements, contracts or transactions that are willfully structured to evade the provisions of Title VII governing the regulation of swaps. The Commissions will look beyond the documentation of a Title VII Instrument to examine its actual substance and purpose. However, Rule 1.6(d) provides that no agreement, contract or transaction structured as a security (including a security-based swap) under the federal securities laws shall be deemed a swap. Therefore, credit-linked notes, equity-linked notes and similar structured notes should not be considered to be swaps.

Derivatives and Other Products Exempt from Regulation

Although the Commissions did not modify the definitions of "swap" and "security-based swap" found in Section 721 of Dodd-Frank, they excluded certain contracts and/or transactions that have "swap-like" features but that will be excluded from the Product Definitions. The Commissions created four broad categories of products that are generally exempted from the Product Definitions: (i) loan participations, (ii) insurance, (iii) nonfinancial commodity forwards and (iv) consumer and commercial transactions.

Loan Participations
The Commissions excluded loan participations meeting certain qualifications from regulation as swaps and security-based swaps. In order to qualify for the exclusion, a loan participation must "represent a current or future direct or indirect ownership interest in the loan or commitment that is the subject of the loan participation."[25]

In determining whether a loan participation represents a current or future direct or indirect ownership interest, the Commissions will expect a participation to have all of the following characteristics:

1. The grantor of the loan participation is a lender under, or a participant or subparticipant in, the loan or commitment that is the subject of the loan participation.
2. The aggregate participation in the loan or commitment that is the subject of the loan participation does not exceed the principal amount of such loan or commitment and does not otherwise grant to the participant, in the aggregate, a greater interest than the grantor holds.
3. The entire purchase price for the loan participation is paid in full when acquired and not financed.[26] The Commissions believe a purchase price would not be paid in full if the grantor of the loan participation extends financing to the participant or if such participant levers its purchase, including by posting collateral to secure a future payment obligation.
4. The loan participation provides the participant all of the economic benefit and risk of the whole or part of the loan or commitment that is the subject of the loan participation.[27]

[25] Definitions Release, p. 162-163.

[26] The Commissions expressly provided that the financing or taking leveraged exposure to a loan participation, including by posting collateral to secure a future payment obligation, would not constitute the payment in full of the purchase price.

[27] Definitions Release, p. 163.

Insurance

The Commissions excluded insurance products[28] from regulation as swaps and security-based swaps if such products comply with certain non-exclusive safe harbor rules (the "Insurance Safe Harbor").[29] The Insurance Safe Harbor consists of two tests: first, an insurance product must either (i) satisfy the conditions set forth in the "Product Test" established by the Commissions or (ii) be one of the "Enumerated Products" expressly excluded from regulation under Title VII ((i) and (ii) collectively, "Exempt Insurance Products"), and second, the Exempt Insurance Product in question must be provided by an insurer that satisfies the "Provider Test" established by the Commissions.

The Insurance Safe Harbor is a non-exclusive safe harbor. An agreement, contract or transaction that does not qualify for the Insurance Safe Harbor is not therefore automatically a swap or a security-based swap.[30] It should be noted that products that have been offered by insurance companies or their affiliates in the past, such as credit default swaps and "transformer" credit default swap products that provided insurance on tranches of securitization notes, such as notes issued by collateralized debt obligation issuers, would not meet the Insurance Safe Harbor.

In addition to the Insurance Safe Harbor, the Commissions also recognized that products traditionally regulated as insurance would remain so, by providing for a grandfather provision (the "Insurance Grandfather") in the rules under the CEA and Exchange Act. The Insurance Grandfather provides "that an agreement, contract, or transaction entered into on or before the effective date of the Product Definitions will be considered insurance and not fall within the Product Definitions, *provided that* at such time it was entered into, such agreement, contract, or transaction was provided in accordance with the Provider Test."[31]

The Forward Contract Exclusion

Noting that forward contracts are primarily intended to transfer ownership of a commodity and not solely to transfer price risk, the CFTC adopted an interpretation excluding from regulation under Title VII "any sale of a nonfinancial commodity[32] or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled." With respect to "book-out" transactions, where parties to multiple forward contracts settle offsetting positions with each other by foregoing delivery and negotiating payment of differences pursuant to a separately negotiated cancellation agreement, the CFTC also retained the "Brent Interpretation," allowing forwards to qualify for the forward contract exclusion if they have binding delivery obligations (and no right to cash settle or otherwise net delivery obligations) but are unwound pursuant to a subsequent, separately negotiated book-out agreement.[33]

If a nonfinancial forward contract contains an embedded commodity option or options, the forward contract will be a nonfinancial forward contract (and not a swap), if the embedded option (i) will be used to adjust the forward contract price, but does not undermine the overall nature of the contract as a forward contract; (ii) does 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 it is embedded.[34]

The Commissions also adopted the Proposing Release's interpretation with respect to mortgage-backed securities ("MBS") sold in the "to be announced" ("TBA") market, which provides that forward sales of MBS in the TBA market would fall within: (i) the exclusion for sales of securities on a deferred settlement or delivery

[28] Definitions Release, p. 18.

[29] Definitions Release, p. 19.

[30] Any such agreement, contract or transaction would need to be analyzed under the Product Definitions to determine whether it is a swap, security-based swap or mixed swap. Definitions Release, p. 24-25.

[31] Definitions Release, p. 57.

[32] The CFTC defines "nonfinancial commodity" to mean a commodity that can be physically delivered and that is an exempt commodity or an agricultural commodity (as both such terms are defined in CEA Section 1a(20)); the CFTC also provided an interpretation stating that intangible commodities (for example, emissions allowances) can qualify as nonfinancial commodities if they can be "conveyed in some manner" and consumed. Definitions Release, pp. 93-95.

[33] In the Definitions Release, the CFTC expanded the application of the Brent Interpretation to all types of nonfinancial commodities (it previously applied only to oil). Definitions Release, pp. 78-82. As a result of the expansion of the Brent Interpretation, the CFTC withdrew the "Energy Exemption" adopted in 1993. Definitions Release, pp. 83-87.

[34] Definitions Release, p. 112.

basis, even MBS sold into the TBA market are not in existence at the time of such forward sale, and (ii) 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 in each case would therefore fall outside the swap and security-based swap definitions.

Consumer and Commercial Transactions
The Commissions also adopted interpretations excluding various types of consumer and commercial transactions that may have "swap-like" features from regulation under Title VII. The Definitions Release provides a non-exhaustive list of excluded consumer and commercial transactions.[35] The Commissions noted that the types of contracts referred to above were not intended to be an exhaustive list and, in determining whether a particular contract was a swap or security-based swap, the Commissions would consider whether the contract in question had the characteristics common to the examples referred to in their interpretation, including whether the contract: (i) contains payment obligations, whether or not contingent, that are severable from the contract; (ii) is traded on an organized market or over-the-counter; (iii) in the case of consumer arrangements, involves an asset of which a consumer is the owner or beneficiary, or that a consumer is purchasing, or involves a service provided, or to be provided, by or to a consumer; and (iv) in the case of commercial arrangements, is 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.[36]

Effective Dates of Title VII Regulation

With the adoption of the Definitions Release, the Title VII rulemaking required by Dodd-Frank is largely complete, and the various rules and regulations will become effective over the next several months. The following charts summarize the various dates by which the listed entities must comply with the specified rules and regulations, based on the Aug. 13, 2012 publication of the Definitions Release in the Federal Register. Please note that the summaries in the charts below are intended for informational purposes only and do not constitute legal advice with respect to any date or compliance requirement.

Effective Dates Related to CPOs/CTAs	
Rule	**Effective Date/Compliance Date**
CTAs whose sole commodity interest trading advice is with respect to swaps, and not futures, commodity options or retail foreign exchange (and, therefore, were not previously required to register), and that are not otherwise exempt, must register with the CFTC and NFA.	Oct. 12, 2012
Registered CPOs with assets under management of $5 billion or more (as of June 30, 2012) are required to submit their initial Form CPO-PQR for the quarter ending Sept. 30, 2012.	Nov. 29, 2012
Final Expiration of Rule 4.13(a)(4) exemption from CFTC registration (and the accompanying CTA exemption for 4.13(a)(4) pools under Rule 4.14(a)(8)(i)(D)); by Dec. 31, 2012, all CPOs and CTAs relying on 4.13(a)(4) (or similar no-action relief) must register with the CFTC and NFA (unless another exemption from registration applies).	Dec. 31, 2012

[35] The Definitions Release lists a number of types of consumer and commercial transactions, including contracts to acquire, lease, buy or sell property (real, personal, intellectual or other), loans or mortgages with variable rates, rate locks or rate caps, and loans with pricing linked to an underlying commodity or index (utility service based on energy cost or contracts with price escalators linked to CPI, for example), among others. Definitions Release, pp. 144-148.

[36] Definitions Release, p. 144.

Effective Dates Related to CPOs/CTAs	
Rule	**Effective Date/Compliance Date**
Swaps will be considered "commodity interests" for purposes of the Rule 4.13(a)(3) and Rule 4.5 de minimis tests.	Dec. 31, 2012
Registered CTAs are required to submit their first Form CTA-PR for the year ending Dec. 31, 2012.[37]	Feb. 14, 2013
Registered CPOs (as of 2012) with assets under management of at least $1.5 billion are required to submit their Form CPO-PQR for the quarter ending Dec. 31, 2012.[38]	March 1, 2013
Registered CPOs with assets under management of less than $1.5 billion are required to submit their initial Form CPO-PQR for the year ending Dec. 31, 2012 (excluding newly registered CPOs as of Jan. 1, 2013).[39]	March 31, 2013

Effective Dates Related to Swap Clearing	
Rule	**Effective Date/Compliance Date**
CFTC rules related to swap processing (customer clearing documentation and timing of acceptance for clearing) become effective for SDs.	Oct. 12, 2012
SDs/MSPs must comply with rules related to protection of customer contracts and collateral for cleared swaps.	Nov. 8, 2012
SDs, MSPs and "active funds" are required to clear with a derivatives clearing organizations ("DCO") certain classes of CDS/IRS.	Q1 2013 (approximately)[40]
All private funds (other than third-party subaccounts (as defined below)) are required to clear with a DCO certain classes of CDS/IRS.	Q2 2013 (approximately)[41]
(i) Accounts managed by an investment manager that is: (a)	Q3 2013 (approximately)[42]

[37] This date assumes that a CTA's fiscal year ends Dec. 31, 2012; the first filing is due 45 days after the last day of the fiscal year occurring after Dec. 15, 2012.

[38] CPOs with less than $5 billion as of June 30 (or those who were not yet registered) will be filing their initial Form CPO-PQR, while this would be the second filing for those with more than $5 billion. This will not be applicable to new registrants who choose to defer the effectiveness of a new CPO registration until Jan. 1, 2013.

[39] While new CPOs (i.e., registered as of Jan. 1, 2013) with less than $1.5 billion in assets under management will not be required to file their first CPO-PQR until 2014, there is still an NFA PQR filing requirement on a quarterly basis for all CPOs. Thus, for the quarter ending March 31, 2013, all CPOs will be required to make a filing, with the level of information required depending on assets under management.

[40] 90 days following the publication of the final rule mandating clearing of the specified classes of CDS/IRS. While the 90-day timeframe has already been finalized, the clearing rules that specifically address IRS/CDS are currently in the proposal stage and can be found at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister072412.pdf.

[41] 180 days following the publication of the final rule mandating clearing of the specified classes of CDS/IRS.

[42] 270 days following the publication of the final rule mandating clearing of the specified classes of CDS/IRS.

independent of and unaffiliated with the account's beneficial owner or sponsor, and (b) responsible for the documentation necessary for the account's beneficial owner to clear swaps ("third-party subaccounts"), (ii) ERISA plans and (iii) any other person not excepted from the relevant clearing requirement are required to clear with a DCO certain classes of CDS/IRS.	

Effective Dates Related to Swap Reporting Rules	
Rule	**Effective Date/Compliance Date**
"Reporting entities" (clearing members and SDs) subject to CFTC's Large Swaps Trader Reporting for Physical Commodities (CFTC Part 20 regulations) are required to submit daily reports of their "reportable positions."	Sept. 21, 2012 (or Dec. 11, 2012, or later)[43]
SD/MSP non-real time reporting[44] of all CDS/IRS, including historical reporting (for both exchange-traded and OTC swaps).	Oct. 12, 2012
CDS/IRS real-time data reporting requirement becomes effective for swaps data repositories (for both exchange-traded and OTC swaps).	Oct. 12, 2012
SD/MSP non-real time reporting of all swaps, including	Jan. 10, 2013

[43] The CFTC has issued no-action relief which allows non-clearing member SDs (upon notifying the CFTC) to delay these reporting requirements until Dec. 11, 2012. The CFTC has also been provided discretion to allow certain SDs with resource limitations or a lack of expertise to delay reporting for an additional six months. (See CFTC No-Action Letter 12-04.)

[44] Reportable information generally includes swap creation data (including "primary economic terms" and valuation data), confirmation data (including a copy of the signed confirmation), and ongoing valuation and transaction modification data. See SRZ's Feb. 1, 2012 *Alert*, "CFTC Publishes Final Swap Data Rules and Real-Time Reporting Rules," for additional details.

Effective Dates Related to Swap Reporting Rules	
Rule	**Effective Date/Compliance Date**
historical reporting (for both exchange-traded and OTC swaps).	
Real-time reporting requirements for swaps data repositories for all swaps.	Jan. 10, 2013
For non-SDs/MSPs that are party to a non-cleared swap (of any type) with another non-SD/MSP, one party to the swap will be required to report the swap's "primary economic terms" and deliver a copy of the confirmation relating to such swap (unless both parties are "non-U.S. persons").	April 10, 2013
For non-SDs/MSPs that are party to a non-cleared swap (of any type) with another non-SD/MSP, one party to the swap will be required to report the terms and conditions of the swap in electronic format (in the form used by SDs/MSPs and including all of the data fields in such form) (unless both parties are "non-U.S. persons").	Oct. 7, 2013

Effective Dates Related to General Regulation of SDs/MSPs	
Rule	**Effective Date/Compliance Date**
SDs and MSPs that are subject to the "Large Trader Reporting" rules (SEC Rule 13h-1) are subject to monitoring, recordkeeping and reporting requirements.	EFFECTIVE
SDs/MSPs required to be registered with the CFTC.	Oct. 12, 2012[45]
SDs/MSPs (or security-based SDs/MSPs), whether or not registered with the SEC or regulated by a prudential regulator must retain/disclose required information relating to swap transactions, including swap data and daily trading records.	Oct. 12, 2012
CFTC-imposed position limits for futures and swaps (initial spot-month limits for referenced contracts, initial non-spot month limits for legacy agricultural referenced contracts), as well as rules related to "bona fide" hedging, visibility reporting, aggregation, revised filing requirements and foreign boards of trade become effective.	Oct. 12, 2012[46]
SDs/MSPs must comply with external business conduct rules.	Oct. 12, 2012

[45] It is possible that the CFTC will allow registration to be postponed until Jan. 1, 2013. Clients with questions about this issue should contact an SRZ attorney.

[46] Notwithstanding the effective date, the CFTC has issued no-action relief which allows firms (upon notifying the CFTC) to rely on certain proposed rules which broaden the exemptions available with respect to the new aggregation requirements until the earlier of: (i) 60 days after the date on which the CFTC's proposed changes to its aggregation policy are published in the Federal Register (or withdrawn by the CFTC); or (ii) Dec. 31, 2012.

Effective Dates Related to General Regulation of SDs/MSPs	
Rule	**Effective Date/Compliance Date**
SDs/MSPs registered with the SEC or regulated by a prudential regulator must: have in place a risk management program, business continuity plan and disaster recovery plan; monitor position limits; adopt and comply with diligent supervision standards and conflict of interest rules; and designate a Chief Compliance Officer (as well as define the CCO's duties).	Oct. 12, 2012
SDs/MSPs that are neither registered with the SEC nor regulated by a prudential regulator must: have in place a risk management program, business continuity plan and disaster recovery plan; monitor position limits; and adopt and comply with diligent supervision standards and conflict of interest rules.	Dec. 29, 2012
CFTC rules related to customer clearing documentation, timing of acceptance for clearing, clearing member risk management and clearing conflicts become effective for SDs/MSPs and futures commission merchants that are clearing members.	Jan. 1, 2013
SDs/MSPs that are neither registered with the SEC nor regulated by a prudential regulator are required to designate a Chief Compliance Officer (as well as define the CCO's duties).	March 29, 2013

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If you have further questions related to the Definitions Release or any other aspect of Title VII's regulatory framework, or would like additional information, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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