

Proposed Insurance Exemption from Definition of Swap

SEC/CFTC Proposal

The Commodity Futures Trading Commission (“CFTC”) and the Securities and Exchange Commission (“SEC”) have issued proposed rules and proposed guidance on key definitions relating to the regulation of derivatives under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act.¹

The SEC agreed with commentators that original definition of “swap” could be interpreted to include insurance products that were not previously considered to be swaps and that this was not intended by Congress. Therefore, the proposed rules and interpretive guidance make it clear that certain insurance products would not be considered to be swaps or security-based swaps. To qualify under the proposed rules and interpretive guidance, both the contract and the entity providing the contract will need to meet certain criteria. An insurance contract is not considered to be a swap where each of the following is satisfied:

- the beneficiary of the contract must have an insurable interest in the subject matter of the contract and thereby carry the risk of loss on that interest continuously throughout the duration of the contract;
- a loss must occur and be proved, and any payment or indemnification must be limited to the value of the insurable interest;
- the contract is not traded, separately from the insured interest, on an organized market or over-the-counter; and
- with respect to financial guaranty insurance only, in the event of payment default or insolvency of the obligor, any acceleration of payments under the policy is at the sole discretion of the insurer.

In addition, the entity writing the insurance contract must be one of the following:

- an insurance company whose primary business activity is writing insurance or reinsurance subject to supervision by a state or federal insurance commissioner and the insurance contract is regulated as insurance;
- the United States or any of its agencies or instrumentalities; or

¹ Release No. 33-9204 dated April 29, 2011, can be downloaded at <http://sec.gov/rules/proposed/2011/33-9204.pdf>

- with respect to reinsurance only, an entity located outside of the United States providing reinsurance to an insurance company eligible under the proposed rules provided that (i) such entity is not prohibited by law from offering such contract to such insurance company, (ii) the contract to be reinsured is an insurance contract under the proposed rules, and (iii) the total amount reimbursable by all reinsurers for such contract cannot exceed the losses paid by the cedant.

Under the interpretive guidance, the SEC proposed to enumerate certain types of contracts to be considered insurance, rather than swaps or security-based swaps, when issued by a qualified entity. Such contracts include surety bonds, life insurance, health insurance, long-term care insurance, title insurance, property and casualty insurance, and certain annuity products.

The SEC have also considered adding an additional criteria to proposed Rule 3a69-1(a). That is, payment under the insurance contract should not be based on the price, rate, or level of a financial instrument, asset, or interest or any commodity. This would prevent the insurance form being used to hedge financial assets. The SEC have noted that variable annuities would need to be specifically exempted.

The SEC also asked whether an insurance “wrap” of a swap should be regulated as a swap. For example, a financial guarantor insures payment under an interest rate swap attached to municipal debt and provides credit enhancement to both the swap and the debt. The CFTC favors calling these insurance contracts swaps whereas the SEC propose applying the criteria set out above. In addition, the SEC asked whether the issuer of an insurance “wrap” of a swap should be considered to be a major swap participant.

Next Steps

The proposed rules are now subject to a period of public comment. Comments are due on or before the date that is sixty (60) days after the date of publication of the proposed rules in the Federal Register. After the comment period has closed, the CFTC and the SEC will consider whether to adopt the proposed rules and interpretive guidance, and in what form.

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