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August 17, 2012

VIA E-MAIL

To Our Investment Adviser Clients and Other Friends

Re: CFTC Finalizes Definition of "Swap"

Summary. On July 18, 2012, the Commodity Futures Trading Commission released final rules and interpretations (the "Final Rules") defining the term "swap." The Dodd-Frank Act established a framework for regulating derivatives, granting the CFTC regulatory authority over "swaps," the SEC regulatory authority over "security-based swaps," and the agencies joint authority over "mixed swaps." Although Dodd-Frank defined those terms, it directed the CFTC and the SEC to interpret and apply the definitions to clarify the treatment of specific types of agreements, contracts and transactions. The Final Rules discuss in detail the categories of derivatives that will be treated as "swaps" and regulated by the CFTC.

The definition of "swap" is important to investment advisers because Dodd-Frank expanded the definitions of "commodity pool operator" and "commodity trading adviser" to include advisers that invest in swaps. Previously, only advisers that invested in futures and commodity-related instruments (together, "commodity interests") were CPOs and CTAs and subject to regulation by the CFTC. Under the Final Rules, an investment adviser that invests in swaps will be a CPO or CTA, or both, even if it does not invest in commodity interests. As such, it must register with the CFTC by December 31, 2012, unless it qualifies for an exemption.

Therefore, all investment advisers -- including those that have not previously had to consider CFTC registration because they do not invest in commodity interests -- must now determine whether the instruments in which they invest include "swaps," as defined in the Final Rules.

Definitions. The definition of "swap" is complex. Some instruments that are commonly called swaps are not treated as "swaps" under the Final Rules, and some instruments that are not traditionally called swaps are treated as "swaps." The Final Rules spend 450 pages analyzing whether various types of contracts fall within the definition, based on the characteristics of their underlying reference instruments and the nature and purpose of the risk exposures they create.

Although the particular characteristics of each instrument must be examined carefully to classify it reliably, under the Final Rules, the following generally will be "swaps" that are regulated by the CFTC:

- swaps on broad-based security indices;
- swaps on U.S. government securities, including swaps on rates or yields of US Treasuries;
- swaps based solely on interest rates or other monetary rates that are not based on securities (such as LIBOR and other interbank rates, money market rates, the Federal Reserve discount rate, prime rates and the CPI);
- swaps on yields based on interest rates or monetary rates;
- credit default swaps, other than single-name credit default swaps;
- certain index credit default swaps on security indices that are not narrow-based;
- total return swaps based on two or more non-security loans, or based on broad-based security indices;
- non-deliverable foreign exchange forwards;
- deliverable foreign exchange swaps and forwards, unless the Treasury Department makes a written determination to exempt them (to date, Treasury has proposed, but not finalized, an exemption for such transactions);
- forward rate agreements;
- foreign currency options, foreign exchange options and foreign exchange rate options (excluding foreign exchange or currency options traded on a national securities exchange);
- currency swaps and cross-currency swaps;
- swaps on futures other than futures on single securities or narrow-based security indices; and
- options on instruments that are "swaps" under the Final Rules ("swaptions").

Transactions that are generally not "swaps" subject to CFTC regulation include:

- swaps on single stocks or loans;
- swaps on narrow-based security indices;
- swaps on portfolios where the parties have discretion to change the composition or weighting of the securities in the portfolio;
- swaps on single foreign government securities or narrow-based indices composed of foreign government securities;
- swaps on yields based on a single debt security, single loan or narrow-based security index, where "yield" is a proxy for price or value (except for swaps on yields of US Treasuries, which are subject to CFTC regulation);

- single-name credit default swaps (that is, those based on a single entity, security or loan);
- index credit default swaps on narrow-based security indices;
- total return swaps based on single securities, single loans or narrow-based security indices (although if the swap incorporates elements that create interest rate or currency exposures that are unrelated to the financing of the security-based swap, the swap may be a mixed swap subject to the jurisdiction of both the SEC and the CFTC);
- options on "security-based swaps" (which include the preceding eight categories);
- swaps on futures on a single security or narrow-based security index;
- exchange traded foreign currency options; and
- bona fide foreign exchange spot transactions (that is, transactions that are settled within the customary timeline of the relevant spot market).

The CFTC expressly declined to offer any guidance regarding the characterization of contracts for differences (CFDs); a CFD may or may not be a swap, depending on its particular terms.

The CFTC noted that whether a transaction is documented using an industry standard form agreement that is typically used for swaps may be a relevant factor, but is not dispositive, in determining whether the transaction is a swap for CFTC purposes. The specific terms of each transaction under an ISDA Master Agreement must be analyzed to determine whether it is a swap.

As evidenced by the above lists, the distinction between a "broad-based" index and a "narrow-based" index is important, because swaps on broad-based indices are typically subject to CFTC regulation, while those on narrow-based indices are not. The distinction is complex. In general, however, a security index is narrow-based if one of the following applies: (a) it has nine or fewer component securities, (b) one of its component securities accounts for more than 30% of the index's weighting, (c) five of its component securities together comprise more than 60% of the index's weighting, or (d) the lowest weighted component securities that together comprise 25% of the index's weighting have an aggregate average daily trading volume of less than $50,000,000 (or $30,000,000, if the index has more than 15 components). Different criteria apply for classifying debt security indices, volatility indices and credit default swap indices as narrow-based or broad-based.

Exemptions from CPO Registration. In February 2012, the CFTC rescinded the popular exemption from CPO registration in CFTC Rule 4.13(a)(4), which was available for funds offered to certain highly sophisticated investors. A CPO that claimed the Rule 4.13(a)(4) exemption before April 24, 2012, may continue to rely on it only until December 31, 2012. In addition, a CFTC no-action letter issued on July 10, 2012, states that a CPO that launches a new fund after July 10, 2012, which meets the conditions of the Rule 4.13(a)(4) exemption, may rely on that exemption until December 31, 2012, but then must register as a CPO or qualify for and take steps to claim a different exemption.

The other exemption from CPO registration that may be available to a hedge fund manager is in CFTC Rule 4.13(a)(3). This exemption is available with respect to funds whose investments in commodity interests and swaps are very limited. A fund may qualify for it if either (a) the aggregate initial margin and premiums required to establish the fund's positions in commodity interests and swaps do not exceed 5% of the liquidation value of the fund's portfolio, taking unrealized profits and losses into account, or (b) the aggregate net notional value of the fund's positions in commodity interests and swaps is not greater than 100% of the portfolio's liquidation value. The 5% and 100% thresholds do not need to be met at all times. They are only measured each time a new position in a commodity interest or swap is established. The exemption also requires that the fund be privately offered and not marketed as a vehicle for trading commodity interests or swaps and that all investors in the fund be accredited investors (as defined in Regulation D under the Securities Act of 1933), knowledgeable employees (as defined in Rule 3c-5 under the Investment Company Act of 1940), or qualified eligible persons (as defined in CFTC Rule 4.7 -- these include non-U.S. persons).

For purposes of the 100% net notional value test, options with the same underlying reference instrument may be netted. Cleared swaps that are cleared by the same clearing organization or board of trade may be netted, but over-the-counter swaps may not. The notional value of a swap is the amount that the reporting counterparty reports as the notional amount of the swap.

Exemptions from CTA Registration. In addition to serving as a CPO, an investment adviser to one or more funds that invest in commodity interests or swaps is the CTA of those funds. An investment adviser to separately managed accounts that invest in commodity interests or swaps is the CTA of those accounts. A CTA may be eligible for one of the following exemptions from registration:

- a CTA that has furnished investment advice about commodity interests and swaps to no more than 15 clients (a fund counts as a single client) in the preceding 12 months and that does not hold itself out to the public as a CTA;
- a CTA that is registered as an investment adviser with the SEC, whose business does not consist primarily of acting as a CTA, and that does not act as a CTA to any fund engaged primarily in trading commodity interests and swaps; and
- a CTA that provides advice about commodity interests and swaps only to funds with respect to which it has claimed the 4.13(a)(3) CPO exemption (this CTA exemption currently also references funds with respect to which the CTA has claimed the 4.13(a)(4) exemption, but it will reference only 4.13(a)(3) funds after the 4.13(a)(4) exemption is eliminated).

An adviser that currently relies on any of these exemptions will need to assess whether it will continue to qualify, once its investments in swaps are taken into account and the 4.13(a)(4) exemption is eliminated.

Effective Date of Final Rules. The Final Rules will become effective on October 12, 2012, but an adviser that invests in swaps has until December 31, 2012, to exit the swaps markets, claim available exemptions from registration as a CPO, CTA or both, as applicable, or register with the CFTC. Accordingly, an adviser that invests in derivatives should contact

us to assess whether it trades any instruments that are included in the new "swap" definition. If so, the adviser will need to evaluate its eligibility for exemptions from CPO and CTA registration (or continued eligibility, for an adviser that has relied on such an exemption but must now re-evaluate whether it still qualifies when swaps are taken into account).

An adviser that currently relies on one exemption and now may claim a different exemption -- for example, a CPO that has claimed the 4.13(a)(4) exemption and intends to switch to the 4.13(a)(3) exemption -- should contact us to begin the process of transitioning to the new exemption, which will require communications with the NFA and notices to investors.

If exemptions are not available, the adviser should contact us immediately to initiate the CFTC registration process, which may take several months.

This letter only generally summarizes very limited aspects of the Final Rules. It is not intended as specific or complete advice and is subject to change if the CFTC issues additional regulations or interpretations. If you need assistance in determining the effects of these developments on your business, or preparing to comply with them, please contact Doug Hammer, John Broadhurst, Geoff Haynes, Chris Rupright, Carolyn Reiser, Neil Koren, Jim Frolik, Joan Grant, Ellyn Roberts, Anthony Caldwell, Christina Hamilton or Charles Clinger.

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