

CFTC Proposes a Swap Product Definition and Capital Requirements Under Dodd-Frank

May 10, 2011

At a public meeting on April 27, the Commodity Futures Trading Commission (CFTC or the Commission) proposed two new rulemakings pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) to address: (i) the further definition of certain products regulated by the Commission and the Securities and Exchange Commission (SEC) under Dodd-Frank, including "swap"; and (ii) capital requirements for non-bank swap dealers and major swap participants (SD/MSPs).

Definition of "Swap"

Although "swap" was generally defined for the purposes of Dodd-Frank in Section 721 of the statute, the CFTC and SEC were tasked with further defining the term along with several other product definitions pertinent to Dodd-Frank, including "security-based swap" and "mixed swap." During the course of the last six months of Dodd-Frank rulemaking proposals made by the CFTC and SEC, many commentators have criticized the lack of a refined swap definition, pointing out that a proper evaluation of the effects of Dodd-Frank implementing regulations hinged on how the term would ultimately be defined. In a separate rulemaking proposed by the CFTC earlier this year regarding *Commodity Options and Agricultural Swaps*,¹ the agency has suggested that physically settling options would be considered swaps.

In further defining the term "swap," the CFTC and SEC have left a degree of ambiguity as to whether what are commonly understood as commodity options (which can settle physically) are to be generally considered swaps, since the statute appears to include such products in its overarching swap definition. In its definition proposal, the CFTC has said that forward contracts for non-financial commodities will be excluded from the definition, consistent with the CFTC's past practice with respect to futures contracts. Options embedded in forwards would also be excluded from the definition. Similarly, transactions that are booked-out (where physical delivery is not effected due to a subsequent agreement) will qualify for an exclusion for market participants that regularly make or take delivery of a commodity in the ordinary course of business (a "book-out" transaction).

With regard to electric power ISO/RTO products, including Financial Transmission Rights (FTRs), the CFTC has said only that it will consider granting exemptions to such transactions where an instrument regulated by the Federal Energy Regulatory Commission (FERC) is involved and such an exclusion would be in the public interest. This would entail a "waiver" process that would implicitly acknowledge CFTC jurisdiction over such products, which have until now been the exclusive regulatory responsibility of FERC.

Commissioner Sommers voted against the swap definition proposal, explaining that the "evasion" provisions of the proposed rule were overbroad. These pertain to a finding by the Commission that a given transaction is intentionally structured to avoid regulation as a swap without an independent legitimate business purpose, in which case it will be treated as a swap by the Commission. The proposal states that the CFTC intends to look beyond the form of a given transaction to examine its actual substance and prevent evasion "through clever draftsmanship." The CFTC's proposed anti-evasion rule would expressly prohibit activity conducted outside of the United States to willfully evade regulation under Dodd-Frank; the proposed further definition of the term "swap" would also expressly encompass any agreement or transaction willfully structured to evade Dodd-Frank regulation as a swap. The proposal includes the Commission's "interpretive guidance" as to what may constitute evasion of the requirements of Dodd-Frank with respect to swaps, while emphasizing that the Commission will examine individual cases on a case-by-case basis. It remains unclear how a given instrument could be a "swap" but for a structure designed to evade a designation as such, and what would be considered a legitimate business purpose under this standard for choosing a given structure for a transaction. The interpretive guidance does state that the Commission will build on the Internal Revenue Service's methods for distinguishing legitimate attempts to minimize tax burdens from tax evasion, stating that the Commission will consider the extent to which conduct involves deceit, deception or other unlawful or illegitimate activity.

Capital Requirements

The proposed rules set capital requirements for non-bank SD/MSPs (which are separately proposed to be defined by the CFTC as entities in the regular business of satisfying demand for and making markets in swaps, or holding very large, "non-swap dealing" and systemically important swaps positions, respectively) according to various characterizations.

- SD/MSPs that are directly subject to capital regulation by federal banking "prudential regulators" including the Federal Reserve, and SD/MSPs that are futures commission merchants (FCMs) (which are already subject to existing CFTC capital requirements) are generally not subject to the new proposed requirements. (Existing FCM capital regulations are, however, amended by the proposed rulemaking.)
- SD/MSPs that are nonfinancial companies designated as systemically important financial institutions by the Financial Stability Oversight Council are also not subject to the proposed capital requirements. Rather, such companies are subject to regulation by the Federal Reserve.
- SD/MSPs that are subsidiaries of a U.S. bank holding company (itself subject to capital regulations by federal prudential banking regulators) are made expressly subject to the capital requirements of those federal banking regulators as if the affiliate itself were the U.S. banking entity. A minimum capital requirement of \$20 million in Tier 1 capital (as defined by application federal banking regulations and excluding certain mandatory convertible debt) would apply to such bank affiliates under the proposed rules, above which the prudential regulators' capital requirements would apply.
- SD/MSPs not already subject to federal prudential banking or FCM capital regulations, and not affiliated with a bank holding company, would have to maintain a minimum capital requirement of \$20 million in "tangible net equity" (calculated to exclude certain intangibles and goodwill), with increased capital requirements based on calculations of market risk and OTC derivatives credit risk.² Tangible net equity can include balance sheet assets such as oil/gas reserves or a power plant owned by an energy company SD/MSP. The Commission presents this concept as an acknowledgement of the fact that non-financial, non-bank affiliated SD/MSPs have fundamentally different capital structures from financial companies and those entities that have previously been subject to regulatory capital requirements. In calculating its tangible net equity for purposes of the capital requirements, an SD/MSP would have to consolidate the assets and liabilities of any subsidiary or affiliate for which the SD/MSP guarantees obligations or liabilities.

Complex calculations based on either internal models approved by the Commission or formulas set forth in the proposal would be utilized to determine the market and credit risk that would add to the capital requirements of non-bank affiliated SD/MSPs above the \$20 million minimum. As explained in its preamble to the proposed regulations, the CFTC intends for these risk calculations to take into account positions held as part of the entities' "swap activities," including swap dealing activities. Positions held to mitigate commercial risk as part of the SD/MSP's commercial operations would not be included in calculating the market and commercial risk elements that in turn would add to the entity's capital requirements. Collateral held by these SD/MSPs to secure positions could be counted to offset credit risk calculations in certain circumstances, but such collateral would be subject to significant haircuts under the proposal.

It appears likely that SD/MSPs, regardless of their characterization as either a bank holding company subsidiary or a non-bank, will face increased capital costs under this proposal, which will likely be passed on to their swap counterparties. However, the proposed capital rules for SD/MSPs that are not FCMs or bank subsidiaries are less onerous, and the ability to utilize "tangible net equity" to satisfy the capital requirements may create a significantly less severe capital burden on such SD/MSPs than liquid capital requirements would create. As a result, the proposed capital rules alone may not result in the serious cost increases to end-user counterparties dealing with non-financial, non-bank subsidiary SD/MSPs that many anticipated. On the other hand, many end-users trade swaps with financial and bank-subsidiary counterparties that will have more significant and cash-dependent capital requirements set by federal banking regulators, and those increased costs will presumably be passed along in future transactions.

Comments on each of these new Dodd-Frank rule proposals will be due in early July. The Commission is likely to face serious questions from SD/MSPs, end-users and other swap participants as to the mechanics and application of the capital rule proposals, and their impact on swap transaction costs in the future. Similarly, commenters can be expected to seek further clarity from the Commission as to the treatment of physically-settling transactions under the swap definition proposal.

¹⁷⁶ Fed. Reg. 6095 (February 3, 2011).

²For both non-bank affiliated, non-FCM SD/MSPs and bank-affiliated SD/MSPs, the proposal would require the SD/MSPs to comply with any future capital requirements of a futures association of which the entity is a member to the extent such requirements are higher than those otherwise applicable under the proposal. The Commission notes that all SD/MSPs are proposed to have to register with a registered futures association, and states that the requirement to comply with any futures association capital requirement is in anticipation of the future adoption of capital requirements by such entities.