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Alert

CFTC Update: Certain Equity Total Return Swaps to Count Toward *De Minimis* Exemption Starting July 1

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Approximately six months ago (on Dec. 21, 2012), the Commodity Futures Trading Commission staff provided temporary no-action relief[1] allowing certain equity total return swaps on foreign securities — which have been termed "compo equity swaps" or "compo equity total return swaps"[2] — to be treated as "securities-based swaps" (which are regulated by the Securities and Exchange Commission) and not as "mixed swaps" (which are regulated by both the CFTC and SEC).[3] Based on that relief, fund managers claiming a *de minimis* commodity pool operator registration exemption — either Rule 4.13(a)(3) (for private funds) or Rule 4.5 (for mutual funds) — have heretofore been able to exclude compo swaps from their calculations.

This relief, however, is set to expire on June 30 and, unless additional relief is granted (which is not anticipated at the moment), fund managers — from and after July 1, 2013 — will have to count compo swaps as "commodity interests" when determining their eligibility for a *de minimis* exemption. Managers should note that the classification of compo equity swaps as mixed swaps could also be applied to other equity swap transactions that have "non-incidental" foreign currency components.[4]

As a result, fund managers relying on either of the two *de minimis* exemptions should examine their equity-related swaps to determine if they will remain eligible for that exemption after July 1. A fund manager in danger of exceeding a *de minimis* threshold may need to employ alternative instruments to obtain similar exposures (or may need to register as a commodity pool operator).

The expiration of the interim relief also means that other CFTC swap-specific requirements, such as adherence to the Dodd-Frank Protocols and swap reporting obligations, will be applicable to compo and similar mixed swaps.

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[1] http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/12-64.pdf.

[2] A "compo equity total return swap" exposes a counterparty to changes in the value of the underlying (foreign) equity as well as the foreign currency in which the underlier is quoted. Economically (and ignoring numerous friction costs), it is similar to taking a position directly in the foreign equity.

[3] In August 2012, the CFTC and the SEC jointly published final rules which defined the term "swap" and "securities-based swaps." They also defined "mixed swaps," which are instruments that have both a commodity interest component (e.g., currency or interest rate exposure) and a securities component and are therefore regulated by both commissions. Nonetheless, for purposes of the *de minimis* exemptions, mixed swaps are treated as swaps (e.g., the initial margin or notional value of mixed swaps must be counted as commodity interests in determining the availability of a *de minimis* exemption). 77 FR 48207 (Aug. 13, 2012).

[4] Total return swaps on a single security or narrow-based index are generally considered "securities-based swaps" (which are not counted for purposes of the *de minimis* exemptions); however, in the August 2012 joint release, the CFTC and the SEC concluded that because (i) "in a compo equity swap, the parties assume exposure to, and the total return is calculated based on, both the performance of specified foreign stocks and the change in the relevant exchange rate" and (ii) that exposure to the foreign exchange rate can be easily avoided (e.g., by entering into a "quanto" total return swap with an embedded currency hedge), that currency exposure is "not [merely] incidental to the equity exposure" and a compo swap is — therefore — a mixed swap.

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