

CLIENT UPDATE

NO-ACTION RELIEF FOR COMPRESSION EXERCISE SWAPS AND COMPO EQUITY SWAPS

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On December 21, 2012, the Commodity Futures Trading Commission (the "CFTC"), in two separate no-action letters, (1) granted no-action relief from the requirement to include "compression exercise swaps" (as defined below) in the calculation of the aggregate gross notional amount of swaps connected with a person's swap dealing activity for purposes of determining whether such person is eligible for the *de minimis* exception from swap dealer ("SD") registration set forth in Regulation 1.3(ggg)(4),¹ and (2) granted temporary relief permitting the treatment of compo equity total return swaps ("compo equity swaps") as security-based swaps, rather than as mixed swaps, subject to certain conditions.²

COMPRESSION EXERCISE SWAPS

De Minimis Exception Generally

The joint final rules issued by the CFTC and the Securities and Exchange Commission (the "SEC") defining the term "swap," "security-based swap" and "security-based swap agreement," and addressing "mixed swaps" (the "Product Definitions")³ became effective on October 12, 2012. As a result, all swaps entered into by a person on or after that date in connection with a person's swap dealing activities are relevant in determining whether the person must register as an SD.

¹ CFTC No-Action Letter No. 12-62 issued on December 21, 2012, <http://www.cftc.gov/PressRoom/PressReleases/pr6477-12>

² CFTC No-Action Letter No. 12-64 issued on December 21, 2012, <http://www.cftc.gov/PressRoom/PressReleases/pr6481-12>

³ *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement;" Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, 77 Fed. Reg. 48208 (Aug. 13, 2012).

Regulation 1.3(ggg)(4)(i) provides a *de minimis* exception (the “*De Minimis* Exception”) from SD registration for any person that, starting on October 12, 2012, enters into swaps positions connected with its swap dealing activities, the aggregate notional amount of which does not exceed either of the two thresholds. The two thresholds are:

- \$3 billion, subject to an initial phase-in level of \$8 billion; and
- \$25 million with regard to swaps in which the counterparty is a “special entity” as defined in Section 4s(h)(2)(C) of the Commodity Exchange Act (the “CEA”).

Request for Relief

In a letter, dated November 16, 2012 (the “Compression Exercise Swaps Request Letter”), to the CFTC’s Division of Swap Dealer and Intermediary Oversight (“DSIO”), an entity that offers multilateral swap portfolio compression services requested relief that would allow swap market participants to engage in multilateral portfolio compression exercises without having terminations of swaps (in whole or in part), changes in the notional value of swaps, or swaps entered into as replacement swaps as part of the exercise (“compression exercise swaps”) included in their aggregate gross notional amount of swaps for purposes of the *De Minimis* Exception.

Regulation 23.500(h) defines “multilateral portfolio compression exercise” as “an exercise in which multiple swap counterparties wholly terminate or change the notional value of some or all of the swaps submitted by the counterparties for inclusion in the portfolio compression exercise and, depending on the methodology employed, replace the terminated swaps with other swaps whose combined notional value (or some other measure of risk) is less than the combined notional value (or some other measure of risk) of the terminated swaps in the compression exercise.”

In the Compression Exercise Swaps Request Letter, the compression service provider represented that portfolio compression exercises have reduced outstanding gross notional values by trillions of dollars since 2003, thereby reducing operational risks, and that, since portfolio compression exercise parameters do not allow participants to provide liquidity or set prices in the market, they would be a poor vehicle for a participant to attempt to arrive at a specific result for a given portfolio. The service provider further represented that a participant in such an exercise submits some criteria for its participation in the exercise (i.e., credit or counterparty limits), but that the outcome of a compression cycle depends on several variables that the participants cannot know or control, such as the positions in counterparties’ portfolios and the criteria set by other participants.

Thus, the service provider asserted that compression exercise swaps do not involve any of the attributes the CFTC has identified as indicative of swap “dealing” activity (i.e., accommodating demand, market making, holding oneself out as a dealer in swaps, seeking to profit by providing liquidity, etc).⁴ The service provider requested no-action or interpretative relief from counting such swaps in connection with a party’s determination of the *De Minimis* Exception, noting that a failure to provide relief would discourage participation in compression exercises and deny such party and the market the benefit of the associated risk reduction.

No-Action Relief

In the no-action letter responding to the Compression Exercise Swaps Request Letter, the DSIO provides that, based on the foregoing, it will not recommend that the CFTC take an enforcement action against any person for failure to include compression exercise swaps in its calculation of the aggregate gross notional amount of swaps connected with its swap dealing activity for purposes of the *De Minimis* Exception. The DSIO also specifies that while the relief was requested by a particular service provider, the relief granted is available to all participants in any multilateral swap portfolio compression exercise.

COMPO EQUITY TOTAL RETURN SWAPS

Background

In the adopting release accompanying the Product Definitions (the “Product Definitions Adopting Release”), the CFTC interpreted quanto equity swaps⁵ to be security-based swaps where certain conditions are satisfied. For illustrative purposes, the CFTC determined that a compo equity swap⁶ is “a similar but contrasting product,” and deemed it to be a mixed swap because “the currency exposure obtained via a compo equity swap is not incidental to the equity exposure for purposes of determining mixed swap status.”

⁴ See Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant,” and “Eligible Contract Participant,” 77 Fed. Reg. 30596, 30606-19 (May 23, 2012).

⁵ A quanto equity swap is an equity swap, in which a person can be exposed to changes in the value of a foreign stock without taking a position in the associated foreign currency (i.e., the underlying foreign stock is denominated in a currency other than the domestic currency in which the swap is denominated, and the final value of the underlying stock is converted into the domestic currency using the exchange rate prevailing at the time the swap was entered into).

⁶ A compo equity swap is an equity swap, in which an investor is exposed to both changes in the value of foreign stock and in the related foreign currency (i.e., a compo swap is financially equivalent to a direct foreign stock investment that is executed in the form of an equity swap).

Requests for Relief

After the effective date of the regulations and interpretations contained in the Product Definitions Adopting Release, several financial institutions (the “Dealers”) informed the CFTC staff that they had believed that all foreign equity total return swaps on single securities or narrow-based indices would be security-based swaps, subject solely to the jurisdiction of the SEC, and that the market was surprised by the CFTC’s interpretation treating compo equity swaps as mixed swaps.

The Dealers represented that the CFTC’s interpretation regarding compo equity swaps had complicated their plans to reorganize their businesses to comply with the new registration, recordkeeping, reporting, and business conduct requirements under the Dodd-Frank Act, and that their clients had not anticipated that they might have to register with the CFTC, and comply with the CFTC’s swap regulations, as a result of entering into compo equity swaps. Therefore, a letter (the “Compo Equity Swaps Letter”) was submitted to DSIO, on behalf of certain Dealers to request relief from certain obligations under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) and the related CFTC regulations applicable to compo equity swaps. The Compo Equity Swaps Letter was referred to the Office of General Counsel (“OGC”).

The Compo Equity Swaps Letter represented that the classification of compo equity swaps as mixed swaps will have “very significant short-term consequences for both sell-side and buy-side market participants,” since “compo” swaps on non-U.S. dollar denominated stocks represent approximately 15-20% of the total market for equity total return swaps transacted with U.S. persons, as compared to “quanto” swaps which represent significantly less than 1% of such market. Further, it was represented that “[b]uilding the necessary infrastructure” within the timeframe required for compliance with the CFTC’s rules would be “extremely difficult,” and that, without additional time to prepare for registration and for treatment of compo equity swaps as mixed swaps, certain entities will be unable to conduct their business as planned, resulting in significant disruption to the market for foreign equity total return swaps.

Temporary No-Action Relief

The no-action letter responding to the Compo Equity Swaps Letter provides that, based on the Dealers’ representations, before July 1, 2013, OGC will not recommend that the CFTC commence an enforcement action against any person in connection with any failure of such person to comply with any provision of the Dodd-Frank Act or the rules promulgated thereunder (other than those relating to the CFTC’s anti-fraud and anti-manipulation

authority) to the extent such failure arises solely because such person treats a compo equity swap solely as a security-based swap and not as a mixed swap.

In order to rely on this no-action relief, market participants must act reasonably and in good faith in progressing to full compliance with all CEA requirements and CFTC regulations applicable to mixed swaps with respect to compo equity swaps by July 1, 2013, including the reporting of historical and transition swaps entered into prior to such date. As of July 1, 2013, compo equity swap activities from October 12, 2012 through June 30, 2013 count in determining whether *de minimis* or other thresholds have been exceeded for an SD, major swap participant, commodity pool operator or other registration purposes.

Moreover, persons relying on this relief must come into full compliance with the CEA and the CFTC regulations with respect to compo equity swaps as soon as the technical and operational issues preventing timely compliance have been resolved, even if such resolution occurs prior to the expiration of the foregoing no-action relief.

Last, during the pendency of the no-action period, and prior to reporting compo equity swap transaction data records to a swap data repository, persons relying on this relief must retain records for all transactions covered by this no-action relief and make such records available to the CFTC for inspection and production immediately upon request to the extent provided in, and in accordance with, any applicable law, rule, or regulation.

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Please do not hesitate to contact us if you have any questions.

January 7, 2013