January 10, 2011

CFTC and SEC Propose Further Definitions of "Swap Dealer" and "Major Swap Participant"

On December 21, 2010, the Commodity Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission (the "SEC" and together with the CFTC, the "Commissions") released proposed joint regulations to clarify the definitions of "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant" and "eligible contract participant" as used in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").[1] The proposed regulations contain additional detailed technical definitions of certain key terms used in the definition of "major swap participant," including "substantial position," "major swap categories," "hedging or mitigating commercial risk," "substantial counterparty exposure," "financial entity" and "highly leveraged." The Commissions also specified the conditions for exempting insured depository institutions from the "swap dealer" definition in connection with originating loans to customers, proposed a *de minimis* exception to the "swap dealer" definition and provided that a swap dealer or a major swap participant may apply to limit its designation as such to certain swap categories. Entities that fall within the definition of "swap dealer" or "major swap participant" will be subject to enhanced requirements under the Dodd-Frank Act, including registration, capital, margin, business conduct, reporting, disclosure and conflicts of interest requirements.

<u>Swap Dealer</u>

Section 1a(49) of the Commodity Exchange Act (the "CEA"), which was added by section 721(a)(21) of the Dodd-Frank Act,[2] defines "swap dealer" as any person who:

- holds itself out as a dealer in swaps,
- makes a market in swaps,
- regularly enters into swaps with counterparties as an ordinary course of business for its own account, or
- engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.

[1] For ease of presentation, the terms "swap dealer" and "major swap participant," include references to "security-based swap dealer" and "security-based major swap participant," respectively, unless otherwise specified.

[2] Section 761(a)(5) of the Dodd-Frank Act added a substantively identical provision to section 3(a)(71) of the Securities Exchange Act of 1934 (the "Exchange Act").

Excluded or exempt from the definition is:

- any insured depository institution to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer,
- any person that enters into a swap for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business, and
- any entity that engages in a *de minimis* quantity of swap dealing in connection with transactions with or on behalf of its customers, as determined by the Commissions.

The joint release includes commentary by the Commissions on the interpretation of the prongs in the "swap dealer" definition as well as further clarity on the excluded or exempt activities. The Commissions believe the definitions should not be interpreted in a "constrained or overly technical manner" but rather in a functional manner, encompassing how a person holds itself out to the market, the nature of the conduct engaged in by the person, and how the market perceives the person's activities. Specifically, with respect to the third prong of the definition (…regularly enters into swaps with counterparties as an ordinary course of business for its own account…), the Commissions address the concern that a literal reading of that prong might encompass <u>any</u> swap trading activities, not just market-making activities. The Commissions interpret said third prong in such a way that the persons who are deemed to enter into swaps as part of a "regular business" only are those persons "<u>whose function is to accommodate demand for swaps from other parties and enter into swaps in response to interest expressed by other parties</u>." In line with this interpretation, the SEC states, in respect of security-based swaps, that the existing distinction between "dealers" under the Exchange Act and "traders" would provide an "important tool" in determining whether a person is a security-based swap participant, but stresses the differences between the cash securities markets, for which the dealer-trader distinction developed, and the markets for security-based swaps.

The proposed regulations clarify the scope of the exclusion from the "swap dealer" definition for insured depository institutions that offer swaps[3] in connection with the origination of loans. Essentially, an insured depository institution may claim the exclusion if it (i) is the source of the funds made available to a borrower in connection with a loan and (ii) enters into a swap with the borrower that is directly related to the financial terms of the loan. "Origination" will be deemed to include participations, participating in a syndicate of lenders and refinancings. The terms of the swap, however, must directly relate to the financial terms of the loan such as the duration, rate of interest, currency or principal amount. The CFTC considered, but decided against, extending the exclusion to swaps that are entered into contemporaneously with the loan but relate to other business activities of the borrower (such as commodity swaps), even if they affect the borrower's ability to repay the loan. The term "loan" excludes sham transactions as well as any synthetic loan, including loan credit default swaps and loan total return swaps. The CFTC specifically requested comments on whether the exclusion should be limited to directly related swaps and as to whether it should apply to swaps that are entered not contemporaneously with the extension of the loan but subsequently during the loan's duration.

[3] This exclusion does not apply to the "security-based swap dealer" definition.

With respect to the *de minimis* exception, the Commissions intend to exempt those entities whose amount of dealing activity is sufficiently small to not give rise to systemic risk concerns that are at the heart of the Dodd-Frank Act. The proposed regulations provide that a person who otherwise would qualify as a swap dealer will be exempted from the definition of "swap dealer" if such person, in connection with swap dealing activities during the immediately preceding 12 months, enters into not more than 20 swap trades with not more than 15 non-swap dealer counterparties which swaps have an aggregate gross notional amount of no more than $100 million, or no more than $25 million where the counterparties are "special entities" (i.e., certain government entities, employee benefit plans and endowments).

Major Swap Participant

In contrast to their conceptual interpretation of the "swap dealer" definition, the Commissions opted for a detailed technical approach in implementing the definition of "major swap participant." Section 1a(33) of the CEA, which was added by section 721(a)(16) of the Dodd-Frank Act,[4] defines "major swap participant" as any person who is not a swap dealer and:

- 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 or held by employee benefit plans for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan,
- 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
- 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 in any major swap category as determined by the Commission.

The Commissions propose to implement this definition by further defining the underlined terms above—i.e., "substantial position," "major swap categories," "hedging or mitigating commercial risk," "substantial counterparty exposure," "financial entity" and "highly leveraged."

"Substantial position" is defined in proposed Rule 1.3(sss) of Part 1 – General Regulations – under the CEA [17 C.F.R. § 1.3(sss)] to include swap positions, other than positions excluded from consideration (such as hedging and risk mitigation), that satisfy either or both of two quantitative tests in any of the specified major categories of swaps.[5]

The first test ("Current Uncollateralized Exposure Test") is satisfied if the sum of swap positions with negative value, calculated using industry standard practices, across all transactions with a counterparty, to the extent not offset by the value of collateral posted to

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4 Section 761(a)(5) of the Dodd-Frank Act added a substantively identical provision to section 3(a)(67) of the Exchange Act.

5 With respect to major security-based swap participants, the proposed regulations include a substantively identical provision in proposed Rule 3a67-3 under the Exchange Act [17 C.F.R. § 240. 3a67-3].

such counterparty, equals or exceeds a certain threshold amount. The relevant thresholds proposed by the Commissions are $3 billion for “rate swaps” and $1 billion for other kinds of major swap categories (credit swaps, equity swaps and other commodity swaps). The calculation is based on a daily average of mark-to-market calculations over the immediately preceding fiscal quarter. If a master netting agreement exists, the exposure may be calculated on a net basis taking into consideration offsetting positions with a positive value with the same counterparty.

The second test (“Current Uncollateralized Exposure plus Potential Future Exposure Test”) is satisfied if the sum of the notional amount of all swap positions adjusted by a risk factor on a position-by-position basis plus the amount calculated in the Current Uncollateralized Exposure Test, as discussed above, equals or exceeds a certain threshold amount—$6 billion for “rate swaps” and $2 billion for all other kinds of swaps and security-based swaps. The risk factors are intended to take into account different levels of risk depending on into which swap category the relevant swap falls, as well as the duration of the relevant position. The calculation excludes the notional amounts of options and other prepaid derivatives and is capped at unpaid premiums with respect to credit default swaps and index credit default swaps. In addition, the notional amounts will be reduced to reflect risk mitigation through any master netting agreement. As with the Current Uncollateralized Exposure Test, only netting of transactions with the same counterparty is allowed. The resulting number is further multiplied by a factor of 0.2 if the relevant swaps are subject to daily mark-to-market margining or clearing by a registered clearing agency or derivatives clearing organization.

For purposes of applying these tests, “major swap categories” are defined in proposed Rule 1.3(rrr) [17 C.F.R. § 1.3(rrr)] as “rate swaps,” “credit swaps,” “equity swaps” and “other commodity swaps”. “Major security-based swap categories” are defined in proposed Rule 3a67-3 [17 C.F.R. § 240. 3a67-2] to include “security-based credit derivatives” and “other security-based swaps.”

“Substantial counterparty exposure” is defined in proposed Rule 1.3(uuu) [17 C.F.R. § 1.3(uuu)] identically as “substantial position” except that the thresholds are $5 billion under the Current Uncollateralized Exposure Test and $8 billion under the Current Uncollateralized Exposure plus Potential Future Exposure Test, and that all positions are included in the calculation without limitation to a major swap category.[6]

The calculation of substantial position in the first prong of the “major swap participant” definition excludes positions held for the purpose of “hedging or mitigating commercial risk.” The proposed regulations clarify in proposed Rule 1.3(ttt) [17 C.F.R. § 1.3(ttt)] and proposed Rule 3a67-4 [17 C.F.R. § 240. 3a67-4] that such position must:

- be economically appropriate[7] to the reduction of risks in the conduct and management of a commercial enterprise from potential changes in the value of

6 With respect to major security-based swap participants, the proposed regulations include a substantively identical provision in proposed Rule 3a67-5 [17 C.F.R. § 240. 3a67-5].

7 The concept of “economically appropriate” exists in the context of the definition of “bona fide hedging” in Rule 1.3(z) [17 C.F.R. § 1.3(z)].

certain assets, liabilities or services or associated foreign exchange rate movements that a person now is subject to or reasonably anticipates to be subject to, or

- qualify for the bona fide hedging exemption from position limits under section 4a(c) of the CEA, or
- qualify for hedging treatment under FASB ASC Topic 815 (Derivatives and Hedging, f/k/a Statement No. 133), and
- not be held for the purpose of speculation, investment or trading, and
- not be held to hedge or mitigate the risk of another swap unless that other position is held for purposes of hedging or mitigating commercial risk.

Whether a position hedges or mitigates commercial risk should, according to the commentary provided in the joint release, be determined by the facts and circumstances at the time the swap is entered into in light of the person's overall hedging and risk mitigation strategies, and not be limited to positions that are recognized as hedges for accounting purposes or for purposes of the bona fide hedging exemption from position limits. The exclusion of hedging positions is meant to exclude from the "substantial position" test those positions that pose limited risk to markets because they offset existing risk.

In this context, the Commissions requested comments from the public on several issues, including whether the hedging exclusion should apply on a position-by-position basis or on an aggregate basis, taking into consideration the total value of the underlying risk thus being mitigated. Comments are also solicited on whether the hedging exclusion should apply to a single entity or together with its affiliates on a consolidated basis, and whether, how and to what extent the actual effectiveness of the relevant hedge should be taken into consideration, including whether an entity has a reasonable basis to believe that the position would constitute an effective hedge. The Commissions also requested comments whether it is appropriate to exclude speculative or directional positions as these equally may reduce risk.

For purposes of the third prong of the "major swap participant" definition, the Commissions define "financial entity" in a manner consistent with the definition of such term in the "commercial end-user exception" to the clearing requirement in section 2(h) of the CEA and section 3C of the Exchange Act to include:

- security-based swap dealers (or, for purposes of the Exchange Act, swap dealers),
- major security-based swap participants (or, for purposes of the Exchange Act, major swap participants),
- commodity pools,
- private funds,
- employee benefit plans, and
- persons predominantly engaged in activities that are in the business of banking or financial in nature.

The Commissions propose to define "highly leveraged" in this context as a ratio of total liabilities to equity in excess of either 8 to 1 or 15 to 1. The 15-to-1 ratio is consistent with the leverage ratio required to be maintained by bank holding companies with assets equal to or greater than $50 billion or by non-bank financial companies supervised by the Board of Governors of the Federal Reserve System that are deemed systemically important.[8] The alternative 8-to-1 ratio is mainly based on the fact that the Commissions' research appears to have identified 10-to-1 as the approximate leverage ratio among relevant financial institutions and that the "highly leveraged" test would have to be lower for those institutions. The ratios would be reassessed quarterly on the basis of 10-Q and 10-K filings. The Commissions solicit comments, among other things, as to which ratio and what timing for reassessment would be most appropriate.

The joint release also provides that an entity that satisfies the criteria for being a major swap participant for any fiscal quarter will, unless already registered, not be deemed a major swap participant and will not be obliged to register with the CFTC or the SEC, as applicable, until the earlier of the date such entity submits a complete registration application and two months after the end of such fiscal quarter. The release contains a rule for reevaluating the status as a major swap participant, such that if an unregistered entity exceeded any of the relevant daily average thresholds in any fiscal quarter by no more than 20 percent, such entity would be deemed subject to the requirements only if the entity continued to exceed any of the thresholds in the next following fiscal quarter. A registered major swap participant would retain its status as such until it no longer satisfies any of the tests for four consecutive fiscal quarters.

Conclusion

The Commissions' interpretation of the "swap dealer" definition is likely to address market participants' concern about the potentially broad scope of a literal reading of the statutory definition. The interpretation clarifies that the central element in determining whether a person is a swap dealer is the functional role of a market maker, as evidenced by how the person holds itself out to the market, how the person's activities are perceived in the market or the nature of the person's activities, and thereby avails itself of existing interpretations and law. Conversely, the absolute quantitative approach to the *de minimis* exemption and the narrow scope of the loan origination exclusion, as well as the Commissions' approach to further define "major swap participant" in a very technical manner quite likely will generate a multitude of comments and questions from market participants. It is worth noting that a number of the technical definitions of key terms used in the "major swap participant" definition will have an impact beyond this joint regulation as they are being used elsewhere throughout the Dodd-Frank Act (an example being the "hedging or mitigation of commercial risk" for purposes of qualifying for the commercial end-user clearing exemption in section 723(a)(7) of the Dodd-Frank Act).

The Commissions themselves requested comments on a host of issues regarding, among other things, thresholds, multipliers, implementation and methodology. Comments must be submitted to the Commissions by February 22, 2011.

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[8] See section 165(j)(1) of the Dodd-Frank Act.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. For questions or further information concerning the issues addressed in this memorandum, please contact Manuel S. Frey ((212) 373-3127), David S. Huntington ((212) 373-3124) or Ian J. Pohl ((212) 373-3638).

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