

## Investment Management Alert

June 24, 2013

### Swaps Based on Foreign Securities May Soon Count Toward *De Minimis* Calculations

In their joint swap definitions release in July 2012, the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) made a distinction between (i) a “compo” equity total return swap, in which the payments under the swap relate to both performance of a foreign security or securities and changes to the exchange rate for the foreign currency in which the foreign security is denominated and (ii) a “quanto” equity total return swap, in which the exchange rate is set at the beginning of the contract.<sup>1</sup> The CFTC and SEC determined that a compo swap is a “mixed swap” that will be subject to both CFTC jurisdiction as a “swap” and SEC jurisdiction as a “securities-based swap.” Compo swaps should, therefore, be included as commodity interest positions in determining whether a fund would have satisfied the *de minimis* thresholds of CFTC Regulation 4.13(a)(3) on December 31, 2012, along with other swaps under CFTC jurisdiction. Quanto transactions will continue to be treated exclusively as “security-based swaps” and, therefore, will not be subject to CFTC jurisdiction or inclusion as commodity interest positions.

On the request of swap dealers that had assumed that all swaps referencing a security would not be a “swap,” the CFTC provided time-limited no-action relief permitting any party to treat a compo swap solely as a security-based swap for the purposes of complying with any provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) or any regulation the CFTC has promulgated under the Dodd-Frank Act. That no-action relief will expire on June 30, 2013. Commodity pool operators for funds that are parties to compo swaps will need to re-compute whether the funds for which they have claimed an exemption from CPO registration under CFTC Regulation 4.13(a)(3) will still be in compliance with the trading limits required by the regulation and, if not, will either need to terminate certain of such swaps, or if necessary, register with the CFTC as commodity pool operators. All persons who have entered into compo swaps will also need to submit appropriate documentation (such as the International Swaps and Derivatives Association’s Dodd-Frank Protocol) and comply with all other CFTC regulations promulgated under the Dodd-Frank Act relating to, among other things, reporting,

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<sup>1</sup> The CFTC and the SEC define a “quanto” swap as an equity swap in which (a) the underlying is denominated in a currency (the foreign currency) other than that in which the equity swap is denominated (the domestic currency) and (b) the final value of the underlying is denominated in the foreign currency and is converted into the domestic currency using the exchange rate prevailing at inception, resulting in the investor not being exposed to currency risk. The commissions deem a quanto swap to be a securities-based swap if (i) the purpose of the swap is to gain exposure to the return of a security or a narrow-based security index without transferring exposure to the currency exchange risk and (ii) any exchange rate or currency risk exposure incurred by the dealer due to a difference in the currency denomination of the quanto equity swap and of the underlying security or security index is incidental to the quanto equity swap and arises from the instrument(s) the dealer chooses to use to hedge the quanto equity swap and is not a direct result of any expected payment obligations by either party under the quanto equity swap.

recordkeeping, margin and, if required, clearing. In addition, compo swaps will be subject to similar rules of the SEC when they are finally adopted.

A copy of the CFTC no-action letter may be found [here](#).

## Contact Information

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