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DERIVATIVES

CFTC and SEC Publish Rules Defining Entities That Will Be Classified as Dealers, Major Participants in Derivatives Market




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Title VII of the The Dodd-Frank Act Wall Street Reform and Consumer Protection Act of 2010 (''Dodd-Frank Act'') requires persons that are swap dealers and major swap participants to register with the Commodity Futures Trading Commission (''CFTC'') and persons that are security-based swap dealers and major security-based swap participants to register with the Securities Exchange Commission (''SEC'', and together with the CFTC, the ''Commissions''). In December 2010, the Commissions proposed rules and interpretive guidance (''Proposed Rules'') with respect to the meaning of these key terms. On April 18, 2012, following almost 18 months, receipt of approximately 968 comment letters, participation in 114 meetings with market participants and a joint public roundtable, the Commissions jointly adopted final rules (''Final Rules'') and provided interpretative guidance (''Interpretative Guidance'') in the commentary of the Final Rules to further define those key terms. As mentioned, entities that are captured by the ''swap dealer'' or ''major swap participant'' definitions will be

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subject to registration.[1] Such entities will also be subject to clearing and exchange trading requirements, as well as capital, margin, reporting and business conduct requirements in respect of their swaps and security-based swaps related activities, which rules either have been or will be promulgated. Futhermore, the swap dealer and major swap participant designations will themselves depend on the upcoming swap product definition rules. This article focuses on a number of the key components of the swap dealer and major swap participant definitions as set out in the Final Rule and Interpretative Guidance and highlight certain significant differences between the Final Rules and the Proposed Rules.

I. Swap Dealer – Key Components of the Test

The Dodd-Frank Act defines a swap dealer as any person who: (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties as an ordinary course of business or for its own account; or (iv) engages in activity causing itself to be commonly known in the trade as a dealer or market maker in swaps. The ''or'' is disjunctive; satisfying any of the four conditions will render a person a swap dealer.

Under the Final Rules, if a person is a dealer with respect to one category of swaps, that person will be a swap dealer with respect to all categories of swaps. A person may apply to the applicable Commission to limit its designation of swap dealing activity to a particular category, type or class of swap. Applicants will be considered on case-by-case basis and will be required to show compliance with the business conduct standards rule.

If a person's swap dealing activities do not exceed a specified *de minimis* threshold (based on aggregate gross notional amounts), the person will not be designated a swap dealer. Furthermore, a person who enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as part of a regular business, will not be designated a swap dealer.

The following swaps are excluded from the consideration of whether a person is a swap dealer: swaps entered into by an insured depositary institution with a customer in connection with originating a loan with that customer (excluded from swap dealer analysis only); swaps between majority-owned affiliates (excluded from both swap dealer and security-based swap dealer analysis); swaps entered into by a cooperative with its members (excluded from swap dealer analysis only); swaps entered into for hedging physical positions (excluded from swap dealer analysis only); and certain swaps entered into by registered floor traders (excluded from swap dealer analysis only).

Dealer-Trader Distinction. In the Interpretive Guidance, the Commissions have embraced the ''dealer-trader'' distinction as a way of interpreting the term ''swap dealer'' and to assist in distinguishing between dealers and non-dealers. The ''dealer-trader'' distinction constitutes a body of case law which the SEC has used in analyzing which entities are dealers, as opposed to mere traders, under the Securities Exchange Act of 1934 (''Exchange Act''). The Commissions recognize, however, that the dealer-trader distinction as applied under the Exchange Act needs to be modified in its application to the question of who is a swap dealer due to differences between the swaps market and the securities market. The goal in utilizing the dealer-trader distinction is to correctly identify those persons that should be regulated either because of the role such person plays in the market or such person's relationships with counterparties. The dealer-trader distinction affords a degree of flexibility to the swap dealer analysis. The Commissions expect the distinction to evolve over time.

The Interpretive Guidance lists the following activities as indicative of dealing activity and therefore indicative that a person is acting as a swap dealer: (i) providing liquidity by accommodating demand for or facilitating interest in swaps, (ii) holding oneself out as willing to enter into swaps (independent of whether another party has already expressed interest) or being known in the industry as being available to accommodate demand for swaps; (iii) advising a counterparty as to how to use swaps to meet the counterparty's hedging goals or structuring swaps on behalf of a counterparty; (iv) having a regular clientele and actively advertising or soliciting clients in connection with swaps; (v) acting as market maker on an organized exchange or trading system for swaps; and (vi) helping to set the prices offered in the market (such as by acting as a market maker) rather than taking those prices.

Ordinary Course of Business v. 'Not as Part of a Regular Business.' Following publication of the Proposed Rules, a number of market participants voiced concerns about prong (iii) of the swap dealer test, whether a person regularly enters into swaps with counterparties as an ordinary course of business, and the related statutory exception for a person entering into swaps for its own account and not as part of a regular business. The comments focused largely on the fact that end-users and other entities that Congress did not intend to regulate could fall foul of this test and be designated as swap dealers. What, asked the market, does the phrase ''not as part of its regular business'' really mean?

In the Interpretative Guidance, the Commissions state that the phrase ''not as part of a regular business'' is synonymous with the phrase ''ordinary course of business''; the two are intended to focus on the activities of the person in question that are usual and normal in such person's course of business. The Commissions gave the following examples of activities that would generally constitute both entering into swaps ''as an ordinary course of business'' and ''as a part of a regular business'' indicative of swap-dealer status: (i) 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); (ii) maintaining a separate profit and loss statement reflecting the results of swap activity or treating swap activity as a separate profit center; or (iii) having staff and resources allocated to dealer-type activities with counterparties, including activities relating to credit analysis, customer onboarding, document nego-

[1] Unless otherwise noted, the term ''swap dealer'' as used herein will refer to both swap dealers and security-based swap dealers. Similarly, unless otherwise noted, the term ''major swap participant'' will refer to both major swap participants and major security-based swap participants.

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tiation, confirmation generation, requests for novations and amendments, exposure monitoring and collateral calls, covenant monitoring, and reconciliation. As a further example, the Commissions also stated that using staff and resources to a significant extent in conducting credit analysis and opening and monitoring accounts is an indication that the person is engaged in ''a regular business'' of entering into swaps.

The Commissions also stated that an activity should not be seen as ''regular business'' if the person's use of a swap is ancillary to or in connection with a separate non-swap business that is the person's primary business.

De Minimis Exception

Pursuant to the Dodd-Frank Act, the Commissions may exempt from swap dealer designation any entity that engages in a *de minimis* amount of dealing. The statute further requires the Commissions to ''promulgate regulations to establish factors with respect to the making of any determination to exempt'' an entity from designation as a swap dealer.[2]

In response to the *de minimis* criteria in the Proposed Rules, many commentators raised concerns that the notional level was set too low and was in fact disproportionately low when compared to the activities of recognized dealers. The Commissions responded to these concerns in the Final Rules; during an initial phase-in period, to qualify for the *de minimis* exemption, the aggregate gross effective notional value of a person's swap dealing activities must not exceed $8 billion, or, for security-based swaps other than CDS, $400 million, and, with respect to swaps where the counterparty is a ''special entity'', $25 million, each over the preceding 12 month period.[3] The phase-in period will end at the earlier of (i) five years from the effective date of the Final Rules or (ii) when each Commission publishes a report on the *de minimis* thresholds and decides whether to adopt the post-phase-in thresholds set in the Final Rules ($3 billion aggregate gross effective notional value of swap-dealing activities, $150 million for security-based swaps other than CDS, and $25 million for special entities) or to adopt different thresholds that each Commission deems proper. Note that the look-back period for the *de minimis* exception will commence on the effective date of the swap product definition rules; swaps entered into before then are not counted.

One notable change from the Proposed Rules is that, in calculating a person's notional value of swaps, the swaps of any entity controlling, controlled by or under common control with such person must also be included in the computation. The rationale for this is the significant jump in the size of the threshold and a desire to prevent a person from evading swap-dealer designation by simply dividing the relevant activities between affiliated entities.

The increased threshold has been criticized by some observers as arbitrary and excessively high, particularly given that during the phase-in period (discussed below) the *de minimis* level is set even higher at $8 billion. Some commentators have reacted with claims that the threshold will allow a significant portion of the market to side-step designation as a dealer and therefore avoid regulation. According to the Commissions, however, the new higher threshold will require approximately 175 entities to register as swap dealers. Further, the Commissions believe that the $8 billion level should still lead to the regulation of persons responsible for the vast majority of dealing activity within the swap markets.

If a person exceeds the *de minimis* swap-dealing thresholds, it must register as a swap dealer within two months after the end of the month in which that person became no longer able to take advantage of the *de minimis* exception. If a person falls below the *de minimis* threshold, it may withdraw its registration as a swap dealer if it has been registered as a swap dealer for at least 12 months. This rule is designed to prevent persons from rapidly moving in and out of swap-dealer status based on short-term fluctuations in swap activities.

Inter-Affiliate Swaps Excluded from Swap Dealer Analysis. The Final Rules exclude from the consideration of whether an entity is a swap dealer swaps between majority-owned affiliates. In the Proposed Rules, a person could exclude from the swap-dealer definition swaps between persons under ''common control,'' and the Commissions rejected the concept of affiliates as too broad. Pursuant to the Final Rules, the only swaps that are excluded are those between majority-owned affiliates. Counterparties are majority-owned affiliates if one counterparty directly or indirectly holds a majority interest in the other, or where a third party directly or indirectly owns a majority interest in both counterparties to the swap. This standard for the majority-owned affiliate exclusion is likely narrower than many commentators prefer.

Physical Hedging Exclusion. The CFTC has adopted by *interim final rule*[4] an exclusion from the swap-dealer analysis for certain swaps entered into for the purposes of hedging physical positions. To benefit from the exclusion, such hedges must meet specified criteria, which include: (a) the swap is entered into for the purpose of offsetting or mitigating the person's price risks; (b) the swap represents a substitute for transactions made or to be made by the person in a physical marketing channel; (c) the swap is economically appropriate to the reduction of the person's risks in the conduct and management of a commercial enterprise; (d) the swap is entered into in accordance with sound commercial practices; and (e) the person does not enter into the swap in connection with activity structured to evade designation as a swap dealer.

These factors resemble, but do not exactly match, the CFTC's rules on bona fide hedging contained in the position limits rule. The CFTC is seeking comment on all aspects of this interim final rule, which comments are due 60 days after publication of the Final Rule in the Federal Register.

Insured Depositary Institution (IDI) Exclusion. The CFTC, but not the SEC, has excluded from swaps considered in determining swap-dealer status any swap entered into by an insured depositary institution with a customer in connection with originating a loan to that same customer.[5] The Final Rules specify the criteria which must be satisfied to benefit from this exclusion.

[2] CEA § 1a(49)(D), 7 U.S.C. § 1a(49)(D); Exchange Act § 3(a)(71)(D), 15 U.S.C. § 78c(a)(71)(D).

[3] CFTC Regulation 1.3(ggg)(4), SEC Regulation 240.3a71-2.

[4] CFTC Regulation § 1.3(ggg)(6)(iii)

[5] CFTC Regulation 1.3(ggg)(5).

II. Major Swap Participant & Major Security-Based Swap Participant – Key Components of the Test

A Major Swap Participant or Major Security-Based Swap Participant (both as used herein, ''MSP'') is any person that is not a dealer and (i) maintains a substantial position in swaps for any of the major swap categories, excluding positions held for hedging or mitigating commercial risk and positions maintained by certain employee benefit plans for hedging or mitigating risks in the operation of the plan; (ii) 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 (iii) is a financial entity that is highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking agency and that maintains a substantial position in outstanding swaps in any of the major swap categories.[6] The ''or'' is disjunctive, and a person meeting any of the three prongs of this definition will be a MSP, unless exempted from the definition by the safe harbors discussed below.

Note also that certain major swap categories and major security-based swap categories are relevant for prongs (i) and (iii) of the MSP definition. The four major swap categories are: rate swaps, credit swaps (on broad-based indices), equity swaps (on broad-based indices), and other commodity swaps (a residual category). The two major security-based swap categories are debt security-based swaps (*e.g.*, single name CDS) and other security-based swaps (a residual category).

The MSP definition focuses on the market impact and risks associated with an entity's swap positions while the dealer definition focuses on the entity's activities and accounts for the amount or significance of those activities only in the context of the *de minimis* exception. As with the swap dealer definition, a person that is a MSP with respect to one major swap category will be deemed a MSP with respect to all swap categories unless it seeks a limited purpose designation from the applicable Commission.

First Prong: Maintains a Substantial Position in Swaps, Excluding Positions Held for Heding or Mitigating Commercial Risk. The first prong of the MSP definition encompasses those persons who maintain a substantial position in swaps for any of the major swap categories, excluding positions held for hedging or mitigating commercial risk and positions maintained by certain employee benefit plans for hedging or mitigating risks in the operation of the plan.

The substantial position rules are complex, and the Final Rules offer two tests generally designed to calculate a person's swap exposure.[7] Test 1 deems a person to have a substantial position when that person's aggregate uncollateralized outward exposure (also known as ''current exposure'') exceeds $1 billion in any major swap or security-based swap category (or $3 billion with respect to rate swaps). Test 2 deems a person to have a substantial position when that person's current exposure plus that person's aggregate potential outward exposure (measured as total notional principal amount, multipled by specified conversion factor percentages, and with adjustments for cleared swaps and swaps subject to margining) exceeds $2 billion in any major swap or security-based swap category (or $6 billion with respect to rate swaps).

Swaps held for hedging or mitigating commercial risk are not considered when determining whether a person has a ''substantial position'' in swaps or security-based swaps.[8] Swaps held for speculation, investing or trading are ineligible for this hedging exclusion from the substantial position analysis.

Acceptable forms of hedging or mitigating commercial risk include: (i) a bona fide hedge for purposes of an exemption from CFTC position limits; (ii) a hedge under Financial Accounting Standards Board Accounting Standards Codification Topic 815, Derivatives and Hedging, or Governmental Accounting Standards Board Statement 52, Accounting and Financial Reporting for Derivatives Instruments (applicable to swaps only); or (iii) positions 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), where the risks in the ordinary course of business arise from one of a specified set of circumstances laid out in the Final Rules.

The ''economically appropriate'' inquiry regarding permissible hedging is determined on the facts and circumstances applicable at the time a swap is entered into. Persons must act in a commercially reasonable manner when making such determination. The Commissions opted for flexibility over a more rigid standard in the Proposed Rules to account for variations of strategies in hedging or mitigating commercial risk. The ''economically appropriate'' standard may take into account the costs of terminating or reducing a position for which a hedge is no longer strictly needed.

While compliance, assurance and quantitative assessments are not required during the term of the swap (unlike in the Proposed Rules), the Interpretive Guidance indicates the need to periodically reevaluate the economic appropriateness of a swap as a hedging position.

Second Prong: Substantial Counterparty Exposure. In respect of the second prong of the MSP definition, any person whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets is a MSP. This test shares the methodology of the substantial position tests; however, swap positions here are aggregated across all major swap and security-based swap categories.[9] The applicable thresholds at or above which a person has ''substantial counterparty exposure'' and becomes a MSP are daily average aggregate uncollateralized outward exposure of $5 billion or a sum of daily average aggregate uncollateralized outward exposure and daily average aggregate potential outward exposure of $8 billion (for swaps) or daily average uncollateralized exposure of $2 billion or a sum of daily average aggregate uncollateralized outward exposure and daily average aggregate potential outward exposure of $4 billion (for security-based swaps).

[6] CFTC Regulation 1.3(hhh) and SEC Regulation 240.3a67-1.

[7] CFTC Regulation 1.3(jjj), SEC Regulation 240.3a67-3.

[8] CFTC Regulation 1.3(kkk), SEC Regulation 240.3a67-4.

[9] CFTC Regulation 1.3(lll), SEC Regulation 240.3a67-5.

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Third Prong: Highly Leveraged Financial Entity. Any financial entity that is highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking agency and that maintains a substantial position in outstanding swaps in any of the major swap categories will be a MSP. After evaluating a range of leverage ratios, the Commissions defined highly leveraged as a ratio of total liabilities to equity, determined in accordance with GAAP, greater than 12 to 1.[10]

The applicable definition of financial entity here matches that in the end-user clearing exemption rules and includes swap dealers, MSPs, commodity pools (as defined in the Commodity Exchange Act), a private fund (as defined in the Investment Advisers Act), employee benefit plans (as defined in ERISA), or persons predominantly engaged in activities that are in the business of banking or financial in nature (as defined in the Bank Holding Company Act).[11]

Safe Harbors. The Commissions acknowledge the compliance burdens imposed by the MSP definition. As a result, they have created several safe harbors from the MSP definition. An entity satisfying any one of these threshold tests will be deemed to not be a MSP:[12]

(i) If the express terms of the person's agreements or arrangements relating to swaps with its counterparties at no time would permit the person to maintain a total uncollateralized exposure of more than $100 million to all such counterparties, and the person does not maintain swap positions in a notional amount of more than $2 billion in any major swap category or more than $4 billion in the aggregate across all major swap categories;

(ii) If the express terms of the person's agreements or arrangements relating to swaps with its counterparties at no time would permit the person to maintain a total uncollateralized exposure of more than $200 million to all such counterparties, and at the end of each month the person has less than $1 billion in aggregate uncollateralized outward exposure plus aggregate potential outward exposure in any major swap category or less than $2 billion in aggregate uncollateralized outward exposure plus aggregate potential outward exposure across all major swap categories; or

(iii) At the end of each month, a person's aggregate uncollateralized outward exposure with respect to its swap positions in each major swap category is (a) less than $1.5 billion with respect to the rate swap category and less than $500 million with respect to each of the other major swap categories, and (b) at the end of each month, the sum of the amount calculated above with respect to each major swap category and the total notional principal amount of the person's swap positions in each such major swap category, adjusted by the multipliers set forth in the swap and security-based swap conversion factor matrices under the substantial position test on a position-by-position basis reflecting the type of swap, is less than $3 billion with respect to the rate swap category and less than $1 billion with respect to each of the other major swap categories, and (c) at the end of each month, a person's aggregate uncollateralized outward exposure with respect to its swap positions across all major swap categories is less than $500 million and the sum of the amount calculated under the paragraph immediately above and the product of the total effective notional principal amount of the person's swap positions in all major swap categories multiplied by 0.15 (for swaps) and multiplied by 0.10 (for security-based swaps) is less than $1 billion.

Timing of Registration Requirement for MSPs. If a person exceeds any of the MSP thresholds, it must register as a MSP within two months after the end of the quarter in which that person first meets the definition of a MSP. If a person does not exceed the applicable MSP threshold by more than 20% in one quarter, the entity will not be immediately subject to registration requirements but will become subject to such requirements at the end of the next fiscal quarter if the entity exceeds any of the applicable daily average thresholds in that next fiscal quarter. MSP status will continue until the MSP does not exceed any of the daily average thresholds for four consecutive fiscal quarters after its original registration date.

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[10] CFTC Regulation 1.3(mmm)(2), SEC Regulation 240.3a67-7.

[11] CFTC Regulation 1.3(mmm)(1), SEC Regulation 240.3a67-6.

[12] CFTC Regulation 1.3(hhh)(6), SEC Regulation 240.3a67-9.