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Legal Update
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The New CFTC and SEC Swap "Entity" Definitions—Highlights

Introduction

On April 27, 2012, the US Commodity Futures Trading Commission ("CFTC") and Securities and Exchange Commission ("SEC") (collectively, the "Commissions") released the text (the "Adopting Release")[1] of their final rulemaking further defining the terms "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant" and "eligible contract participant."[2] We offer below selected observations on the final rules and the Commissions' interpretive guidance in the Adopting Release. One significant question generally not addressed by the Commissions is how these definitions and the various exemptions will ultimately apply to the swap activities of entities outside of the United States. The Commissions note that extraterritoriality issues will be addressed separately. This update does not purport to be a complete summary of the Adopting Release or the accompanying new rules.

Swap Dealer Definition

The final rule essentially repeats the four Dodd-Frank statutory prongs of the dealer definition: (1) holding oneself out as dealer; (2) making a market in swaps; (3) regularly entering into swaps as an ordinary course of business for one's own account; *or* (4) engaging in any activity causing oneself to be commonly known in the trade as a dealer or market-maker. The Commissions stress the disjunctive aspect of the definition.

The decision-making process to determine swap dealer status is described as follows: (a) determine if the activity is "swap dealing"; (b) determine if any of the swaps in question are not to be considered because they are excluded (e.g., insured depository institution swaps in connection with loan origination, swaps between majority-owned affiliates, swaps between a cooperative and its members, swaps hedging physical positions and certain swaps entered into by registered floor traders; and (c) apply the *de minimis* criteria (described below). If at the end of this analysis, the entity concludes that it is a swap dealer, then it may consider applying to limit its designation to specified categories of swaps or specified activities in connection with swaps.[3]

IS THE ACTIVITY SWAP DEALING?

This is a facts and circumstances analysis considering "all the activities of the swap participant" to "identify those persons for which regulation is warranted either: (i) due to the nature of their interactions with counterparties; or (ii) to promote market stability and transparency, in light of the role those persons occupy within the swap and security-based swap markets."

- The Commissions adopt the SEC's securities dealer-trader distinction in principle, but each does so in its own selective manner. For example, the SEC emphasizes its view that dealers provide advisory or swap structuring services, have a regular "clientele" and actively solicit same, and use inter-dealer brokers.

- Other factors both Commissions view as indicative of swap dealing include: acting in a market-maker capacity on a trading system; providing liquidity by "accommodating demand or facilitating interest"; and holding oneself out as willing to enter into swaps (independent of whether another party has already expressed interest, but even if confined to willingness to trade only one side of the market). Trade association membership is an indicator of holding oneself out or being commonly known as a dealer.
  - Customer or counterparty relationships are not a prerequisite.
  - A "swap for the purpose of hedging, absent other activity, is unlikely to be indicative of dealing."
  - Market-making would include routinely: (i) quoting bid or offer prices or other terms for swaps on an exchange; (ii) responding to requests made directly or through interdealer brokers regarding bilaterally negotiated swaps; and (iii) placing limit orders for swaps or acting in a market-maker capacity on an exchange or trading system. A willingness "to routinely stand ready to enter into swaps at the request or demand of a counterparty…then to enter into offsetting positions, either in the swap market or in other markets" is noted even though two-sided transactions are not a necessary condition.
- "Ordinary course of business" and "regular business" are merged, read into all prongs of the definition and are indicated by: (i) entering into swaps "with the purpose of satisfying the…needs of the counterparty"; (ii) maintaining a separate P&L statement for swap activity; or (iii) having staff and resources available to "dealer-type activities with counterparties…."

DE MINIMIS EXEMPTION

The final *de minimis* exemption is based on the aggregate notional amount of swaps "connected" with dealing activity that an entity and its commonly controlled affiliates have entered into during a "look back" period (see below) that, initially, commences on the effective date of the yet-to-be-issued product definitions and will expand to a 12-month period as time lapses following such effective date. The Commissions have greatly increased the proposed notional amount thresholds for most swaps (see "Phase-in Period" below), other than those with special entities, for which a US $25 million notional threshold was retained. Proposed limitations on the number of swaps and counterparties have not been retained in the final rule. The Commissions have disregarded comments that the statutory reference to "customers" should be given effect by not counting swaps with non-customers toward the *de minimis* thresholds.

Phase-in Period

Each Commission's "phase-in" *de minimis* threshold of $8 billion (swaps and security-based credit default swaps ("CDS"), other than with special entities) will remain in effect no longer than until the end of a five-year data collection period.[4] Earlier termination of the phase-in period may occur nine months after publication of Commission staff reports (which will be subject to public comment) analyzing the *de minimis* thresholds and other aspects of the entity definitions in light of collected data. At such time, the post-phase-in threshold of $3 billion will replace the $8 billion threshold or a Commission may propose an alternative *de minimis* level. For non-CDS security-based swaps (other than with special entities) the *de minimis* thresholds are $400 million (phase-in) and $150 million (permanent).

Market participants will not find any reliably predictable minimum duration for the phase-in periods. The rules specify deadlines (30 months for the CFTC or three years for the SEC after the

start of data collection) for the staff reports, but do not require the staff to wait for a minimum period of data collection before issuing their reports. In addition, the rules provide that a Commission may change the requirements of the *de minimis* exemption, leaving open the possibility of a change to the *de minimis* levels even before publication of the staff reports.

Measurement Period

The *de minimis* threshold takes into account swaps "connected" with dealing activity (aggregating swaps among commonly controlled affiliates) entered into during the period looking back to the effective date of the "swap/security-based swap" definitional rulemaking (or, after the first anniversary of such effective date, a 12-month look back period). The rules allow a period for registration of two months following the end of the month in which a person is no longer able to take advantage of the *de minimis* exemption.

Connection to Dealing Activity

The CFTC, in particular, offers minimal guidance regarding the identification of swaps "connected" with dealing activity. The SEC states that security-based swaps that hedge or offset positions entered into as part of dealing activity count toward the *de minimis* threshold. The CFTC makes the more general statement that the relevant question is whether the swaps fall within its swap dealer definition. Swaps that are excluded under the loan-origination exclusion (see below) are not counted toward the insured depository institution's *de minimis* thresholds.

Aggregation of Affiliates' Activity

In aggregating the swap positions of a group of companies for purposes of the *de minimis* thresholds, the final regulation adopts a "common control" standard for aggregation that reaches a broader set of entities than those linked by holdings of a "majority interest" and therefore eligible for the inter-affiliate exclusion (see below). As a result, groups that encompass non-majority affiliates and engage in intra-group swaps or security-based swaps may be required effectively to double count offsetting positions.

INTER-AFFILIATE SWAPS

Swaps between affiliates linked by holdings of a "majority interest" are not taken into consideration in the dealer analysis. The Commissions view common majority ownership as "an alignment of economic interest that is sufficient to eliminate concerns that underpin dealer regulation." Financial statement consolidation is not a requirement of the inter-affiliate exclusion.

LOAN ORIGINATION EXCLUSION

As adopted, the exclusion is available to insured depository institutions for swaps[5] if (i) an underlying term of the swap is or is directly related to a financial term of the loan or (ii) the swap is required, as a condition of the loan under the institution's underwriting criteria, to be in place in order to hedge price risks incidental to the borrower's business and arising from potential changes in the price of a commodity (other than an excluded commodity). The final regulation does not extend the exemption to uninsured branches and agencies of non-US banks.

The exclusion is limited to swaps entered into within 90 days before or 180 days after the execution of the loan or transfers of principal to the borrower pursuant to the loan. To be eligible for the exclusion, the institution must be a source of funds for the loan (either directly or through syndication, participation, assignment, purchase, financing or otherwise). If the institution is not the sole source of funds, its commitment must equal or exceed 10 percent of the maximum principal amount or the aggregate notional amount of all of its swaps with the customer in connection with the financial terms of the loan.

Among reporting and other conditions for the exclusion, the aggregate notional amount of all swaps entered into by the customer in connection

with the financial terms of the loan must, at any time, not be more than the aggregate principal amount outstanding under the loan at that time. It is not stated whether an insured depository institution may rely on representations or covenants from the borrower in the swap or credit agreement in order to satisfy this condition. Swaps entered into by an insured depository institution for the purpose of hedging or laying off the risk of a swap covered by the loan-origination exclusion will not be considered for the *de minimis* exemption or the general dealer analysis.[6]

SWAPS HEDGING PHYSICAL POSITIONS

The CFTC adopted as an interim final rule (with a comment period closing 60 days after the publication of the Adopting Release in the Federal Register) an exclusion for certain swaps that hedge physical positions. Among other conditions, the swap must be a substitute for present or future transactions or positions in a physical marketing channel, and must be economically appropriate to the reduction of a person's risk in the conduct and management of a commercial enterprise. The CFTC's "reasons for caution" regarding an exclusion that would encompass all hedging swaps appear to stem from concern about reliably distinguishing in a *per se* rule between swaps with a hedging purpose and those that have merely a hedging consequence but also constitute dealing activity.

SWAPS BY COOPERATIVES

Swaps between a member and a "producer cooperative" (other than excluded commodities), Farm Credit System institution or Federal Home Loan Bank are generally excluded but must be reported and appropriately risk managed.

Major Participant Definition

There are three parts to the Dodd-Frank definition of major participant: (1) a 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; (2) a 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 (3) 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.

IMPLEMENTATION OF FIRST PART OF STATUTORY DEFINITION

The Commissions elected to follow the general approach of the proposed rule for defining "substantial position," including the combined use of current exposure and potential future exposure tests. The Commissions also retained the proposed quantitative thresholds for a substantial position, rejecting arguments from commenters that the proposed thresholds were inappropriately low. Thus, a substantial position exists where the daily average current uncollateralized exposure associated with a person's swaps in a major category (i.e., rate swaps, credit swaps, equity swaps and commodity swaps) amount to $1 billion or more (or $3 billion in the case of rate swaps), or the daily average of the sum of the current uncollateralized exposure plus the potential future exposure associated with its positions in a major category amount to $2 billion or more (or $6 billion for the rate swap category). In addition:

- the final rule does not prescribe a particular methodology for measuring current exposure or for valuing collateral posted, but instead requires the use of standard industry practices;
- the Commissions rejected requests from commenters to approve particular

methodologies or provide a safe harbor for good faith valuations;

- the final rule expands the recognition of netting for purposes of measuring uncollateralized current exposure (i.e., as compared to the proposal), by extending netting principles to any financial instruments that may be netted for purposes of applicable bankruptcy law; and
- the final rule also includes several adjustments to the proposed method for calculating potential future exposure, including a reduction of the potential future exposure associated with positions that are subject to central clearing.

Definition of Hedging or Mitigating Commercial Risk

As proposed, the Commissions' respective final rules implementing the commercial risk hedging exclusion are different from one another in certain regards, but both Commissions:

- adopt the proposed "economically appropriate" standard for determining whether a swap is eligible for the commercial risk hedging exclusions;
- confirm that the commercial risk hedging exclusion is available to financial entities, the Commissions having rejected the argument from some commenters that "commercial risk" should be limited to risks related to non-financial activities. However, because the final rule makes the exclusion unavailable to swaps that hedge positions held for speculation, investment or trading, the Commissions note that the ability of financial entities to take advantage of the exclusion will be limited; and
- confirm that the exclusion is available to positions that hedge "financial" or "balance sheet" risks, and that the exclusion would apply not only to the hedging of a person's own risks but also would extend to the hedging of the risks of a person's majority-owned affiliate.

ERISA Plans

In calculating exposures under the first test of the major participant definition, an employee benefit plan as defined under ERISA is permitted to exclude its hedging positions. The final rule confirms that the exclusion is broader than the commercial risk hedging exclusion (described above) and thus may include positions that have a "primary" hedging purpose directly associated with the operation of the plan. The Commissions do not "foresee" that the use of swaps to replicate exposure to a foreign market or to a particular asset class will meet the "primary" test. The final rule also clarifies that the exclusion is available to trusts or pooled vehicles that hold plan assets.

IMPLEMENTATION OF SECOND PART OF STATUTORY DEFINITION

Consistent with the proposal, the final rule defines "substantial counterparty exposure" based on the same current uncollateralized exposure and potential future exposure tests that are used to identify a "substantial position" under the first statutory test for a major participant. The final rule also follows the approach of the proposed rule with respect to quantitative thresholds: for swaps, the threshold for major participant is $5 billion or more in daily average uncollateralized exposure or $8 billion or more in daily average uncollateralized exposure plus potential future exposure; for security-based swaps, the thresholds are $2 billion and $4 billion, respectively. The Commissions generally rejected comments on the proposed rule suggesting that hedging positions should be excluded and that the proposed thresholds should be changed.

IMPLEMENTATION OF THIRD PART OF STATUTORY DEFINITION

As proposed, financial entity is defined in the same way as in the definition used for the exception from mandatory clearing for end users, including commodity pools, private funds, employee benefit plans and persons predominantly engaged in banking or in

activities that are financial in nature as defined in the Bank Holding Company Act. However, the Commissions have decided to exclude from the definition of financial entity in this context certain centralized hedging and treasury entities, because it would discourage the use of such entities whose purpose is to hedge or mitigate commercial risks of other entities within a corporate group. For these purposes, "highly leveraged" is defined, as recommended by the comments, as a ratio of liabilities to equity in excess of 12 to 1. The ratios would be calculated under GAAP as of the close of the last business day of the applicable fiscal quarter.

OTHER MAJOR PARTICIPANT INTERPRETATIONS

Majority-Owned Affiliate as Counterparty

The final rule provides that the major participant definitions should not include swaps for which the counterparty is a majority-owned affiliate. This liberalizes the approach of the proposed rule which required that the affiliate be wholly-owned.

Attribution of Swap Positions to Parent Companies and Affiliates

The Adopting Release modifies the proposed approach with respect to aggregating swap positions at a parent company and with respect to the effect of affiliate guarantees: Swap positions would be attributed to a parent company, other affiliate or guarantor for major participant purposes only if the counterparties would have recourse to that entity. Moreover, a guarantee would not attribute a swap position to the guarantor if the guarantor is a US banking entity subject to US banking regulation (including capital requirements) or to capital regulation by the CFTC or the SEC.

Investment Managers

The Commissions have adopted the interpretation that investment advisers and other asset managers will not include the swap positions of their managed accounts in determining major participant status. With respect to beneficial owners of swap positions, the Adopting Release provides that the swap positions will be attributed to them only if the counterparties have recourse against the beneficial owners. For example, if they have recourse only to the assets in the account, the beneficial owner (e.g., the owner of shares in a registered investment company) will not be required to count those positions in its major participant analysis. The same approach of attribution when there is recourse is adopted in the context of insurance company separate accounts and master-feeder fund arrangements.

Exclusion of Certain Entities

Public commenters had requested that certain categories of entities be excluded from the definition of major participant. The Commissions adopted none of these blanket exclusions because:

- legacy entities that hold swaps in run-off status may still pose a systemic risk to the US financial system and should therefore not get a categorical exclusion;
- domestic entities that are otherwise regulated such as insurance companies, broker-dealers, etc., are not excluded. However, the Commissions will seek to coordinate their regulatory oversight of such entities to avoid unnecessary duplication; and
- in the CFTC's view, foreign entities such as foreign governments, foreign central banks, international financial institutions like the IMF and sovereign wealth funds are not immune from US jurisdiction for their commercial activities.[7]

Financing Subsidiary

The final rule implements the statutory exclusion for captive subsidiaries whose primary business is providing financing for the sale of products of their parent companies and that use derivatives for purposes of hedging underlying commercial

risks related to interest rate and foreign currency exposures. The CFTC stated that this exclusion applies when the subsidiary's financing activity "finances the purchase of products sold by the parent company in a broad sense, including service, labor, component parts and attachments that are related to the products."

New Safe Harbors

Under new safe harbors added to the final rule, a person will not be deemed to be a major participant if:

- the express terms of the person's arrangements relating to swaps with its counterparties at no time would permit that person to maintain a total uncollateralized exposure of more than $100 million, and the person does not maintain notional swap positions of more than $2 billion in any major category of swaps or more than $4 billion in the aggregate;
- the express terms of the person's arrangements relating to swaps with its counterparties at no time would permit the person to maintain a total uncollateralized exposure of more than $200 million, and the person performs the major participant calculations (e.g., the "substantial position" and "substantial counterparty exposure" calculations associated with the major participant tests) as of the end of every month, and the results of each of those monthly calculations indicate that the person's swap positions lead to no more than one-half of the level of current exposure plus potential future exposure that would cause the person to be a major participant;
- the person's current uncollateralized exposure in connection with a major category of swaps is less than $500 million (or less than $1.5 billion with regard to the rate swap category) and the person performs certain modified major participant calculations (e.g., the "substantial position" and "substantial counterparty exposure" calculations, simplified based on assumptions that are adverse to the person) as of the end of every month, and the results of each of those monthly calculations indicate that the person's swap positions in each major category are less than one-half of the substantial position threshold; or
- its monthly calculations indicate that the person's swap positions across all major categories of swaps are significantly less than the substantial counterparty exposure threshold.

Eligible Contract Participant Definition

Dodd-Frank effectively prohibits a person who is not an eligible contract participant ("ECP") from entering into a swap/security-based swap except on or subject to the rules of a designated contract market/national securities exchange. The Commissions were granted authority to define ECP beyond the statutory definition,[8] and the Commissions used this authority to:

- starting in 2013, prohibit a commodity pool from qualifying as an ECP for the purpose of entering into "retail forex transactions"[9] if such "Forex Pool" and has one or more direct participants that are not ECPs;[10]
  - notwithstanding the fact that a Forex Pool has one or more direct participants that are not ECPs, it may qualify as an ECP if it (a) is not formed for the purpose of evading regulation under Sections 2(c)(2)(B) or (C) of the Commodity Exchange Act ("CEA") or related rules, regulations or orders, (b) has total assets exceeding $10 million and (c) starting in 2013, is formed and operated by a registered commodity pool operator ("CPO") or by a CPO who is exempt from registration;
  - in determining whether a direct participant is an ECP, the indirect participants in a Forex Pool will not be considered unless such Forex Pool, a commodity pool holding a direct or indirect (through one or more intermediate tiers of pools) interest

in such Forex Pool, or any commodity pool in which such Forex Pool holds a direct or indirect interest has been structured to evade Subtitle A of Title VII of the Dodd-Frank Act;

- starting in 2013, prohibit a commodity pool from qualifying as an ECP unless it has total assets exceeding $5 million and is operated by certain persons described in CEA Section 1a(18)(A)(iv)(II);
- explicitly include swap dealers, security-based swap dealers, major swap participants and major security-based swap participants in the definition of ECP; and
- permit a non-ECP to qualify as an ECP, with respect to swaps (but not security-based swaps or mixed swaps) used to "hedge or mitigate its commercial risk" (by meeting conditions in the major participant definition of that same phrase) if the owners are ECPs (based on any prong of the definition) and each owner has a net worth exceeding $1 million.[11]

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Endnotes

[1] Available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister041812b.pdf. In discussing common aspects of the CFTC's and the SEC's analysis, we use the term "swap" to encompass security-based swaps and the terms "dealer" and "major participant" to encompass both the CFTC- and the SEC-regulated variants of such entities.

[2] The regulation of swaps is largely driven by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), and the Adopting Release is part of the Commissions' ongoing efforts to issue implementing rules for the statutory provisions therein.

[3] If limited designation is granted, the person must consider whether it is a major participant in connection with positions that fall outside its limited dealer designation. More generally, persons who are not swap dealers yet engage in swap activities of potentially systemically significant size needed to do the major participant analysis described below; swap dealers do not.

[4] Swaps and security-based swaps with special entities are subject to a $25 million notional amount threshold with no phase-in. With certain exceptions, the phase-in level is not available to the extent a person engages in security-based swap dealing activity with natural persons.

[5] This exclusion does not appear in the definition of "security-based swap dealer".

[6] This categorical statement of exclusion is tempered by the Commissions' note that an institution seeking out counterparties to such hedging swaps "would *generally* [emphasis added] not be accommodating demand…or facilitating interest…."

[7] However, the CFTC also concludes under principles of international comity that Congress did not intend to reach foreign governments, foreign central banks and international financial institutions. This rationale is not extended to sovereign wealth funds and foreign commercial entities. The SEC will address these issues in its separate release on entities outside the United States.

[8] The Dodd-Frank Act also amended the existing statutory definition of ECP by: (i) providing that, for certain purposes, the term ECP does not include a commodity pool in which any participant is not itself an ECP; (ii) raising the monetary threshold that governmental entities may use to qualify as ECPs, in certain situations, from $25 million in investments owned and invested on a discretionary basis to $50 million in investments owned and invested on a discretionary basis; and (iii) replacing the "total asset" standard for individuals to qualify as ECPs with an "amounts invested on a discretionary basis" standard.

[9] Retail forex transactions are off-exchange foreign currency futures; off-exchange options on foreign currency futures; off-exchange options on foreign currency; leveraged or margined foreign currency transactions; and foreign currency transactions that are financed by the offeror, the counterparty or a person acting in concert with the offeror or counterparty on a similar basis.

[10] The Commission will, however, deem Forex Pools with no US participants operated by commodity pool operators located outside the United States to be ECPs.

[11] Each person, other than a shell company, holding a direct ownership interest in the otherwise non-ECP entity is considered an owner for these purposes. Shell companies in the non-ECP entity's ownership chain will be disregarded; instead, a shell company's owners will be considered to be the owners of the otherwise non-ECP entity.

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