

# JONES DAY

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December 4, 2012

Mr. David A. Stawick  
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Commodity Futures Trading Commission  
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1155 21st Street, N.W.  
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Ms. Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549-1090

Office of the  
Secretary

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Received  
CFTC

Re: Compo Swaps under the CFTC and SEC Rules providing Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping (RIN 3038-AD46)

Dear Mr. Stawick and Ms. Murphy:

COMMENT

This letter is submitted by Jones Day, a law firm which represents a range of diverse clients, including dealers, corporations, hedge funds and other entities that participate in the derivatives markets. Jones Day is submitting this letter independently and not on behalf of any particular client in order to provide comments on the treatment of compo equity swaps in the Commodity Futures Trading Commission (“CFTC”) and the Securities and Exchange Commission (collectively, “Commissions”), jointly adopted rules and interpretations published in the Federal Register on August 13, 2012, regarding Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping (RIN 3038-AD46) (the “Final Rules”). We appreciate the opportunity to submit comments on this matter, and we hope that the Commissions will consider the analysis we provide herein regarding the regulatory treatment of compo swaps.

The Final Rules provide that “a compo equity swap is a mixed swap”<sup>1</sup> and note that the parties’ exposure is to “both the performance of specified foreign stocks and the change in the

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<sup>1</sup> Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping 77 Fed. Reg. 48208, 48266 (August 13, 2012), available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-18003a.pdf>.

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relevant exchange rate.”<sup>2</sup> Although the Commissions did not seek comment on this interpretation, as described herein, in light of other interpretations within the Final Rules and the economics of how compo swaps work, we believe that this result is incorrect and this interpretation should be modified by the Commissions.

As per the Final Rules, “[a] TRS is a Title VII instrument in which one counterparty, the seller of the TRS, makes a payment that is based on the price appreciation and income from an underlying security or security index.”<sup>3</sup> The Final Rules provide that a TRS contains a financing payment often based on a variable rate such as LIBOR and a payment based on the appreciation or depreciation of the underlying asset and “[a]ccordingly, where a TRS is based on a single security or loan, or a narrow-based security index, the TRS would be a security-based swap.”<sup>4</sup> The Final Rules reference a third party comment that, “the terms of a TRS that create interest rate or currency exposures incidental to the primary purpose of the TRS should not cause a transaction that otherwise would be deemed to be a security-based swap to be characterized as a mixed swap.”<sup>5</sup> The Commissions also discuss quanto equity swaps and note that “the dealer’s exchange rate exposure could be seen as incidental to the securities exposure desired by the party initiating the quanto equity swap.”<sup>6</sup>

The primary purpose of a compo swap is for a party to get exposure to the performance of a foreign stock. The Commissions’ view that the interest rate exposure in a TRS is incidental to the primary purpose of getting this performance exposure should be extended to the foreign exchange exposure in a compo swap. The currency feature in a compo swap simply reflects a party’s election to be paid in a currency other than the currency in which the stock is traded. Quanto swaps and compo swaps both contain currency exposure but merely address it by different methods, each of which is incidental to the primary purpose of those swaps. The quanto swap fixes the foreign exchange rate as a pre-agreed number at the swap’s inception and this rate is used to convert the stock price into another currency (the “Settlement Currency”) to establish the inception price and the maturity price. The difference between these prices multiplied by the number of shares of the underlying stock will be the performance payment. By fixing this foreign exchange level, the parties are not eliminating foreign exchange exposure but

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<sup>2</sup> *Id.* at 48265.

<sup>3</sup> *Id.* at 48264.

<sup>4</sup> *Id.*

<sup>5</sup> *Id.* at 48266.

<sup>6</sup> *Id.* at 48265.

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using an agreed foreign exchange rate to convert the stock price at maturity.<sup>7</sup> In contrast, in a compo swap, the foreign exchange rate used at inception is an agreed rate, which is generally the foreign exchange rate for the currencies at the time of the trade's inception, and the foreign exchange rate used at maturity is the foreign exchange rate for the currencies at the trade's maturity. In the case of both a quanto swap and a compo swap, the party's primary purpose for entering into the TRS is exposure to the foreign stock and the choice of using a quanto methodology or a compo methodology for converting payments to the Settlement Currency is incidental. This difference should matter no more than whether parties agree to use 3 month LIBOR or 6 month LIBOR as the variable rate under a TRS, although they provide different interest rate exposures.

The Commissions note that "where the counterparties embed interest-rate optionality (e.g., a cap, collar, call, or put) into the terms of a security-based swap in a manner designed to shift or limit interest rate exposure, the inclusion of these terms would cause the TRS to be both a swap and a security-based swap (i.e., a mixed swap)."<sup>8</sup> If a compo swap provided that the foreign exchange rate used to convert the foreign stock price at maturity to the Settlement Currency, were determined based on whether that foreign exchange rate were higher or lower than a specified cap or floor foreign exchange rate, then there would be an additional type of transaction within the compo TRS, and this could change the analysis. Absent such a provision, as with the interest rate exposure, the foreign exchange exposure should not cause a security-based swap to be a mixed swap.

The Commissions also point out that a party can avoid currency exposure by entering into a quanto swap. However, the pricing for quanto swaps and compo swaps may not be the same. Moreover, a party that enters into a TRS for the primary purpose of getting exposure to the performance of a stock should not have a security-based swap in one instance and a mixed swap in the other instance solely due to the incidental foreign exchange feature that allows that party to make or receive payments in another currency. These TRS transactions are too substantially similar to result in different classifications. The Commissions note that "the scope of the mixed swap category of Title VII instruments is intended to be narrow and that, when variable interest rates are used for financing purposes incidental to counterparties' purposes, and risks assumed,

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<sup>7</sup> A quanto swap can also be documented as the Notional Amount in the Settlement Currency multiplied by the rate of return using the local currency in which the stock trades. Regardless of how it is documented the economics and resulting performance payment will be the same.

<sup>8</sup> Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping 77 Fed. Reg. 48208, 48265 (August 13, 2012), available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-18003a.pdf>.

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in entering into a TRS, the TRS is a security-based swap and not a mixed swap.”<sup>9</sup> The similar foreign exchange feature of a compo swap is incidental and in light of the Commission’s point that the scope of mixed swaps should be narrowly determined, a compo swap, like a quanto swap, should be treated as a security-based swap.

As described herein, in both compo swaps and quanto swaps the local value of the underlying stock is converted to the Settlement Currency at the relevant foreign exchange rate at inception. However, in a quanto swap that inception rate is used at maturity, whereas in a compo swap, the local value of the underlying stock is converted to the Settlement Currency at the relevant foreign exchange rate at maturity. This is the economic equivalent of a spot foreign exchange transaction at maturity. As an example, if a US party chose to buy stock denominated in British Pounds in order to get exposure to that stock, rather than enter into a TRS, such party may take US Dollars, convert them into enough British Pounds in the spot foreign exchange market to buy that stock and then use those British Pounds to buy that stock in the foreign stock market. If that US party later wished to sell its stock, it could do so and receive British Pounds. If that US party wanted to realize these proceeds in US Dollars, it could enter into a spot US Dollar/British Pound foreign exchange transaction at maturity. These spot foreign exchange transactions at inception and maturity would not be considered swaps under the Final Rules as “[t]he CEA generally does not confer regulatory jurisdiction on the CFTC with respect to spot transactions.”<sup>10</sup> Moreover, in order to address any delay concerns in respect of such transactions in connection with the purchase or sale of stock, the Final Rules provide that a Securities Conversion Transaction as defined in the Final Rules is a bona fide foreign exchange spot transaction.<sup>11</sup> Although a spot foreign exchange transaction is settled by an exchange of currencies, which does not occur in a compo swap, the party to a compo swap is seeking exposure to the performance of a stock, and that party could exchange one currency for another to buy the relevant stock and then convert it to back to the Settlement Currency at maturity if that party later sold that stock. A compo swap replicates these economics but lets the party achieve this performance through a derivative transaction.

The CEA distinguishes foreign exchange forwards and foreign exchange swaps from other foreign exchange derivatives, such as foreign exchange options, currency swaps, and non-deliverable forwards. The Secretary issued a “determination that exempts both foreign exchange swaps and foreign exchange forwards from the definition of “swap,” in accordance with the

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<sup>9</sup> *Id.* at 48266.

<sup>10</sup> *Id.* at 48256.

<sup>11</sup> *Id.* at 48257

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applicable provisions of the CEA”<sup>12</sup> which was published in the Federal Register on November 20, 2012. Although some foreign exchange transactions are swaps within the Final Rules, those transactions give parties rights and obligations in respect of foreign currencies that are different than the rights and obligations that such parties would have in a spot foreign exchange transaction, the economics of which are embedded in compo swaps. If a party were asked to value the right to enter into a spot foreign exchange transaction at a date in the future (e.g., the settlement date of a compo swap) at the spot foreign exchange rate on a date in the future (e.g., the valuation date of a compo swap), there would be no value for such transaction, since one is simply agreeing to convert one currency into another at the then-applicable foreign exchange rate. Therefore, the economics of the spot foreign exchange transaction contained in a compo swap would not be a separately identified swap product, and, accordingly, we believe that there is no “mixed” swap as the foreign exchange component is merely using the then-current foreign exchange rate.

Finally, a compo swap which uses the spot foreign exchange rate on the valuation date of the compo swap to convert the value of a foreign stock into the Settlement Currency meets the first prong of a Securities Conversion Transaction, which is that “[a] security and related foreign currency transactions are executed contemporaneously”<sup>13</sup> since the value of the foreign stock and the spot foreign exchange rate are taken on the same day. The second prong of the definition of a Securities Conversion Transaction is that “actual delivery of the foreign security and foreign currency occurs by such deadline.”<sup>14</sup> In a compo swap, the value of the foreign stock at maturity and the related foreign exchange rate used to convert that value to the Settlement Currency are both taken at maturity. Confirmations for compo swaps often reference this foreign exchange rate as i) the spot foreign exchange rate at maturity taken from a publically available source, such as a Reuters page or a Bloomberg page or ii) the foreign exchange rate at which the swap dealer transacts in the spot foreign exchange market at maturity in respect of its hedge. These spot foreign exchange rates typically reference or use a settlement cycle that is the same length as, or is shorter than the settlement cycle of the stock. Accordingly, as a compo swap replicates the economics of a Securities Conversion Transaction, for which the foreign exchange trade is a bona fide spot foreign exchange transaction, the compo swap should be a security-based swap.

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<sup>12</sup> Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act 77 Fed. Reg. 69694 (November 20, 2012), available at <http://www.gpo.gov/fdsys/pkg/FR-2012-11-20/pdf/2012-28319.pdf>.

<sup>13</sup> Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping 77 Fed. Reg. 48208, 48257 (August 13, 2012), available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-18003a.pdf>.

<sup>14</sup> *Id.*

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We appreciate the opportunity to submit these comments for your consideration and would welcome the opportunity to discuss them further.

A handwritten signature in cursive script, appearing to read "Ilene K. Froom", with a long horizontal flourish extending to the right.

Ilene K. Froom