

**MEMO# 24788**

December 14, 2010

# **CFTC and SEC Jointly Propose Definitions for "Swap Dealer" and "Major Swap Participant"; Conference Call December 17**

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TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 29-10  
ETF ADVISORY COMMITTEE No. 56-10  
EQUITY MARKETS ADVISORY COMMITTEE No. 53-10  
FIXED-INCOME ADVISORY COMMITTEE No. 36-10  
SEC RULES COMMITTEE No. 65-10  
SMALL FUNDS COMMITTEE No. 31-10 RE: CFTC AND SEC JOINTLY PROPOSE DEFINITIONS FOR "SWAP DEALER" AND "MAJOR SWAP PARTICIPANT"; CONFERENCE CALL DECEMBER 17

The Securities and Exchange Commission and the Commodity Futures Trading Commission (collectively "Commissions"), in consultation with the Board of Governors of the Federal Reserve System, have proposed joint rules and interpretive guidance on the further definition of the terms "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant," and "eligible contract participant," as required by Sections 712(d)(1), 721(c), and 761(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA"). [\[1\]](#)

Comments are due within 60 days of publication in the Federal Register. We will hold a preliminary conference call on Friday, December 17, at 2:30 p.m. Eastern time to discuss the joint proposal and possible ICI comments. If you plan to participate on the call, please contact Ruth Tadesse by email at [rtadesse@ici.org](mailto:rtadesse@ici.org) or by phone at 202/326-5836 to receive the dial-in information. If you are unable to participate on the call but have views to offer, please contact Heather Traeger at [htraeger@ici.org](mailto:htraeger@ici.org) prior to the call.

## **I. Swap Dealer and Security-Based Swap Dealer**

A swap dealer under the DFA is defined as any person who: holds itself out as a swap dealer; makes a market in swaps; regularly enters into swaps as an ordinary course of business for its own account; or engages in activity that causes it to be commonly known in

the trade as a dealer or market maker. The definition excludes a person trading swaps for its own account, either individually or as a fiduciary, but not as a part of a regular business. [2] It also provides a de minimis exemption for entities that engage in swap dealing in connection with transactions with or on behalf of their customers, as well as for insured depository institutions that offer or enter into a swap (but not a security-based swap) with a customer in connection with a loan to that customer. The proposal would require that a person that satisfies the definition of swap dealer be a dealer for all its swap activities (i.e., each type, class or category of swap) unless it receives individual relief from the relevant Commission.

## **A. “Function” and Swap Dealers**

The proposal emphasizes that the Commissions intend to interpret the term “swap dealer” and “security-based swap dealer” by reviewing the function being performed – e.g., how a person holds itself out to the market, the person’s conduct and how that conduct is perceived by the market. [3] To be a swap dealer, a person’s dealing activity needs to be greater than the de minimis exception thresholds but does not have to be the person’s predominant business activity.

The proposal includes a four-part test to determine if a person is a swap dealer. Specifically, a person would be considered a swap dealer if: it meets demand for transactions; enters into swaps to facilitate other parties’ interests; tends not to ask that other parties propose terms; and, tends to arrange customized swap terms. The Release also identifies the following factors, among others, that suggest that a person holds itself out or is commonly known as a dealer:

- contacting potential counterparties to solicit interest in swaps;
- developing new types of swaps and informing potential counterparties of their availability;
- membership in a swap association in a category reserved for dealers;
- providing marketing materials that describe the types of swaps that one is willing to enter into; or
- generally expressing a willingness to offer or provide a range of financial products that would include swaps.

Noting that relevant principles may differ in the swap and securities-based swap markets, the proposal states that the core tests applicable to identifying dealers would also differ such that the focus would be on “those persons whose function is to serve as the point of connection” in the relevant markets. With respect to security-based swaps, the SEC also intends to consider the same factors that are relevant to determining whether a person is a “dealer” under the Securities Exchange Act of 1934. The proposal explains that the concepts of inventory and regular place of business are not clearly applicable to the security-based swap market and that this distinction needs to be taken into account when determining whether a person is a security-based swap dealer.

## **B. De Minimis Exemption**

The proposal would include a de minimis exemption from registration as a swap dealer. Under the exemption, dealing activity would be limited to: (1) an aggregate effective gross notional amount of no more than \$100 million; (2) an aggregate effective notional amount of swaps with a “special entity” counterparty of no more than \$25 million; [4] (3) no more than 15 non-swap dealer counterparties (counterparties in a single group or under common control would be a single counterparty); and (4) no more than a total of 20 swaps. These factors would apply to the preceding 12-month period and would not distinguish between

types of swaps. In addition, all four factors would have to be met to qualify for the exemption.

## **II. Major Swap Participant (“MSP”) and Major Security-Based Swap Participant (“MSBSP”)**

Under the DFA, an MSP is any non-swap dealer that: (1) maintains a substantial position in swaps in any of the “major” categories determined by the relevant Commission (except positions held for hedging or mitigating commercial risk, or held by an ERISA employee benefit plan); (2) whose outstanding 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) is highly leveraged relative to the amount of capital it holds, is not subject to a federal banking agency’s capital requirements, and maintains a substantial position in outstanding swaps in a major category. The Release explains that the MSP definition looks to the impact and risks associated with an entity’s swap positions in contrast to the swap dealer definition which focuses on a market participant’s functions. If a person were deemed to be an MSP, it would be an MSP for all categories of swaps and all swap-related activities unless it obtained individual relief from the relevant Commission.

### **A. “Major” Categories of Swaps or Security-Based Swaps**

The proposal would designate four categories of swaps, which together are intended to cover all swaps, with each swap falling into the category it most closely fits. The categories would be: (1) rate swaps; (2) credit swaps; (3) equity swaps; and (4) other commodity swaps, which would include all swaps not included in the first three categories. [\[5\]](#) If a swap is based on more than one underlying item of different types, it would fall into the category that describes the underlying item likely to have the most significant effect on the economic return of the swap.

The proposal would designate two major categories of security-based swap. The first would include any security-based swap based, in whole or in part, on one or more debt (including loan) instruments or on a credit event relating to one or more issuers or securities, including a credit default swap, total return swap on debt, debt swap, debt index swap, or credit spread. The second category would include all other security-based swaps, e.g., equity swaps.

### **B. Substantial Position**

The proposal would use objective numerical criteria to set the substantial position thresholds and would look at both current uncollateralized and potential future exposure. In the Release, the Commissions explain that both metrics are needed to address gaps left by either if used alone and thus a position that satisfied either of the tests would be a “substantial position.”

#### **1. Current Exposure Test**

The proposed “current exposure test” would focus on current uncollateralized exposure by marking-to-market (using industry standard practices) the exposure arising from each of the person’s positions with negative value in each of the applicable major swap and security-based swap categories (other than positions excluded from consideration, such as positions for the purpose of “hedging or mitigating commercial risk”). Thus, the test would measure the dollar value of the aggregate portion of the exposure within a particular major category that is not offset by the posting of collateral. The test would allow persons to

calculate exposure on a net basis by applying the terms of netting agreements. Persons could not, however, “double count” any offset or collateral or take into account the market risk offsets associated with holding positions with multiple counterparties. [\[6\]](#)

The current uncollateralized exposure threshold would be set at a daily average of \$1 billion in each major category of swap and security-based swap except for the rate swap category, which would be set at \$3 billion. These thresholds would be evaluated by reference to a calculation of the mean of an entity’s uncollateralized exposure measured at the close of each business day, beginning on the first business day of each calendar quarter and continuing through the last business day of that quarter.

## **2. Current Exposure Plus Potential Future Exposure Test**

The second proposed test is intended to take into account estimates of how the value of a swap position could move against an entity over time. [\[7\]](#) It would reflect the potential exposure in the applicable major swap or security-based swap category by looking at the total notional principal amount of positions, adjusted up or down by certain risk factors, such as the type of swap and the duration of the position. Calculations for leveraged positions would be based on the position’s effective notional amount. Calculations for cleared swaps, or swaps subject to daily mark-to-market margining, would be adjusted down to 20 percent of the potential future exposure. Such positions would not be fully excluded because, according to the Release, clearing does not completely eliminate risk.

The threshold for the “current exposure plus potential future exposure” test would be \$2 billion in combined current uncollateralized exposure plus aggregate potential outward exposure in a particular major swap category, except that the threshold for the rate swap category would be \$6 billion. The Release notes that only a relatively few entities should have to perform potential future exposure calculations for security-based swaps.

## **C. Hedging or Mitigating Commercial Risk**

The first prong of the MSP definition excludes positions held for “hedging or mitigating commercial risk.” This language is virtually identical to the language in the end-user exception from mandatory clearing and, according to the Release, the Commissions intend to interpret the language the same way for both concepts. While a financial entity may not qualify for the end-user exception, the Release makes clear that positions held to hedge or mitigate commercial risk would be excluded from the first prong of the MSP definition regardless of the nature of the entity.

The proposal would define hedging to cover hedging or mitigating any of a person’s business risk, regardless of the swap’s status under accounting guidelines or the Commodity Exchange Act’s bona fide hedging exemption. Whether a position is held for “hedging” would be determined by the facts and circumstances at the time the swap is entered into, taking into account the entity’s overall hedging and risk mitigation strategies. Positions held primarily to take an outright view of the direction of the market, including positions held for short-term resale, or to obtain arbitrage profits, would be considered entered into for purposes of speculation or trading and not hedging. In addition, swap positions that hedge other positions that themselves are held for speculation or trading would not be viewed as hedging positions.

## **D. Substantial Counterparty Exposure**

The second prong of the MSP definition covers entities whose swap positions create substantial counterparty exposure that could have systemic effects. This prong does not

include a hedging exemption, nor does it focus on different categories of swaps or security-based swaps. The proposal would apply the same measures of current uncollateralized exposure and potential future exposure as in the “substantial position” determination but at a threshold that focuses on the entirety of an entity’s swap positions, whether or not they are hedged. Specifically, an entity would be an MSP under the second prong if its current uncollateralized exposure were \$5 billion for swaps and \$2 billion for security-based swaps, or its combined current uncollateralized and potential future exposure were \$8 billion for swaps and \$4 billion for security-based swaps, across all its swap or security-based swap positions.

### **E. Financial Entity and Highly Leveraged**

The third prong of the MSP definition covers any “financial entity” (other than banking entities with capital requirements) that is “highly leveraged.” Although the prong does not define “financial entity,” the term is defined for purposes of the end-user exception from clearing. The proposal would use essentially the same definition, making only technical changes to avoid circularity. A financial entity would be “highly leveraged” if the ratio of its total liabilities to equity were in excess of either 8 to 1 or 15 to 1, measured at the close of business on the last business day of the applicable fiscal quarter. Liabilities would be determined in accordance with U.S. generally accepted accounting principles.

### **F. Implementation Standard, Reevaluation Period and Minimum Duration of Status**

According to the Release, an unregistered entity that meets the MSP or MSBSP criteria as a result of its swap or security-based swap activities in a fiscal quarter would be deemed an MSP or MSBSP until the earlier of the date on which it submits a complete application for registration or 2 months after the end of that quarter. The proposal would provide for a reevaluation of MSP status for entities that meet one or more of the MSP prongs but only by a modest amount (i.e., by no more than 20 percent over any applicable threshold) for only one quarter. Such an entity would only be required to register if it met any of the applicable thresholds in the next quarter. In addition, the proposal would provide that any entity that is deemed to be an MSP or MSBSP would retain that status until such time that it does not exceed any of the applicable thresholds for four consecutive quarters after the entity becomes registered.

### **G. Potential Exclusions for Funds**

The proposal would not include an exclusion from the definitions for MSP or MSBSP for funds. In the Release, however, the Commissions seek comment on whether there should be a conditional or unconditional exclusion for funds, among others, on the grounds that such entities do not present the risks that underpin the major participant definitions and/or to avoid duplication of existing regulation.

## **III. Eligible Contract Participant**

The DFA requires the Commissions to define the term “eligible contract participant” or “ECP” further. In the Release, the Commissions have limited their revisions to including the new categories of swap dealer, security-based swap dealer, MSP, and MSBSP within the scope of ECP.

**endnotes**

[1] See SEC Release No. 63452 (Dec. 7, 2010) (“Release”), available at: [sec.gov/rules/proposed/2010/34-63452.pdf](http://sec.gov/rules/proposed/2010/34-63452.pdf).

[2] In the Release, the Commissions explain that persons who enter into swaps as a part of a “regular business” are those persons whose function is to accommodate demand for swaps from other parties and enter into swaps in response to interest expressed by other parties.

[3] The Release states that the definitions should be interpreted flexibly to respond to evolution in the ways that dealers enter into swaps and security-based swaps.

[4] Under DFA, “special entities” are generally government agencies, employee benefit plans and endowments.

[5] The major categories designations would apply only for purposes of the MSP and MSBSP definitions.

[6] According to the Release, the Commissions believe that an entity that has net uncollateralized exposure to a counterparty should, for purposes of the test, allocate that net uncollateralized exposure pro rata in a manner that reflects the exposure associated with each of its out-of-the-money swap positions, security-based swap positions and non-swap positions.

[7] The Release notes that the second test builds on, but modifies, bank capital standards to account for risk to counterparties rather than risk to an entity itself.