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CFTC and SEC Adopt Final Swap Dealer, Major Swap Participant and Eligible Contract Participant Definitions

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On April 18, 2012, the CFTC and SEC adopted final rules[1] to further define the terms "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant," and "eligible contract participant."[2] The rules initially establish the threshold for the *de minimis* exclusion from SD registration requirements at $8 billion for swaps connected with dealing activity effected in a 12-month period for CFTC-regulated swaps and all credit default swaps and $400 million for other SBS.[3] Importantly, the rules also exclude from the scope of dealing activity swaps between majority-owned affiliates. The Commission also excluded certain hedging activity from the SD registration analysis.

The Commissions generally declined to adopt exclusions from the definition of SD and MSP for categories of persons, including for sovereign wealth funds, agricultural cooperatives and employee benefit plans. Furthermore, the Commissions confirmed that absent a limited purpose designation, an SD registration applies to the entire legal entity and to all of such person's swaps or SBS, whether or not such swaps or SBS are entered into in a dealing capacity. The final rules do not address the extraterritorial application of Title VII, including whether a limited designation would be available for a U.S. branch of a foreign bank or to separate U.S.-facing activities from non-U.S.-facing activities; instead, the Commissions stated that they will address such issues in future releases.

With the adoption of these rules, there remains one step – the issuance of final swap product definition rules – before the start of the countdown for swap dealer and MSP provisional registration. The swap entity definition rules will be effective 60 days after they are published in the Federal Register, which is expected to occur shortly. For further information regarding the CFTC's expected compliance timetable, see the last section of this memorandum.

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[1] Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," *available* here.

[2] The term "SD" refers to swap dealers and security-based swap dealers, the term "MSP" refers both to major swap participants and major security-based swap participants, the term "swap entity" refers to SDs and MSPs, and the term "swap" refers to both swaps and security-based swaps ("SBS").

[3] As discussed below, these initial limits will be reduced in the future and are subject to an exception for swaps with municipalities, certain employee benefit plans and other "special entities."

The *de minimis* phase-in timeline is:

- Upon effectiveness, an $8 billion threshold for dealing in CFTC-regulated swaps and in SBS that are CDS, a $400 million threshold for all other SBS, and for all swaps and SBS, a $25 million threshold with regard to swap dealing with special entities over the prior 12 months;
- Two and a half years after a date tied to data reporting or other rules, the Commissions will each separately prepare studies including data about the *de minimis* threshold;
- Nine months after each study, each Commission may end the phase-in period, or propose new rules to change the *de minimis* threshold (either up or down); and
- Five years after data starts to be reported to swap data repositories, if no action has been taken, the phase-in thresholds will terminate.

Absent action by the Commissions, the ultimate *de minimis* thresholds will be:

- For credit default swaps that are SBS, $3 billion in notional CDS dealing transactions over the prior 12 months;
- For other types of SBS, $150 million in notional CDS dealing transactions over the prior 12 months;
- For all CFTC-regulated swaps, $3 billion in notional dealing transactions over the prior 12 months; and
- For all swaps, a $25 million threshold for swap dealing with "special entities" over the prior 12 months.

Swap Dealer and Security-Based Swap Dealer

What Is A Swap Dealer?

Consistent with the Dodd-Frank Act, the rules define swap dealer and SBS dealer to include any person that engages in any of the following types of activities:

- holding oneself out as a dealer in swaps or SBS;
- making a market in swaps or SBS;
- regularly entering into swaps or SBS with counterparties as an ordinary course of business for one's own account; or
- engaging in activity causing oneself to be commonly known in the trade as a dealer or market maker in swaps or SBS.

The term SD includes a person that regularly enters into swaps with counterparties as an ordinary course of business for its own account but does not include a 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 Commissions' guidance in the adopting release draws heavily upon the so-called "dealer-trader distinction," which has been developed over time by the SEC in the context of broker-dealer regulation, with certain adaptations to reflect the special circumstances of swaps. A key indicator is whether a person is providing liquidity by accommodating demand for, or facilitating interest expressed by, other participants. The Commissions set forth a list of activities (see the sidebar on page 3) that are indicative, although not conclusive, that a person is acting as an SD, as opposed to a non-SD "trader." They also specify that entering into a swap for the purpose of hedging risks, absent other activity, is unlikely to be indicative of dealing. In addition, the Commissions note that the SD analysis does not turn on whether a person's swap dealing activity constitutes that person's sole or predominant business, and a customer relationship is not a prerequisite to SD status.

The Commissions also provide extensive guidance concerning the interpretation of various elements of the swap dealer definition, including the terms: "holding oneself out" or "commonly known in the trade as a dealer in swaps," "making a market in swaps," and "as an ordinary course of business" and "as part of a regular business."

De Minimis Exclusion

The initial *de minimis* amount for analyzing whether a person is an SD is an effective notional value of $8 billion per year for CFTC-regulated swaps and for SBS that are CDS, and $400 million for other SBS. This represents a substantial increase from the numerical limits that were originally proposed. However, consistent with the proposed rule, the threshold for swap dealing with special entities (*e.g.*, municipalities, endowments, and employee benefit plans) is $25 million over the prior 12 months.

Indicators of Dealer Activity

- Seeking to profit by providing liquidity;
- Providing advice in connection with swaps or structuring swaps;
- Presence of regular clientele and actively soliciting clients;
- Use of inter-dealer brokers;
- Acting as a market maker on an organized exchange or trading system; and
- Helping to set prices offered in the market.

Unlike the proposed rules, the final rules do not impose a limit on the number of swaps a person can enter or the number of a person's swap counterparties. A swap does not count against the *de minimis* threshold if it:

- is not connected to dealing activity;
- is entered into with a person's majority-owned affiliates;
- is entered into by an insured depository institution in connection with the origination of loans to customers, subject to conditions (in the case of CFTC-regulated swaps); or
- qualifies for hedging exclusions under the Commissions' guidelines.

Significantly, the notional thresholds for the *de minimis* exception are based on an aggregation of all swap dealing positions entered into by the person and any entity controlling, controlled by, or under common control with such person. The Commissions will likely address the application of this aggregation principle to swaps involving non-U.S. persons in their forthcoming extraterritoriality releases.

The lookback period for calculating the notional amount of swaps begins on the effective date of the swap product definition rules (in other words, swaps entered into before the effective date of the swap product definition rules do not count towards the *de minimis* calculation). Once a person exceeds the threshold, such person has two months after the end of the month in which it breaches the threshold until it is deemed to be an SD. This may allow additional time for persons to register as SDs.

As described in the sidebar on page 2, the final rules contain a mechanism for potentially reducing the *de minimis* thresholds. As described in the sidebar, the Commissions will each separately prepare studies of swaps market activity to analyze the *de minimis* level and determine whether to change the threshold level. In the absence of action by either Commission, the relevant thresholds will drop significantly.

Hedging Exclusion

Under the CFTC's rule, a swap is excluded from the dealer analysis if:

- price risks being hedged 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 an SD.

Exclusions from the Definition of Swap Dealer

Although the Commissions generally declined to adopt categorical exclusions for persons from the definition of SD, they adopted several exclusions for certain types of activities, in addition to the *de minimis* exclusion discussed above.

Exclusion for Swaps Entered Into to Hedge Physical Positions

The CFTC adopted an interim final rule that excludes hedging of price risk associated with physical positions from swap dealer activity, provided the conditions in the sidebar are met.

The CFTC's hedging exclusion is similar to the CFTC's existing interpretation of *bona fide* hedging and also excludes swap activity for the purpose of portfolio hedging and anticipatory hedging. The CFTC requests comments on the interim final rule.

Notably, the hedging exclusion is of the nature of a safe harbor, and therefore does not mean that all other hedging activities, such as hedging of commercial or financial risk, are necessarily swap dealing activity. Instead, such hedging activity is to be considered in light of all other

Criteria for CFTC-Regulated Swaps In Connection with a Loan:

- The IDI enters into the swap with the customer within 90 days before or 180 days after the execution of the loan agreement, or within 180 days after any transfer of principal to the customer by the IDI pursuant to the loan;
- The rate, asset, liability, or other notional item underlying such swap is, or is directly related to, a financial term of such loan (*e.g.*, the loan's duration, rate of interest, and currency), or the swap is required, as a condition of the loan under the IDI's loan underwriting criteria, to be in place 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, *e.g.*, an interest rate or currency);
- The swap's duration does not exceed the termination date of the loan;
- The IDI is the sole source of funds to the customer under the loan, committed to be the source of at least 10% of the maximum principal amount under the loan, or committed to be the source of a principal amount that is at least the aggregate amount of all swaps entered into by the IDI with the customer in connection with the loan;
- The aggregate notional amount of all swaps entered into by the customer in connection with the loan is not more than the aggregate principal amount outstanding under the loan at any time; and
- If the swap is not cleared, the IDI reports the swap.

relevant facts and circumstances to determine whether the person is engaging in activity (*e.g.,* accommodating demand for swaps or making a market for swaps) that makes the person a swap dealer.

The SEC's SBS dealer definition also excludes certain swaps used for hedging purposes, but differs from the CFTC's rule by clarifying that an SBS position that hedges or otherwise offsets a position entered into as part of SBS dealing activity cannot be excluded from the *de minimis* calculation.

Exclusion for Inter-Affiliate Swaps

The final rules exclude from the SD and MSP analysis swaps between majority-owned affiliates.

Exclusion for Swaps Entered Into By Floor Traders

In determining whether a CFTC-registered floor trader is a swap dealer, such person need not take into account swaps entered into in its capacity as a floor trader, provided certain conditions set forth in the final rules are met. Floor traders that rely on this exclusion must comply with recordkeeping and risk management rules applicable to swap dealers as a condition of the relief.

Exclusion for Swaps In Connection with Originating a Loan

An insured depository institution ("**IDI**") is not considered a swap dealer to the extent it offers to enter into a CFTC-regulated swap with a customer in connection with originating a loan with that customer and meets certain criteria set forth in the sidebar. There is no similar exclusion for SBS.

Exclusion for Activities of a Cooperative

Any CFTC-regulated swap that is entered into by a cooperative with a member is not considered in determining whether the cooperative is a swap dealer subject to certain conditions, including that the cooperative reports the swap to a swap data repository or to the CFTC.

Limited Purpose Designation

Absent a limited purpose designation, a person that satisfies the "swap dealer" or "SBS dealer" definition will be considered a dealer for all types, classes, or categories of the person's swaps or SBS, and all activities involving swaps or SBS. In addition, the registration is at the legal entity level, rather than the desk or division undertaking dealing activities.

Consistent with the proposed rules, the final rules permit a person to apply for a limited purpose designation based on a particular type, class, or category of swap or SBS or to a particular business unit within an entity. The application would have to demonstrate how the applicant would satisfy the transaction-specific requirements in the context of a limited designation, as well as the entity-level requirements, such as capital, risk management, and supervision. The final rules also note that the SEC intends to address limited designation issues in two subsequent releases, including its extraterritoriality release.

Interaction with Broker-Dealer Registration

Pursuant to the Dodd-Frank Act, effective July 2011, SBS became "securities" under the Securities Act and Securities Exchange Act. The Dodd-Frank Act excludes from the Securities Exchange Act definition of "dealer" persons who engage in SBS transactions with eligible contract participants only. Therefore, a person must register as a broker-dealer if it engages in SBS dealing activities with persons other than eligible contract participants. A person must also register as a broker-dealer if it acts as a "broker" with respect to SBS for any type of counterparty. The *de minimis* threshold does not apply with respect to broker-dealer registration.

Major Swap Participant

MSP Thresholds

First and third statutory prongs:

- Current Uncollateralized Exposure greater than $3B for rate swaps or greater than $1B for each other category of swaps; or
- Current Uncollateralized Exposure + Potential Future Exposure greater than $6B for rate swaps or greater than $2B for each other category of swaps.

Second statutory prong:

- For swaps, Current Uncollateralized Exposure greater than $5B or Current Uncollateralized Exposure + Potential Future Exposure greater than $8B across all categories of swaps; and
- For security-based swaps, Current Uncollateralized Exposure greater than $2B or Current Uncollateralized Exposure + Potential Future Exposure greater than $4B across all categories of security-based swaps.

Title VII of the Dodd-Frank Act requires the CFTC and SEC to regulate "major swap participants" and "major security-based swap participants." The statute includes a three-prong test that seeks to capture those non-dealers with swaps or security-based swaps positions so large as to pose systemic risk and necessitate regulation. MSPs are subject to a regulatory regime very similar to that of SDs.

Dodd-Frank defines MSP to include any person who is not an SD and that:

- maintains a "substantial position" in one or more of the "major swap categories," excluding positions held to "hedge or mitigate commercial risk" and certain hedging positions held by an "employee benefit plan" (as defined in ERISA);
- has outstanding swaps that 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," is not subject to capital requirements of a Federal banking entity and has a "substantial position" in one or more of the "major swap categories," including positions used to hedge and mitigate risk.

As required by Dodd-Frank, the final rules include a further definition of MSP.

The final rule uses two building blocks for calculating the three statutory prongs: a "current uncollateralized exposure" component and a "potential future exposure" component. The "current uncollateralized exposure" component is, generally speaking, the amount the entity owes to its counterparty on swaps at any point in time less collateral it has posted, and is meant to represent the risk that the entity currently poses to its counterparties. The "potential future exposure" component is generated by multiplying swap notional amounts by factors related to the type and tenor of the swap, whether the swap is cleared or marked-to-market daily and netting arrangements related to the swap. This calculation is meant to

Hedging

The first and third statutory prongs differ in that the first allows an entity that is not a highly leveraged financial entity to exclude positions held to "hedge or mitigate commercial risk" and certain hedging positions held by an "employee benefit plan" (as defined in ERISA). The hedging exclusion is also available to parties that hedge the risks of a majority-owned affiliate.

The Commissions differ in their definition of "hedging or mitigating commercial risk" and in the guidance around those definitions. Both require that the swap is not held:

- for a purpose that is in the nature of speculation or trading; or
- to hedge or mitigate the risk of another swap, unless that other position itself is held for the purpose of hedging or mitigating commercial risk

and both allow exclusion of swaps that are "economically appropriate to the reduction of risks in the conduct of management of a commercial enterprise," where the risks arise from a number of enumerated scenarios.

The CFTC, but not the SEC, explicitly allows exclusion of swaps that are bona fide hedges from CFTC position limits or qualify for FASB/GASB hedging treatment. The CFTC, but not the SEC, excludes swaps held for "investing" purposes.

serve as a proxy for the risk that the entity's positions may pose in the future. To determine whether the entity is an MSP, the "current uncollateralized exposure" and "potential future exposure" calculations are combined in different ways corresponding to the three statutory MSP tests and compared to thresholds in the rule. The thresholds are quite high, as evidenced by the Commissions' indications that they expect only between 6 and 12 entities to qualify as MSPs. Swaps between majority-owned affiliates are excluded.

Entities are required to test for MSP status on a quarterly basis using the average of data collected daily. In response to commenters' concerns about the burdens of such calculations for entities that are far below the threshold, the final rule includes three calculation safe-harbors. One of these safe harbors does not require the MSP calculations to be done at all, while the other two look at modified versions of the MSP calculations at the end of each month, rather than based on daily information.

Since the MSP calculations are complex, we have created a separate slide presentation outlining its general steps. The presentation can be found here.

The MSP calculations attribute the swap positions of a subsidiary or affiliate to a parent, other affiliate or guarantor for the MSP analysis only "to the extent the counterparties would have recourse to that other entity in connection with the position," including through a guarantee. The entity to whom swaps are attributed for MSP analysis (the parent) can delegate transaction-level, but not entity-level, requirements to the person entering into the swap (the subsidiary). However, if the party entering into the swap is subject to capital regulation by the CFTC or SEC or is a U.S. entity regulated as a bank in the U.S., the position will not be attributed to a parent or other entity, even if there is a guarantee. As a result, bank holding companies will not be MSPs through guarantees of their bank or Commission-regulated subsidiaries. The CFTC and SEC will deal with guarantee issue for non-U.S. entities in their extraterritoriality releases.

The CFTC and SEC will not aggregate accounts managed by asset managers or investment advisers to determine if the asset manager or investment adviser is an MSP, unless necessary for anti-evasion purposes. Individual accounts of a beneficial owner will be aggregated at the beneficial owner only if the counterparty to the swap has recourse to the beneficial owner.

As with the SD definitions, a person breaching any of the MSP thresholds is presumed to be an MSP for all categories of swaps or security-based swaps, though an entity can apply to the Commissions for limited designation. It is not entirely clear how the MSP calculations would apply to an entity that has limited SD designation.

Eligible Contract Participant

Dodd-Frank requires that all swaps and security-based swaps with non-eligible contract participants ("**ECPs**") be executed on a designated contract

market or securities exchange, respectively, that a registration statement must be in effect for any security-based swap entered into with a non-ECP and that entities that deal in security-based swaps with non-ECPs must register with the SEC as broker-dealers. Dodd-Frank also amends the definition of ECP in the Commodity Exchange Act by increasing the ECP threshold for government entities, changing the way the ECP threshold is calculated for natural persons and providing that no commodity pool is an ECP for purposes of retail foreign exchange transactions (a "**retail forex pool**") if any of the pool's participants is not an ECP (the "**retail forex look-through**").

The final rules further define and provide guidance on the ECP definition. This includes:

- clarifying that the retail forex look-through reaches only to direct investors in the retail forex pool unless the structure has been developed to evade the rules;
- allowing a retail forex pool to be an ECP even if it has direct participants that are not ECPs if it is not formed for evasive purposes, has total assets exceeding $10 million and is formed and operated by a registered commodity pool operator ("**CPO**") or a CPO exempt from registration;
- limiting commodity pools' qualification as ECPs to the prong of the ECP definition specific to commodity pools, which requires a commodity pool to have assets exceeding $5 million and be operated by a registered CPO or a CPO exempt from registration;
- including swap entities as ECPs;
- providing that retail forex pools with no U.S. participants that are operated by CPOs outside the United States are ECPs for the purpose of retail forex transactions; and
- providing a "line of business" provision that allows a non-ECP to qualify as an ECP with respect to swaps used to hedge or mitigate its commercial risk if all of its owners are ECPs and any one of the owners has a net worth exceeding $1 million.[4]

Extraterritoriality

The final rule release states that the Commissions intend to issue separate releases addressing the application of Title VII to non-U.S. persons. In addition, Chairman Gary Gensler has stated that the CFTC is considering

[4] The CFTC has had a "line of business" provision allowing non-ECPs to enter into swaps in connection with their business since the CFTC's 1989 Swap Policy Statement. The final rule makes clear that market participants can no longer rely on the Swap Policy Statement.

issuing temporary exemptions that would allow for the phase-in of the Title VII requirements for cross-border swaps activities.

Commodity Options

In addition to the adoption of the final swap entity definition rules, the CFTC also adopted a final rule and an interim final rule concerning commodity options. Under the final rule, transactions in commodity options, which are statutorily defined as swaps, are permitted and subject to the rules applicable to all other swaps.

The interim final rule provides an exemption for certain physically delivered commodity options involving commercial users, subject to conditions including recordkeeping and reporting, an annual notice filing requirement, position limits and large trader reporting rules, risk management and transaction reporting for swap dealers and major swap participants, and anti-fraud and anti-manipulation provisions. The interim final rule also allows the CFTC, upon written request or upon its own motion, to exempt any other person from the commodity option regulations if the CFTC finds that the exemption would not be contrary to the public interest.

The effective date of the rule is 60 days after publication in the Federal Register, with a compliance date of 60 days after the swap product definition rules are published in the Federal Register.

Swap Entity Compliance Deadlines

The CFTC's final registration rules require an entity that is, or intends to be, a swap dealer or major swap participant to provisionally register with the CFTC by the later of the effective date of the swap entity definition rules and the effective date of the swap product definition rules. Entities that surpass the swap dealer *de minimis* threshold have two months to register from the end of the month in which the threshold is breached. The compliance dates for swaps regulations are generally keyed off either the publication date of the regulations or the date on which swap dealers and major swap participants are first required to file for provisional registration. To date, the CFTC's final swap regulations include:

- external business conduct;
- real-time reporting;
- swap data recordkeeping and reporting;
- swap dealer and major swap participant reporting, recordkeeping and daily trading records;
- conflicts of interest involving research and clearing activities;
- chief compliance officer designation and duties; and
- risk management and operational requirements.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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The compliance deadlines discussed above do not take into account the possibility that the CFTC may phase-in the compliance deadlines for cross-border swaps activities.

The deadlines for SBS dealer and major SBS participant registration and compliance with associated SEC rules are currently unknown because the SEC has not yet finalized its registration rules.

Market participants are required to comply with the retail forex look-through provision by December 31, 2012. By the same date, CPOs that previously relied on the repealed CFTC exemption from registration, and do not fit the terms of any other exemption, need to register as a CPO with the CFTC.