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Swap Dealer, Major Swap Participant and Eligible Contract Participant: SEC and CFTC Adopt Entity Definition Rules

The Commodity Futures Trading Commission ("CFTC") and the Securities Exchange Commission ("SEC") (collectively, the "Commissions") have adopted joint final rules (the "Rules") further defining the key Dodd-Frank entity definitions, "swap dealer" ("Dealer"), "security-based swap dealer" ("SBSD"), "major swap participant" ("MSP"), "major security-based swap participant" ("MSBSP") and "eligible contract participant" ("ECP")[1]

The Rules represent a fundamental piece of the emerging regulatory framework for derivatives under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**" or the "**Act**"). Under the Dodd-Frank Act and implementing regulations, Dealers and MSPs will be required to register with the CFTC or SEC, as applicable, and will be subject to comprehensive regulation, including as to capital, margin, reporting and business conduct requirements.

Although the Rules will for the most part be effective on July 23, 2012, registration of Dealers and MSPs will not be required until certain additional rulemakings have been finalized and become effective. CFTC registration for Dealers and MSPs is not expected to be required until 60 days after the effectiveness of the final rules further defining the terms "swap" and "security-based swap" (the "**Product Definitions**").[2] SEC registration for MSBSPs and SBSDs is not expected to be required until the effectiveness of the Product Definitions and the adoption of SEC regulations governing the registration process.[3]

[1] Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 Fed. Reg. 30596 (May 23, 2012) (to be codified at 17 C.F.R. pts. 1 and 240).

[2] Registration of Swap Dealers and Major Swap Participants, 77 Fed. Reg. 2613 at 2616 (Jan. 19, 2012) (to be codified at 17 C.F.R. pts. 1, 3, 23 and 170).

[3] Id.

I. Summary

The final Rules address to varying degrees certain significant concerns expressed by market participants about the proposed rules.[4] Specifically, the Rules:

- Establish a significant de minimis exception from Dealer registration, initially with an $8 billion notional limit in any 12 month period
- Exclude transactions between majority-owned affiliates in determining Dealer or MSP status
- Establish a limited safe harbor from Dealer registration for physical commodity hedging activities
- Establish safe harbors from MSP registration for entities with limited trading activities
- Clarify that foreign governments and foreign central banks would not normally be subject to Dealer or MSP registration (although sovereign wealth funds and other government-owned entities may be subject to registration)
- Provide a procedure for obtaining a "limited designation" as a Dealer or MSP for only certain categories of Swaps or certain business units (although the default rule is that Dealer or MSP status applies to all of an entity's Swap activities).

The Rules and the accompanying adopting release (the "**Release**") also leave several key questions unanswered, including the application of the Dealer and MSP registration requirements to non-US entities. Both the CFTC and SEC have indicated that they intend to provide further guidance in this area (both as to registration and as to the application of the regulatory requirements for Dealers and MSPs located outside of the United States and/or acting on a cross-border basis.[5] Additional interpretive questions are likely to arise as institutions try to apply the de minimis exemptions in the context of groups with operations in multiple jurisdictions and seek limited designation of Dealer or MSP status for only a part of an entity's business.

With respect to the Dealer definition, this publication provides an overview of (i) the general analysis for identifying dealing activity involving Swaps; (ii) the exclusion of Swaps in connection with the origination of loans by insured depository institutions from the Dealer definition analysis; (iii) the treatment of inter-affiliate Swaps; (iv) the application of the de minimis exception from the Dealer definition; and (v) the potential for limited designation of Dealers and SBSDs. With respect to the MSP definition, this publication will provide an overview of (i) the "major" categories of Swaps; (ii) the meaning of "substantial position"; (iii) the meaning of "hedging or mitigating commercial risk"; (iv) the meaning of "substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets"; and (v) the meanings of "financial entity" and "highly leveraged."

[4] Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 Fed Reg 80173 (Dec. 21, 2010) (to be codified at 14 C.F.R. pts. 1 and 240).

[5] Gary Gensler, Chairman, Keynote Address on the Cross-Border Application of Dodd-Frank Swaps Market Reforms before the 2012 FINRA Annual Conference (May 21, 2012).

II. "Swap Dealer" and "Security Based Swap Dealer"

A. Overview

The Rules largely restate the text of the Dodd-Frank Act in defining Dealers based on the functional role they fulfill in the Swaps market.[6] Dealers are persons who:

(i) hold themselves out as a dealer in Swaps,

(ii) make a market in Swaps,

(iii) regularly enter into Swaps with counterparties as an ordinary course of business for their own account, or

(iv) engage in activity causing them to be commonly known in the trade as a dealer or market maker in Swaps.

However, a person that enters into Swaps for its own account, either individually or in a fiduciary capacity, but not as a part of regular business, is not a Dealer.

If a person is engaged in one of these types of Swap dealing activities as part of its regular business, other than activities excluded by the Rules, then the person will likely be required to register as a Dealer unless it can qualify for the de minimis exemption. The Rules provide limited guidance as to how the definition should be applied to market participants and their Swap activities in certain circumstances.

Reliance on "Dealer-Trader" Distinction

Both Commissions expressly state that the so-called "dealer-trader" distinction, which has long been used in the context of securities dealer registration requirements, provides a basis for interpreting the term Dealer because of the parallels between the definitions of Dealer and securities dealer.[7] Under this analysis, evidence of dealing activity includes (i) providing liquidity by accommodating demand for or facilitating interest in the instrument (Swaps, in this case), 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; (ii) advising a counterparty as to how to use Swaps to meet the counterparty's hedging goals, or structuring Swaps on behalf of a counterparty; (iii) having a regular clientele and actively advertising or soliciting clients in connection with Swaps; (iv) acting in a market maker capacity on an organized exchange or trading system for Swaps; and (v) helping to set the prices offered in the market (such as by acting as a market maker) rather than taking those prices, although the fact that a person regularly takes the market price for its Swaps does not foreclose the possibility that the person may be a Dealer. The SEC has also included use of inter-dealer brokers as evidence of dealing activity by SBSDs.

[6] In the commentary to the Rule, the Commissions urge the public to not interpret the Dealer definition in a constrained or overly technical manner. This is because rigid standards will not provide the necessary flexibility to respond to evolution in the ways that Dealers enter into Swaps. The Commissions intends to apply the definitions of Dealer and SBSD flexibly and generally intend to follow a "facts-and-circumstances" approach with respect to identifying dealing activities.

[7] By contrast, in the proposed rules, the CFTC had suggested it would not rely on the dealer-trader distinction. See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 Fed Reg 80173 at 80177 (Dec. 21, 2010, to be codified at 14 C.F.R. pts 1 and 240).

Other non-exclusive factors that are relevant for distinguishing between Dealers and non-dealers can include the receipt of customer property and the furnishing of incidental advice in connection with transactions. However, no single factor is considered definitive and the determination ultimately depends on the relevant facts and circumstances.

The Commissions make several distinctions between the application of the dealer-trader distinction in the Swap and securities markets, however, on the theory that in contrast with securities markets, the Swap market is characterized by lower levels of activity, the absence of a separate issuer and trading that is predominantly over-the-counter and involves mutuality of obligations between counterparties. The ongoing nature of the relationship between counterparties to a Swap differs from a securities market transaction which is expected to terminate upon completion of the sale or delivery. Unlike for a dealer in the securities market, the Commissions take the position that buying and selling (i.e., creating a two way market) is not a necessary characteristic of a Dealer in the Swap market, where one-way dealing activity is possible. It is not entirely clear from the Rules or the release what activities may constitute such "one-way" dealing.

Market Making

The Commissions also provided additional guidance on what constitutes market making in Swaps. Market makers routinely engage in (i) quoting bid or offer prices, rates or other financial terms for Swaps on an exchange; (ii) 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; (iii) placing limit orders for Swaps; or (iv) receiving compensation for acting in a market maker capacity on an organized exchange or trading system for Swaps. As noted above, the Commissions take the position that market-making can occur on one side of the market only.

Regular Business

Persons who do not enter into Swaps for their own account as a part of a regular business are not Dealers. As discussed in the Release, entering into Swaps as a part of a "regular business" includes (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 negotiation, confirmation generation, requests for novations and amendments, exposure monitoring and collateral calls, covenant monitoring, and reconciliation. There is no requirement, however, that dealing activity be the predominant or primary business of the person for such person to be a Dealer or SBSD.

Additionally, the Commissions highlighted the following additional points for the Dealer analysis:

- a willingness to enter into Swaps on either side of the market is not a prerequisite to Dealer status;
- the Dealer analysis does not turn on whether a person's Swap dealing activity constitutes that person's sole or predominant business;
- a customer relationship is not a prerequisite to Dealer status; and
- in general, entering into a Swap for the purpose of hedging (whether or not that trading falls within the safe harbor discussed below), absent other activity, is unlikely to be indicative of dealing.

B. Exclusions

The Rules also provide additional exclusions from the Dealer definition, several of which reflect concerns raised by market participants with the proposed rules.

(i) Insured Depository Institution Exclusion

Consistent with the statutory definition, the CFTC Rules provide that Swaps entered into by an insured depository institution with a customer in connection with originating a loan to that customer are not to be considered for purposes of determining a person's status as a Dealer. This exception does not apply to the SBSD definition adopted by the SEC. This exemption is by its terms limited to insured depository institutions (i.e., FDIC insured US banks) and would not apply to other types of institutions, including most US branches of non-US banks, that commonly make loans and enter into Swaps in connection with them.

In order to qualify for this exclusion, the Swap must be entered into in connection with originating a loan and to satisfy this requirement, the following criteria must be met:

- **(a) The Swap must be entered into no more than 90 days before or 180 days after the date of the execution of the loan agreement or any draw of principal under the loan.**
- **(b) The Swap needs to mitigate the risks to the borrower that arise from the loan itself, such as interest rate risk and F/X risk. Generally, other Swaps that are unrelated to the financial terms of the loan will not qualify for this exclusion, even if they are required by the terms of the loan. The Rule makes an exception for commodity hedges that offset the borrower's commercial risk, but only if the Lender's underwriting criteria require the hedge as a condition of the loan.**
- **(c) The duration of the Swap cannot be longer than the duration of the loan.**
- **(d) The insured depository institution lender (the "Lender") must be either (1) the sole source of the loan, (2) committed to fund 10% of the loan under a loan agreement or (3) committed to fund a loan where its portion of the loan is at least equal to the notional amount of all Swaps entered into with the borrower "in connection with the financial terms of the loan."[8] (If the Lender is relying on this final test, then the determination of the notional amount becomes important. If the same Lender provides Swaps to hedge interest rates and F/X exposure, and instead of entering into a single cross-currency interest rate Swap, enters into two separate confirmations to hedge the separate risks, then it is unclear if the notional amount will in effect be double counted and thus fall outside of the exclusion.**
- **(e) The notional amount of a Swap linked to the financial terms of the loan must not exceed the principal amount outstanding under the loan.[9] (As noted above, questions may arise as to the calculation of the notional amount where multiple Swaps of different types (and hedging different risks) may be entered into with the customer. Also, it does not appear that this requirement applies to a permitted commodity price hedge to offset the borrower's commercial risk, as such a Swap would not relate to a "financial term of the loan," although there is some ambiguity about the point in the Release.**

[8] The use of the phrase "in connection with the financial terms of the loan" appears to have the effect of carving out Swaps used to hedge commodity price risk.

[9] A Lender that is part of a syndicate, where the lender is providing more than 10% of the loan, may provide a Swap whose notional amount is larger than its individual commitment under the loan.

(f) Where a Swap is not cleared by a derivatives clearing organization, the Swap must be reported to a Swap Data Repository.[10]

An insured depository institution is deemed to have originated a loan with a customer if it (i) directly transfers the loan amount to the customer, (ii) is a part of a syndicate of lenders that is the source of the loan amount, (iii) purchases or receives a participation in the loan, or (iv) is otherwise the source of funds. The exclusion does not apply where the loan is synthetic, such as a loan credit default Swap or loan total return Swap, or is a "sham."

(ii) Swaps Between Affiliates

It is not uncommon for multiple affiliated entities to engage into Swap transactions with both third parties and each other. The Commissions have recognized this and stated that an affiliated group of legal persons under common control could include more than one Dealer, since within such group, any legal person that engages in a sufficient volume of Swap dealing activities would be a Dealer. Therefore entities engaging in a significant volume of Swap activity, even where an affiliate is a Dealer, will want to carefully consider whether they also meet the definition of a Dealer, taking into consideration the economic reality of any Swaps they enter into with affiliates, including whether those Swaps simply represent an allocation of risk within a corporate group. However, the determination of whether a person is a Dealer generally excludes from consideration Swaps between majority-owned affiliates, on the theory that Swaps between persons under common control may not involve the interaction with unaffiliated persons that is fundamental to holding oneself out as a Dealer or being commonly known as a Dealer.[11] The Commissions also noted that if an entity uses transactions between persons under common control to avoid one of the Dealer definitions, the Commissions have the authority to prohibit such practices.

(iii) Hedging Physical Positions

As noted above, the Commissions indicated that hedging activity, on its own, would not normally be expected to constitute dealing activity under the basic Dealer analysis, although it would depend on the particular facts and circumstances. The Commissions stated that they did not think it was appropriate to create a categorical exclusion from the Dealer definition for engaging in hedging activity.

The CFTC did, however, adopt an interim final Rule that provides a safe harbor from the Dealer definition for Swaps entered into for the purpose of hedging a physical commodity position. The Rule draws upon the principles of bona fide hedging under the CFTC's position limit rule, CFTC Regulation 151.5, that the CFTC applies to identify when a financial instrument is used for hedging purposes.[12] In order to qualify for the exclusion, the Swap must hedge price risks from either (1) assets the person does or anticipates owning, producing, manufacturing, processing or merchandising, (2) liabilities that the person owns or anticipates incurring, or (3) services that the person provides, purchases or anticipates providing or purchasing. The Swap must represent a substitute for transactions made or positions taken in a physical market. The Swap is also required to be entered into in accordance with sound commercial practices and must be economically appropriate to the reduction of the hedger's risks in the conduct and management of a commercial enterprise. The CFTC requested comment on the scope of the

[10] Swap Data Recordkeeping and Reporting Requirements, 77 Fed. Reg. 2136 (Jan. 13, 2012) (to be codified at 17 C.F.R. pt. 45).

[11] Also excluded are Swaps between a cooperative and its members.

[12] The definition of bona fide hedging in CFTC Regulation § 1.3(z), which applies for excluded commodities, is not relevant here, because it does not contain the requirement that the Swap represents a substitute for a transaction made or to be made or a position taken or to be taken in a physical marketing channel, as required by CFTC Regulation § 1.3(ggg)(6)(iii)(B).

safe harbor. This hedging definition is a particularly narrow concept that may exclude may commercial and financially hedging activities.

(iv) De Minimis Exception

Dodd-Frank provides an exemption for a person who "engages in a de minimis quantity of Swap dealing in connection with transactions with or on behalf of its customers." In an unexpected move, the Commissions significantly increased the de minimis threshold for Swap dealing activity in any twelve month period from $100 million in the proposing release to $3 billion, with a threshold phase-in period that sets the initial threshold at $8 billion.[13]

Consequently, if an entity's Swap dealing activity over the past year[14] results in Swap positions with an aggregate gross notional amount[15] of less than $8 billion,[16] then it will not be required to register as a Dealer. Swaps that do not constitute dealing activity (including those, such as inter-affiliate Swaps, that are specifically excluded under the Rules when analyzing if a person is a Dealer) are not taken into consideration for purposes of this calculation.

Significantly, though, the notional thresholds to the de minimis exception encompass Swap dealing positions entered into by an affiliate controlling, controlled by or under common control with the person at issue. This will likely complicate the de minimis test analysis for large corporate groups that engage in Swap dealing activities through multiple entities. It is also unclear how this test will ultimately be applied to affiliates engaged in potential dealing activity outside the United States. Nonetheless, it is expected that the de minimis threshold will exempt numerous smaller market participants from having to register as a Dealer, and may delay registration for those entities that will ultimately have to register.

For Security-Based Swaps, the de minimis threshold mirrors the Swap threshold. For Security-Based Swap that are credit default swaps, there will an $8 billion gross notional threshold to be reduced to $3 billion following a phase in period in SBS. For all other SBS, the de minimis threshold is $400 million aggregate gross notional amount, to be reduced to $150 million following the phase in period.

The de minimis threshold for Swaps and Security-Based Swaps in which the counterparty is a special entity is $25 million aggregate gross notional amount per year.[17]

The final Rules specify that nine months after its staff report is published, the CFTC may order that the phase-in period ends as of the date set out by the CFTC in such an order, or else issue a notice of proposal to modify the de minimis threshold, in

[13] This threshold will automatically fall to $3 billion after 5 years if no further action is taken. During the CFTC's hearing, the commissioners commented that it is anticipated that this threshold will be fine-tuned following completion of a study that will be undertaken two and half years after Swap data repositories begin receiving information.

[14] According to the CFTC's adopting release, over the first year following the effective date of the Product Definition, the analysis of whether a person may take advantage of the de minimis exception will not encompass the Swaps entered into prior to that effective date, given the need for the person to know whether an instrument is a Swap or Security-Based Swap for purposes of the analysis. Therefore for the first year following the effective date of the Product Definitions rule, the period of time under consideration will be from the effective date to the present.

[15] If the stated notional amount is leveraged or enhanced by the structure of the Swap, the calculation is based on the effective notional amount rather than the stated notional amount.

[16] The Commissions have maintained the separate and lower threshold applicable for transactions with "special entities" (e.g., federal agency or other government entity, municipalities, ERISA plans, endowments). The de minimis threshold applicable for transaction with special entities is $25 million.

[17] Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 Fed. Reg. 30596 (May 23, 2012) (to be codified at 17 C.F.R. pts. 1 and 240).

which case the CFTC would establish a new end date for the phase-in period.[18] The final Rules provide that the phase-in period will end no later than five years after the date that a swap data repository initially receives Swap data under the CFTC's regulations.[19] The staff report will be prepared by the CFTC and will analyze data available to the CFTC via swap data repositories. The report will also recommend if other changes are warranted to the Rules implementing the Dealer definition.

Commenters suggested that entities that exceed the de minimis thresholds should have a grace period for registration as Dealers or SBSDs.[20] Without such grace period, entities which engage in dealing activities that surpass the de minimis threshold would be immediately in violation of Dealer registration requirements. In general, the final Rules have been revised in order to give the entity two months after the end of the month it exceeds the de minimis threshold to apply for registration as a Dealer or an SBSD. In order for a registered dealer to again rely on the de minimis exemption a person must be registered as a Dealer for one year.

C. Registration

Registration rules for Dealers and MSPs have been adopted[21] and Dealers and MSPs may provisionally register under those rules. Registration for persons deemed to be Dealers, absent an exemption, will be required by the effective date of the Product Definitions, which is expected to be in September 2012.[22] The registration requirements for SBSDs and MSBSPs will be proposed in a separate rulemaking. Because the SEC has not yet adopted final rules regarding SBSD and MSBSP registration, no registration will be required until after such adoption. Institutions that expect to become Dealers, notwithstanding the de minimis threshold, may want to begin preparing applications and establishing compliance programs well in advance of the application due date in order to be in a position to file by the applicable deadline.

D. Limited Dealer Designation

As a general rule, if a person is required to register as a Dealer or SBSD, then all of its Swap or Security-Based Swap activity, as the case may be, will be subject to the dealer regulatory requirements.

The Commissions noted in this regard that the term "person" should be interpreted such that the designation applies with respect to a particular legal person (i.e., a discrete business unit that is not a separately organized legal person will not be a Dealer, but the legal person of which it is a part of would be the Dealer). This means that all of the Swap activity of the organization will be subject to the Rules governing Dealers and MSPs.

However, it will be possible to apply to the CFTC or SEC to limit its Dealer or SBSD designation to a specific type, class, or category of Swap or SBS. A person can apply for this limited designation when applying for registration or any time thereafter.

[18] Id. at 151.

[19] Id.

[20] Id. at 183.

[21] Registration of Swap Dealers and Major Swap Participants, 77 Fed. Reg. 2613 at 2616 (Jan. 19, 2012) (to be codified at 17 C.F.R. pts. 1, 3, 23 and 170).

[22] Id.

The Commissions stated that they will consider any application for this limited designation on an individual basis through an analysis of the unique circumstances of each applicant. Persons seeking such a designation would need to initiate a conversation with the Commissions, as appropriate, to discuss matters such as derivatives activities being conducted, future plans, and to demonstrate compliance with Title VII standards applicable to Dealers as such in the context of the limited designation.

III. "Major Swap Participant" and "Major Security-Based Swap Participant"

A. Overview

The Commissions noted that as a policy matter, the MSP definition is intended to focus on the market impact and systemic risks associated with a person's Swap positions and so looks principally at the size of a person's positions. In this respect, the MSP definition differs from the definition of Dealer, which focuses on the entity's activities and accounts for the size of those activities only in the context of the de minimis exception. According to the Release, the Commissions expect that only a relatively small number of entities will be required to register as MSPs.

An MSP is defined as any person that is not a Dealer[23] and meets *any* of the criteria set forth in the three-part test below:

(i) it 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 for hedging or mitigating risks in the operation of the plan (the "**Substantial Position Test**"),

(ii) its 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 (the "**Substantial Exposure Test**"), or

(iii) it 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 any of the major Swap categories (the "**Financial Entity Test**").

B. Substantial Position Test and Financial Entity Test: Definition of "Substantial Position"

The Commissions adopted two tests to calculate "substantial position," one looking at only uncollateralized exposure and the other looking at both uncollateralized exposure <u>and</u> potential future exposure. The tests would apply to Swap positions in each of the four major Swap categories (rates, credit, equity, and other commodity Swaps) or, with respect to Security-Based Swaps, in each of the two major Security-Based Swap categories (Security-Based Swaps that are credit derivatives and other Security-Based Swaps – mainly equity Swaps). A position that satisfies *either* test below would constitute a "substantial position."

[23] If the Dealer had been granted a limited Dealer designation, then the Dealer may be an MSP for Swaps outside of the scope of the limited Dealer designation.

(i) Test 1 – Aggregate Uncollateralized Outward Exposure

This test is designed to measure the amount of potential risk that an entity would pose to its counterparties if the entity were to default. A person must first determine the mark to market[24] value of its out-of-the-money positions with each counterparty within each major Swap category and then deduct the aggregate value of collateral posted with respect to such Swap or Security-Based Swap positions. Finally, aggregating the net amounts for all such counterparties within each major Swap category will result in the aggregate uncollateralized outward exposure.

Current exposure is calculated on a net basis taking into account offsetting positions entered into with that particular counterparty involving Swaps (in any Swap category) and securities financing transactions (i.e., securities lending and repos) to the extent consistent with the offsets permitted under one or more master netting arrangements.

To constitute a "substantial position," the daily average current uncollateralized exposure would need to equal or exceed a threshold[25] of $1 billion in any Swap and Security-Based Swap category (except the rate Swap category, which has a threshold of $3 billion).

(ii) Test 2 – Aggregate Uncollateralized Outward Exposure plus Aggregate Potential Outward Exposure

The second test accounts for both current uncollateralized exposure (described in Test 1 above) and the potential future exposure associated with a party's Swap positions. The potential future exposure test is intended to measure the risk of loss from a change in the current exposure under the contract. Aggregate potential future exposure for Swaps within a given major Swap category would be calculated by:

- multiplying the total notional principal amount[26] of the Swap positions by risk factor percentages (ranging from 0-15% for Swaps, and from 6-10% for Security-Based Swaps) based on the type of Swap and the duration;
- discounting the amount of positions subject to a master netting agreement by a factor ranging between 0 and 60%, depending on the terms of the master netting agreement; and
- further discounting the amount of positions that are cleared or subject to daily mark-to-market margining[27] by 90% and 80%, respectively.

To constitute a "substantial position" under the second test, the daily average current uncollateralized exposure plus potential future exposure in the applicable Swap or Security-Based Swap category would need to exceed the threshold of $2 billion (except the rate Swap category, which has a threshold of $6 billion). The calculation in Test 2 excludes purchased options and other positions for which the person has prepaid or otherwise satisfied all payment obligations.

[24] Calculation of collateral value is to be done in accordance with industry standard practices. The Release expresses the Commissions' expectation that collateral calculations be performed in accordance with the same methodologies that they use in connection with their business activities and any applicable rules and regulations.

[25] The threshold would be the mean of a person'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.

[26] For positions in which the stated notional amount is leveraged or enhanced by the particular structure, this calculation would be based on the position's effective notional amount.

C. Substantial Position Test: "Hedging or Mitigating Commercial Risk" Exclusion

The Substantial Position Test excludes positions held for "hedging or mitigating commercial risk." According to the Commissions, whether a person's hedging activity falls within this exception should be determined by a facts-and-circumstances analysis at the time the Swap is entered into, taking into account a person's overall hedging and risk mitigation strategies. Consistent with the statutory language, qualifying hedge positions include those that are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where the risks in the ordinary course of business arise from a potential change in the value of the (i) assets a person owns, produces, manufactures, processes or merchandises, (ii) liabilities a person incurs, (iii) services a person provides or purchases. This exclusion extends to "financial" or "balance sheet risk" and also permits hedging the risks of a majority-owned affiliate. This definition is considerably broader than under the physical commodity hedging safe harbor from the Dealer definition.

The CFTC noted that, in addition to the Swap positions mentioned above, Swap positions deemed to be held for the purpose of hedging or mitigating commercial risk would also include the following: (i) a bona fide hedge for purposes of an exemption from position limits under the Commodity Exchange Act;[28] (ii) a hedge under Financial Accounting Standards Board Accounting Standards Codification Topic 815, Derivatives and Hedging or Government Accounting Standards Board Statement 53, Accounting and Financial Reporting for Derivative Instruments; or (iii) a position that is economically appropriate to the reduction of risks arising from a potential change in value related to foreign exchange rate movements or fluctuation in interest, currency or foreign exchange rate exposures, arising from a person's assets or liabilities. These definitions, while largely overlapping, provide greater clarity for entities potentially subject to different regulatory schemes along with providing a broad independent definition.

With respect to Security-Based Swaps, the SEC noted that the concept of "economically appropriate" is based on whether a reasonably prudent person would consider the Security-Based Swap to be appropriate for managing the identified commercial risk. To be deemed "economically appropriate," an Security-Based Swap should not introduce any new material quantum of risks (i.e., it cannot reflect over-hedging that could reasonably have a speculative effect) and should not introduce any basis risk or other new types of risk (other than the counterparty risk that is attendant to all Security-Based Swaps) more than reasonably necessary to manage the identified risk. Examples of positions that may satisfy the economically appropriate standard include positions established to manage customer, supplier or counterparty default risk or to manage equity market price risk associated with employee compensation plans or business combinations. This standard is also satisfied when banks enter into positions to hedge counterparty risk in connection with loans they have made.

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[27] If the person is permitted by agreement to maintain a threshold for which it is not required to post collateral, the total amount of that threshold (regardless of the actual exposure at any time) will be added to the person's aggregate uncollateralized outward exposure. Similarly, if the minimum transfer amount under the agreement is in excess of $1 million, the entirety of the minimum transfer amount shall be added to the person's aggregate uncollateralized outward exposure.

[28] See Bona Fide Hedging and Other Exemptions for Referenced Contracts at 17 C.F.R. § 151.5 (2012).

To qualify as a hedge, a position must not be held for the purpose of speculation, investing or trading or to hedge or mitigate the risk of another Swap position, unless that other position itself is held for the purpose of hedging or mitigating commercial risk. In commentary, the CFTC offered the following examples:

- positions held primarily to take an outright view on the direction of the market, including positions held for short term resale, or to obtain arbitrage profits are held for the purpose of speculation or trading;
- positions that hedge other positions that themselves are held for the purpose of speculation or trading are also speculative or trading positions;[29]
- positions held primarily to obtain an appreciation in value of the Swap position itself, without being used to hedge an underlying risk, are held for the purpose of investing; and
- positions related to a non-Swap investment (such as the purchase of an asset used to produce income or otherwise advance commercial interests) may be a hedging position if it otherwise qualifies for the definition of hedging or mitigating commercial risk.

In a departure from the proposed rule, the SEC is not requiring that a person holding an Security-Based Swaps position also identify and document the risks being reduced by the Security-Based Swap position, establish and document a method of assessing the effectiveness of the Security-Based Swap as a hedge, and regularly assess the effectiveness of the Security-Based Swap as a hedge. However, the presence of supporting documentation will help support a person's assertion that a Security-Based Swap position should be excluded. And while there is no requirement to monitor the effectiveness of a hedge, failure to do so may undermine an argument that the position was economically appropriate for the commercial risks facing the entity.

The exclusion of positions held for the hedging or mitigating of commercial risk under the Substantial Position Test is generally available to financial as well as non-financial entities. However, because of the Financial Entity test, as discussed below, financial entities that are highly leveraged and not subject to capital requirements established by a Federal banking agency may effectively be precluded from relying on this exclusion.

D. Substantial Exposure Test: Meaning of "Substantial Counterparty Exposure"

The Substantial Exposure Test uses the same calculation method as for the "substantial position" in the Substantial Position Test, but on an aggregate basis for all Swaps and without excluding hedging or employee plan positions. For Swaps, the threshold is current uncollateralized exposure of $5 billion or a sum of current uncollateralized exposure and potential future exposure of $8 billion, across all Swap positions. With respect to Security-Based Swaps, the threshold is current uncollateralized exposure of $2 billion or a sum of current uncollateralized exposure and potential future exposure of $4 billion, across all Security-Based Swap positions.

E. Financial Entity Test: Meaning of "Financial Entity" and "Highly Leveraged"

The "substantial position" calculation in the Financial Entity Test uses the same method used to calculate "substantial position" in the Substantial Position Test but does <u>not</u> exclude hedging or employee plan positions.

[29] Note that the impact of this may operate as a disincentive to hedge speculative positions.

"**Financial entity**" means a: (i) Dealer (or SBSD); (ii) MSP (or MSBSP); (iii) commodity pool as defined in the Commodity Exchange Act; (iv) private fund as defined in the Investment Advisers Act of 1940; (v) employee benefit plan as defined in the Employee Retirement Income Security Act of 1974; and (vi) person predominantly engaged in activities that are in the business of banking or financial in nature, as defined in the Bank Holding Company Act of 1956. Otherwise non-financial companies that engage in hedging on behalf of majority-owned affiliates are excluded from the definition of financial entity.

"**Highly leveraged**" generally means a ratio of liabilities to equity in excess of 12 to 1, as measured at the close of business on the last business day of the applicable fiscal quarter. Entities that file quarterly reports on Form 10-Q and annual reports on Form 10-K with the SEC would determine their total liabilities and equity based on the financial statements included with such filings. All other entities would calculate the value of total liabilities and equity consistent with the proper application of GAAP.

The Financial Entity Test thus may capture highly leveraged funds and similar entities that hold a substantial position. It may also capture affiliates of financial institutions that are highly leveraged but are not themselves subject to capital requirements.

F. Safe Harbor

Notably, the Rules provide a safe harbor whereby a person will be deemed not to be an MSP if any of the following are satisfied:

(a) the express terms of the person's Swap agreements do not permit the person to maintain a total uncollateralized exposure of more than $100 million to all counterparties and the person does not maintain notional positions of more than $2 billion in any major category of Swaps or more than $4 billion in the aggregate;

(b) the express terms of the person's Swap agreements do not permit the person to maintain a total uncollateralized exposure of more than $200 million to all counterparties and the person performs the MSP calculations at the end of every month and the result of those calculations indicates that current exposures plus potential future exposure is less than 50% of the level that would cause the person to be a major participant; or

(c) the person's current uncollateralized exposure for any major Swap category is less than $500 million ($1.5 billion for the rate Swap category) and the person performs the MSP calculations at the end of every month and the result of those calculations indicates that the person's position for each major Swap category is less than 50% of the substantial position threshold.

The safe harbors appear to be intended to permit parties with limited Swap activity to avoid having to engage in the more detailed calculations required to determine if they may have a substantial position at any time. The Rule further provides that even if a person does not meet the conditions required to take advantage of the safe harbor, that fact by itself will not lead to a presumption that a person is required to perform the calculations required to determine if it is an MSP.

G. Registration

Registration procedures for MSPs have been adopted by the CFTC, but registration will not be required until the Product Definitions have become effective.[30] Registration procedures for MSBSPs were proposed by the SEC but have not yet been adopted, and therefore registration will not be required at least until those rules are adopted.

(i) Timing of registration requirement

In general, an unregistered entity that meets the MSP criteria as a result of its Swap activities at any time in a fiscal quarter will have until two months after the end of that quarter to register as an MSP.

However, if an unregistered entity meets the MSP criteria in a fiscal quarter, but does not exceed any applicable threshold by more than twenty percent in that quarter, then the entity will not be deemed to be an MSP unless, at the end of the next fiscal quarter, the entity has exceeded any of the applicable substantial position thresholds in that fiscal quarter.

(ii) Termination of status

Once a person is deemed to be an MSP, such status will continue until the MSP does not exceed any of the applicable substantial position thresholds for four consecutive fiscal quarters.

H. Limited Major Swap Participant Designation

A person that is an MSP will be deemed to be an MSP with respect to each Swap it enters into, regardless of the category of the Swap or the person's activities in connection with the Swap. As a general rule, if a person is required to register as an MSP or MSBSP, then all of its Swap or Security-Based Swap activity, as the case may be, will be subject to the MSP regulatory requirements. The Commissions noted that the term "person" should be interpreted such that the designation applies with respect to a particular legal person (i.e., a discrete business unit that is not a separately organized legal person will not be an MSP, but the legal person of whom it is a part of would be the MSP). However, it will be possible to apply to the CFTC or SEC to limit its MSP or MSBSP designation to a specific type, class, or category of Swap. A person can apply for this limited designation when applying for registration or any time thereafter.

The Commissions stated that they will consider any application on an individual basis through an analysis of the unique circumstances of each applicant. Persons seeking such a designation would need to initiate a conversation with the Commissions, as appropriate, to discuss matters such as derivatives activities being conducted, future plans, and to demonstrate compliance with Title VII standards applicable to MSP in the context of the limited MSP designation.

I. Application to Certain Entities

In commentary, the Commissions clarified how the Rules should be interpreted with respect to certain entities and trading accounts. With respect to managed accounts, the Commissions stated that asset managers or investment advisers do not have to include managed accounts when determining if the asset manager or investment adviser itself is a major participant.

[30] Registration of Swap Dealers and Major Swap Participants, 77 Fed. Reg. 2613 at 2616 (Jan. 19, 2012) (to be codified at 17 C.F.R. pts. 1, 3, 23 and 170).

If a Swap counterparty has recourse to the beneficial owner of a managed account, then that Swap should be attributed to the beneficial owner for purposes of the determination of the beneficial owner's MSP status, but if no such recourse is available to the counterparty, then there should be no such attribution.

As with the Dealer definition, the MSP definitions do not count a person's Swaps for which the counterparty is a majority-owned affiliate. However, a Swap entered by a subsidiary may be attributed to the subsidiary's majority owned parent, affiliate or guarantor for purposes of its MSP determination if (i) the counterparties to those Swaps have recourse to that other entity (including by way of a guaranty) and (ii) the subsidiary is not already subject to capital regulation by the CFTC, SEC or a US bank regulator. Where a person is an MSP as a result of subsidiary or affiliate transactions, the MSP can delegate operational compliance with transaction-focused requirements to the subsidiary or affiliates.

The Commissions rejected comments requesting categorical exclusions from the major participant definitions for specific entity types such as investment companies, ERISA plans, registered broker-dealers and/or registered futures commission merchants, and long-term investors such as sovereign wealth funds.

Dodd-Frank specifically excludes captive finance companies from the definition of MSPs, but not MSBSPs. The provision of financing must be the primary business, which requires that the captive finance company finance the purchase of products sold by the parent company, including service, labor, and accessories. The captive finance company must use derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company. The CFTC interprets this 90 percent test to include financing activity that finances the purchase of the products sold by the parent company in a broad sense, including service, labor, component parts and attachments that are related to the products.

IV. "Eligible Contract Participant"

The Rules also make certain clarifications to the definition of ECP, which is used in several Dodd-Frank provisions. Specifically, Dodd-Frank makes it unlawful for a person that is not an ECP to enter into a Swap other than on a designated contract market ("**DCM**") or subject to the rules of a DCM. It is also unlawful to enter into a Security-Based Swap with or for a person that is not an ECP unless the transaction is effected on a registered national securities exchange.

In addition, certain foreign exchange transactions entered into with persons that are not ECPs are subject to special retail foreign exchange dealing requirements. The Dodd-Frank Act had changed the ECP definition to impose a "look-through" requirement for commodity pools for purposes of determining whether the pool met the ECP standard in connection with foreign exchange trading.

The Rules expand the ECP definition to include Dealers and MSPs. With respect to commodity pools, the Rules clarify that, in order to be an ECP, a pool must meet the requirements of clause (iv) of the ECP definition, which requires commodity pools to satisfy minimum asset levels and be operated by certain regulated persons, and cannot circumvent this requirement by qualifying under the general entity provision asset test in clause (v) of the definition.

For purposes of the retail foreign exchange trading requirements, the Rules follow the statutory definition that a commodity pool where one or more direct participants is not an ECP will itself not be an ECP, although the Rule clarifies that indirect pool participants do not need to be ECPs unless structured to evade the Dodd-Frank requirements.

If this statutory look-through provision were to be strictly implemented, it would subject commodity pools operated by CPOs that are sophisticated, professional asset managers, to an array of additional compliance costs and deprive them of access to

many Dealers as counterparties when engaging in forex transactions. In response to these concerns, the CFTC adopted CFTC Regulation § 1.3(m)(8), pursuant to which certain commodity pools may qualify as ECPs notwithstanding the look-through requirement.

As adopted, CFTC Regulation § 1.3(m)(8) enables a commodity pool that enters into a forex transaction to qualify as an ECP with respect thereto, irrespective of whether each participant in the commodity pool is an ECP, if the commodity pool satisfies the following conditions: (i) the commodity pool is not formed for the purpose of evading CFTC regulation of retail commodity pools and retail forex transactions under CEA Section 2(c)(2)(B) or (C); (ii) the commodity pool has total assets exceeding $10 million;[31] and (iii) commodity pool must be formed and operated by a CPO registered as such with the CFTC or by a CPO which is exempt from registration as such pursuant to CFTC Regulation § 4.13(a)(3). However, commodity pools formed prior to December 31, 2012 do not need to satisfy the requirement to have been "formed" by a registered CPO or by a CPO exempt from registration as such pursuant to CFTC Regulation § 4.13(a)(3) in order to be qualified as ECPs under the new test, so long as they are operated by a registered CPO on or before such date.[32] The full requirement will apply for pools formed after such date.

Conclusion

The CFTC and SEC made significant modifications to the Rules from the proposed definitions of Dealer and MSP that address a number of concerns raised by market participants. Although the Rules complete a key part of the regulatory framework, there are still significant regulatory issues to be addressed including the application of the Dealer and MSP registration requirements to non-US entities. We await further guidance from the Commissions on this subject and will continue to provide updates as new information becomes available.

[31] The $10 million threshold is twice the general total asset threshold for a commodity pool to qualify as an ECP under CEA section 1a(18)(A)(iv).

[32] The CFTC provided this exception because many CPOs will have to register as such for the first time by that date due to the CFTC's recent rescission of the exemption from CPO registration set forth in CFTC Regulation § 4.13(a)(4) or its modification of the criteria for claiming the exclusion from the CPO definition in CFTC Regulation § 4.5 and such pools were formed prior to their CPOs' registration as such.

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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