BUSINESS LAW TODAY
The ABA Business Law Section's Online Resource

Keeping Current: Securities

Redefining "Swap" under Dodd-Frank

By J. Paul Forrester

Title VII of the Dodd Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), titled "Wall Street Transparency and Accountability Act," contains significant reforms of the over-the-counter derivatives markets. The actual extent of many of these reforms may turn on the extent of regulatory reach under Title VII, which in turn will be determined by the meaning to be given to certain key terms used in Title VII. Importantly, section 712(d) of the Dodd-Frank Act requires that the Commodities and Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC), in consultation with the Federal Reserve Board, jointly further define these key terms.

Not surprisingly, one of the first actions taken by the CFTC and the SEC under the Dodd-Frank Act was to solicit comments regarding so-called "key definitions" of Title VII, including the terms "swap," "swap dealer," and "major swap participant" in their joint Advance Notice of Proposed Rulemaking (ANPR).

This article will focus on the term "swap" and the potential breadth thereof unless the Dodd-Frank Act's definition (included in pertinent part below in *Appendix I*) is limited by rulemaking. While the joint rulemaking by the CFTC and SEC required under Dodd-Frank section 712(d) is still pending, there were 70 related comments made to the SEC and 83 related comments and presentations made to, and meetings held with the CFTC regarding the ANPR. Only a few comment letters raised any significant issue with the potential breadth of the definition of "swap" under the Dodd-Frank Act.

Much of the current attention to this definition (at least as inferred from the comments submitted to the CFTC and SEC) concerns: the extent of the exclusion in the Commodity Exchange Act (7 U.S.C 1a) section 2(a)(47)(B)(ii); the scope of the so-called "end-user" exclusion; and the level of systemic risk and substantial position in swaps that will trigger "swap dealer" and "major swap participant" (or the corresponding "security-based swap dealer" and "major security-based swap participant") status. However, only the occasional comment (e.g., the comments of the American Council of Life Insurers) raises serious question regarding the breadth of the definition of the term "swap" in the Dodd-Frank Act. The definition of "swap" contained in the Dodd-Frank Act can be reasonably read to apply to many ordinary transactions that are not widely regarded as swaps, including the following examples:

- Certain insurance and reinsurance contracts, particularly non-traditional contracts such as industry-loss warranties or contracts with embedded derivatives (e.g., variable annuity policies and policies with guaranteed income and similar features).
- Credit agreements, bonds or other debt instruments that provide for a fluctuating interest rate that is based on a variable interest rate or index or on the borrower's financial condition or specified financial metrics.
- Loan participations (discussed in further detail below).
- Post-closing purchase price adjustments for changes in working capital or other specified economic or financial event or contingency in business acquisition or combination agreements.
- Earn-out and similar provisions where payments vary based on specified economic or financial performance in business acquisition or combination agreements.
- Lotteries and other gaming contracts.
- Catastrophe bonds.
- Provisions in leases, employment and other agreements that index payments for inflation or other specified economic or financial event or contingency.
- Provisions for collateral or a guaranty to be provided or some other change in contractual relations upon a specified economic or financial event or contingency.
- Provisions requiring a notice of default or other economic or financial event or contingency.

There are undoubtedly many other examples of transactions that could not have been intended by anyone, including Congress, to be deemed swaps subject to

potential regulation under the Dodd-Frank Act.

Loan participations illustrate some of the difficulties that lie in the interpretation of swap under the Dodd-Frank Act. U.S.-style loan participations still appear "caught" by CEA section 1a(47)(A)(ii), even if—as is usually the case with the U.S.-style loan participation agreement—they convey a beneficial interest in the underlying loan or loans and would thereby escape section 1a(47)(A)(iii). In contrast, the Loan Market Association's participation agreement forms often used in Europe do not convey any interest in the underlying loan and, as a result, appear to fall within CEA sections 1a(47)(A)(ii) and (iii). The swap analysis for loan participations does not end here, however, as section 725(g)(2) of the Dodd-Frank Act excludes "identified banking products" as swaps. Identified banking products are defined in section 206 of the Gramm-Leach-Bliley Act to include:

(5) a participation in a loan which the bank or an affiliate of the bank (other than a broker or dealer) funds, participates in, or owns that is sold—
  (A) to qualified investors; or
  (B) (to other persons that—
    (i) have the opportunity to review and assess any material information, including information regarding the borrower's creditworthiness; and
    (ii) based on such factors as financial sophistication, net worth, and knowledge and experience in financial matters, have the capability to evaluate the information available, as determined under generally applicable banking standards or guidelines.

The term "qualified investor" is defined in section 3(a)(54) of the Securities Exchange Act as follows:

54. Qualified investor
  (A) Definition
    Except as provided in subparagraph (B), for purposes of this title, the term 'qualified investor' means
    (i) any investment company registered with the Commission under section 8 of the Investment Company Act of 1940;
    (ii) any issuer eligible for an exclusion from the definition of investment company pursuant to section 3(c)(7) of the Investment Company Act of 1940;
    (iii) any bank (as defined in paragraph (6) of this subsection), savings association (as defined in section 1813(b) of Title 12), broker, dealer, insurance company (as defined in section 2(a)(13)) of the Securities Act of 1933, or business development company (as defined in section 2(a)(48) of the Investment Company Act of 1940);
    (iv) any small business investment company licensed by the United States Small Business Administration under section 681(c) or (d) of this title;
    (v) any State sponsored employee benefit plan, or any other employee benefit plan, within the meaning of the Employee Retirement Income Security Act of 1974, other than an individual retirement account, if the investment decisions are made by a plan fiduciary, as defined in section 1002(21) of Title 29, which is either a bank, savings and loan association, insurance company, or registered investment adviser;
    (vi) any trust whose purchases of securities are directed by a person described in clauses (i) through (v) of this subparagraph;
    (vii) any market intermediary exempt under section 3(c)(2) of the Investment Company Act of 1940;
    (viii) any associated person of a broker or dealer other than a natural person;
    (ix) any foreign bank (as defined in section 3101(b)(7) of Title 12);
    (x) the government of any foreign country;
    (xi) any corporation, company, or partnership that owns and invests on a discretionary basis, not less than $25,000,000 in investments;
    (xii) any natural person who owns and invests on a discretionary basis, not less than $25,000,000 in investments;
    (xiii) any government or political subdivision, agency, or instrumentality of a government who owns and invests on a discretionary basis not less than $50,000,000 in investments; or
    (xiv) any multinational or supranational entity or any agency or instrumentality thereof.
  (B) Altered thresholds for asset-backed securities and loan participations
    For purposes of subsection (a)(5)(C)(iii) of this section and section 206(a)(5) of the Gramm-Leach-Bliley Act [15 U.S.C.A. § 78c note], the term 'qualified investor' has the meaning given such term by subparagraph (A) of this paragraph except that clauses (xi) and (xii) shall be applied by substituting '$10,000,000' for '$25,000,000'.
  (C) Additional authority
    The Commission may, by rule or order, define a "qualified investor" as any other person, taking into consideration such factors as the financial sophistication of the person, net worth, and knowledge and experience in financial matters.

Confused? So are experienced legal practitioners, who are finding it difficult to explain to clients the inconsistent results of this statutory and definitional interplay, leaving aside the basic incongruity that substantially similar transactions (e.g., loan credit default swaps) are potentially treated in a very dissimilar manner.

Accordingly, there is a real risk of inadvertent/unintentional regulatory treatment for swaps that are not thought of as such. And, while this may be mostly limited to some possible reporting and other "minor" inconvenience, there remains a further risk of significant adverse consequences if an entity has substantial swap exposure so as to possibly trigger "swap dealer" or

"major swap participant" (or the corresponding "security-based swap dealer" or "major security-based swap participant) status and related registration, business conduct and other more onerous Dodd-Frank Act compliance requirements.

It is unclear at this time whether the CFTC or the SEC would agree with the suggested "unintended" swaps or regarding the potential exclusion thereof (if applicable). Interested parties will have to wait for the CFTC and SEC proposed rules for the opportunity to comment thereon; however, if the CFTC and/or the SEC take the view that these transactions are appropriately treated as "swaps" it will likely be more difficult to persuade them otherwise in connection with the related rulemaking.

J. Paul Forrester is a partner at Mayer Brown LLP in Chicago.

APPENDIX I

The Dodd-Frank Act defines "swap" in section 721(a)(21) and adds to section 1a of the Commodity Exchange Act (7 U.S.C 1a) the following (**emphasis added**):

(47) Swap.

(A) In general.—Except as provided in subparagraph (B), the term 'swap' means any agreement, contract, or transaction—

(i) That is a 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;

(ii) 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**;

(iii) 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, **including any agreement, contract, or transaction commonly known as—**

(I) An interest rate swap;
(II) A rate floor;
(III) A rate cap;
(IV) A rate collar;
(V) A cross-currency rate swap;
(VI) A basis swap;
(VII) A currency swap;
(VIII) A foreign exchange swap;
(IX) A total return swap;
(X) An equity index swap;
(XI) An equity swap;
(XII) A debt index swap;
(XIII) A debt swap;
(XIV) A credit spread;
(XV) A credit default swap;
(XVI) A credit swap;
(XVII) A weather swap;
(XVIII) An energy swap;
(XIX) A metal swap;
(XX) An agricultural swap;
(XXI) An emissions swap; and
(XXII) A commodity swap;

(iv) That is an agreement, contract, or transaction that is, or in the future becomes, commonly known to the trade as a swap;

(v) Including any security-based swap agreement which meets the definition of 'swap agreement' as defined in section 206A of the Gramm-Leach-Bliley Act (15 U.S.C. 78c note) of which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein; or

(vi) That is any combination or permutation of, or option on, any agreement, contract, or transaction described in any of clauses (i) through (v).

(B) Exclusions.—The term 'swap' does not include—

(i) Any contract of sale of a **commodity for future delivery** (or option on such a contract), leverage contract authorized under section 9, security futures product, or agreement, contract, or transaction described in section 2(c)(2)(C)(i) or section 2(c)(2)(D)(i);

(ii) Any **sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled;**

(iii) Any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities, including any interest therein or based on the value thereof, that is subject to—

(I) The Securities Act of 1933 (15 U.S.C. 77a *et seq.*); and
(II) The Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*);

(iv) Any put, call, straddle, option, or privilege relating to a foreign currency entered into on a national securities exchange registered pursuant to section 6(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78f(a));

(v) 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 of 1933 (15 U.S.C.77a et seq.); and
(II) The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.);

(vi) 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 of 1933 (15 U.S.C. 77a et seq.) and the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), 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;

(vii) Any note, bond, or evidence of indebtedness that is a security, as defined in section 2(a)(1) of the Securities Act of 1933 (15 U.S.C. 77b(a)(1));

(viii) Any agreement, contract, or transaction that is—

(I) Based on a security; and

(II) Entered into directly or through an underwriter (as defined in section 2(a)(11) of the Securities Act of 1933 (15 U.S.C. 77b(a)(11)) by the issuer of such security for the purposes of raising capital, unless the agreement, contract, or transaction is entered into to manage a risk associated with capital raising;

(ix) 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; and

(x) Any security-based swap, other than a security-based swap as described in subparagraph (D).

(C) Rule of Construction regarding master agreements.—

(i) In general.—Except as provided in clause (ii), the term 'swap' includes a master agreement that provides for an agreement, contract, or transaction that is a swap under subparagraph (A), together with each supplement to any master agreement, without regard to whether the master agreement contains an agreement, contract, or transaction that is not a swap pursuant to subparagraph (A).

(ii) Exception.—For purposes of clause (i), the master agreement shall be considered to be a swap only with respect to each agreement, contract, or transaction covered by the master agreement that is a swap pursuant to subparagraph (A).