

May 4, 2011

Despite SEC and CFTC proposed rules on "swap" definition in Dodd-Frank Act, uncertainty remains on financial guaranty insurance policies.

The Dodd-Frank Act¹ imposes considerable new requirements on the business of derivatives, including, among others, rules concerning clearing and settlement, margin requirements, capital requirements, reporting and position limitations. The Act sets forth a detailed definition of "swap"² for purposes of these rules and directs the Commodities Futures Trading Commission and the Securities and Exchange Commission, in consultation with the Board of Governors of the Federal Reserve System, to further define "swap" and related terms.³

On April 29, 2011, the SEC and the CFTC jointly proposed rules defining a number of terms referred to in the Act, including "swap."⁴ Public comments on the rule proposal are due within 60 days after it is published in the Federal Register.

In language being closely watched by the insurance sector, the proposed rule states that insurance products would *not* be considered swaps or security-based swaps (a related term). To qualify for this exclusion, however, the rules would require that both the product and the person providing the product meet certain criteria.⁵

The required product characteristics are as follows:

- The beneficiary of the insurance product must have an insurable interest and thereby bear the risk of loss with respect to that interest continuously throughout the duration of the agreement, contract or transaction.
- In order for benefits to be payable, the loss must occur and be proved.
- Any payment or indemnification for loss must be limited to the value of the insurable interest.

¹ Public Law 111-203.

² Dodd-Frank Act § 721(a)(21).

³ *Id.* § 712(d).

⁴ CFTC Release at 17 CFR Part 41, RIN 3038-AD46; SEC Release at 17 CFR Part 240, Release No. 33-9204 and 34-64372, File No. S7-16-11, RIN 3235-AL14 ("Release").

⁵ Proposed rule 1.3(xxx)(4) under the Commodity Exchange Act, 7 U.S.C. 1 *et seq.* (hereinafter cited as "Proposed rule ____"); Release at p. 20.

- The agreement, contract or transaction must not be traded, separately from the insured interest, on an organized market or over-the-counter.
- With respect to financial guaranty insurance only, in the event of a payment default or insolvency of the obligor, any acceleration of payments under the policy must be at the sole discretion of the insurer.⁶

The required characteristics for the provider of the product are that the provider must be an insurance company whose "primary and predominant" business activity is insuring or reinsuring risks underwritten by insurance companies, "subject to supervision by a state or federal insurance commissioner"; the United States or any of its agencies or instrumentalities; or in the case of reinsurance, a person located outside the United States providing the agreement, contract or transaction to an insurance company eligible under the proposed rules, provided that:

- such person is not otherwise prohibited by law from offering the agreement, contract or transaction to such an insurance company;
- the product to be reinsured meets the requirements under the proposed rules to be an insurance product; and
- the total amount reimbursable by all reinsurers for such insurance product cannot exceed the claims or losses paid by the cedant.⁷

While many of the foregoing criteria raise significant interpretive issues, one item likely to cause particular concern is the prong relating to financial guaranty insurance. A brief comparison with New York insurance law, whose provisions on financial guaranty insurance⁸ are influential in this area, is instructive.

Prior to 2004, Section 6905 (a) of the New York Insurance Law ("NYIL") required that a financial guaranty policy, in order to be considered valid, could not be subject to mandatory acceleration. Policy benefits would have to be disbursed on a "pay-as-you-go" basis. In other words, upon a default of the underlying instrument, the holder would be entitled to principal and interest payments in accordance with the original payment schedule of the underlying instrument, rather than a bullet payment of all remaining payments at once.

As monolines (so called because of statutory restrictions that prohibit financial guaranty insurers from writing other lines) expanded from insuring municipal bonds into structured finance products over the 1980s and 1990s, mandatory "pay-as-you-go" presented an obstacle. In many types of asset-backed or other structured transactions, credit or other risks are allocated by means of a derivative such as a credit default swap. Under standard swap documentation, events of default or termination can give rise to large payment obligations from one swap party to the other in settlement of the position. A financial guaranty insurance policy guaranteeing one swap party's obligations to the other would include the requirement to make such a termination payment. Under NYIL Article 69, as in effect at that point, it was

⁶ Proposed rule 1.3(xxx)(4)(i).

⁷ Proposed rule 1.3(xxx)(4)(ii).

⁸ NYIL Art. 69.

ambiguous whether this could be considered an "acceleration" payment, thereby making the policy invalid under Article 69.

A series of interpretive letters from the New York Insurance Department (the "NYID") beginning in the late 1990's held that such a payment would not be considered an improper acceleration and that therefore a credit default swap could in fact be insured under a financial guaranty,⁹ and amendments to NYIL Article 69 in 2004 codified this guidance. Current Section 6905(a) reads as follows, with the 2004 amendments (including a clarifying amendment made in 2005) denoted by italics:

Every [financial guaranty] policy shall provide that, in the event of a payment default by or insolvency of the obligor, there shall be no acceleration of the payment required to be made under such policy unless such acceleration is at the sole option of the [insurer]; *provided that (1) policies may insure amounts payable under a credit default swap or interest rate, currency or other swap upon a credit event or termination event if the expected amount payable on an accelerated basis in respect of any individual obligation referenced by a credit default swap or in the aggregate under an interest rate, currency or other swap does not exceed the single risk limits [applicable to financial guaranty insurers under Article 69]¹⁰ . . . and (2) policies insuring credit default swaps referencing an obligation shall be treated as if the insurer had directly insured the referenced obligation for all other purposes of this article, . . .*

By not including some version of the italicized language in the criterion for financial guaranty under the proposed Dodd-Frank rule, the SEC and the CFTC may have re-opened this conceptual issue.

In their commentary on the proposed rule, the commissions do distinguish between credit default swaps and financial guaranty policies, concluding that as a policy matter, the latter should not in general be treated as the former for Dodd-Frank purposes.¹¹ However, while such discussion notes the non-accelerated nature of financial guaranty policies written on "bonds," it muddies the waters when it wades into the issue of insurance policies written on swaps. The Release explains, in relation to interest rate swaps, that "[t]he CFTC believes that an insurance 'wrap' of a swap *may not be sufficiently different* from the underlying swap to suggest that Congress intended the former to fall outside the definition of the term 'swap' in Title VII [of Dodd-Frank]"¹² (emphasis added). The Release continues, "[t]he SEC, however, believes that, where an agreement, contract, or transaction is a security-based swap, the insurance of that security-based swap should not be regulated pursuant to Title VII, *provided that the insurance meets the proposed requirements [for insurance policies and providers] discussed above*"¹³ (emphasis added). Among other things, these passages employ conditional language, signal a potential discrepancy between the two commissions on this point and, by means of the proviso, beg the question of whether acceleration encompasses a CDS termination payment in the first place. Accordingly, on the basis of the proposed rule

⁹ For a discussion of the NYID's historical guidance on credit default swaps, see NYID Circular Letter 19 (2008), Sept. 22, 2008, at 6-7.

¹⁰ This refers to limitations on the amount of any single exposure that a financial guaranty insurer is permitted to underwrite.

¹¹ Release at pp. 23-24.

¹² Release at p. 30.

¹³ *Id.*

and accompanying Release, it is difficult to distill clear guidance on whether financial guaranties on credit default swaps qualify for the exclusion, and, in turn, whether this could lead to these policies being treated as swaps under Dodd-Frank. Although this result seems unlikely (at least with respect to policies on security-based swaps), whether this anomaly is addressed in the public comment process or otherwise is something that the derivatives and insurance industries will be watching closely.

For More Information

Our client alerts are for general informational purposes and should not be regarded as legal advice. If you would like additional information or have any questions, please contact:

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