

The CFTC and SEC Jointly Propose Definitions for Swap Market Participants

The Dodd-Frank Act requires the US Commodity Futures Trading Commission (CFTC) and the US Securities and Exchange Commission (SEC) to define certain so-called “key” terms used in Title VII of the Dodd-Frank Act.¹ In Release No. 34-63452² (the Release), the CFTC and the SEC, in consultation with the Board of Governors of the Federal Reserve System, have now proposed definitions for the following terms:

- Swap dealer
- Security-based swap dealer
- Major swap participant
- Major security-based swap participant
- Eligible contract participant

The CFTC also published a related fact sheet³ and Q&A.⁴ As this fact sheet notes, the proposed definitions closely follow the related text of the Dodd-Frank Act. The fact sheet also notes, perhaps controversially, the CFTC’s intention to interpret these terms to respond to market evolution and diversity among market participants, which may pose a threat to consistency and certainty. In an accompanying statement,⁵ CFTC Commissioner O’Malia expressed disappointment regarding the lack of regulatory certainty under the proposed definitions, especially for commercial end-users, and he specifically noted the absence of a more thorough discussion of safe harbor activities. Commissioner O’Malia’s statement includes an encouragement for public comments to raise additional appropriate *de minimis* exclusions.

Similarly, CFTC Commissioner Sommers issued a related statement⁶ that, among other things, took issue with the lack of distinction for specific types of swaps (a flexibility permitted under the Dodd-Frank Act) complaining that, under the proposed definition, once an entity is a swap dealer for any type of swap, it is a swap dealer for all swaps that it enters into.

The full import of the proposed definitions will not be known until the CFTC and SEC issue proposed definitions for other related terms, including “swap.” The interrelatedness of these proposed rulemakings has prompted criticism of the current CFTC/SEC process, including the recent joint letter⁷ by several trade and industry groups to request that the process be more coordinated and deliberative, including the reasonable suggestion that comment periods remain open until all related rulemakings have been made to permit potentially affected persons to determine whether proposed rules affect them and to permit them to determine whether they want to comment thereon.

A “swap dealer” (and generally with correlative meaning, a “security-based swap dealer”) is to be any person that:

- 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 activity causing itself to be commonly known in the trade as a dealer or market maker in swaps.

The CFTC and SEC note that the following may be distinguishing characteristics of swap dealers:

- Swap dealers tend to accommodate demand for swaps from other parties;
- Swap dealers are generally available to enter into swaps to facilitate other parties' interest in entering into swaps;
- Swap dealers tend not to request that other parties propose the terms of swaps; rather, they tend to enter into swaps on their own standard terms or on terms they arrange in response to other parties' interest; and
- Swap dealers tend to be able to arrange customized terms for swaps upon request, or to create new types of swaps at their own initiative.

For the *de minimis* exemption from otherwise being a swap dealer, the Release proposes that a person must meet all of the following conditions:

- An aggregate effective notional amount (measured on a gross basis) of \$100 million for swaps in a 12-month period in connection with dealing activities;
- The aggregate effective notional amount of such swaps with "special entities" (as defined in Commodity Exchange Act (CEA) Section 4s(h)(2)(C) to include certain governmental and other entities) over the prior 12 months must not exceed \$25 million;
- The person must not enter into swaps as a dealer with more than 15 counterparties, other than swap (and security-based swap) dealers, over the prior 12 months; and
- The person must not enter into more than 20 swaps as a dealer over the prior 12 months.

The Release proposes that a "major swap participant" (and generally with correlative meaning, a "major security-based swap participant") is any person:

- That 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;
- 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 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 proposed definition excludes swap dealers and certain financing affiliates.

The CFTC and SEC propose numerical criteria to determine "substantial position" that take into account both *current uncollateralized exposure* and *potential future exposure* and applies these tests to a person's swap positions in four "major" swap categories: rate swaps (interest or currency); credit swaps; equity swaps; and other (as in all other) commodity swaps.

Under the first test of substantial position based on current uncollateralized exposure, a person would determine their exposure by:

- Marking all swap positions to market using industry standard practices,
- Deduct the value of collateral posted for such positions, and
- Calculate the net swap position exposure according to any applicable master netting agreement.

The proposed threshold for the first test is \$1 billion for a daily average current swap exposure in any major swap category (or, for rate swaps, \$3 billion).

Under the second test of substantial position, a person determines its swap exposure for both current uncollateralized exposure (determined as under the first test) and for its potential future exposure by:

- Multiplying the total notional amount of its swap positions by specified risk factors (ranging from 0.5 to 15 percent) based on the type of swap and related duration,
- Discounting the amount of the positions subject to master netting agreement by a factor (ranging between 0 and 60 percent) depending on the effects of the agreement, and
- If the swaps are cleared or subject to daily mark-to-market margining, further discounting the amount of the positions by 80 percent.

The proposed threshold for the second test is \$2 billion in daily average total (current uncollateralized and potential future) exposure in any major swap category (or, for rate swaps, \$6 billion).

Responding to comments made regarding the treatment of commercial end-users that are “hedging or mitigating commercial risk,” the Release indicates that the CFTC and/or SEC will determine whether a swap hedges or mitigates risk by analyzing the facts and circumstances at the time that the swap is entered into, taking into account the person’s overall hedging and risk mitigation strategies. This ex post facto determination appears potentially to create significant uncertainty for commercial end-users at least until further definition or interpretative guidance is available.

Specifically, the proposed definition of “substantial position” excludes a swap that:

- Qualifies as a *bona fide* hedge under the CEA and rules thereunder;
- Qualifies for hedge accounting treatment under Financial Accounting Standards Board Statement no. 133 (now codified at Accounting

Standards Codification 815, Derivatives and Hedging); or

- Is 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.

A person’s “substantial counterparty exposure” is to be determined in the same way as its “substantial position,” except that it is not limited to the “major” swap categories and does not exclude hedging or employee benefit plan positions.

The proposed threshold for substantial counterparty exposure is current uncollateralized exposure of \$5 billion or total exposure (both current uncollateralized and potential future) of \$8 billion.

The term “financial entity” for purposes of the major swap participant definition has the same meaning as in the end-user exemption from clearing under CEA Section 2(h)(7).

Two possible definitions are proposed for “highly leveraged”: a ratio of total liabilities to equity (determined in accordance with US generally accepted accounting principles) of either 8:1 or 15:1.

Comments on the proposed definitions are due within 60 days of the pending publication in the *Federal Register*.

Endnotes

- ¹ For more information, see our August 23, 2010, Legal Update “Comments Requested on Proposed “Key Definitions” of the Wall Street Transparency and Accountability Act,” available at <http://www.mayerbrown.com/derivatives/article.asp?id=9509&nid=155>.
- ² Available at <http://www.sec.gov/rules/proposed/2010/34-63452.pdf>.
- ³ Available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/defs_factsheet.pdf.
- ⁴ Available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/defs_qa.pdf.
- ⁵ Available at <http://www.cftc.gov/PressRoom/Speeches/Testimony/omaliastatement120110.html>.
- ⁶ Available at <http://www.cftc.gov/PressRoom/Speeches/Testimony/sommersstatement120110.html>.
- ⁷ Available at <http://www.sifma.org/WorkArea/DownloadAsset.aspx?id=22530>.

For more information about the proposed definitions, or any other matter raised in this Legal Update, please contact the author, listed below.

J. Paul Forrester

+1 312 701 7366

jforrester@mayerbrown.com

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