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CFTC Final Rulemaking Defining Swap Dealer MSP and ECP

On April 18, 2012, the Commodity Futures Trading Commission ("CFTC") and the Securities Exchange Commission ("SEC") adopted joint final rules further defining "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant." The CFTC also adopted a final and interim final rule for commodity options. These rules implement Section 721 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") and provide long-awaited guidance on which entities will be subject to various statutory and regulatory requirements, including registration, margin, capital and business conduct standards. The summary below is based on the CFTC open meeting and fact sheets provided by the SEC and CFTC. To date, the text of the rules has not yet been released. Compliance with the rules is effective 60 days after the final product definitions are adopted (and December 31, 2012 for commodity pool operators required to satisfy the look-through provisions for eligible contract participants).

I. CFTC Rules

Swap Dealer

The final rule closely follows the text of Dodd-Frank: a "swap dealer" means 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 for its own account, or (iv) engages in any activity causing itself to be commonly known in the trade as a dealer or market maker in swaps. The CFTC indicates that the release accompanying the rule provides interpretive guidance on what is intended by "holding out" and "commonly known", what is captured by the "regular business" exception, and further notes that (i) determination of whether a person is a swap dealer will need to consider all the relevant facts and circumstances as well as focus on such person's usual and normal swaps dealing activities, (ii) a person making a one-way market in swaps may be a market maker and exchange-executed swaps will be relevant in the determination, (iii) activities that are part of a person's "regular business" would include entering into swaps to satisfy the business or risk management needs of the counterparty, maintaining separate profit and loss statements for swaps activities and allocating resources for such swaps dealing activities, and (iv) the SEC's dealer-trader distinction may be applied in identifying swap dealers.

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Excluded from the definition of swap dealer are persons engaged in a de minimis amount of swaps dealing activity, with the following thresholds:

- no more than US$8 billion in aggregate gross notional amount of swaps entered into over the prior 12 months in connection with dealing activities (during a phase-in period that will last at least 39 months after data starts to be reported to swap data repositories and, unless the CFTC acts, not more than five years after such initial reporting of data)
- after the phase-in period ends and if the CFTC has not otherwise determined to change the threshold amount, no more than US$3 billion in aggregate gross notional amount of swaps entered into over the prior 12 months in connection with swaps dealing activities
- during both periods, the aggregate gross notional amount of swaps entered into with "special entities" (i.e., pension plans and governmental entities) over the prior 12 months may not exceed US$25 million

The final rule further clarifies the loan origination exclusion for swaps entered into by an insured depository institution ("IDI"). Swaps entered into by an IDI with a customer in connection with the origination of a loan will not be considered for purposes of the determination of whether such IDI is a swap dealer, so long as (i) the swap is connected to the financial terms of the loan or is required as a condition to the loan to hedge the borrower's exposure to commodity price risks, (ii) the swap is entered into within 90 days before or 180 days after the date of the loan agreement or the date any principal is drawn under the loan, (iii) the loan falls within the common law meaning of "loan," and (iv) the IDI is the sole lender or is responsible for at least 10% of the loan if it is a participant in a lending syndicate, or, if neither, the notional amount of the swap may not exceed the amount of the insured depositary institution's participation.

The CFTC has also, by interim final rule, excluded certain swaps entered into to hedge a physical position from being considered as part of the determination of a person's status as a swap dealer. A swap will be excluded from the determination if entered into to offset or mitigate price risk so long as (i) the price risk to be hedged by the swap arises from the potential change in the value of assets that the person owns, produces, manufactures, processes, or merchandises, liabilities that the person owns or anticipates incurring, or services that the person provides or purchases, (ii) the swap represents a substitute for transactions or positions in a physical marketing channel, (iii) the swap is economically appropriate to the reduction of the person's risks in the conduct and management of a commercial enterprise, and (iv) the swap is entered into in accordance with sound commercial practices and is not structured to evade designation as a swap dealer.

Swaps between financial institutions and agricultural cooperatives as well as swaps between majority-owned affiliates are excluded from the determination of a person's status as a swap dealer. Moreover, floor traders will be exempt from registration as swap dealers subject to certain conditions.

Persons required to register as swap dealers may, by application, request the CFTC to limit designation as a swap dealer to specified categories of swaps or activities.

Major Swap Participant

Under Dodd-Frank, a major swap participant is (i) any person who maintains a "substantial position" in any of the major swap categories, excluding positions held for hedging or mitigating commercial risk and positions maintained by certain employee benefit plans, (ii) 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," or (iii) 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 any of the major swap categories.

The final rule defines "substantial position" as a daily average current uncollateralized exposure of at least US$1 billion (or US$3 billion for rates), or a daily average current uncollateralized exposure plus potential future exposure of US$2 billion (or US$6 billion for rates). "Substantial counterparty exposure" is defined as daily average current uncollateralized exposure of US$5 billion or more, or present daily average current uncollateralized exposure plus potential future exposure of US$8 billion or more. As a practical matter, these current exposure calculations will rarely include centrally cleared swaps, because such swaps are often subject to full mark-to-market margining. "Highly leveraged" is now defined as a ratio of total liabilities to equity of 12:1.

The definition of "substantial position" in the first prong of the definition of major swap participant excludes positions held for "hedging or mitigating commercial risk." This excludes any swap positions that:

- qualify as bona fide hedging under Commodity Exchange Act rules;
- qualify for hedging treatment under Financial Accounting Standards Board Statement No. 133 or Governmental Accounting Standards Board Statement No. 53, Accounting and Financial Reporting for Derivative Instruments; or
- are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where the risks arise in the ordinary course of business from:
  - a potential change in the value of (i) assets that a person owns, produces, manufactures, processes, or merchandises, (ii) liabilities that a person incurs, or (iii) services that a person provides or purchases;
  - a potential change in value related to any of the foregoing arising from foreign exchange rate movements; or
  - a fluctuation in interest, currency, or foreign exchange rate exposures arising from a person's assets or liabilities.

The rule also provides a safe harbor for persons who are clearly not within the scope of the definition of major security-based swap participant in order to reduce the regulatory burden and avoid the costs of performing the calculations for the "substantial position" tests.

Eligible Contract Participant

Under Dodd-Frank, persons who are not eligible contract participants ("ECPs") may only enter into swaps on or subject to the rules of a designated contract market. The final rule gives interpretive guidance on, and provides a safe-harbor from, the look-through provisions for retail forex transactions in the context of commodity pools. Swap dealers and major swap participants are automatically deemed ECPs.

Commodity Option

While the CFTC has yet to issue its final rule defining the term "swap," the CFTC's final rule on commodity options clarifies that commodity options may continue to transact subject to the same rules applicable to any other swap. In addition to the final rule, the CFTC adopted an interim final rule providing a trade option exemption for certain physically delivered commodity options discussed above. Commodity options subject to the trade option exemption will be excluded from the definition of swap but will remain subject to position limits, large trader reporting, antifraud and anti-manipulation rules, certain recordkeeping and reporting requirements, and the retention of certain swap requirements for swap dealers and major swap participants that engage in trade options.

II. SEC Rules

The definition of "security-based swap dealer" in new SEC Rule 3a71-1 is consistent with Dodd-Frank and defines such person as someone who:

- holds him/herself out as a dealer in security-based swaps;
- makes a market in security-based swaps;
- regularly enters into security-based swaps with counterparties as an ordinary course of business for his/her own account; or
- engages in activity causing them to be commonly known in the trade as a dealer or market maker in security-based swaps.

The SEC does not provide much detail in the fact sheet from which guidance may be drawn for the determination of whether a person is a security-based swap dealer. It does note, though, that the rule relies upon its traditional dealer-trader distinction regarding dealer status for other types of securities, and that because the SEC anticipates that the vast majority of security-based swaps will be single name CDS, the final rule draws from readily available CDS market information. The definition of security-based swap dealer excludes trading in security-based swaps by persons for his/her own account "not as part of a regular business," and, as in the CFTC's final rule, swaps between counterparties that are majority-owned affiliates are not included in the security-based swap dealer analysis.

New Exchange Act Rule 3a71-2 provides for a de minimis exception for security-based swap dealers. The final rule exempts persons entering into up to US$3 billion in notional value for CDS transactions over the prior 12 months (or US$150 million in notional value for other types of security-based swaps). Like the CFTC rules, the de minimis exception for security-based swaps with "special entities" is US$25 million in notional value over the prior 12 months. The thresholds are also subject to a similar phase-in period as set forth in the CFTC rules, except that the respective limits for the de minimis exception are (i) US$8 billion in notional value for CDS over the prior 12 months, and (ii) US$400 million in notional value for other security-based swaps over the prior 12 months. Unlike the original proposal by the SEC, the final rule does not limit the number of security-based swaps or number of counterparties a person can have to utilize the de minimis exception.

The SEC's final rule defines "major security-based swap participant" in new Exchange Act Rules 3a67-1 through 3a67-9. While the definition generally tracks that of a "major swap participant," some differences in the calculations apply. If a person has US$1 billion in daily average current uncollateralized exposure or US$2 billion in daily average current uncollateralized exposure plus potential future exposure, that person will be considered a major security-based swap participant.

Security-based swaps entered into for "hedging or mitigating commercial risks," which are not included in the "substantial position" calculations, are determined by reference to the same concepts as in the CFTC's final rule for hedging or mitigating commercial risk that is economically appropriate for risk reduction purposes in the ordinary course of business. The definition of "substantial counterparty exposure" covers all of a persons' security-based swap positions (including hedging positions or employee benefit plan positions). The thresholds established under the final rule for substantial counterparty exposure are (i) US$2 billion for current uncollateralized exposure or (ii) US$4 billion for the aggregate current uncollateralized exposure and potential future exposure across the entirety of a person's security-based swap positions. The SEC's definitions of "financial entity" and "highly leveraged" track the definitions of the same terms in the CFTC's final rule.

Finally, like the CFTC, the SEC's major security-based swap participant definition includes a safe harbor for persons who are clearly not major security-based swap participants in order to reduce the regulatory burden and avoid the costs of performing the calculations for the "substantial position" tests.

Within three years following the later of (i) the last compliance date for registration and regulatory requirements for major security-based swap participants and security-based swap dealers or (ii) the first date on which trade-by-trade reporting for security-based swaps is required, the SEC staff must deliver a study on whether changes to these definitions are necessary.

This summary is a high-level overview of the recently adopted rules and will be updated through a supplemental publication once the final texts of the rules are released.