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Final Rules Regarding Further Defining "Swap Dealer," "Major Swap Participant" and "Eligible Contract Participant"

The Commodity Futures Trading Commission (CFTC) announced its intent to publish in the Federal Register final regulations concerning the definitions of "swap dealer," "major swap participant" and "eligible contract participant." This is a joint rulemaking with the Securities and Exchange Commission (SEC).

Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)

Section 721 of the Dodd-Frank Act amends the Commodity Exchange Act (CEA) by adding definitions of the terms "swap dealer" and "major swap participant." Section 712(d)(1) provides that the Commission and the SEC, in consultation with the Federal Reserve Board, shall jointly further define those terms, and the term "eligible contract participant."

Definition of "Swap Dealer"

The final rules closely follow the text of the Dodd-Frank Act in defining the term "swap dealer" as any person who:

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

The rules also follow the statute in excluding any person that enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business.

Interpretive Guidance on the Definition of "Swap Dealer"

The Adopting Release provides interpretive guidance on the "holding out" and "commonly known" criteria, market making, the not part of "a regular business" exception, and the overall interpretive approach to the definition. The guidance clarifies the following:

- the determination of whether a person is a swap dealer should consider all relevant facts and circumstances, and focus on the activities of a person that are usual and normal in the person's course of business and identifiable as a swap dealing business;
  making a market in swaps is appropriately described as routinely standing ready to enter into swaps at the request or demand of a counterparty;
- a person making a one-way market in swaps may be a market maker, and exchange-executed swaps are relevant in the determination;
- examples of activities that are part of "a regular business," and therefore indicative of swap dealing, are entering into swaps to satisfy the business or risk management needs of the counterparty, maintaining a

separate profit and loss statement for swap activity, or allocating staff and resources to dealer-type activities; and
- the SEC's dealer-trader distinction may be applied in identifying swap dealers.

Exclusion for Swaps in Connection with Originating a Loan

The Dodd-Frank Act provides an exclusion for an insured depository institution "to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer." The rules provide that the exclusion applies to any swap that meets the following conditions:

- the swap is connected to the financial terms of the loan or is required by loan underwriting criteria to be in place as a condition of the loan in order to hedge the borrower's commodity price risks;
- the swap is entered into within 90 days before or 180 days after the date of the loan agreement, or any draw of principal under the loan;
- the loan is within the common law meaning of "loan;" and
- the insured depository institution is the sole lender or, if it is a participant in a lending syndicate, it is responsible for at least 10% of the loan (otherwise, the notional amount of the swap may not exceed the amount of the insured depository institution's participation).

Exclusion of Certain Hedging Swaps

While the activity of using swaps to hedge or mitigate risk is not specifically excluded in the statutory definition, the Commission believes it is appropriate to provide, in an interim final rule, that entering into a swap in certain situations for the purpose of hedging a physical position is not swap dealing. Accordingly, the interim final rule provides that the determination will exclude swaps that a person enters into for the purpose of offsetting or mitigating the person's price risks if:

- the price risks arise from the potential change in the value of assets that the person owns, produces, manufactures, processes, or merchandises, liabilities that the person owns or anticipates incurring, or services that the person provides or purchases;
- the swap represents a substitute for transactions or positions in a physical marketing channel;
- the swap is economically appropriate to the reduction of the person's risks in the conduct and management of a commercial enterprise; and
- the swap is entered into in accordance with sound commercial practices and is not structured to evade designation as a swap dealer.

The interim final rule draws upon principles in the Commission's long standing interpretation of bona fide hedging. It excludes swap activity for the purpose of portfolio hedging and anticipatory hedging. The Commission believes the interim final rule is at this time the best means of providing certainty regarding which hedging swaps may be disregarded in the swap dealer analysis. The Commission invites commenters to discuss whether other approaches to hedging swaps in the dealer analysis would be easier to implement or provide greater certainty, while still addressing the goals of swap dealer regulation.

Exclusion of Swaps Between Affiliates

The determination of whether a person is a swap dealer excludes swaps between majority-owned affiliates. Similarly, the determination also excludes swaps between a cooperative – including agricultural cooperatives and cooperative financial institutions – and its members.

De Minimis Exemption from the Definition of Swap Dealer

The Dodd-Frank Act 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." The rule requires that, in order for a person to be exempt from the definition on the basis of de minimis activity, the aggregate gross notional amount of the swaps that the person enters into over the prior 12 months in connection with dealing activities must not exceed $3 billion. Also, the aggregate gross notional amount of such swaps with "special entities" (as defined under CEA Section 4s(h)(2)(C) to include certain governmental and other entities) over the prior 12 months must not exceed $25 million.

The rule also provides for a phase-in of the de minimis threshold to facilitate orderly implementation of swap dealer requirements. During the phase-in period, the de minimis threshold would effectively be $8 billion (while the $25 million threshold for swaps with special entities would apply unchanged). Two and one-half years after data starts to be reported to swap data repositories, the Commission's staff will prepare a study of the swap markets, including data and information that becomes available about the de minimis threshold. Nine months after this study, the Commission may end the phase-in period, or propose new rules to change the de minimis threshold (either up or down). If the Commission does not take action to end the phase-in period, it will terminate automatically five years after data starts to be reported to swap data repositories.

Limited Purpose

A person that is covered by the definition of "swap dealer" is required to register with the Commission, and the regulatory requirements applicable to swap dealers will apply to all of its swap activities. However, the person may apply to limit its designation as a swap dealer to specified categories of swaps or specified activities. The Commission will consider any application on an individual basis through analysis of the unique circumstances of each applicant.

Definition of "Major Swap Participant" (MSP)

There are three parts to the Dodd-Frank Act definition. A person that satisfies any one of them is an MSP:

- 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.
- 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."
- Any "financial entity" that is "highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking agency" and that maintains a "substantial position" in any of the major swap categories.

The statutory definition excludes swap dealers and certain financing affiliates.

Definition of Substantial Position

The final rules define "substantial position" using objective numerical criteria, which promote the predictable application and enforcement of the requirements governing MSPs. The tests adopted by the Commission account for both current uncollateralized exposure and potential future exposure. A position that satisfies either test would be a "substantial position." The definition of substantial position excludes positions hedging commercial risk and employee benefit plan positions.

The tests apply to a person's swap positions in each of four major swap categories: rate swaps (any swap based on reference rates such as interest rates or currency exchange rates), credit swaps (any swap based on instruments of

indebtedness or related indices), equity swaps (any swap based on equities or equity indices) and other commodity swaps (any swap not included in the first three categories, including any swap based on physical commodities).

First Test of Substantial Position

The first substantial position test:

- measures a person's current uncollateralized exposure by marking the swap positions to market using industry standard practices;
- allows the deduction of the value of collateral that is posted with respect to the swap positions; and
- calculates exposure on a net basis, according to the terms of any master netting agreement that applies.

The thresholds adopted for the first test are the daily average current uncollateralized exposure of $1 billion in the applicable major category of swaps, except that the threshold for the rate swap category would be $3 billion.

Second Test of Substantial Position

The second test adopted by the Commission for substantial position accounts for both current uncollateralized exposure (as discussed above) and the potential future exposure associated with a person's swap positions. The second substantial position test determines potential future exposure by:

- multiplying the total notional principal amount of the person's swap positions by specified risk factor percentages (ranging from ½% to 15%) based on the type of swap and the duration of the position;
- discounting the amount of positions subject to master netting agreements by a factor ranging between zero and 60%, 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%.

The thresholds adopted for the second test are $2 billion in daily average current uncollateralized exposure plus potential future exposure in the applicable major swap category, except that the threshold for the rate swap category would be $6 billion.

Definition of "Hedging or Mitigating Commercial Risk"

The definition of substantial position excludes positions held for "hedging or mitigating commercial risk." The Commission in the final rules has interpreted whether a swap hedges or mitigates commercial risk to be determined by analyzing the facts and circumstances at the time the swap is entered into, and taking into account the person's overall hedging and risk mitigation strategies. The definition encompasses any swap position that:

- qualifies as bona fide hedging under CEA rules;
- qualifies for hedging treatment under Financial Accounting Standards Board Statement No. 133 or Governmental Accounting Standards Board Statement 53, Accounting and Financial Reporting for Derivative Instruments; 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.

The final definition of hedging or mitigating commercial risk does not encompass any swap position that is held for a purpose that is in the nature of speculation, investing or trading. The Commission believes that the meaning of "speculation, investing or trading" is apparent when read in the overall context of the definition of "hedging or mitigating commercial risk." Accordingly, swap positions executed for the purpose of speculating, investing, or trading are those positions executed primarily to take an outright view on market direction or to obtain an appreciation in value of the swap position itself and not primarily for hedging or mitigating underlying commercial risks. For example, swaps positions held primarily for the purpose of generating profits directly upon closeout of the swap, and not to hedge or mitigate underlying commercial risk, are speculative or serve as investments. Further, as an alternative example, swaps executed for the purpose of offsetting potential future increases in the price of inputs that the entity reasonably expects to purchase for its commercial activities serve to hedge a commercial risk.

Definition of "Substantial Counterparty Exposure"

The final definition of substantial counterparty exposure uses a calculation method that is the same as the method used to calculate substantial position. However, the definition of substantial counterparty exposure is not limited to the major categories of swaps, and it does not exclude hedging or employee benefit plan positions. Rather, it encompasses all of a person's swap positions.

The thresholds as adopted for substantial counterparty exposure are a current uncollateralized exposure of $5 billion, or a sum of current uncollateralized exposure and potential future exposure of $8 billion, across the entirety of a person's swap positions.

Definition of "Financial Entity" and "Highly Leveraged"

The third aspect of the statutory definition of major swap participant addresses any "financial entity," other than one subject to capital requirements established by an appropriate Federal banking agency, that is "highly leveraged" relative to the amount of capital it holds, and that maintains a substantial position in a major category of swaps. The final rules use the same definition of substantial position described above, without excluding hedging or employee benefit plan positions.

For this aspect of the definition, the definition of "financial entity" in the Dodd-Frank Act provision for an end-user exception from mandatory clearing in CEA Section 2(h)(7). With respect to the definition of "highly leveraged," the final rules have adopted a ratio of total liabilities to equity, as determined in accordance with U.S. GAAP, of 12 to 1.

Definition of Eligible Contract Participant (ECP)

Section 723(a)(2) of the Dodd-Frank Act added new subsection (e) to CEA section 2. Under CEA section 2(e), a person who is not an ECP cannot enter into a swap except on or subject to the rules of a designated contract market. Section 741(b)(10) of the Dodd-Frank Act also amended the ECP definition by providing that, for purposes of certain foreign exchange transactions specified in CEA sections 2(c)(2)(B) and 2(c)(2)(C) (retail forex transactions), a commodity pool is not an ECP if any participant in the pool is not itself an ECP.

Swap Dealer and Major Swap Participant ECP Prongs

Commission Regulations §§ 1.3(m)(1)-(4) provide that the ECP definition now includes swap dealers, security-based swap dealers, major swap participants and major security-based swap participants, as those terms are defined in the CEA (swap dealers and major swap participants) or the Securities Exchange Act of 1934 (security-based swap dealers and major security-based swap participants) and further defined in today's joint final rules, based on their status as such.

Retail Forex Commodity Pool Look-Through

Commission Regulation § 1.3(m)(5) provides that a commodity pool that is the counterparty to retail forex transactions (a transaction-level pool) and that has one or more non-ECP participants is not itself an ECP under either prong (iv) or prong (v) of the ECP definition for purposes of CEA sections 2(c)(2)(B) and (C) of the CEA.

In determining whether a pool that is a direct participant in a transaction-level pool (investor pool) is an ECP for purposes of the transaction-level pool's retail forex transactions, the investor pool's investors will not count unless the transaction-level pool, any direct or indirect investor pool, or any commodity pool in which the transaction-level pool holds a direct or indirect interest, has been structured to evade subtitle A of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act by permitting non-ECPs to participate in retail forex transactions.

The impact of the look through is further mitigated by:

- delaying the effective date until the end of 2012, consistent with the compliance date for CPOs effected by the recent withdrawal of the 4.13(a)(4) CPO registration exemption; and
- deeming pools with no U.S. participants operated by CPOs located outside the U.S. ECPs.

Relationship of ECP Prongs (iv) and (v) with respect to Commodity Pools Generally

Commission Regulation § 1.3(m)(6) provides that, a commodity pool that does not satisfy prong (iv) of the CEA's ECP definition (i.e., because it either lacks total assets exceeding $5,000,000 or is not formed and operated by a person subject to regulation under the CEA, or a foreign equivalent) is not an ECP pursuant to prong (v) of the CEA's ECP definition.

The impact of Commission Regulation § 1.3(m)(6) is mitigated by delaying the effective date until the end of this year, as is also the case with respect to Commission Regulation § 1.3(m)(5).

Line of Business ECP Prong

Commission Regulation § 1.3(m)(7) provides that, an entity that does not qualify as an ECP on its own can qualify as an ECP with respect to a swap used to hedge or mitigate its commercial risk if all of its owners are ECPs (based on any prong of the ECP definition) and any of such owners has a net worth exceeding $1 million.

- For purposes of the line of business ECP prong, a swap is used to hedge or mitigate commercial risk if the swap complies with the conditions in the new regulation defining that term in the context of an MSP (i.e., Commission Regulation § 1.3(ttt)).
- Each person, other than a shell company, holding a direct ownership interest in the otherwise non-ECP entity is considered an owner.
- In this context, the term "shell company" means any entity that limits its holdings to direct or indirect interests in entities that are relying on the line of business ECP prong.
- 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.
- An individual will be considered to be a proprietorship for purposes of qualifying as an ECP owner of the otherwise non-ECP entity only if the individual (1) has an active role in operating a business other than an entity; (2) directly owns all the assets of the business; (3) directly is responsible for all of the liabilities of the business; and (4) acquires its interest in the entity seeking to qualify as an ECP under the line of business ECP prong in connection with operating the individual's proprietorship or to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by the individual in the operation of its proprietorship.

- An otherwise non-ECP entity can qualify as an ECP under the line of business ECP prong solely with respect to a swap that is not a security-based swap, security-based swap agreement or mixed swap.

Alternative to the Retail Forex Look Through

Commission Regulation § 1.3(m)(8) provides that, notwithstanding the look-through language in Section 1a(18)(A)(iv) of the CEA and Commission Regulation § 1.3(m)(5), a commodity pool that enters into a retail forex transaction is an ECP with respect thereto, regardless of whether each participant in the pool is an ECP, if all of the following conditions are satisfied:

- the pool is not formed for the purpose of evading regulation under Section 2(c)(2)(B) or Section 2(c)(2)(C) of the Act or related Commission rules, regulations or orders;
- the pool has total assets exceeding $10,000,000; and
- the pool is formed and operated by a registered CPO or by a CPO who is exempt therefrom pursuant to § 4.13(a)(3).

Because many pools will have been formed by CPOs exempt from registration, the "formed by a registered CPO" element of 1.3(m)(8) will not be a requirement for pools formed before the end of the year.