Major Swap Participant Analysis under Joint CFTC/SEC Definitions Finalized on April 18, 2012

Davis Polk

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Major Swap Participants and Major Security-Based Swap Participants

Title VII of the Dodd-Frank Act provides the CFTC with jurisdiction over “swaps” and the SEC with jurisdiction over “security-based swaps.”

“Swap dealers” and “major swap participants” are required to register with the CFTC. “Security-based swap dealers” and “major security-based swap participants” are required to register with the SEC.

Major swap participants and major security-based swap participants (“**MSPs**”) are subject to a regulatory regime almost identical to that imposed on swap dealers and security-based swap dealers. This regime includes requirements related to, among other topics:

- registration;
- internal and external business conduct;
- recordkeeping and reporting;
- documentation; and
- capital and margin.

The CFTC and SEC have stated that they expect very few entities (up to 6 on the CFTC side and approximately 12 on the SEC side) to register as MSPs.

The Statutory Three-Prong Test

Under Title VII, a person who is not a swap or security-based swap ("*Swap*") dealer is an MSP if it:

- 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) ("**prong 1**");
- 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" ("**prong 2**"); or
- Is a "financial entity" that is "highly leveraged," is not subject to capital requirements by 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 ("**prong 3**").

The joint CFTC/SEC final rule released on April 18 clarifies this test by defining the terms used within the test. The final rule also includes three safe harbors, discussed beginning on slide 28.

The methodology to be used in evaluating whether one of the prongs is satisfied is set forth in the following slides.

Building Blocks

The tests of "substantial position" and "substantial counterparty exposure" both use the same building block quantitative tests – a test for ***aggregate uncollateralized outward exposure*** and a test for ***aggregate potential outward exposure***.

These tests both look to *outward exposure* – the risk that an entity poses to its counterparties because of amounts that are due, or may be due, to the counterparties. This differs from usual bank capital and other conceptions of positional risk, which generally consider the risk posed *to the entity* through amounts owed to it.

The SEC and CFTC tests are done separately, but will be combined in this presentation for clarity.

Building Block 1 – Current Uncollateralized Exposure

The ***aggregate uncollateralized outward exposure*** test is meant to capture current uncollateralized exposure – the amount that an entity currently owes to its counterparties on Swaps.

To determine aggregate current uncollateralized exposure:

1. Determine the dollar value of your Swap positions with "negative value" in each category with respect to each counterparty by marking-to-market using standard industry practices and applying netting provisions

2. Deduct from that amount the aggregate collateral you have posted with respect to your Swap positions

The resulting number is your aggregate current uncollateralized exposure, or **Current Uncollateralized Exposure.**

Building Block 1 – Current Uncollateralized Exposure

For purposes of calculating current uncollateralized exposure, master netting agreements entered into between the entity and a single counterparty are given effect, but no netting is allowed between different counterparties.

Netting can be done across master netting agreements and all financial instruments, as allowed under applicable bankruptcy law. The final rule provides formulas for *pro rata* allocation of collateral in such situations.

Building Block 2 – Potential Future Exposure

The ***aggregate potential outward exposure*** test is meant to capture potential future exposure – the amount that an entity may owe to its counterparties on Swaps.

The aggregate potential outward exposure of an entity is determined using the sum, for each Swap, of the formula:

Notional x Risk Factor x Clearing-MTM Factor x Netting Factor

This is your aggregate potential outward exposure,
or **Potential Future Exposure**.

The Risk Factor

Notional x Risk Factor x Clearing-MTM Factor x Netting Factor

The Risk Factor depends on time to maturity (which may be the time to the next reset if certain conditions are satisfied) and type of Swap.

Swaps:

Residual Maturity	Interest Rate	Foreign Exchange and Gold	Other Precious Metals	Other Commodities	Credit	Equity
One year or less	0.00	0.01	0.07	0.10	0.10	0.06
Over one to five years	0.005	0.05	0.07	0.12	0.10	0.08
Over five years	0.015	0.075	0.08	0.15	0.10	0.10

Security-: based Swaps

Residual Maturity	Debt	Equity and Other
One year or less	0.10	0.06
Over one to five years	0.10	0.08
Over five years	0.10	0.10

The Clearing-MTM Factor

Notional x Risk Factor x Clearing-MTM Factor x Netting Factor

If the Swap is marked-to-market daily, the calculation is decreased by 80% - meaning that the Clearing-MTM Factor is 0.2. Daily marking-to-market may include thresholds or minimum transfer amounts, but the total amount of the threshold (less initial margin posted up to the amount of the threshold), and the entirety of any minimum transfer amount above $1 million, will be added to the person's current uncollateralized exposure.

If the Swap is centrally cleared, the calculation is decreased by 90% - meaning that the Clearing-MTM Factor is 0.1.

If the swap is not cleared or marked-to-market daily, there is no reduction and the Clearing-MTM Factor is 1.

The Netting Factor

Notional x Risk Factor x Clearing-MTM Factor x **Netting Factor**

If the Swap position is subject to a master netting agreement, the Netting Factor with respect to a particular counterparty is equal to:

$$0.4 + 0.6 \times \left(\frac{\text{Net exposure for counterparty}}{\text{Gross exposure for counterparty}} \right)$$

where the net and gross exposures for counterparties are the current uncollateralized exposures as calculated above.

This implies that the Netting Factor can vary from 0.4 to 1, which means a reduction for netting of up to 60%.

Excluded or Modified Positions

The potential future exposure calculations exclude:

- purchases of an option for which the purchaser has no additional payment obligations under the option;
- other positions for which the person has prepaid or otherwise satisfied all of its payment obligations; and
- positions for which, pursuant to law or a regulatory requirement, the person has assigned an amount of cash or U.S. Treasury securities sufficient at all times to pay their maximum possible liability, and the person may not use that cash or those Treasury securities for other purposes.

The potential future exposure for purchased protection through CDS or a purchased option through which the person retains additional payment obligations under the position is capped at the net present value of the unpaid premiums.

The Three-Prong Test

With the building blocks complete, we can return to the three-prong test.

- 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 by 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.

The Three-Prong Test

With the building blocks complete, we can return to the three-prong test.

- 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 by 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.

First Prong – Substantial Position Minus Some Hedges

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).

The CFTC has divided swaps into 4 "major categories":

- rate swaps
- credit swaps (including CDS and total return swaps on debt instruments)
- equity swaps
- other commodity swaps.

The SEC has divided security-based swaps into 2 "major categories":

- debt security-based swaps
- other security-based swaps (including equity swaps).

First Prong – Substantial Position Minus Some Hedges

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)

The "substantial position" determination relies on the building blocks from earlier. A "substantial position" with respect to any major Swap category is defined as:

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

Notional amounts must be adjusted for leverage and other structural enhancements.

For this and the other tests, the exposures are ***daily averages*** over all business days in a calendar quarter. This means that calculations must be made on a ***daily basis.***

First Prong – Substantial Position Minus Some Hedges

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).

The CFTC and SEC each provide indicia of what it means to "hedge or mitigate commercial risk." In general, these indicia attempt to determine whether a position is hedging or mitigating commercial risk or is a position used for speculation, investing or trading.

The exclusion is also available to parties that hedge the risks of a majority-owned affiliate.

CFTC Hedges

The CFTC defines a swap as "hedging or mitigating commercial risk" if it:

- is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where the risks arise from a number of enumerated scenarios;
- qualifies as bona fide hedging for exemptions from CFTC position limits; or
- qualifies for hedging treatment under FASB 815 (formerly Statement No. 133) or GASB 53;

and it is not held:

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

The CFTC provides additional guidance as to what qualifies as "hedging or mitigating commercial risk" and what does not.

SEC Hedges

The SEC defines a security-based swap as "hedging or mitigating commercial risk" if it:

- is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where the risks arise from a number of enumerated scenarios;

and it 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 or security-based swap position, unless that other position itself is held for the purpose of hedging or mitigating commercial risk.

The SEC provides additional guidance as to what qualifies as "hedging or mitigating commercial risk" and what does not. The guidance provided by the SEC is not the same as the guidance provided by the CFTC.

The Three-Prong Test

With the building blocks complete, we can return to the three-prong test.

- 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 by 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.

Second Prong – Substantial Counterparty Exposure

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."

"Substantial counterparty exposure" is calculated using the same building blocks as "substantial position." However, it is measured across all swaps or security-based swaps, not by category. In addition, the thresholds are different, and there is no credit for hedge positions.

"Substantial counterparty exposure" is defined for "swaps" as:

- Current Uncollateralized Exposure greater than $5 billion; or
- Current Uncollateralized Exposure + Potential Future Exposure greater than $8 billion.

"Substantial counterparty exposure" is defined for "security-based swaps" as:

- Current Uncollateralized Exposure greater than $2 billion; or
- Current Uncollateralized Exposure + Potential Future Exposure greater than $4 billion.

The Three-Prong Test

With the building blocks complete, we can return to the three-prong test.

- 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 by 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.

Third Prong – Substantial Position, No Hedges

Is a "financial entity" that is "highly leveraged" and has a "substantial position" in one or more of the "major Swap categories," including positions used to hedge and mitigate risk

The third prong is similar to the first prong, but only applies to financial entities that are highly leveraged and, for those entities, does not provide hedging credit.

Like the first prong, a "substantial position" with respect to any major Swap category is defined as:

- Current Uncollateralized Exposure greater than $3 billion for rate swaps or greater than $1 billion for any other category of Swap; or
- Current Uncollateralized Exposure + Potential Future Exposure greater than $6 billion for rate swaps or greater than $2 billion for any other categories of Swap

Third Prong – Substantial Position, No Hedges

Is a "financial entity" that is "highly leveraged" and has a "substantial position" in one or more of the "major Swap categories," including positions used to hedge and mitigate risk.

A "financial entity" includes:

- Swap Dealers and MSPs;
- commodity pools;
- private funds;
- ERISA employee benefit plans; and
- persons predominantly engaged in activities that are in the business of banking or financial in nature as defined in section 4(k) of the BHC Act.

For purposes of determining whether a person is an MSP, this does not include an entity that is a financial entity solely as a result of activities that facilitate hedging and/or treasury functions on behalf of one or more majority-owned affiliates that themselves do not constitute a financial entity (note this appears to be mistakenly left out on the CFTC side).

Third Prong – Substantial Position, No Hedges

Is a "financial entity" that is "highly leveraged," is not subject to capital requirements set by a Federal banking agency and has a "substantial position" in one or more of the "major Swap categories," including positions used to hedge and mitigate risk.

"Highly leveraged" is defined as a ratio of total liabilities to equity greater than 12:1 as measured at the close of business on the last business day of the fiscal quarter.

Liabilities and equity should each be determined in accordance with U.S. GAAP. Special rules apply to ERISA plans.

Notes About the MSP Definition

Calculation Frequency

- Except for the safe harbors, the calculations must be done for each calendar quarter, taking the average of the calculations at the close of each business day.

Effective Notional Amounts

- Whenever a notional amount is used, the "effective notional amount" should be used instead if the stated notional amount is "leveraged or enhanced by the structure of the position."
- The rule provides specific "effective notional amount" calculations for options.

Legacy Positions

- All legacy positions must be included in the MSP calculations. The Commissions will deal with specific issues relating to legacy positions in the relevant substantive rulemakings.

Notes About the MSP Definition

Guarantees

- The positions of a subsidiary or affiliate will only be attributed to a parent, other affiliate or guarantor for the MSP analysis "to the extent the counterparties would have recourse to that other entity in connection with the position," including through a guarantee.
- 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 CFTC/SEC-regulated subs.
- The CFTC and SEC will deal with guarantee issues for non-U.S. entities in their extraterritoriality releases.
- In this context, 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).

Notes About the MSP Definition

Affiliates

- Swaps between majority-owned affiliates are not counted for the MSP calculations.
- Majority-owned affiliates are those where:
  - one counterparty directly or indirectly owns a majority interest in the other; or
  - a third party directly or indirectly owns a majority interest in both counterparties to the swap, where “majority interest” is the right to vote or direct the vote of a majority of a class of voting securities of an entity, the power to sell or direct the sale of a majority of a class of voting securities of an entity, or the right to receive upon dissolution or the contribution of a majority of the capital of a partnership.

Managed Accounts

- 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 level only if the counterparty to the swap has recourse to the beneficial owner.

Notes About the MSP Definition

Excluded Entities

- The CFTC, but not the SEC, explicitly excludes registered clearinghouses from the MSP definitions. The SEC indicates its belief that clearinghouses should be excluded.
- Foreign governments, foreign central banks and international financial institutions are excluded from MSP designation by the CFTC. The SEC is silent on treatment of these entities.
- Captive finance companies are excluded from being a major swap participant, but not a major security-based swap participant.
  - A captive finance company is defined as a company whose primary business is providing financing and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90% or more of which arise from financing that facilitates the purchase or lease of products, 90% or more of which are manufactured by the parent company or another subsidiary of the parent company.

Extraterritoriality

- The release states that the CFTC and SEC will provide further guidance on extraterritorial issues related to the MSP definitions.

Safe Harbors

The rule includes 3 safe harbors to relieve market participants of daily calculations.

Only the first safe harbor can be calculated without the building blocks described above.

The first safe harbor provides that an entity is not an MSP if:

- the express terms of the entity's swaps or security-based swaps provide that the person will not be able to maintain a total uncollateralized exposure of more than $100 million to all counterparties, including exposure that may result from the application of thresholds or minimum transfer amounts; and
- the entity does not have notional swap or security-based swap positions greater than $2 billion in any major category of Swaps, or more than $4 billion in aggregate (separate for swaps and security-based swaps).

Second Safe Harbor

The second safe harbor provides that a person is not an MSP if:

- the express terms of the entity's swaps or security-based swaps provide that the person will not be permitted to maintain a total uncollateralized exposure of more than $200 million to all such counterparties (including from financial instruments other than swaps), including any exposure that may result from the application of thresholds or minimum transfer amounts; and
- the entity's current uncollateralized exposure plus potential future exposure calculated **at the end of each month** (rather than on a daily basis) is no greater than:
  - $1 billion in any single major category of Swaps (excluding hedges, if not a highly-leveraged financial entity); or
  - $2 billion for all Swap positions (not excluding any positions, and with swaps and security-based swaps calculated separately).

Third Safe Harbor – Full Version

The full version of the third safe harbor provides that a person is not an MSP if:

- the person's current uncollateralized exposure is in connection with a major category of Swaps is less than:
  - $1.5 billion for the rate swap category; and
  - $500 million in any other Swap category; and
- the sum of the current uncollateralized exposure and notional amount (adjusted by the relevant Risk Factor) **at the end of each month** (rather than calculated daily) is less than:
  - $3 billion for the rate swap category; and
  - $1 billion in any other Swap category.

The uncollateralized outward exposure for positions with Swap Dealers is the exposure reported on the most recent reports received from the Swap Dealer.

Third Safe Harbor – Simplified Version

The simplified version of the third safe harbor provides that a person is not an MSP if:

- the person's current uncollateralized exposure in connection with all swaps or security-based swaps is less than $500 million; and
- the sum of:
  - the current uncollateralized exposure; and
  - the notional amount of the person's swap positions in all swap categories, multiplied by 0.15 for CFTC swaps and 0.10 for SEC security-based swaps,

  is less than $1 billion.

The uncollateralized outward exposure for positions with Swap Dealers is the exposure reported on the most recent reports received from the Swap Dealer.

Note: The description of this safe harbor is garbled in the rule text, but this appears to be the correct interpretation.

MSP Registration and Timing

- Entities meeting the MSP tests in a fiscal quarter are deemed MSPs at the earlier of their complete application for registration or two months after the end of the quarter.
- Entities that meet the MSP test by surpassing a threshold by no more than 20% in a given fiscal quarter do not have to register unless they surpass a threshold in the next fiscal quarter.
- MSPs remain MSPs until they do not breach any MSP threshold for four consecutive fiscal quarters.
- Entities that breach any MSP threshold in a fiscal quarter are MSPs for all categories of swaps or security-based swaps – there is no automatic “limited purpose” designation, though entities can apply to the CFTC or SEC for designation with respect to particular categories of Swaps.
- The SEC has proposed a four-month conditional registration for MSPs under their jurisdiction.

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