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CFTC and SEC Adopt Definitions of "Swap Dealer," "Major Swap Participant" and "Eligible Contract Participant"

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 22-12
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 16-12
INVESTMENT ADVISER MEMBERS No. 5-12
SEC RULES MEMBERS No. 35-12 RE: CFTC AND SEC ADOPT DEFINITIONS OF "SWAP DEALER," "MAJOR SWAP PARTICIPANT" AND "ELIGIBLE CONTRACT PARTICIPANT"

Recently, the Commodity Futures Trading Commission ("CFTC") and Securities and Exchange Commission ("SEC") jointly adopted new rules and interpretive guidance to define further the terms "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant," and "eligible contract participant." [1] Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") provides, among other things, for the registration and regulation of these entities, including capital requirements and business conduct standards. The Dodd-Frank Act includes definitions for these terms but directs the CFTC and SEC ("Commissions") jointly, in consultation with the Federal Reserve Board, to define those terms further. The Commissions proposed rules and interpretations in December 2010 to define further each of the terms, which rules and interpretations the Commissions have now finalized ("Final Rules") .

Despite the ICI's request, the Commissions declined to exclude explicitly registered investment companies from the major swap and major security-based swap participant definitions, nor did the Commissions provide categorical exclusions for other types of entities. The Commissions stated, however, that "registered investment companies generally are not likely to meet the thresholds of the major participant definitions." [2] The Commissions also expect "very few entities" to meet the test of being a major participant or come close to the various thresholds for meeting that test. [3] A summary of the Final Rules is provided below.

I. Swap Dealer and Security-Based Swap Dealer

The Dodd-Frank Act defines a swap dealer ("SD") or a security-based swap dealer ("SBSD")

as a person engaged in any of the four enumerated activities: (1) holding oneself out as a dealer in swaps or security-based swaps; (2) making a market in swaps or security-based swaps; (3) regularly entering into swaps or security-based swaps with counterparties as an ordinary course of business for one's own account; or (4) engaging in any activity causing oneself to be commonly known in the trade as a dealer or market maker in swaps or security-based swaps. The Dodd-Frank Act also excludes certain persons from these definitions. Specifically, a person that enters into swaps or security-based swaps for its own account (either individually or in a fiduciary capacity) but not as a part of a "regular business" is excluded. The Dodd-Frank Act also exempts a person that engages in a de minimis amount of swaps or security-based swaps activities.

In the Adopting Release, the Commissions provided interpretive guidance to determine if a person is engaged in swap dealing activity and the de minimis quantity thresholds of swap dealing activity over which a person would be a SD or SBSD. A person that is a SD or SBSD will be deemed a dealer with regard to all of that person's swaps or security-based swaps activities although that person may apply for a limited designation based on a particular type, class or category of swap or security-based swap.

A. Swap Dealing Activity

According to the Commissions, whether a person is acting as a dealer will turn on the relevant facts and circumstances as informed by interpretive guidance provided in the Adopting Release. The Commissions generally believe that the dealer-trader distinction under the Securities Exchange Act of 1934 provides an appropriate framework and offered guidance on the various terms in the statutory definition. For example, the Commissions noted that they continue to believe the factors described in the Proposing Release as indicia of "holding out as a dealer" in swaps and being "commonly known in the trade" as a dealer or market maker in swaps are relevant to determining if a person is a swap dealer. [4] In addition, the Commissions provided a non-exhaustive list of activities indicative of whether a person routinely stands ready to enter into swaps at the request or demand of a counterparty for purposes of whether a person makes a market in swaps. [5] The Commissions also provided a list of activities that generally would constitute entering into swaps as a part of a "regular business." [6]

In the Adopting Release, the Commissions stated that certain swaps are not considered in the determination of whether a person is a swap dealer. These include, among others, swaps entered into by an insured depository institution with a customer in connection with originating a loan to that customer, swaps entered into as a registered floor trader, and swaps between majority-owned affiliates. The CFTC also adopted an interim final rule excluding from the swap dealer analysis certain swaps entered into for hedging physical positions.

B. De Minimis Exception

Even if a person engages in any swap dealer activity, the Dodd-Frank Act exempts from the dealer designation any entity that engages in a de minimis quantity of dealing. The proposed de minimis exemption required persons to meet three factors, including a limit on the dealing activity to an aggregate effective gross notional amount of no more than $100 million or $25 million with "special entities" (e.g., government agencies, employee benefit plans, and endowments). In the Final Rules, the Commissions adopted a one-part test: to qualify for the de minimis exemption, an entity's dealing activity involving swaps would be capped at $3 billion over the prior 12 months for swaps and security-based swaps that are

credit default swaps ("CDS") [7] and $25 million for swaps in which the counterparty is a special entity. The Commissions did not adopt the other two proposed factors in the Final Rules.

In addition, the Commissions decided to adopt a phase-in period during which time higher de minimis thresholds would apply. During this phase-in period, a person's swap dealing activity over the prior 12 months is capped at a gross notional value of $8 billion for swaps and security-based swaps that are CDS (and $400 million for security-based swaps other than CDS) and $25 million gross notional value for swaps with special entities.

During this phase-in period, the Commissions directed their respective staffs to complete a report on the effects of the adopted definitions. [8] Nine months after publication of the report, the Commissions may either issue an order that the phase-in period will end at a certain date or issue a notice of proposed rulemaking for public comment to modify the de minimis thresholds. If the Commissions take no action, the phase-in period will end no later than five years.

II. Major Swap Participant and Major Security-Based Swap Participant

The Dodd-Frank Act defines a person as a major swap participant ("MSP") or major security-based swap participant ("MSBSP") (collectively "major participant") as a person that satisfies any one of three alternative tests. Under the statutory tests, a person would be a major participant if:

1. it maintains a "substantial position" in swaps or security-based swaps for any of the major swap categories (except positions held for hedging or mitigating commercial risk or held by an ERISA employee benefit plan);
2. its outstanding swaps or security-based swaps create "substantial counterparty exposure" that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or
3. it is a "financial entity" that is "highly leveraged" relative to the amount of capital it holds (and that is not subject to capital requirements established by an appropriate Federal banking agency) and maintains a substantial position in outstanding swaps or security-based swaps in any major category.

In the Final Rules, the Commissions further defined major participant by addressing, among others, the meaning of several key elements of the statutory tests: "substantial position," "substantial counterparty exposure," "financial entity," and "highly leveraged." As with SDs, the Commissions noted that a person that meets one of the major participant definitions will be deemed to be a major participant in connection with all categories of swaps or security-based swaps, but that person may apply for a limited designation.

A. Substantial Position

Under the Final Rules, the Commissions will use two tests to determine whether a person has a "substantial position" – the current uncollateralized exposure and the potential future exposure tests. A person will have a "substantial position" in a major category of swaps or security-based swaps if it has a daily average current uncollateralized exposure of at least $1 billion (or $3 billion for the rate swap category) or a daily average current uncollateralized exposure plus potential future exposure of $2 billion (or $6 billion for the rate swap category). The Final Rules provide that the four "major" categories of swaps are rate swaps, credit swaps, equity swaps, and other commodity swaps. The two "major" categories of security-based swaps are debt security-based swaps and other security-based

swaps.

1. Current Exposure Test

The current exposure test measures the amount of potential risk that an entity would pose to its counterparties if the entity were to default. For each counterparty, a person would determine the dollar value of the aggregate current exposure arising from each of its swap or security-based swap positions with negative value in that major category by marking-to-market using industry practices and deduct from that amount the aggregate value of the collateral the entity has posted with respect to the swap or security-based swap positions. The aggregate uncollateralized outward exposure would be the sum of those uncollateralized amounts over all counterparties with which the person has entered into swaps or security-based swaps in that major category.

The Final Rules have been modified from the proposed rules to reflect that two counterparties may have multiple netting arrangements and to permit an entity to calculate its exposure on a net basis by applying the terms of one or more master netting agreements with a counterparty. The netting provisions apply only to offsetting positions with a single counterparty. [9] The Adopting Release also re-affirmed that centrally cleared swaps and security-based swaps, which are subject to mark-to-market margining that would largely eliminate the uncollateralized exposure associated with a position, effectively would be excluded from the analysis.

2. Potential Future Exposure Test

The potential future exposure test is intended to measure how the value of an entity's swap or security-based swap positions may move against the entity over time. The potential future exposure would be measured by adjusting notional positions using risk multipliers. [10] The Final Rules provide that the potential future exposure associated with positions that are subject to daily mark-to-market margining will equal 0.2 times the amount that otherwise would be calculated. In response to commenters, the Final Rules also provide that the potential future exposure associated with positions that are subject to central clearing will equal 0.1 (rather than the proposed 0.2) times the potential future exposure that would otherwise be calculated.

B. Hedging or Mitigating Commercial Risk

The first part of the test of a major participant definition excludes positions held for "hedging or mitigating commercial risk." A swap position would be held for the purpose of hedging or mitigating commercial risk when such position is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise (or of a majority-owned affiliate of the enterprise). The Final Rules identify categories of permissible commercial risk.

The Final Rules also permit financial entities to take advantage of the commercial risk hedging exclusion. In addition, the Commissions declined to limit "commercial risk" to only risks related to non-financial activities, and the exclusion would be available to positions that hedge financial or balance sheet risks. Swaps that hedge positions held for speculation, investment or trading will not qualify for the exclusion.

C. Substantial Counterparty Exposure

The second part of the Dodd-Frank Act's definition of a major participant turns on whether a

person's "substantial counterparty exposure" could have serious adverse effects on U.S. financial stability. The definition of "substantial counterparty exposure" is based on the same current uncollateralized exposure and potential future exposure tests that are used to identify a "substantial position" under the first part of the Dodd-Frank Act definition. Unlike the first part, however, the analysis in the second part of the definition evaluates all of the person's swap or security-based swap positions (rather than positions in a major swap category) and does not exclude hedging positions.

Under the Final Rules, the threshold for a MSP definition is $5 billion or more in daily average current uncollateralized exposure or $8 billion or more in daily average uncollateralized exposure plus potential future exposure. The threshold for a MSBSP is $2 billion or more in daily average current uncollateralized exposure or $4 billion or more in daily average uncollateralized exposure plus potential future exposure.

D. Financial Entity and Highly Leveraged

The third statutory test of a major participant includes a "financial entity" (other than banking entities subject to capital requirements) that is "highly leveraged." The Final Rules generally define "financial entity" based on the corresponding financial entity definition used in the Title VII exception from mandatory clearing for end users. Moreover, the Final Rules define "highly leveraged" to mean generally a ratio of liabilities to equity in excess of 12 to 1 rather than the alternative proposals of 8 to 1 or 15 to 1. The leverage ratio is measured in accordance with GAAP and calculated as of the close of business on the last business day of the applicable fiscal quarter.

E. Safe Harbor

Recognizing the concerns expressed regarding the compliance burdens associated with conducting the major participant calculations, the Commissions adopted three alternative safe harbors. Under these safe harbors, a person would not be a major participant if:

1. the express terms of a person's arrangements relating to swaps and security-based swaps with its counterparties would not permit the person to maintain a total uncollateralized exposure of more than $100 million to all such counterparties (including any exposure that may result from the application of thresholds or minimum transfer amounts established by credit support annexes or similar arrangements) and the person does not maintain notional swap or security based swap positions of more than $2 billion in any major category of swaps or security-based swaps or more than $4 billion in aggregate;
2. the express terms of a person's arrangements relating to swaps and security-based swaps with its counterparties would not permit the person to maintain a total uncollateralized exposure of more than $200 million to all such counterparties (including any exposure that may result from thresholds or minimum transfer amounts) and the major participant calculations as of the end of every month indicate that the person's swap or security-based swap positions are no more than one-half of the level of current exposure plus potential future exposure that would cause the person to be a major participant; or
3. a person's current uncollateralized exposure in connection with a major category of swaps or security-based swaps is less than $500 million (or less than $1.5 billion with regard to the rate swap category) and the modified major participant calculations as of the end of every month indicate that the person's swap or security-based swap positions in each major category of swaps or security-based swaps are less than one-

half of the substantial position threshold.

F. Other Issues

In the Adopting Release, the Commissions also provided several clarifications regarding the applications of the major participant analysis. A few that may be of most interest to funds and their managers are described below.

1. Managed Accounts

The Commissions confirmed in the Adopting Release that it is not necessary to consider the swap or security-based swap positions of the client accounts managed by asset managers or investment advisers when determining whether those entities are major participants. In addition, the Commissions modified their views regarding the application of the major participant analysis to the beneficial owners of managed swaps and security-based swap positions. Therefore, if the counterparties to a swap or security-based swap position within a managed account have recourse only to the assets of that account in the event of default and lack recourse to other assets of the beneficial owners, the Commissions do not believe it would be appropriate to attribute that position to its beneficial owners.

2. Inter-Affiliate Swaps and Security-Based Swaps

Under the Final Rules, a person may exclude particular swaps or security-based swaps from the analysis of whether the person is a major participant as long as the counterparties are majority-owned affiliates.

3. Positions of Affiliated Entities and Guarantees

In the Adopting Release, the Commissions modified their position regarding the attribution of a subsidiary's swap or security-based swap positions to the subsidiary's majority-owner parent. An entity's swap or security-based swap positions in general would be attributed to a parent, other affiliate or guarantor for purposes of the major participant analysis only to the extent that the counterparties to those positions would have recourse to that other entity in connection with that position.

G. Implementation Standard, Reevaluation Period, and Minimum Period of Status

Under the Final Rules, a major participant generally has two months after the end of the quarter in which it meets the major participant criteria to submit an application for registration. The Final Rules, however, provide that if an entity meets the criteria but does not exceed any applicable threshold by more than 20 percent in a particular quarter, the entity may wait to see whether it exceeds the thresholds in the next fiscal quarter. Such an entity must file an application for registration at the end of the next fiscal quarter if it exceeds any of the applicable daily average thresholds in the next fiscal quarter. A person must remain registered as a major participant until it does not exceed any of the applicable thresholds for four consecutive quarters following registration.

III. Eligible Contract Participant

The Dodd-Frank Act makes it unlawful for a person that is not an eligible contract participant ("ECP") to enter into a swap other than on, or subject to the rules of, a designated contract market or a security-based swap other than on a national securities exchange registered with the SEC. In addition, the Dodd-Frank Act amended the ECP definition by, among others, excluding a commodity pool in which any participant is not

itself an ECP. A number of requirements and restrictions apply if a commodity pool enters into certain types of foreign currency transactions ("Forex Pool") and does not satisfy the ECP definition.

In the Final Rules, the Commissions, among others, adopted further definitions of ECP generally to prohibit a Forex Pool from qualifying as an ECP if such Forex Pool directly enters into retail foreign currency transactions and has a direct participant that is not an ECP. The Final Rules also clarify that in determining whether the Forex Pool is an ECP, the participants in a commodity pool that invests in the Forex Pool (e.g., feeder fund investors) will not be considered unless any of the pools have been structured to evade subtitle A of Title VII of the Dodd-Frank Act. Absent a structure to evade this provision, the Commissions will limit the look through to the participants of the commodity pool that enters into the retail foreign currency transaction.

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endnotes

[1] Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant." RIN 3038-AD06, available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister041812b.pdf (Apr. 27, 2012) ("Adopting Release"); see Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant" 75 FR 80174 (Dec. 21, 2010) ("Proposing Release").

[2] Adopting Release, supra note 1, at n. 1174 .

[3] Id. at 369. The CFTC states that "[t]he number of persons covered by the definition of "major swap participant" is estimated to be quite small, at six or fewer." Adopting Release, supra note 1 at n. 1351 and accompany text. The SEC estimates that the number of major security-based swap participants likely will be "fewer than five and, in actuality, may be zero." Id. at 501.

[4] These factors are: contacting potential counterparties to solicit interest; developing new types of swaps or security-based swaps and informing potential counterparties of their availability and of the person's willingness to enter into the swap or security-based swap; membership in a swap association in a category reserved for dealers; providing marketing materials describing the type of swaps or security-based swaps the party is willing to enter into; and generally expressing a willingness to offer or provide a range of products or services that include swaps or security-based swaps. See Adopting Release, supra note 1, at n. 187 and Proposing Release, supra note 1., at 80178.

[5] These activities include routinely: (1) quoting bid or offer prices, rates or other financial terms for swaps on an exchange; (2) responding to requests made directly, or indirectly through an interdealer broker, by potential counterparties for bid or offer prices, rates or other similar terms for bilaterally negotiated swaps; (3) placing limit orders for swaps; or (4) receiving compensation for acting in a market maker capacity on an organized exchange or

trading system for swaps. See Adopting Release, supra note 1, at 59-60. In applying these factors, the Commissions are of the view that it would be useful to consider whether the person is seeking compensation for providing liquidity, compensation through spreads or fees, or other compensation not attributable to changes in the value of the swaps to which it enters.

[6] The activities include: (1) entering into swaps with the purpose of satisfying the business or risk management needs of the counterparty (as opposed to entering into swaps to accommodate one's own demand or desire to participate in a particular market); (2) maintaining a separate profit and loss statement reflecting the results of swap activity or treating swap activity as a separate profit center; or (3) having staff and resources allocated to dealer-type activities with counterparties, including activities relating to credit analysis, customer onboarding, document negotiation, confirmation generation, requests for novations and amendments, exposure monitoring and collateral calls, covenant monitoring, and reconciliation. See Adopting Release, supra note 1, at n. 206 and accompanying text.

[7] For other types of security-based swaps (e.g., single-name or narrow-based equity swaps or total return swaps), the exception caps an unregistered person's dealing activity at $150 million in notional amount over the prior 12 months.

[8] The reports are due to the CFTC no later than 30 months following the date that a swap data repository first receives swap data under the CFTC regulations and to the SEC no later than three years following the later of the last compliance date for registration for security-based swap dealer and major security-based swap participant and the first date on which compliance with the trade-by-trade reporting to a security-based swap data repository is required.

[9] The Final Rules also provide that the amount of net uncollateralized exposure that is attributable to a particular major category of swap or security-based swap would be allocated pro rata in a manner that compares the amount of the entity's out-of-the-money positions in that major category to its total out-of-the-money positions in all categories that are subject to the netting arrangements with that counterparty.

[10] The approach incorporates and builds upon tests used by bank regulators for the purpose of setting prudential capital.