PATTON BOGGS LLP

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CFTC and SEC: Joint Final Rule Defining Dealers and Major Participants

Financial Services Client Alert

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On April 27, 2012, the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) released their joint final rule defining "Swap Dealer", "Security-Based Swap Dealer", "Major Swap Participant", "Major Security-Based Swap Participant", and "Eligible Contract Participant" (ECP) (collectively, the Final Rule). The Final Rule is the result of a long and contentious debate between the SEC, the CFTC, and the financial services industry regarding the appropriate scope for each definition. Further, although the rule is final, there continues to be some uncertainty surrounding the Rule, and particularly, its application in conjunction with the yet-to-be-finalized definition of a "swap" and other related products.

In this Alert, we provide you with a brief analysis of the joint final rule. The Patton Boggs Financial Services Group is closely tracking developments related to the Dodd-Frank Act regulatory rulemakings. Further information on the legislation is available by contacting Micah Green at msgreen@pattonboggs.com.

Swap Dealers and Security-Based Swap Dealers

i. Summary of Security-Based Swap Dealer Rule

The Dodd-Frank Act definitions of the terms "swap dealer" and "security-based dealer" focus on whether a person engages in particular types of activities involving swaps or security-based swaps (SBS)[1]. The definitions encompass persons that engage in any of the following types of activity: (1) holding oneself out as a dealer in swaps or SBS; (2) making a market in swaps or SBS; (3) regularly entering into swaps or SBS with counterparties as an ordinary course of business for one's own account; or (4) engaging in any activity causing oneself to be commonly known in the trade as a dealer or market maker in swaps or SBS. Persons that meet any of those definitions are subject to statutory requirements related to, among other things, registration, margin, capital, and business conduct. The statutory dealer definitions provide for certain exceptions, including the following: (i) a person that enters into swaps or SBS for the person's own account, either individually or in a fiduciary capacity, but not as a part of a "regular business;"[2] (ii) a person that "engages in a *de minimis* quantity of [swap or SBS] dealing in connection with transactions with or on behalf of its customers;"[3] (iii) 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."[4] Finally, the definitions also provide that a person may be designated as a dealer for one or more types, classes or categories of swaps or SBS, or activities, without being designated a dealer for other types, classes, categories or activities. The Commissions explain that the exclusions from the dealer definitions depend on whether a person engages in certain types of swap or SBS activity, not on other characteristics of the person.

The Commissions also adopted a final rule to define "security-based swap dealer." In determining whether the "security-based swap dealer" designation applies to a party, the Commissions note that they should consider the relevant facts and circumstances, as well as elements of the dealer-trader distinction within the Exchange Act, which provide a framework for interpreting the meaning of "security-based swap dealer."[5] If a person determines that it

is engaged in SBS dealing activity based on an analysis of the four statutory tests and applicable interpretive guidance, the next analytical step is to determine whether the person is engaged in more than a *de minimis* quantity of SBS dealing. If such person is engaged in more than a *de minimis* quantity of SBS dealing, it must register as a SBS dealer.

Principles for Applying the Dealer-Trader Distinction to SBS Activity

The Commissions provide the following factors for identifying SBS dealers and for distinguishing such dealers from other market participants: (1) providing liquidity to market professionals or other persons in connection with SBS; (2) seeking to profit by providing liquidity in connection with SBS; (3) providing advice in connection with SBS or structuring SBS; (4) presence of regular clientele and actively soliciting clients; (5) use of inter-dealer brokers; and (6) acting as a market maker on an organized SBS exchange or trading system. The Commissions note, however, that the determination of whether a person is acting as a SBS dealer depends on the relevant facts and circumstances of a person's overall activities in the SBS market, and the lack of one or more factors does not mean that a person is not a SBS dealer.

The Commissions state that a market participant may provide liquidity to other persons in connection with SBS by accommodating demand or facilitating interest expressed by other market participants, holding itself out as willing to enter into SBS, being known in the industry as being available to accommodate demand for SBS, or maintaining a sales force in connection with SBS activities. Further, the Commissions note that a market participant may seek to profit by providing liquidity in connection with SBS by seeking compensation in connection with providing liquidity, including seeking a spread, fees, or other compensation not attributable to changes in the value of the SBS. The Commissions also note that a market participant does not necessarily need to be available to take either side of the market at any time, or continuously engage in this type of activity, in order to be a SBS dealer.

In terms of advice provided, the Commissions note that advising a counterparty as to how to use SBS to meet the counterparty's hedging goals, or structuring SBS on behalf of a counterparty, would indicate SBS dealing activity. Further, the Commissions state that the presence of regular clientele and actively soliciting clients indicate a business model that seeks to profit by providing liquidity, and the use of an inter-dealer broker indicates a person's status as a dealer. Finally, the Commissions note that acting in a market maker capacity on an organized exchange or trading system for SBS would indicate that the person is acting as a dealer.

Additional Interpretive Guidance Related to the "Security-Based Swap Dealer" Definition

The Commissions note that the SBS dealer analysis should not depend upon whether a person's dealing activity constitutes its sole or predominant business, but the separate *de minimis* exemption may excuse from dealer regulation those persons whose SBS dealing activities are relatively modest. In terms of the presence or absence of a customer relationship in SBS activities, the Commissions state that, to the extent that a person regularly enters into SBS to seek profit by providing liquidity, rather than by taking directional positions, that person may be a SBS dealer regardless of whether it views itself as maintaining a "customer" relationship with its counterparties. For example, the Commissions state that a person's activity involving entering into SBS on a swap execution facility (SEF) may cause the person to be considered as an SBS dealer even in the absence of a customer relationship with any of the person's counterparties.

The Commissions articulate several activities that could constitute "holding oneself out as a dealer" or being "commonly known in trade as a dealer:" (1) contacting potential counterparties to solicit interest; (2) developing new types of swaps or SBS and informing

potential counterparties of their availability and of the person's willingness to enter into the swap or SBS; (3) membership in a swap association in a category reserved for dealers; (4) providing marketing materials describing the type of swaps or SBS the party is willing to enter into; and (5) generally expressing a willingness to offer or provide a range of products or services that include swaps or SBS. The Commissions explain, however, that these activities must be considered within the context of whether a person engages in the activities with the purpose of facilitating dealing activity. Note that any of these activities by themselves would not necessarily indicate that a person is acting as a SBS dealer. Rather, under certain circumstances, the Commissions believe these activities may indicate a business purpose of seeking to profit by providing liquidity in connection with SBS.

ii. Summary of "Swap Dealer" Rule

Similar to the definition of "security-based swap dealer," the Commissions adopted a definition for the term "swap dealer" in terms of the four statutory tests discussed above and the exclusion for SBS activities that are not part of "a regular business." The analytical methodology employed with respect to the "security-based swap dealer" Final Rule is similar to the process for determining whether the "swap dealer" designation applies to a person. In other words, if a person determines that it is engaged in swap dealing activity based on an analysis of the four statutory tests and applicable interpretive guidance, the next step is to determine if the person is engaged in more than a *de minimis* quantity of swap dealing. If such person is engaged in more than a *de minimis* quantity of swap dealing, that person must register as a swap dealer. The Commissions also note that the elements of the dealer-trader distinction within the Exchange Act provide a framework for interpreting the meaning of "security-based swap" dealer and, therefore, the elements of the dealer-trader distinction, as discussed above, are relevant factors for indicating whether a person is acting as a swap dealer.

Further, the Commissions also identify the same potential indicia of "holding oneself out as a dealer in swaps" and "engaging in any activity causing oneself to be commonly known in the trade as a dealer or market maker in swaps" as applicable to swap dealers as with SBS dealers. The Commissions state that the potential indicia should not be considered in a vacuum, rather should be considered in the context of all the activities of the swap participant, and note that they are not per se conclusive and could be countered by other factors indicating that the person is not a swap dealer.

Though the definitions of the terms "swap dealer" and "security-based swap dealer" are substantially similar, interpretations regarding the application of the definitions differ in certain respects given the differences in the uses of and markets for swaps and SBS. The following discussion addresses the separate interpretive guidance provided by the Commissions with respect to the "swap dealer" final rule.

<u>Market Making</u>

The Commissions describe making a market in swaps as routinely standing ready to enter into swaps at the request or demand of a counterparty[6]. Activities indicative of whether a person is routinely standing ready to enter into swaps at the request or demand of a counterparty include routinely: (1) quoting bid or offer prices, rates, or other financial terms for swaps on an exchange; (2) responding to requests made directly, or indirectly through an interdealer broker, by potential counterparties for bid or offer prices, rates, or other similar terms for bilaterally negotiated swaps; (3) placing limit orders for swaps; or (4) receiving compensation for acting in a market maker capacity on an organized exchange or trading system for swaps. The Commissions note that the examples are not exhaustive and other activities may also indicate making a market in swaps.

The Commissions state that given that the dealer-trader distinction of seeking profit by providing liquidity to the market is indicative of dealer activity, if a person is seeking compensation for providing liquidity, compensation through spreads or fees, or other compensation not attributable to changes in the value of the swaps it enters into, such activity would be indicative of market making. Further, the Commissions explain that a person making a one-way market in swaps may be a maker of a market in swaps if, for example, a person routinely stands ready to enter into swaps on a particular side of the market while entering into transactions on the other side of the market in other instruments. In other words, the indicator of market maker status is a person's willingness to routinely stand ready to enter into swaps at the request or demand of a counterparty, as opposed to entering into swaps to accommodate one's own demand or desire to participate in a particular market, regardless of whether it is on one or both sides of the market, or whether the parties meet on a disclosed basis through bilateral negotiations or anonymously through an exchange, and then to enter into offsetting positions.

Exception for Activities Not Part of a "Regular Business"

The statutory dealer definitions provide for certain exceptions, including a person that enters into swaps or SBS for the person's own account, either individually or in a fiduciary capacity, but not as a part of a "regular business."[7] The Commissions state that, for the purposes of the definition of "swap dealer," the phrase a "regular business" focuses on activities of a person that are usual and normal in the person's course of business and identifiable as a swap dealing business.

The Commissions provide that any of the following activities would generally constitute entering into a swap "as part of a regular business:" (1) entering into swaps with the purpose of satisfying the business or risk management needs of the counterparty (as opposed to entering into swaps to accommodate one's own demand or desire to participate in a particular market); (2) maintaining a separate profit and loss statement reflecting the results of swap activity or treating swap activity as a separate profit center; or (3) having staff and resources allocated to dealer-type activities with counterparties, including activities relating to credit analysis, customer onboarding, document negotiation, confirmation generation, requests for novations and amendments, exposure monitoring and collateral calls, covenant monitoring, and reconciliation.

iii. De Minimis Exception

The Dodd-Frank Act's definitions of "swap dealer" and "security-based swap dealer" require that the Commissions exempt from dealer designation any entity "that engages in a *de minimis* quantity" of dealing "in connection with transactions with or on behalf of customers." The Commissions note that, while they have sought to balance the various interests associated with a *de minimis* exception, as well as the benefits and burdens associated with the exception[8], more available information following the full implementation of Title VII will permit the Commissions to assess and revise the exception as appropriate.

The Commissions explain that the *de minimis* exception takes into account the notional amount of an entity's swap or SBS positions over the prior 12 months arising from its dealing activity[9]. Specifically, this notional test will be based on a person's dealing activity for the first year following the effective date of the final rules implementing the statutory definition of "swap" and "security-based swap,"[10] which is yet to be determined.[11] The Commissions explain that, in developing the final rule, they considered data regarding the SBS market, data regarding the activity of participants in the single-name credit-default swap (CDS) market, and the comparative amount of SBS dealing activity that could be excluded from dealer regulation as a result of the exception.

De Minimis Exception to "Security-Based Swap Dealer" Definition

The Commissions state that the final rule caps dealing activity involving SBS that are CDS at $3 billion in notional amount over the prior 12 months.[12] In formulating this threshold, the Commissions state that the currently available data regarding the single-name CDS market indicates that a notional threshold of $3 billion would be expected to result in the regulation of persons responsible for the vast majority of dealing activity within such market.

The final rules also provide for a phase-in period for dealing activity involving CDS that constitute SBS. In particular, persons with notional dealing activity of $8 billion or less over the prior 12 months involving CDS that constitute SBS would not be subject to the generally applicable compliance date that occurs no later than 60 days following publication of these final rules in the Federal Register. The Commission notes, however, that market participants will not necessarily be SBS dealers at the end of the 60-day compliance period because the *de minimis* analysis would only address SBS dealing activity following the effective date of the final rules implementing the definition of "security-based swap" pursuant to the Exchange Act section 3(a)(68). In other words, until the rules defining "security-based swap" are effective, no market participant would be deemed to be a SBS dealer.

The Commissions note that the phase-in period will: (1) provide the SEC with additional time to study the SBS market, as it evolves in the new regulatory framework; (2) allow potential dealers that engage in relatively smaller amounts of activity additional time to adjust their business practices; and (3) preserve the focus of the regulation on the largest and most significant dealers. Further, the Commissions state that SEC staff will draft a report considering, in part, the operation of the *de minimis* exception following the full implementation of section 15 under Title VII, pertaining to the registration and regulation of SBS dealers and major SBS participants. The Commissions state that the SEC will consider this report, as well as public comments on the report, in determining whether to propose any changes to the rule implementing the *de minimis* exception, including any increases or decreases to the $3 billion threshold.

The final rule provides that the phase-in period will continue until the "phase-in termination date," which the SEC will publish on its website and in the Federal Register. Specifically, nine months following the publication of the SEC report, the SEC may either: (1) terminate the phase-in period and by order establish and publish the phase-in termination date; or (2) determine that it is necessary or appropriate in the public interest to propose an alternative *de minimis* threshold, in which case the SEC would provide notice of that determination and establish the phase-in termination date. If the SEC does not establish the phase-in termination date in either of these ways, the phase-in termination date will automatically occur five years following the data collection initiation date.[13]

For other types of SBS, including single-name or narrow-based equity swaps or total return swaps, the exception caps an unregistered person's dealing activity at $150 million in notional amount over the prior 12 months. A phase-in period will be available for persons whose dealing activity involving such instruments is $400 million or less in notional amount over the prior 12 months. The Commissions note that this phase-in period will be subject to the same provisions regarding the termination of the phase-in period as applied in connection with CDS.

Importantly, the final rule caps an unregistered person's SBS dealing activity involving counterparties that are "special entities" at $25 million in notional amount over the prior 12 months[14], and the Commissions state that no phase-in period will apply to transactions involving special entities. The Commissions note that they will consider whether to lower the threshold even further for transactions involving special entities.

De Minimis Exception to "Swap Dealer" Definition

Similar to the definition of "security-based swap dealer," the Final Rule implementing the *de minimis* exception caps dealing activity involving swaps at $3 billion in notional amount over the prior 12 months. The Commissions note that the notional analysis would only address activity following the effective date of the rules implementing the definition of "swap." For swaps in which the counterparty is a "special entity," the Final Rule sets the notional threshold at $25 million over the prior 12 months. As with the definition of the "security-based swap dealer," the swap dealer definition also provides for a phase-in period for swap dealing activity during which the threshold is set at a gross notional value of $8 billion. The Commissions state that, in terms of swaps with special entities, a $25 million gross notional value threshold will apply during the phase-in period.

The Commissions explain that CFTC staff will draft reports regarding the swap dealer definition during the phase-in period to consider, in part, market data on swap dealing activity over a period of approximately two years, as well as any resulting changes in swap dealing activity by dealers above and below the $8 billion phase-in threshold, and above and below the $3 billion level applicable after the phase-in period. The report is required to be completed by CFTC staff no later than 30 months following the date that a swap data repository receives swap data pursuant to the CFTC's reporting regulations and the report will be published for public comment.[15] The Commissions add that the CFTC will consider the report and any associated public comments in determining whether to propose any changes to the *de minimis* exception at the end of the phase-in period.[16]

The Final Rule provides that the phase-in period will continue until the "phase-in termination date." Specifically, nine months following the publication of the CFTC report, the CFTC may either: (1) terminate the phase-in period by order; or (2) propose an alternative *de minimis* threshold for public comment, in which case the CFTC would also issue an order establishing the phase-in termination date. The Commissions note that the final rules include a finality provision, stating that the phase-in period will end no later than five years after the date that a swap data repository first receives swap data under the CFTC's regulations.

Registration Period for Entities that Exceed the *De Minimis* Factors

According to the Final Rule, if an entity that has relied on the *de minimis* exception is no longer able to rely on the exception because its dealing activity exceeds a relevant threshold, the entity will have two months—following the end of the month in which it no longer is able to take advantage of the exception—to submit a completed application to register as a swap dealer or SBS dealer. Further, the Final Rule states that a person registered as a swap dealer or SBS dealer may apply to withdraw that registration, while continuing to engage in a limited amount of dealing activity in reliance on the *de minimis* exception, if that person has been registered as a dealer for at least 12 months.[17] The Commissions also note that, unlike the major participant definitions discussed below, the Final Rule implementing the *de minimis* exception does not provide for a reevaluation period for entities engaging in a level of dealing activity above the *de minimis* thresholds.[18]

iv. Limited Purpose Designation as a Dealer

The definitions of the terms "swap dealer" and "security-based swap dealer" provide that the Commissions may designate a person as a dealer for a particular type, class or category of swap or SBS, or specified swap or SBS activities, without the person being considered a dealer for other types, classes, categories, or activities. Though a person may apply for a limited designation when submitting a registration application, or at a later time, the Commissions note that the Final Rule presumes that a person who satisfies one of the dealer definitions will be considered a dealer for all of its swaps or SBS activities, unless the CFTC

or SEC exercises its authority to limit the person's designation as a dealer to specified categories of swaps or SBS or specified activities.

The Commissions will consider limited purpose applications on an individual basis and analyze the unique circumstances of each applicant. Regardless of the type of limited designation being requested, however, the Commissions will not designate a person as a limited purpose dealer unless the person can demonstrate that they can fully comply with the requirements applicable to dealers in the context of a limited designation.

Major Swap Participants and Major Security-Based Swap Participants

i. Summary of Major Participant Rule

Unlike the dealer definition, which focuses on the person's activities and the amount or significance of the same, the major participant definition focuses on the major market impacts and risks associated with a person's swap or SBS positions. The statutory tests defining a major participant (and not a dealer) encompass a person: (1) that maintains a "substantial position" in swaps or SBS for any of the major swap categories as determined by the Commissions; (2) whose outstanding swaps or SBS create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or (3) that is a "financial entity" that is "highly leveraged" relative to the amount of capital it holds (and that is not subject to capital requirements under a federal agency) and maintains a "substantial position" in outstanding swaps or SBS in any major category as determined by the Commissions.

The first statutory test excludes: (1) positions held for "hedging or mitigating commercial risk," and (2) positions maintained by any employee benefit plan as defined by ERISA. The statutory tests also allow for the limited designation of a person as a major participant in certain categories of swaps or SBS, but not others.

ii. First Test for Designating Major Participants

"Major" Categories

The final rule establishes 4 major categories of swaps: (1) rate swaps, (2) credit swaps, (3) equity swaps, and (4) other commodity swaps. Rate swaps include swaps primarily based on one or more reference rate. Credit swaps include swaps primarily based on default, bankruptcy and other credit-related risks. Equity swaps include swaps primarily based on equity securities. Other commodity swaps include any swap not included in the other three categories, for which the primary underlying item is a physical commodity or any other aspect of the same.

The final rule also establishes 2 major categories of SBS: (1) SBS based, in whole or in part, on one or more instruments of indebtedness, or a credit event relating to one or more issuers or securities (i.e. CDS or debt swaps), and (2) any other SBS not included in the first category, including swaps on equity securities.

"Substantial Position"

Under the rule, a person would have a "substantial position" in swaps and SBS if: (1) the daily average current uncollateralized exposure associated with its swap or SBS positions in a major category (as described above) in a calendar quarter amounted to $1 billion or more (or $3 billion for rate swaps), or (2) the daily average of the sum of the current uncollateralized exposure plus the potential future exposure[19] associated with its positions in a major category in a calendar quarter amounted to $2 billion or more (or $6 billion for rate swaps).

Additionally, the rule provides that the method used for calculating current exposure or valuing collateral posted should be consistent with counterparty practices and industry practices, including accounting for netting agreements on a counterparty-by-counterparty basis.

The major participant definition focuses on the default-related risk resulting from a person's swap or SBS positions. As such, the definition emphasizes aggregate risk over concentration and interconnection principles. In calculating the aggregate current uncollateralized exposure,[20] the person would (1) examine the positions it maintains with each counterparty, determining the dollar value of the aggregate current exposure arising from each of its swap or SBS positions with negative value in that major category by marking-to-market using industry standard practices, and (2) deduct from that amount the aggregate value of the collateral the entity has posted with respect to the swap or SBS positions. Further, the uncollateralized exposure attributable to a major category will be allocated pro rata.[21]

The potential future exposure calculation estimates how much the value of swaps or SBS might change against an entity over the remaining life of the contract. The calculation of potential future exposure excludes the purchase of options and other positions for which a person has prepaid or otherwise satisfied payment obligations. The potential future exposure is calculated by multiplying the total notional principal amount of the person's swap or SBS positions by specified risk factor percentages (ranging from 0.5 to 15 percent) based on the type of swap or SBS and the duration of the position. Further, some risk mitigating factors are considered in the calculation, such as master netting agreements (discounting the amount of the positions by 60 percent), central clearing, or daily mark-to-market margining requirements of the swap or SBS positions (discounting amount of the positions by 80 percent).

Hedging or Mitigating Commercial Risk

An entity involved in hedging or mitigating commercial risk qualifies for exclusion, regardless of whether it is a financial or non-financial entity.[22] Such entity would qualify for the exclusion when its swap or SBS position is "economically appropriate" to the reduction of risks in the conduct and management of a commercial enterprise, and when such risks arise from a potential change in the value of assets, liabilities, or services connected with the ordinary course of business of the enterprise. The Final Rule clarifies that the exclusion is for positions that hedge "financial" or "balance sheet" risks, and it applies not only to a person's own risks, but also to the hedging of the risks of a person's majority-owned affiliate. Further, according to the Commissions, "economically appropriate" includes: (1) positions to manage risk posed by a counterparty's potential default related to financing provided to a customer in connection with sale of real property or a good, product or service; (2) positions to manage default risk posed by a financial counterparty in connection with a separate transaction; and (3) positions to manage equity or market risk associated with employee compensation plans or certain business combinations (i.e. mergers), or positions by a bank to manage counterparty risk in connection with loans made by the bank. The exclusion is not extended to SBS positions that hedge speculative or trading positions.[23]

With regard to SBS that are credit derivatives, the Final Rule also provides examples of the use of CDS to purchase credit protection that, depending on the circumstances, may be excluded from the first major participant test. These examples include (1) the use of a CDS to purchase credit protection for the potential default of a customer, supplier, counterparty, or in connection with loans made by a bank; (2) purchases of credit protection using CDS to manage the risks associated with securities that a non-financial company holds in a corporate treasury and that are not held for speculative or trading purposes; or (3) the sale of offsetting credit protection, if this sale is reasonably necessary to address changes in the amount of underlying commercial risk hedged by the initial security-based swap position.

Certain Exclusions

The major participant definitions exclude swap and SBS positions that are maintained by any employee benefit plan as defined in the Employee Retirement Income Security Act (ERISA).

iii. Second Test for Designating Major Participants

"Substantial Counterparty Exposure"

The second test for defining a major participant encompasses those whose outstanding swaps and SBS can create substantial counterparty exposure which could have adverse effects in the U.S. financial stability. Unlike the first test described above, this test is not limited to positions in a single category and does not include certain exclusions for hedging positions. Under this test, a person's swap positions pose substantial counterparty exposure if such positions present a daily average current uncollateralized exposure of $5 billion or more, or present a daily average uncollateralized exposure plus potential future exposure of $8 billion or more. With respect to SBS positions, the person's positions pose substantial counterparty exposure if those positions present a daily average current uncollateralized exposure of $2 billion or more, or present a daily average current uncollateralized exposure plus potential future exposure of $4 billion or more. These thresholds are higher than those included in the first test.[24]

The calculation for substantial counterparty exposures would be the same as that done under the first test. However, the substantial counterparty exposure analysis would consider all of the person's swap or SBS positions rather than solely considering positions in a particular major category.

iv. Third Test for Designating Major Participants

Highly Leveraged and Financial Entity

Under the third test, a person falls under the definition of major participant if he: (1) is a financial entity; (2) is highly leveraged relative to the amount of capital it holds; and (3) maintains a substantial position in any major category of swaps or SBS. The third test does not include positions that hedge commercial risk or ERISA risks. Further, the third test defines "financial entity" in the same way it is defined under the Title VII exception from mandatory clearing for end users, but excludes certain centralized hedging and treasury entities.[25]

Separately, an entity is identified as "highly leveraged" if its ratio of liabilities to equity exceeds 12 to 1. The third test does not exclude certain hedging positions because, according to the Commissions, (1) an entity's high leverage indicates that an entity poses a heightened risk of being unable to meet its obligations, and (2) such entity should not be permitted to exclude hedging positions from the "substantial position" analysis in light of the counterparty risks those positions pose. Generally, the leverage ratio of a person's liabilities to equity is determined in accordance with GAAP and "as of the close of business on the last business day of the applicable fiscal quarter."

v. Other Issues

Entities can qualify for the safe harbor provision of the Final Rule when their positions are far below any threshold for any particular quarter. However, it is important to note that those entities that will be closer to a particular threshold are not excused from completing the calculations provided in the Final Rule (or from compliance, if found to be major participants thereafter).

Inter-Affiliate Participants

The Final Rule notes that the major participant definitions do not encompass a person's swaps or SBS for which the counterparty is a majority-owned affiliate (not necessarily wholly-owned). The Commissions explained that this is because they do not believe these swaps or SBS raise systemic risk or other concerns that the major participant regulation is intended to address.

Application to Positions of Affiliated Entities or to Guarantees

The Final Rule states that an entity's swap or SBS positions will be attributed to a guarantor (or a parent or other affiliate), to the extent that the counterparties to those positions would have recourse to that other entity in connection with the position. Thus, under the Final Rule, positions will not be attributed in the absence of recourse. Further, the Commissions clarified their belief that, "when an insurer guarantees the performance of other parties' swap or SBS positions, in an amount that is greater than the applicable major participant thresholds, it would be appropriate to regulate that entity as a major participant."[26] In explaining the attribution of an entity's position to a guarantor, the Commissions noted that they recognized the complications that could arise from the application of the transaction-focused requirements applicable to registered major participants. However, despite these complications, the Commissions stated that entities that become major participants because of swaps or SBS directly entered into by others, must be responsible for compliance with all applicable major participant requirements (though they may delegate operational compliance to entities that directly are party to the transactions). Finally, the Commissions clarified that such designated entities will not be allowed to delegate compliance duties with entity-level requirements (i.e. registration and capital).

Application to Managed Accounts

The Final Rule states that the Commissions will not consider the swap or SBS positions of the client accounts managed by asset managers or investment advisers when determining whether such managers or investment advisers are major participants. With regard to beneficial owners of the managed positions, the Final Rule focuses on where the risk associated with those positions ultimately resides (if the counterparties to a swap or SBS position within a managed account have recourse only to the assets of that account in the event of default, then it would not be appropriate to attribute that position to its beneficial owner). In short, the Final Rule attributes a swap or SBS position when recourse is available.

Requests for Exclusion

The Final Rule states that there is no per se exclusion from the major participant definition for insurance companies, entities with legacy portfolios, entities already regulated at the state level (or otherwise), or foreign entities. In explaining their decision, the Commissions stated that (1) entities with legacy portfolios are not excluded because "the fact that these entities no longer engage in new swap or security-based swap transactions does not overcome the fact that entities that are major participants will have portfolios that are quite large and could pose systemic risk to the U.S. financial system"[27] ; (2) insurance companies (or other industries) are not excluded so as to ensure a more level playing field and avoid unfair competitive advantages to certain industries; (3) entities already regulated are not excluded because current regulations do not overlap with the Dodd-Frank Act regulations, which target the risks posed by major participants (although the Commissions will coordinate regulation if major participants are already regulated by the SEC and the CFTC); and (4) foreign entities are not excluded as issues regarding the application of the major participant definition to non-U.S. entities will be explained in a separate release by the SEC.

Separately, in the Cost-Benefit Analysis portion of the Final Rule, the Commissions explain that entities with legacy portfolios do not have to worry about new margin or capital requirements leading to their insolvency because the Commissions will examine the treatment of legacy portfolios on a case-by-case basis and because many of the compliance requirements of the Final Rule will not apply to operators of legacy portfolios given that "such obligations will not be applicable to swaps executed prior to the enactment of the Dodd-Frank Act such as the swaps in legacy portfolios"[28] (most of their obligations will relate only to reporting and risk management).

Financing Subsidiary Exclusion

The Final Rule provides exclusion to those captive finance companies whose "primary business" is financing and who use swaps for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures. The Final Rule's captive finance exception can be applied when the financing activity is for the purchase of products sold by the parent in areas related to the products.

Safe Harbor

Under the Final Rule, only a limited number of entities will be deemed to be major participants. However, for purposes of calculation, for those entities that are at the edge of the major participant definition, the Final Rule includes a safe harbor provision. The safe harbor provision states that a person will not be a major participant when the express terms of the persons' arrangements regarding swaps and SBS would not permit the person to maintain a total uncollateralized exposure above $100 million to all such counterparties or the person does not maintain notional swap or SBS positions for more than $2 billion in any major category of swaps or SBS or more than $4 billion in aggregate.

Additionally, a person will not be a major participant when the express terms of person's arrangements regarding swaps and SBS would not permit the person to maintain a total uncollateralized exposure of more than $200 million to all such counterparties or a person performs the major participant calculations as of the end of every month, "and the results of each of those monthly calculations indicate that the person's swap or SBS positions lead to no more than one-half of the level of current exposure plus potential future exposure that would cause the person to be a major participant."[29]

Finally, a person will not be a major participant when the person's current uncollateralized exposure in connection with a major category of swaps or SBS "is less than $500 million and the person performs certain modified major participant calculations at of the end of every month, and the results of each of those monthly calculations indicate that the person's swap or SBS positions in each major category of swaps or SBS are less than one-half of the substantial position threshold."[30]

Limited Major Participant

Under the Final Rule, a person may apply for a limited designation at the time they submit a registration application, or later.

[1] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act] (adding Section 1a(49) of the Commodity Exchange Act (CEA), 7 U.S.C. 1a(49), to define "swap dealer") and section 761 of the Dodd-Frank Act (adding Section 3(a)(71) of the Exchange Act, 15 U.S.C 78c(a)(71), to define "SBS dealer").
[2] *See* CEA section 1a(49)(C), 7 U.S.C. 1a(49)(C); Exchange Act section 3(a)(71)(C) , 15 U.S.C. 78c(a)(71)(C).
[3] *See* CEA section 1a(49)(D), 7 U.S.C. 1a(49)(D); Exchange Act section 3(a)(71)(D) , 15 U.S.C. 78c(a)(71)(D).
[4] *See* CEA section 1a(49)(A), 7 U.S.C. 1a(49)(A). The rule also excludes from the determination of whether a person is a swap dealer swaps between majority owned affiliates, swaps entered into by a cooperative with its members, swaps entered into for hedging physical positions as defined in the rule, and certain swaps entered into by registered floor traders.
[5] The Commissions noted that they recognize that the dealer-trader distinction must be adapted to apply to SBS activities in light of the differences between the "dealer" and "security-based swap dealer" definitions, including: 1) the level of activity with regard to SBS markets compared to markets involving certain other types of securities; 2) the lack of a separate issuer other than each counterparty to a SBS; 3) the predominance of over-the-counter and non-standardized instruments in the SBS market; and 4) the mutuality of obligations for parties to a SBS.
[6] In this context, the term "routinely" means that a person must do so more frequently than occasionally, but there is no requirement that the person do so continuously. A person that occasionally, or less than routinely, enters into a swap at the request of a counterparty is not a maker of a market in swaps, and therefore is not a swap dealer on that basis. The Commission notes, however, that since many types of swaps are not entered into on a continuous basis, it is not necessary that a person enter into swaps at the request or demand of counterparties on a continuous basis in order for the person to be a market maker in swaps and a swap dealer.
[7] *See* CEA section 1a(49)(C), 7 U.S.C. 1a(49)(C); Exchange Act section 3(a)(71)(C) , 15 U.S.C. 78c(a)(71)(C).
[8] For example, the Commissions clarify that the *de minimis* exception is intended to permit an unregistered person to engage in a limited amount of dealing activity without regard to the person's non-dealing activity and, therefore, if a particular swap or SBS position is not connected to dealing activity, it will not count against the *de minimis* threshold.
[9] The Commissions state that the notional standards will be based on "effective notional" amounts when the stated notional amount is leveraged or enhanced by the structure of the swap or SBS.
[10] *See* CEA section 1a(47) and Exchange Act section 3(a)(68).
[11] As discussed in further detail below, until the rules defining the term SBS are effective, no market participant would be deemed to be a SBS dealer.
[12] The Commissions note that the analysis of *de minimis* levels must be based on effective notional amounts to the extent that the stated notional amount is leveraged or enhanced by the structure of the SBS, such as, for example, if the exchange of payments associated with an equity swap was based on a multiple of the return associated with the underlying equity. *See* Exchange Act rule 3a71-2(a)(3).
[13] Exchange Act rule 3a71-2(a)(2)(iii) states that "the term 'data collection initiation date' shall mean the date that is the later of: the last compliance date for the registration and regulatory requirements for SBS dealers and major SBS participants under Section 15F of the Act (15 U.S.C. 78o-10); or the first date on which compliance with the trade-by-trade reporting rules for credit-related and equity-related SBS to a registered SBS data repository is required. The Commission shall announce the data collection initiation date on the Commission website and publish such date in the Federal Register."
[14] The Commissions state that in this context, "special entity" means: (i) a Federal agency; (ii) a state, state agency, city, county, municipality, or other political subdivision of a state; (iii) any employee benefit plan, as defined in section 3 of the Employee Retirement Income Security Act of 1974 (ERISA); (iv) any governmental plan, as defined in section 3 of ERISA; or (v) any endowment, including an endowment that is an organization described in section 501(c)(3) of the Internal Revenue Code of 1986. *See* CEA section 4s(h)(2)(C) and CFTC Regulation § 23.401(c); Exchange Act section 15F(h)(2)(C).
[15] CFTC, Final Rule on Swap Data Recordkeeping and Reporting Requirements, 77 Fed. Reg. 2,136 (Jan. 13, 2012).
[16] The Final Rule provides that the CFTC may change the requirements of the *de minimis* exception by rule or regulation. The CFTC may, therefore, revisit the rule implementing the exception and potentially change it, for example, if data regarding the post-implementation swap market suggests that different *de minimis* thresholds would be appropriate.
[17] The Commissions note that this should ensure that persons do not rapidly move in and out of dealer status based on short-term fluctuations in their swap or SBS activities.
[18] *See* CFTC Regulation § 1.3(hhh)(4); Exchange Act rule 3a67-8(b) (providing for a reevaluation period in connection with the major participant definitions when a person does not exceed any applicable threshold by more than 20 percent in a calendar quarter).
[19] Future exposure would be discounted by up to 60 percent to reflect the risk mitigation provided by netting agreements, and would further be decreased by 80 percent for positions subject to central clearing or daily mark-to-market margining.
[20] Cleared, fully collateralized, or net in-the-money positions are not excluded from the current exposure test.
[21] The allocation compares the amount of the entity's out-of-the-money positions in that major category to its total out-of-the-money positions in all categories that are subject to the netting agreements wit that particular counterparty.
[22] *See* Commodity Futures Trading Commission, 17 CFR 1, RIN 3038-AD06; Securities and Exchange Commission, 17 CFR 240, RIN 3235-AK65, pp. 305-06 (Apr. 27, 2012) [hereinafter Final Rule] (stating that "the final rules with regard to both major participant definitions do not foreclose financial entities from being able to take advantage of the commercial risk hedging exclusion in the first major participant test. This conclusion in part is guided by the fact that the statutory text implementing this hedging exclusion does not explicitly foreclose financial entities from taking advantage of the exclusion – in contrast to Title VII's exceptions from mandatory clearing requirements for commercial hedging activities."). The Commissions also stated that not allowing the exclusion to cover swaps or SBS used for speculation or trading will be sufficient to limit financial entities' ability to engage in risky transactions.
[23] *See Id.* at p. 318. The Commissions note the difference between speculative or trading positions and hedging by stating that it would not be appropriate "to interpret the term 'commercial risk' to accord the same regulatory treatment to security-based swap positions for speculative or trading purposes as is accorded to the use of SBS positions in connection with commercial activities such as producing goods or providing services to customers." Final Rule, p. 320.
[24] This reflects the fact that the second test includes the 4 major categories of swaps or 2 categories of SBS, and that hedging positions are not excluded.
[25] Title VII of the Dodd-Frank Act defines a financial entity as: "a swap dealer; a SBS dealer; a major swap participant; a major SBS participant; a commodity pool; a private fund as defined in section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C.

80–b–2(a)); an employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002); a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956." See Dodd-Frank Act.

[26] Final Rule, p. 357-58.

[27] Id. at p. 367.

[28] *Id.* at p. 465.

[29] *Id.* at p. 380-81.

[30] *Id.*