The SEC and CFTC Propose Joint Rules Defining Swap Dealers and Major Swap Participants

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The Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") (jointly, the "Commissions"), in consultation with the Board of Governors of the Federal Reserve System ("Federal Reserve"), have proposed joint rules and interpretive guidance ("Proposed Rules")[1] on the further definition of the terms "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant," and "eligible contract participant," as required by Sections 712(d)(1), 721(c), and 761(b) of the Dodd-Frank Act.[2] Swap dealers, security-based swap dealers, major swap participants ("MSPs"), and major security-based swap participants ("MSBSPs")[3] will be required to register with either or both the SEC and CFTC and will be subject to a comprehensive new framework of regulation, including, among other things, margin, capital, business conduct, recordkeeping, and reporting requirements.[4]

The Proposing Release acknowledges that the rules the Commissions adopt will significantly affect the swap markets, and it seeks comment on a wide range of questions relating to these important new definitions. Comments are due within 60 days of publication in the Federal Register.

I. Swap Dealer and Security-Based Swap Dealer

A swap dealer under the Act is defined as any person who: (1) holds itself out as a swap dealer; (2) makes a market in swaps; (3) regularly enters into swaps as an ordinary course of business for its own account; or (4) engages in activity that causes it to be commonly known in the trade as a dealer or market maker. The definition specifically excludes a person trading swaps for its own account, either individually or as a fiduciary, but not as a part of a regular business. It also provides an exemption for entities that engage in *de minimis* swap dealing in connection with transactions with or on behalf of their customers, as well as for insured depository institutions that offer or enter into a swap (but not a security-based swap) with a customer in connection with a loan to that customer.

Under the Proposed Rules, affiliates would be considered separate persons for purposes of this definition. Thus, an affiliated group under common control could have more than one swap dealer. However, a discrete business unit, such as a trading desk, would not be a person separate from the

legal entity to which it belongs. Assuming affiliate transactions are not used to evade the dealer definitions, in general swaps between persons under common control would not be considered dealing activity.

Under the Dodd-Frank Act, the Commissions may (but are not required to) designate a person as a swap dealer in one or more types, classes, or categories of swap or swap activities without designating the person as such for all types, classes, categories, or activities. The Proposed Rules would generally not provide for limited designations but would require that a person that satisfies the definition of swap dealer be a dealer for all its swap activities unless it receives individual relief from the relevant Commission. For example, a non-financial entity, such as a physical commodity firm, that conducts swap dealing activity through a division of the entity could be required to register as a swap dealer but request relief so that it would be so designated only with respect to the dealing activities of the division.

A. Characteristics of Swap Dealers

The Proposing Release emphasizes that the Commissions intend to interpret the term "swap dealer" functionally and flexibly, to reflect how a person holds itself out to the market as well as the person's conduct and how that conduct is perceived by the market. To be a swap dealer, the person need not be "predominantly" engaged in swap dealing. Its dealing activity need only be greater than the *de minimis* exception thresholds.

The Proposing Release notes that dealers typically tend:

- To accommodate demand from other parties;
- To be generally available to enter into swaps to facilitate other parties' interest in entering into those instruments;
- Not to request that other parties propose the terms of swaps, but rather to enter into those instruments on their own standard terms or on terms they arrange in response to other parties' interest; and
- To be able to arrange customized terms upon request, or to create new types of swaps at the dealer's own initiative.

Factors that suggest that a person holds itself out or is commonly known as a dealer include, without limitation, that the person:

- Contacts potential counterparties to solicit interest in swaps;
- Develops new types of swaps and informs potential counterparties of their availability;
- Communicates and/or markets its willingness to enter into swaps with potential

counterparties;

- Is a member of a swap association in a category reserved for dealers; or
- Generally expresses a willingness to offer or provide a range of financial products that would include swaps.

Acknowledging that relevant principles may differ in the swap and securities-based swap markets, the Proposing Release proposes that the core tests applicable to identifying dealers would also differ such that the focus would be on "those persons whose function is to serve as the point of connection" in the relevant markets. With respect to security-based swaps, the SEC also intends to consider the same factors that are relevant to determining whether a person is a "dealer" under the Securities Exchange Act of 1934 ("Exchange Act"), including drawing a distinction between dealers–which, among other things, generally have regular clients, hold themselves out as buying or selling securities at a regular place of business, have a regular turnover of inventory, and provide liquidity services in transactions with investors or other market professionals–and traders. The Proposing Release notes, however, that the concepts of inventory and regular place of business are not clearly applicable to the security-based swap market and that this distinction needs to be taken into account when determining whether a person is a security-based swap dealer.

In addition, to the extent that security-based swaps are used by end-users to hedge business risk, the Proposing Release suggests that these end-users would be more likely to be viewed as traders than dealers. The Commissions expressly request comment on the application of the dealer-trader distinction in the context of security-based swap dealing.

B. De Minimis Exemption

The *de minimis* exemption would apply "only when an entity's dealing activity is so minimal that applying dealer regulations to the entity would not be warranted." The Proposed Rules would establish a number of factors for determining whether dealing activity is *de minimis*. Each factor would apply to the preceding 12-month period and would not distinguish between types of swap. Under this approach, dealing activity would be limited to: (1) an aggregate effective gross notional amount of no more than $100 million; (2) an aggregate effective notional amount of swaps with a "special entity" counterparty[5] of no more than $25 million; (3) no more than 15 non-swap dealer counterparties (counterparties in a single group or under common control would be a single counterparty); and (4) no more than a total of 20 swaps. All four factors would have to be met to qualify for the exemption. Stating that they are particularly interested in input on this exemption, the Commissions request comment on a number of related questions, including whether the exemption should be conditioned on the presence of an existing customer relationship.

C. Persons Acting as Brokers in Security-Based Swaps Transactions

The Dodd-Frank Act excludes from the definition of "dealer" under the Exchange Act a person who engages in a security-based swap transaction with an eligible contract participant ("ECP"). However,

it does not include a parallel amendment for a person acting as a *broker* in a similar transaction. The Proposing Release reflects the SEC's view that persons who act as brokers in connection with security-based swaps, which are now securities, "must, absent an exemption, register with the SEC as a broker pursuant to Exchange Act section 15(a), and comply with the Exchange Act's requirements applicable to brokers."

II. Major Swap Participant and Major Security-Based Swap Participant

Under the Act, a major swap participant is any non-swap dealer: (1) that maintains a substantial position in swaps in any of the "major" categories determined by the relevant Commission, except positions held for hedging or mitigating commercial risk, or held by an ERISA employee benefit plan; (2) whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; *and/or* (3) that is a financial entity that is highly leveraged relative to the amount of capital it holds, is not subject to a federal banking agency's capital requirements, and maintains a substantial position in outstanding swaps in a major category.

With respect to swaps (but not security-based swaps), the definition specifically excludes captive financing arms, *i.e.*, entities whose primary business is providing financing and that use swaps to hedge underlying commercial risks related to interest rate and foreign currency exposures, at least 90 percent of which arise from financing the purchase or lease of products, at least 90 percent of which are manufactured by an affiliate.

While the dealer definition focuses on a market participant's activities, the MSP definition looks to the impact and risks associated with an entity's swap positions. Both swap dealers and MSPs, however, are subject in large part to identical statutory requirements. As with the definition of swap dealer, the Proposed Rules would not require registration for different categories of swap. Instead, if a person were deemed to be an MSP in general, then it would be an MSP for all categories of swap and all swap-related activities unless it obtained individual relief from the relevant Commission.

A. "Major" Categories of Swaps or Security-Based Swaps

The Proposed Rules would designate major categories of swaps and security-based swaps in a way that would reflect that the instruments used by MSPs and MSBSPs involve different types of risks and are often used for different purposes. Accordingly, "[i]nterpretation of the definitions must appropriately account for those differences." The major categories designations would apply only for purposes of the MSP/MSBSP definitions.

The Proposed Rules would designate four categories of swap, which together are intended to cover all swaps, with each swap falling into the category it most closely fits. The categories would be: (1) rate swaps; (2) credit swaps; (3) equity swaps; and (4) other commodity swaps, which would include all swaps not included in the first three categories. If a swap is based on more than one underlying item of different types, it would fall into the category that describes the underlying item

likely to have the most significant effect on the economic return of the swap.

The Proposed Rules would designate two major categories of security-based swap. The first would include any security-based swap based, in whole or in part, on one or more debt (including loan) instruments or on a credit event relating to one or more issuers or securities, including a credit default swap, total return swap on debt, debt swap, debt index swap, or credit spread. The second category would include all other security-based swaps, e.g., equity swaps.

B. Substantial Position

The Act requires the Commissions to define "substantial position" at a prudent threshold for monitoring systemic risk, taking into consideration an entity's relative position in uncleared versus cleared swaps and, possibly, the value and quality of collateral held against counterparty exposures. To allow market participants and regulators to evaluate whether a position meets the threshold and achieve predictable application and enforcement of applicable regulatory requirements, the Proposed Rules would use objective numerical criteria to set the substantial position thresholds and would look at both *current uncollateralized* and *potential future* exposure. The Proposing Release asserts that both tests are needed to address gaps left by either if used alone and thus a position that satisfied either of the tests would be deemed "substantial."

1. Current Uncollateralized Exposure Test

The proposed current uncollateralized exposure test would set the threshold by marking-to-market (using accepted industry standards) the exposure arising from each of the person's unhedged positions with negative value in each of the applicable major categories. Thus, the test would measure the aggregate portion of the exposure within a particular major category that is not offset by the posting of collateral. According to the Proposing Release, this test would account for the lower risk involved in central clearing because cleared positions would be largely fully-collateralized and would thus be effectively eliminated from the analysis. This test would also allow persons to calculate exposure on a net basis by applying the terms of netting agreements.

The current uncollateralized exposure threshold would be set at a daily average of $1 billion in each major category of swap and security-based swap except for the rate swap category, which would be set at $3 billion.

2. Proposed Current Exposure Plus Potential Future Exposure Test

This second test, which builds on but modifies bank capital standards to account for risk to counterparties rather than risk to an entity itself, is intended to take into account estimates of how the value of a swap position could move against the entity over time. It would reflect the potential exposure in the applicable major category by looking at the total notional principal amount of positions in a particular category, adjusted up or down by certain risk factors, such as the type of swap and the duration of the position. Calculations for leveraged positions would be based on their

effective notional amount. The calculations for cleared swaps, or swaps subject to daily mark-to-market margining, would be adjusted down to 20 percent of the potential future exposure. Such positions would not be fully excluded because, according to the Commissions, clearing does not completely eliminate risk.

The substantial position threshold for this second test would be $2 billion ($6 billion for the rate swap category) in combined current uncollateralized exposure plus "aggregate potential outward exposure" in a particular category. The Proposing Release notes that only a relatively few entities should have to perform potential future exposure calculations for security-based swaps.

C. Hedging or Mitigating Commercial Risk

The first prong of the MSP definition excludes positions held for "hedging or mitigating commercial risk." This language is virtually identical to the language in the end-user exception from mandatory clearing and the Commissions intend to interpret the language the same way for both concepts.[6] While a financial entity may not qualify for the end-user exception, however, the Proposing Release makes clear that positions held to hedge or mitigate[7] commercial risk would be excluded from the first prong of the MSP definition regardless of the nature of the entity. Thus, financial entities of all kinds would be permitted to exclude positions held for hedging for purposes of calculating whether they hold a substantial position.

The Proposed Rules would define hedging broadly to cover hedging or mitigating "any of a person's business risk," including "economic hedges," regardless of the swap's status under accounting guidelines or the Commodity Exchange Act's ("CEA's") *bona fide* hedging exemption. Whether a position is held for "hedging" would be determined by the facts and circumstances at the time the swap is entered into, taking into account the entity's overall hedging and risk mitigation strategies.

Positions held intentionally for short-term resale or "primarily taking an outright view of the direction of the market" would be considered entered into for purposes of speculation or trading and not hedging. Moreover, swap positions that hedge other positions that themselves are held for speculation or trading would not be viewed as hedging positions.

Security-based swap positions would be subject to additional risk management requirements before they could be excluded, including identification and documentation of the risks being reduced; documented methodology to assess the effectiveness of the hedge; and regular assessment of the effectiveness of the hedge.

Whether an activity is "commercial" would not be determined by an entity's organizational status, but rather by whether the underlying activity to which the swap relates is "commercial in nature." The Proposed Rules would require that the swap be "economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise."

D. Substantial Counterparty Exposure

The second prong of the MSP definition covers entities whose swap positions create substantial counterparty exposure that could have systemic effects. This prong does not include a hedging exemption, nor does it focus on different categories of swap. The Proposed Rules would apply the same analysis as in the "substantial position" determination but at a threshold that focuses on the entirety of an entity's swap positions, whether or not they are hedged, and that takes the view that security-based swaps involve greater potential systemic risk than swaps. Thus, an entity would be an MSP under the second prong if its current uncollateralized exposure were $5 billion for swaps and $2 billion for security-based swaps, or its combined current uncollateralized and potential future exposure were $8 billion for swaps and $4 billion for security-based swaps, across all its swap or security-based swap positions.

E. Financial Entity and Highly Leveraged

The third prong of the MSP definition covers any "financial entity" (other than banking entities with capital requirements) that is "highly leveraged." It does not define "financial entity." However, "financial entity" is defined for purposes of the end-user exception from clearing. The Proposed Rules would use essentially the same definition, making only technical changes to avoid circularity. A financial entity would be "highly leveraged" if the ratio of its total liabilities to equity were in excess of *either* 8 to 1 or 15 to 1, measured at the end of the fiscal quarter. Liabilities would be determined in accordance with U.S. generally accepted accounting principles. The Proposing Release seeks comment on which ratio is more appropriate.

F. Reevaluation for Entities Close to the Threshold

The Proposed Rules would provide for a reevaluation of MSP status for entities that barely meet one or more of the MSP prongs (*i.e.*, by no more than 20 percent over any applicable threshold) for only one quarter. Such an entity would only be required to register if it met any of the applicable thresholds in the next quarter.

G. Other Interpretive Issues

The Proposing Release also seeks comment on the following issues related to the MSP definition:

- Treatment of ERISA plans;
- Application to managed accounts;
- Application to positions of affiliated entities;
- Application to inter-affiliate swaps;
- Legacy portfolios (credit default swaps previously entered into in connection with monoline insurers and credit derivative product companies); and

- Other potential exclusions (e.g., investment companies, banks, registered broker-dealers, registered futures commission merchants, and/or long-term investors such as sovereign wealth funds).

III. Eligible Contract Participant

The Commodity Futures Modernization Act of 2000 generally exempted or excluded transactions between ECPs from most of the provisions of the CEA. The Dodd-Frank Act repealed those exemptions and exclusions. In order to protect retail investors, however, the Act prohibits a non-ECP from entering into a swap except on a registered exchange (for security-based swaps) or on or subject to the rules of a designated contract market (for swaps). The Act also amended the ECP definition: (1) to raise the threshold for government entities to qualify as ECPs from $25 million in discretionary investments to $50 million; and (2) to change the standard for individuals to qualify as ECPs from a total assets of $10 million standard to a discretionary investment of $10 million standard.

Although the Act requires the Commissions to define the term "ECP" further, the Commissions have determined not to "undertake a wholesale revision of the ECP definition" and have limited the Proposed Rules to include the new categories of swap dealer, security-based swap dealer, MSP, and MSBSP.

IV. Conclusion

The definitions and thresholds in the Proposed Rules, which will have sweeping ramifications for participants in the swap and security-based swap markets, are complex and raise a number of important questions, including whether they provide enough certainty to market participants while at the same time retaining the flexibility to evolve with market developments. The Proposing Release requests comment on a wide range of questions, offering an important opportunity for companies to provide input to the Commissions before adoption of final rules.

[1] Securities Exchange Act Release No. 63,452, Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant" (Dec. 7, 2010) ("Proposing Release"), *available at: sec.gov/rules/proposed/2010/34-63452.pdf*.

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"), Pub. L. No. 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank Act" or "Act").

[3] Swap dealers and security-based swap dealers are treated virtually identically under the Dodd-Frank Act, as are MSPs and MSBSPs. Accordingly, unless otherwise noted, we use the terms "swap" to include both swaps and security-based swaps, "swap dealer" to include both swap dealers and security-based swap dealers, and "MSP" to include both MSPs and MSBSPs.

[4] The CFTC has issued separate rule proposals that address registration and other requirements

for swap dealers and MSPs. *See, e.g.*, Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, 75 Fed.Reg. 71,397 (Nov. 23, 2010); Registration of Swap Dealers and Major Swap Participants, 75 Fed.Reg. 71,379 (Nov. 23, 2010); Implementation of Conflicts of Interest Policies and Procedures by Swap Dealers and Major Swap Participants, 75 Fed.Reg. 71391 (Nov. 23, 2010). The SEC has not yet issued similar rule proposals for security-based swap dealers and MSBSPs.

[5] Under Sections 731 and 764 of the Dodd-Frank Act, "special entities" are essentially government agencies, employee benefit plans, and endowments.

[6] Section 723 of the Act allows non-financial end-user entities that use swaps to hedge or mitigate commercial risk to elect not to clear their swaps.

[7] The Proposed Rules would not distinguish between "hedging" and "mitigating."

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