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What's In A Name? Understanding the New Dodd-Frank Rules Defining "Swap Dealer," "Major Swap Participant" and "Eligible Contract Participant"

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Overview
Introduction

- Final Rules Further Definition of "Swap Dealer," Security-Based Swap Dealer," "Major Swap Participant," Major Security-Based Swap Participant" and "Eligible Contract Participant"
- Published in the Federal Register May 23, 2012.
- Jointly issued by the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC).
- For ease of reference the terms "swap", "swap dealer," and "major swap participant" are intended to refer as well to "security-based swaps (SBS), dealers and major swap participants as well unless the context requires otherwise.

Overview
Background

- Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) – watershed legislation
- Pre-Dodd Frank – over-the-counter (OTC) swaps were not subject to direct regulation since their creation in early 1980s
- Dodd-Frank creates a comprehensive regulatory regime for "swap dealers" and "major swap participants"; unlawful not to be registered if such an entity
- Dodd-Frank makes it unlawful for anyone to enter into an OTC swap unless such entity is an eligible contract participant (ECP).

Overview
The Consequences

- Swap Dealers and Major Swap Participants are subject to:
  - Registration with the CFTC, SEC or both
  - Capital requirements
  - Internal and external business conduct requirements
  - Recordkeeping and reporting
  - Position limits monitoring
  - Documentation obligations
- US counterparties will require an ECP rep before entering into an OTC swap.

Overview
The Big Unknowns

- Cross-Border Regulation
  - CFTC cancelled open meeting of 21 June 2012
  - CFTC Chairman Gensler's remarks and testimony provide insight
- Product Definitions
  - Further defining "swap" and "security-based swap"

Overview
The Presentation

- Swap Dealer Definition
- Major Swap Participant
- Changes to the ECP Definition
- Concluding Remarks

SWAP DEALER

Swap Dealer
Definition

A person is a “swap dealer” if that person:

- holds himself or herself out as a dealer in swaps;
- makes a market in swaps;
- regularly enters into swaps with counterparties as an ordinary course of business for his or her own account; or
- engages in activity causing him or her to be commonly known in the trade as a dealer or market maker in swaps.

Swap Dealer
Exceptions and Exclusions

- Certain swaps are not considered in determining whether a person is a "swap dealer":
  - Swap activities that are not "part of a regular business"
  - Swaps between an "insured depository institution" and a customer in connection with loan origination
  - Swaps between majority-owned affiliates
  - Swaps entered into by an agricultural cooperative with its members
  - Swaps entered into for hedging physical positions
  - Swaps entered into by registered "floor traders"
- A person who is a "swap dealer" may be exempt from registration by not exceeding a *de minimis* threshold of swap dealing activity.

Swap Dealer
The Analysis

- Step 1: Do you fall within the definition of "swap dealer"?
  - Apply the statutory definition, including the CFTC rules implementing the statutory tests
  - Exclude consideration of swaps not entered into as "part of a regular business", using the CFTC's interpretive guidance
  - As applicable, exclude consideration of swaps entered into: (1) between majority-owned affiliates; (2) by an agricultural cooperative with its members; (3) for hedging physical positions; or (4) by registered "floor traders"
- Step 2: If you are a "swap dealer", do you qualify for the *de minimis* exception?
  - Determine whether the amount of swaps dealing activity exceeds the applicable thresholds in the rules implementing the *de minimis* exception
- If you engage in swaps dealing activities that exceed the applicable *de minimis* threshold, you are a swap dealer and must register.

Swap Dealer
Implementing the Statutory Definition (1)

- The traditional SEC distinction between “dealers” and “traders” informs the regulatory guidance on who is a “swap dealer” and who is not
- A person may be a “swap dealer” even if its swap dealing activities constitutes its sole or predominant business
- NB: A person who enters into security-based swaps in order to profit by providing liquidity (rather than by taking directional positions) will likely be a security-based swap dealer regardless of the existence of a customer relationship with the counterparty

Swap Dealer
Implementing the Statutory Definition (2)

- The following activities are indicative of swap dealing:
  - Providing liquidity by accommodating demand for or facilitating interest in swaps, holding oneself out as willing to enter into swaps (independent of whether another party has already expressed interest), or being known in the industry as being available to accommodate demand for swaps;
  - Advising a counterparty as to how to use swaps to meet the counterparty's hedging goals, or structuring swaps on behalf of a counterparty;
  - Having a regular clientele and actively advertising or soliciting clients in connection with swaps;
  - Acting in a market maker capacity on an organized exchange or trading system for swaps; and
  - Helping to set the prices offered in the market (such as by acting as a market maker) rather than taking those prices, although the fact that a person regularly takes the market price for his or her swaps does not foreclose the possibility that the person may be a swap dealer.

Swap Dealer
Implementing the Statutory Definition (3)

- A person is a "market maker" in swaps if that person "routinely stands ready to enter into swaps at the request of a counterparty".
- "Routinely" means more than occasionally but need not be continuously.
- Indicia of acting as a "market maker" in swaps includes:
  - Providing bids or offers for swaps on an exchange;
  - Responding to requests for quotations made directly, or indirectly through an inter-dealer broker, by potential counterparties for bilaterally negotiated swaps;
  - Placing limit orders for swaps; and
  - Receiving compensation for acting in a market maker capacity on an organized exchange or trading system for swaps.
- A person may be a "market maker" even if only entering into swaps on one side of the market and also includes exchange-traded as well as OTC swaps.
- A person engaging in these activities but who does not seek compensation based on the change in the value of swaps entered into is not engaging in "market making".

Swap Dealer
Implementing the Statutory Definition (4)

- A person entering into swaps "with counterparties…for its own account" to refer to a person who enters into a swap as a principal, and not as an agent.
- Any person who enters into swaps as an agent for customers is not a "swap dealer" but may be required to register as a broker-dealer, FCM or an IB.

Swap Dealer
Exclusion: Not "Part of A Regular Business"

- When determining whether it falls within the definition of "swap dealer", a swap market participant need not consider any swap activities that are not "part of a regular business"
- The following are indicia of engaging in swaps as "part of a regular business":
  - entering into swaps with the purpose of satisfying the business or risk needs of the counterparty;
  - maintaining a separate profit and loss statement relating to swaps or treating swaps activities as a separate "profit centre"; or
  - having internal staff and resources allocated to dealer-type activities.
- **NB:** The factors above are also relevant to interpreting the meaning of the engaging in swaps "as an ordinary course of business" in the statutory definition of "swap dealer".

Swap Dealer
Exclusion: Loan Origination (1)

- When determining whether it falls within the definition of "swap dealer", an "insured depository institution" (IDI) need not consider certain swaps with a customer in connection with originating a loan with such customer.
- If the loan was originated in good faith, the IDI may elect to hedge only some of the risk of the loan and may subsequently transfer or terminate the connected loan.

Swap Dealer
Exclusion: Loan Origination (2)

- The term of the swap between the IDI and the borrower may not extend beyond the termination of the loan;
- The swap must be connected to the financial terms of the loan or is required by the IDI's loan underwriting criteria to be in place as a condition of the loan in order to hedge commodity price risks incidental to the borrower's business;
- The loan cannot be a sham or a synthetic loan;
- The IDI must, directly or indirectly (through syndication, participation, assignment or otherwise), be the source of funds for at least 10% of the maximum principal amount of the loan;
- The IDI must enter into the swap with the borrower within 90 days before or 180 days after the date the execution of the loan agreement, or within 90 days before or 180 days after any transfer of principal to the borrower from the IDI pursuant to the loan; and
- The aggregate notional amount of all swaps entered into by the IDI and the borrower cannot exceed the notional principal amount of the loan at any time during the term of the loan.

Swap Dealer
Exclusion: Hedging Physical Positions (1)

- Under an interim final rule, a person need not take into consideration certain hedging swaps when determining whether it falls within the definition of “swap dealer”.
- The exclusion is not available in connection with portfolio hedging.

Swap Dealer
Exclusion: Hedging Physical Positions (2)

- The person must enter into the swap for the purpose of offsetting or mitigating the person's price risks that arise from the potential change in the value of one or several:
  - assets that the person owns, produces, manufactures, processes or merchandises, or anticipates owning, producing, manufacturing, processing or merchandising;
  - liabilities that the person owns or anticipates incurring; or
  - services that the person provides, purchases or anticipates providing or purchasing.
- The swap must represent a substitute for transactions made or to be made or positions taken or to be taken by the person at a later time in a physical marketing channel;
- The swap must be economically appropriate to the reduction of the person's risks in the conduct and management of a commercial enterprise;
- The swap must be entered into in accordance with sound commercial practices; and
- The person must not enter into the swap in connection with activity structured to evade designation as a swap dealer.

Swap Dealer
Exclusion: Inter-Affiliate Swaps

- A person need not take into consideration swaps entered into with majority-owned affiliates when determining whether it falls within the definition of “swap dealer”.
- “Majority ownership” means:
  - one party directly or indirectly holds a majority ownership interest in the other;
  - a third party directly or indirectly holds a majority interest in both; or
  - if one party has the right to receive the majority of the capital of the other party upon its dissolution
- Swaps on non-financial commodities between a cooperative – including agricultural cooperatives and cooperative financial institutions – and its members also qualify for this exclusion.

Swap Dealer
Exclusion: Floor Traders

- A person need not need take into consideration any swaps entered into in his or her capacity as a "floor trader" on a trading platform (DCM or swap execution facility(SEF)).
- To rely on the exclusion, the person must be registered as a floor trader with the CFTC and must:
  - enter into cleared swaps solely with proprietary funds on or subject to the rules of a DCM or SEF;
  - not be an affiliated person of a registered swap dealer;
  - not directly, or through an affiliated person, negotiate the terms of swap agreements, other than price and quantity or to participate in a request for quote process subject to the rules of a DCM or SEF;
  - not directly or through an affiliated person offer or provide swap clearing services to third parties;
  - not directly or through an affiliated person enter into swaps that would qualify as hedging physical positions as described above or which hedge or mitigate commercial risk pursuant to CFTC Rules, other than swaps that are executed opposite a counterparty for which the transaction would qualify as a bona fide hedging transaction;
  - not participate in any market making program offered by a DCM or SEF; and
  - comply with the recordkeeping and risk management requirements of relevant CFTC Rules with respect to each such swap as if it were a swap dealer.
- This exclusion is not available in respect of security-based swaps.

Swap Dealer
De Minimis Exemption

- Rule: a person is not required to register as a swap dealer if its non-excluded swap dealing activity is below an applicable *de minimis* threshold.
- Test: in the previous 12 months a person's aggregate gross notional must not exceed:
  - $3 billion in respect of swaps and index CDS;
  - $150 million in respect of all other security-based swaps; and
  - $25 million with "special entities".
- Phase-In Period: the first two thresholds are raised to $8 billion and $400 million, respectively, for a maximum of five years after swap data begins to be reported to registered swap data repositories.
- A person must register as a swap dealer no later than two months following the end of the calendar month during which it is no longer eligible to rely on the *de minimis* exemption.

Swap Dealer
Limited Designation

- In general, swap dealer registration applies to all swap dealing activities of a registrant.
- However, a person may apply for limited registration as a swap dealer in respect of a limited category of swap products.
- Limited designation will only be granted where the applicant can demonstrate its ability to comply fully with the requirements applicable to swap dealers, including entity-level as well as transaction-level compliance obligations.

MAJOR SWAP PARTICIPANT (MSP)

Major Swap Participant
The Concept

- Entities other than swap dealers transacting in swaps can create global systemic risk.
- An entity's "risk" is measured by the amount of uncollateralized exposure (present and future) its counterparty has to it (opposite of prudential bank analysis).
- Risk can arise: (1) in a particular category of swaps; (2) across all swap categories; (3) due to leverage.
- Examples: Long Term Capital Management; any entity with market clout

Major Swap Participant
The Irony

- CFTC and SEC have publicly stated they expect very few entities will be required to register as MSPs.
  - CFTC - up to 6
  - SEC - approximately 12
- Significant time and other resources must potentially be expended by an entity to determine it is not an MSP in applying the tests and possible safe harbors.

Major Swap Participant
Major Swap Participant vs. Swap Dealer

- Swap dealer determination is qualitative
- Major swap participant determination is highly quantitative
  - Mathematical tests
  - Mathematical safe harbors
  - Many calculations must be performed daily

Major Swap Participant
The Three Tests

An entity will be a major swap participant if:

- **The Substantial Position Test**
  - it maintains a "substantial position" in any of the major swap categories, excluding swaps held for hedging/mitigating commercial risk or swaps maintained by certain employee benefit plans for hedging/mitigating risks in operating the plan;
- **The Substantial Counterparty Exposure Test**
  - its outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the US banking system or financial markets; or
- **The Highly Leveraged Financial Entity Test**
  - it is a highly leveraged financial entity not subject to capital requirements promulgated by a Federal banking agency and maintains a substantial position in any of the major swap categories.

Major Swap Participant
Understanding the Tests

- CFTC has divided "swaps" into four "major categories":
  - Rate swaps, credit swaps (including CDS and TRS on debt instruments), equity swaps and other commodity swaps
- SEC has divided "security-based swaps into two "major categories":
  - Debt security-based swaps
  - Other security-based swaps (including equity swaps)

Major Swap Participant
The Fundamentals

- Current Exposure
  - Daily average aggregate uncollaterallized net outward exposure (can net across bankruptcy permissible products)
  - Mark-to-market (MTM) of out-of-the money swaps less any collateral paid
- Potential Future Exposure
  - Daily average aggregate potential future exposure
  - Notional * Risk Factor * Clearing/MTM Factor * Netting Factor

NB: must be performed on a swap category by category basis

Major Swap Participant
Potential Future Exposure Metrics

- Risk Factor
  - Based on maturity
  - Based on swap category
  - Ranges from 0.00 to 0.15
- Clearing Factor - 0.10
- MTM Factor - .20
- Netting Factor
  - 0.40 + 0.6 * (Net exposure for counterparty/Gross exposure for counterparty)
  - ranges from 0.4 to 1

Major Swap Participant
The Substantial Position Test

An entity will be a major swap participant if either:

- Current Exposure Test
  - The daily average net aggregate current uncollateralized exposure exceeds $1 billion in the relevant swap category ($3 billion for Rate swaps)[$1billion in SBS category]; or
- Current Exposure Plus Future Exposure
  - The sum of daily average net aggregate current uncollateralized exposure plus potential future exposure exceeds $2 billion in the relevant swap category ($6 billion for Rate swaps)[$2billion in SBS category].

NB: Excludes swaps hedging/mitigating commercial risk

Major Swap Participant
Hedging or Mitigating Commercial Risk

- Economically appropriate to the reduction of risks
- Qualifies as bona fide hedging exemptions from CFTC position limits or qualifies for hedging treatment under FASB 815 or GASB 53 (CFTC only)
- Is not held for speculation, investing or trading
- To mitigate the risk of another swap unless the other swap is held for hedging or mitigating commercial risk
- CFTC & SEC guidance differ

Major Swap Participant
The Substantial Counterparty Exposure Test

An entity will be a major swap participant if either:

- Current Exposure Test
  - The daily average net aggregate current uncollateralized exposure exceeds $5 billion across ***all*** swap categories [$2 billion for SBS]; or
- Current Exposure Plus Future Exposure
  - The sum of daily average net aggregate current uncollateralized exposure plus potential future exposure exceeds $8 billion across ***all*** swap categories [$4 billion for SBS].

NB: No exclusion for swaps hedging/mitigating risk

Major Swap Participant
The Highly Leveraged Financial Entity Test

A ***highly leveraged*** entity (total liabilities/equity >12) ***financial entity*** will be a major swap participant if either:

- Current Exposure Test
  - The daily average net aggregate current uncollateralized exposure exceeds $1 billion in the relevant swap category ($3 billion for Rate swaps) [$1billion in SBS category]; or
- Current Exposure Plus Future Exposure
  - The sum of daily average net aggregate current uncollateralized exposure plus potential future exposure exceeds $2 billion in the relevant swap category ($6 billion for Rate swaps) [$2billion in SBS category].

NB: No exclusion for swaps hedging/mitigating risk

Major Swap Participant
Financial Entity Definition

- Look to the definition of "financial entity" for purposes of the end user exemption for mandatory clearing, which includes:
  - Swap dealers and major swap participants
  - 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 Bank Holding Company Act

Major Swap Participant
The Four Safe Harbors (1)

Intended to relieve market participants of daily calculations.

An entity will not be a major swap participant if:

- Safe Harbor 1
  - Express terms of its swaps provide it will not be able to maintain a total uncollateralized exposure of more than $100 million to all counterparties, including exposure that may result from thresholds or minimum transfer amounts; and
  - The entity does not have notional swap positions greater than $2 billion in any major category of swaps, or more than $4 billion in aggregate.

NB: Same terms for SBS

Major Swap Participant
The Four Safe Harbors (2)

An entity will not be a major swap participant if:

- Safe Harbor 2
  - Express terms of its swaps provide it will not be able to maintain a total uncollateralized exposure of more than $200 million to all counterparties (including other financial instruments), including exposure that may result from thresholds or minimum transfer amounts; and
  - The entity's net aggregate current uncollateralized exposure plus potential future exposure at the ***end of each month*** exceeds:
    - $1billion in the relevant swap category (excluding hedges, if not a highly leveraged financial entity): or
    - $2 billion across ***all*** swap categories.

NB: Same terms for SBS

Major Swap Participant
The Four Safe Harbors (3)

An entity will not be a major swap participant if:

- Safe Harbor 3
  - The entity's net current aggregate uncollateralized exposure across all swaps or SBS is less than $500 million; and
  - The sum of:
    - The net current aggregate uncollateralized exposure; and
    - The notional amount of the entity's swap positions across all categories, multiplied by 0.15 for swaps and 0.10 for ***SBS*** does not exceed $1 billion.

Major Swap Participant
The Four Safe Harbors (4)

An entity will not be a major swap participant if:

- Safe Harbor 4
  - The entity's monthly calculations indicate that the entity's swaps positions across all swap categories are significantly less than the thresholds under the Substantial Counterparty Exposure Test.

Major Swap Participant
Interpretative Issues

- Limited registration – requires affirmative application
- Exclusion for Affiliate Transactions
- Captive Finance Companies
- Attribution Test – parent or guarantor transaction if recourse, except when guarantor is subject to capital regulation by CFTC, SEC, or bank regulator
- Regulated Entities – will be required to register
- Investment Managers – not required to include swap positions of their managed accounts

Major Swap Participant
Timing Considerations

- Any entity satisfying any of the three MSP tests in a fiscal quarter is not deemed an MSP until the earlier of: (1) the date on which that entity submits their complete application for registration to the CFTC or SEC; or (2) two months after the end of that quarter.
- Any entity satisfying any of the three MSP tests by surpassing a threshold by no more than 20% in a given fiscal quarter do not have to register unless thy surpass a threshold in the next fiscal quarter.
- An MSP remains an MSP until they do not breach any MSP threshold for four consecutive fiscal quarters.

Eligible Contract Participant
In General

- The Dodd-Frank Act provides that any swap (or security-based swap) entered with a non-ECP must be transacted on a DCM (or national securities exchange).
- The Dodd-Frank Act amended the ECP definition to generally include the following:
  - financial institutions;
  - swap dealers;
  - major swap participants;
  - insurance companies;
  - registered investment companies (i.e., US mutual funds);
  - regulated US pension plans;
  - government entities;
  - registered broker-dealers, FCMs and their associated persons; and
  - certain entities and individuals with greater than $10 million in total assets or discretionary investments, respectively.
- The amended ECP definition narrows the scope of “commodity pools” that are ECPs.

Eligible Contract Participant
Retail Foreign Exchange Transactions (1)

- General Rule: A commodity pool entering into retail foreign exchange transactions (a Forex Pool) will not be an ECP if it has one or more direct or indirect participants that is not an ECP.
- Exception: The status of indirect participants in a Forex Pool may be disregarded if the Forex Pool (or any investee Forex Pool thereof) was not structured to evade the provisions of the CEA.
- Due Diligence: operators of Forex Pools, and counterparties to Forex Pools, may rely on written representations unless there is a reasonable basis to question the accuracy thereof.
- Loss of Status: a Forex Pool will maintain its ECP status if a participant ceases to be an ECP if such participant is required to notify the Forex Pool promptly and such participant is redeemed.

Eligible Contract Participant
Retail Foreign Exchange Transactions (2)

- Safe Harbour: a Forex Pool is exempt from the look-through test for determining ECP status if:
  - it was not formed for the purpose of evading CFTC regulations relating to retail forex transactions;
  - it has total assets exceeding $10 million; and
  - it is formed and operated by a registered commodity pool operator (CPO) or by a CPO who is exempt from registration as such pursuant to CFTC Regulation 4.13(a)(3).

Eligible Contract Participant
Foreign Forex Pools

- A Forex Pool whose participants are all non-US persons and which is operated by a non-US CPO qualifies as an ECP.
- A participant is a non-US person if it satisfies the definition of "Non-United States person" in CFTC Regulation 4.7.
  - If a participant is an entity organized principally for passive investment, it will qualify only if all of its investors are "Non-United States persons".
- A foreign Forex Pool will also qualify as an ECP if:
  - less than 10% of the Pool's beneficial owners are US persons; and
  - the counterparty has reasonable policies and procedures in place to verify the ECP status of the foreign Forex Pool.

Eligible Contract Participant
"Line of Business" Test

- The ECP definition includes an entity that:
  - has a net worth exceeding $1 million, and
  - enters into an agreement, contract or transaction in connection with the conduct of the entity's "line of business".
- For purposes of this provision, an entity may determine its net worth by reference to the net worth of its owners if all such owners are ECPs.

The Entity Definitions
Concluding Remarks (1) – Compliance Deadlines

- CFTC
  - Final registration rules require an entity to provisionally register by the later of the effective date of the "Entity Definitions" and the effective date of the "Product Definitions"
  - Entities that surpass the *de minimis* threshold have two months to register from the end of the month in which the threshold is breached
  - May phase-in compliance deadlines for cross-border activities
- SEC
  - Registration and compliance dates are currently unknown because registration rules are not yet finalized

The Entity Definitions
Final Concluding Remarks (2) – Action Points

- Classify your swap counterparties as: US person, non-US branch of a US institution, non-US subsidiary of a US institution and no US nexus
- If have "US facing activity" classify your swaps as: Rates, Credit, Equity; Other Commodity, Debt-Security Based Swaps; Other Security-Based Swaps
- Apply the swap dealer qualitative tests
- Consider applicability of the *de minimis* exemption and major swap participant safe harbors
- Determine your ECP status
- Obtain ECP rep from any US counterparty

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Qualifications and Career Profile

Carolyn Jackson's practice focuses on the structuring and offering of complex securities, commodities and derivatives transactions as well as U.S. securities and commodities law regulation. Having practiced outside of the United States for her entire legal career, she is particularly expert in the extraterritorial effects of U.S. regulation. Carolyn advises a broad range of market participants, including commercial banks, investment banks, investment managers, broker-dealers, electronic trading platforms, clearinghouses, trade associations and OTC derivatives service providers.

Prior to joining Katten, Carolyn was counsel and the European head of Allen & Overy LLP's U.S. Regulatory Practice, where she began her legal career in 2000. Carolyn was a frequent external and internal speaker while at Allen & Overy, participating in conferences concerning OTC derivatives regulatory reform, investment manager regulation, U.S. support and liquidity measures and fixed-income mathematics.

Prior to becoming a lawyer, Carolyn was the executive director and a board member of the International Swaps and Derivatives Association, Inc. (ISDA) from 1995–1997. Notable achievements included the establishment of the London ISDA office and the Southeast Asian Working Committee, which led to the establishment of ISDA offices in Singapore and Hong Kong. Carolyn spent the initial 13 years of her career as a derivatives trader and was part of the original swaps team at the Chase Manhattan Bank, NA from 1982–1987. She established the New York derivatives trading desk for Banque Nationale de Paris, where she worked from 1987–1993. From 1993–1995, Carolyn was first vice president and manager of the Banque Indosuez International Capital Markets Group in New York.

Memberships and Affiliations

Carolyn is a member of the American and New York State Bar Associations. She is a 2011–2012 vice-chair of the International Financial Products and Services Committee of the ABA Section of International Law, as well as a steering committee member of the ABA Section of International Law Task Force on Financial Engineering for Economic Development (FEED). She participates in various U.S. regulatory reform advisory working groups to the Alternative Investment Management Association (AIMA), and serves on the Legal Advisory Forum to the Managed Funds Association. In addition, Carolyn was a founding and is a current board member, and former secretary (1997–2000) of the International Association of Financial Engineers (IAFE). She has recently been named to the Panel of Recognised International Market Experts in Finance (PRIME).

Lectures and Publications

- "The Devil Is in the Detail: Interpreting Master Agreements (Valuations, Measuring Loss, Set-Off and Tax Characterisation)," Opening Conference of PRIME Finance: Seminars on Dispute Resolution in the Financial Markets, The Hague (January 17, 2012)
- "Keeping Up with the Markets: Which Ones Do You Monitor—Who Decides?" Mondo Visione Surveillance & Compliance Seminar, London (November 2, 2011)

- "After the Storm: Navigating the New World Order in Financial Services Regulation," ABA Section of International Law 2011 Fall Meeting, Dublin (October 12, 2011)
- "The Changing World of Cross-Border Derivatives: Dodd-Frank, EMIR and What They Mean For You," Katten Seminar, London (October 6, 2011)
- “Dodd-Frank Derivatives Update: The Implementation Challenge,” Katten Seminar, New York (June 21, 2011)
- “Derivatives: U.S. Issues,” *Law of Investment Management*, Tim Spangler (editor), Oxford University Press (2010) (co-authored with Nathaniel W. Lalone)
- “The Road Toward Mandatory Registration for Fund Advisers and the Closure of Gaps,” Complinet (December 3, 2009) (co-authored with Nathaniel W. Lalone)
- “Hedge Fund Transparency Act: The End of Derivative-Linked Structured Products as We Know Them,” *Derivatives Week* (May 16, 2009) (co-authored with Nathaniel W. Lalone)
- “Two Regulatory Changes to Watch in the US,” *The 2005 Guide to Structured Finance*, International Finance Law Review (co-authored with Christopher Bernard)
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- “US Regulatory Reform for OTC Derivatives and Asset Managers,” G20 Asian Reform Conference, Hong Kong (October 15, 2009)
- “Food for Thought: Hedging the Hunger Crisis,” 2008 IAFE Annual Conference: Investing Through Volatile Markets, New York (June 25, 2008)

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Nathaniel is a member of the American and New York State Bar Associations. He has also been active in industry initiatives regarding the regulation of derivatives, such as the Dodd-Frank working groups of the Alternative Investment Management Association

Lectures and Publications

- "Business Conduct Standards for Derivatives under Dodd-Frank," FOA Compliance Forum, London (October 27, 2011)
- "The Changing World of Cross-Border Derivatives: Dodd-Frank, EMIR and What They Mean For You," Katten Seminar, London (October 6, 2011)
- "Derivatives: U.S. Issues," *Law of Investment Management*, Tim Spangler (editor), Oxford University Press (2010) (co-authored with Carolyn H. Jackson).
- "The Road Toward Mandatory Registration for Fund Advisers and the Closure of Gaps," *Complinet*, December 3, 2009 (co-authored with Carolyn H. Jackson).
- "Hedge Fund Transparency Act: The End of Derivative-Linked Structured Products as We Know Them," *Derivatives Week*, May 16, 2009 (co-authored with Carolyn H. Jackson).

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Financial Services

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CFTC and SEC Adopt Final Rules Further Defining "Swap Dealer," "Major Swap Participant" and "Eligible Contract Participant"

I. BACKGROUND

The Dodd-Frank Act (the Act)[1] requires persons who act as swap dealers and major swap participants to register as such with the Commodity Futures Trading Commission and/or the Securities and Exchange Commission and subjects these entities to, among other things, margin, capital and business conduct requirements. On April 18, the CFTC and the SEC (collectively, the Commissions) approved the long-awaited final rules further defining the terms "swap dealer" and "major swap participant" (the Final Rules). The Final Rules also clarify certain aspects of the definition of the term "eligible contract participant" (ECP)[2] and adopt certain look-through provisions for commodity pools that engage in retail foreign exchange transactions.

The Final Rules have responded to the vast market commentary on the Commissions' earlier proposed rules (the Proposed Rules) regarding entity definitions as evidenced by the significant increase in the *de minimis* threshold, as well as the elimination of the restrictions concerning the number of counterparties and swaps under the *de minimis* test. This advisory summarizes some of the more significant aspects of the Final Rules as set forth in the Commissions' adopting release (the Adopting Release).

II. EXECUTIVE SUMMARY

A. Swap Dealers

The Final Rules and the Adopting Release set forth a framework under which a person who engages in swaps[3] may determine whether he or she is a swap dealer. First, the person would analyze his or her activity in light of the four statutory tests and exclude any swap activities that are not part of his or her regular business. The person would also exclude from his or her calculations any swap activity to which a specific exemption applies under the Final Rules, such as the exemptions for swaps that hedge physical positions and swaps between majority-owned affiliates. If after this analysis, the person determines that he or she is engaging in an amount of swap activity that exceeds the *de minimis* threshold,

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

[2] Among other things, the Act generally provides that any swap transacted with a person who is not an ECP must be transacted on a designated contract market (DCM) or a national securities exchange.

[3] For ease of reference, the term "swap" is intended to refer to swaps and security-based swaps unless the context otherwise requires.

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that person is a swap dealer and required to register as such. Upon application to and approval from the Commissions, a person's registration as a swap dealer may be limited to certain specified categories of swaps or specified activities in connection with swaps.

B. Major Swap Participants

Under the Act, a person who is not a swap dealer must determine whether he or she is a major swap participant (MSP) by performing one or more applicable complex statutory tests (the MSP Tests). The MSP Tests require a person to calculate his or her current uncollateralized exposure and potential future exposure as defined in the Final Rules. The current uncollateralized exposure is essentially the amount a person owes to all of his or her counterparties, excluding any posted collateral, but generally including minimum threshold and minimum transfer amounts. Potential future exposure is the product of the notional amount of swaps outstanding and a factor which varies depending on the type of swap and its remaining maturity. A person is required to conduct the MSP Tests on a quarterly basis using the average of data collected daily. However, in recognition of the considerable compliance burdens involved in making these calculations, the Final Rules include three alternative calculation safe harbors. As with swap dealer registration, an MSP may apply for limited MSP registration.

C. ECP and Retail Forex Look-Through

The Final Rules amend the definition of an ECP and establish a look-through requirement for commodity pools that engage in so-called retail forex transactions. Under the Final Rules, a retail forex pool will not be an ECP unless each pool participant is an ECP. The Final Rules, however, provide that this look-through requirement only applies to the pool's direct investors unless an indirect structure has been created for the purpose of evading the Final Rules. In addition, a retail forex pool will be an ECP even if it has non-ECP participants if it has assets exceeding $10 million and is formed and operated by a registered commodity pool operator (CPO) or a person who is exempt from CPO registration.

III. SWAP DEALERS

A. General Overview

Under the Act, a person will be deemed to be a swap dealer or a security-based swap dealer if he or she engages in any of the following types of activities:

i. Holds himself or herself out as a dealer in swaps or security-based swaps;

ii. Makes a market in swaps or security-based swaps;

iii. Regularly enters into swaps or security-based swaps with counterparties as an ordinary course of business for his or her own account; or

iv. Engages in activity causing him or her to be commonly known in the trade as a dealer or market maker in swaps or security-based swaps.[4]

Under the Act, persons who enter into swaps or security-based swaps for their own account, either individually or in a fiduciary capacity, but not as a part of a regular business, are excluded from this definition. Swap dealing activity that does not exceed a certain threshold is disregarded in determining whether a person is a swap dealer. Further, swaps entered into by an insured depository institution with a customer in connection with originating a loan with that customer, 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 are disregarded for purposes of determining whether a person is a swap dealer.

B. Interpretive Guidance on the Definition of "Swap Dealer"

1. Background

In order for a person to determine whether he or she is a swap dealer, the person would begin by applying the statutory definition, the provisions of the rule that implement the four statutory tests, and the exclusion for swap activities that are not part of a

[4] The definitions are disjunctive, and a person who engages in any of these activities may be a swap dealer or security-based swap dealer even if he or she does not engage in any of the other enumerated activities.

regular business.[5] As a part of that analysis, the person must apply the interpretive guidance provided by the Commissions described below.

If, after completing this review, the person determines that he or she is engaged in swap dealing activity, the next step is to determine whether such activity exceeds the threshold set forth in the Final Rules. If so, then the next step is for the person to determine whether any of his or her excess swap dealing activity may be subject to one of the specific exclusions described below. If not, then that person is a swap dealer.

2. General Interpretive Principles

In the Adopting Release, the Commissions stated that the SEC's historical distinction between traders and dealers generally provides an appropriate framework for distinguishing between those persons who should be regulated as swap dealers and those who should not. In particular, the Commissions stated that the following activities, which are indicative of dealing activity in the application of the trader-dealer distinction, also are indicative of whether a person is acting as a swap dealer:

i. Providing liquidity by accommodating demand for or facilitating interest in swaps, holding oneself out as willing to enter into swaps (independent of whether another party has already expressed interest), or being known in the industry as being available to accommodate demand for swaps;

ii. Advising a counterparty as to how to use swaps to meet the counterparty's hedging goals, or structuring swaps on behalf of a counterparty;

iii. Having a regular clientele and actively advertising or soliciting clients in connection with swaps;

iv. Acting in a market maker capacity on an organized exchange or trading system for swaps; and

v. Helping to set the prices offered in the market (such as by acting as a market maker) rather than taking those prices, although the fact that a person regularly takes the market price for his or her swaps does not foreclose the possibility that the person may be a swap dealer.

The Commissions noted that the swap dealer analysis does not turn on whether a person's swap dealing activity constitutes his or her sole or predominant business. Further, to the extent that a person regularly enters into security-based swaps with a view toward profiting by providing liquidity—rather than by taking directional positions—that person may be a swap dealer regardless of whether he or she views himself or herself as maintaining a customer relationship with his or her counterparties.[6]

3. Definition of Market Making

The Commissions stated that making a market in swaps is appropriately described as routinely standing ready to enter into swaps at the request or demand of a counterparty. In this regard, "routinely" means that the person must do so more frequently than occasionally, but there is no requirement that the person do so continuously. Some of the activities that indicate whether a person is routinely standing ready to enter into swaps at the request or demand of a counterparty are as follows:

i. Providing bids or offers for swaps on an exchange;

ii. Responding to requests for quotations made directly, or indirectly through an interdealer broker, by potential counterparties for bilaterally negotiated swaps;

iii. Placing limit orders for swaps; and

iv. Receiving compensation for acting in a market maker capacity on an organized exchange or trading system for swaps.

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[5] In general, the analysis of whether a person is acting as a swap dealer is made without regard to his or her other activities. However, the SEC has stated that a person may be deemed to be a security-based swap dealer if the transactions he or she effects in security-based swaps are integrally related to the person's dealing activities in the cash markets. For example, if a dealer in government bonds enters into a security-based swap transaction with one of its bond customers, the bond dealer may be deemed to be acting as a security-based swap dealer with respect to that customer. This is because the customer would be expected to view such person as a dealer for purposes of the security-based swap, thus generating the need for the relevant business conduct requirements to apply to this transaction.

[6] Under the Act, security-based swaps are included in the definition of a "security" under both the Securities Act of 1933, as amended, and under the Securities Exchange Act of 1934, as amended (the Exchange Act). The Act, however, expressly excludes from the Exchange Act's definition of "dealer" persons who limit their transactions in security-based swaps to ECPs. In contrast, any person that acts as a "broker" in security-based swaps with any type of counterparty, even ECPs, must register as a broker-dealer, absent any other applicable exemption.

In applying these four factors, it is important to consider whether 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 he or she enters into. If not, such activity would not be indicative of market making.

A person may be a market maker even if he or she only routinely stands ready to enter into swaps on one side of the market and then enters into offsetting positions in the swap market or in other markets. Further, because the statutory definition of the term "swap dealer" makes no distinction between swaps executed on an exchange and swaps that are not, a person may be a market maker even if that person only effects swap transactions on an anonymous basis on an organized market.

4. Agency Transactions

The Commissions interpret the reference in the definition of the term "swap dealer" to a person entering into swaps "with counterparties . . . for its own account" to refer to a person who enters into a swap as a principal, and not as an agent. Accordingly, a person who enters into swaps as an agent for customers (i.e., for the customers' accounts) would not be required to be registered as a swap dealer, but may be required to register as a broker-dealer, as a futures commission merchant or as an introducing broker, depending on the nature of the person's activity.

C. Exclusions

1. Exclusion for Swaps in Connection with Loan Origination

The Act provides an exclusion from swap dealer status for an insured depository institution (IDI) to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer. In order to fall within this exclusion, the following conditions must be satisfied:

i. The term of the swap between the IDI and the borrower may not extend beyond the termination of the loan;

ii. The swap must be connected to the financial terms of the loan or is required by the IDI's loan underwriting criteria to be in place as a condition of the loan in order to hedge commodity price risks incidental to the borrower's business;

iii. The loan cannot be a sham or a synthetic loan;

iv. The IDI must, directly or indirectly (through syndication, participation, assignment or otherwise), be the source of funds for at least 10% of the maximum principal amount of the loan;

v. The IDI must enter into the swap with the borrower within 90 days before or 180 days after the date the execution of the loan agreement, or within 90 days before or 180 days after any transfer of principal to the borrower from the IDI pursuant to the loan; and

vi. The aggregate notional amount of all swaps entered into by the IDI and the borrower cannot exceed the notional principal amount of the loan at any time during the term of the loan.

For purposes of this exclusion, it is not relevant whether a swap hedges all or only some of the risk of the loan or if the IDI later transfers or terminates the loan in connection with which the swap was entered into, so long as the swap otherwise qualifies for the exclusion and the loan was originated in good faith. Swaps that are covered by this exclusion and swaps that an IDI enters into to hedge or lay off the risk of these transactions are not considered in determining if an IDI exceeds the *de minimis* threshold discussed below.

2. Exclusion for Certain Hedging Transactions

The Act does not expressly exclude swap transactions that are used to hedge or mitigate risk in determining whether a person is a swap dealer. However, the CFTC has taken the position that entering into swaps to hedge physical positions is not swap dealing activity and has adopted an interim final rule which provides that the determination of whether a person is a swap dealer will not consider a swap that the person enters into if:

i. The person enters into the swap for the purpose of offsetting or mitigating the person's price risks that arise from the potential change in the value of one or several (a) assets that the person owns, produces, manufactures, processes or merchandises, or anticipates owning, producing, manufacturing, processing or merchandising; (b) liabilities that the person owns or anticipates incurring; or (c) services that the person provides, purchases or anticipates providing or purchasing;

ii. The swap represents a substitute for transactions made or to be made or positions taken or to be taken by the person at a later time in a physical marketing channel;

iii. The swap is economically appropriate to the reduction of the person's risks in the conduct and management of a commercial enterprise;

iv. The swap is entered into in accordance with sound commercial practices; and

v. The person does not enter into the swap in connection with activity structured to evade designation as a swap dealer.[7]

This interim final rule is based upon the principles underlying the CFTC's interpretation of "bona fide hedging" and thus excludes portfolio hedging activities.

3. Exclusion for Transactions Between Affiliates

Under the Final Rules, swaps and security-based swaps between majority-owned affiliates will be excluded from the analysis of whether a person is a swap dealer. For the purposes of this exclusion, two counterparties will be deemed to be majority-owned affiliates if one party directly or indirectly holds a majority ownership interest in the other, if a third party directly or indirectly holds a majority interest in both, or if one party has the right to receive the majority of the capital of the other party upon its dissolution. This exclusion also applies to swaps between a cooperative—including agricultural cooperatives and cooperative financial institutions—and its members that are based on any commodity other than an excluded commodity.

4. Exclusion for Proprietary Trading Firms

The Final Rules provide that, in determining whether a person is a swap dealer under the Commodity Exchange Act (the CEA), the swaps that it enters into in its capacity as a floor trader on a designated contract market (DCM) or swap execution facility (SEF) will not be considered for the purpose of determining whether the person is a swap dealer, so long as he or she:

i. Is registered with the CFTC as a floor trader;

ii. Enters into swaps solely with proprietary funds for his or her own account on or subject to the rules of a DCM or SEF, and submits each such swap for clearing to a clearing house;

iii. Is not an affiliated person of a registered swap dealer;

iv. Does not directly, or through an affiliated person, negotiate the terms of swap agreements, other than price and quantity or to participate in a request for quote process subject to the rules of a DCM or SEF;

v. Does not directly or through an affiliated person offer or provide swap clearing services to third parties;

vi. Does not directly or through an affiliated person enter into swaps that would qualify as hedging physical positions as described above or which hedge or mitigate commercial risk pursuant to CFTC Regulation 1.3, other than swaps that are executed opposite a counterparty for which the transaction would qualify as a bona fide hedging transaction;

vii. Does not participate in any market making program offered by a DCM or SEF; and

viii. Complies with the recordkeeping and risk management requirements of CFTC Regulation §§ 23.201, 23.202, 23.203, and 23.600[8] with respect to each such swap as if it were a swap dealer.

Because the SEC does not have a regulatory category that is equivalent to the floor trader category under the CEA, this exclusion does not apply to a person's security-based swap activities.

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[7] Each of these requirements must be met with respect to the swap in order to exclude the swap from the analysis of whether a person is a swap dealer.

[8] CFTC Regulation 23.201 generally requires a swap dealer to keep complete and systematic records of all its swap activities; CFTC Regulation 23.202 generally requires a swap dealer to make and keep daily trading records of all of the swaps it executes; and CFTC Regulation 23.203 generally requires swap dealers to keep such records at their principal place of business. Regulation 23.600 generally requires a swap dealer to (i) establish a risk management program to manage the risks associated with its swaps activities; (ii) maintain written policies and procedures that describe its risk management program and have these procedures approved by its governing board; (iii) furnish a copy of its written risk management policies and procedures to the CFTC or the NFA upon request; and (iv) establish and maintain a risk management unit to carry out its risk management program. This risk management unit must report directly to senior management and must be independent from the swap dealer's business trading unit.

D. *De Minimis* Exemption

The Act provides an exemption for a person who "engages in a *de minimis* quantity of swap dealing in connection with transactions with or on behalf of its customers." Accordingly, the Final Rules provide that a person will be exempt from swap dealer regulation to the extent that the aggregate gross notional amount of the swaps and security-based swaps that are credit default swaps that the person enters into over the prior 12 months in connection with his or her swap dealing activities does not exceed $3 billion.[9] For other security-based swaps, this threshold will be $150 million. In addition, the aggregate gross notional amount of such swaps with special entities[10] over the prior 12 months must not exceed $25 million.[11]

The Final Rules also provide for a phasing-in of the *de minimis* threshold to facilitate orderly implementation of swap dealer requirements. During this phasing-in period (which will last a maximum of five years from the time data starts to be reported to swap data repositories), the *de minimis* threshold applicable to swaps and security-based swaps that are credit default swaps will be $8 billion, with the same $25 million limitation for swaps with special entities. For other types of security-based swaps, the *de minimis* threshold that applies during the phase-in period will be $400 million.

The *de minimis* test is designed to measure a person's swap dealing activities on a gross basis and thus reflect the person's overall dealing activity. Accordingly, this test does not take any collateral held by or provided by a person into account. If a person who has relied on the *de minimis* exception is not able to rely on the exception because his or her dealing activity exceeds the relevant threshold, that person will have two months following the end of the month in which he or she is no longer able to utilize this exception to register as a swap dealer or security-based swap dealer.

After data starts to be reported to swap data repositories, the staffs of the Commissions will prepare studies of the swap markets, including data and information that becomes available about the *de minimis* threshold. After these studies are completed, the Commissions may end the phase-in period, or propose new rules to change the *de minimis* threshold (either up or down). If the Commissions do not take action to end the phase-in period, it will terminate automatically five years after data starts to be reported to swap data repositories.

E. Limited Purpose Registration

In general, the regulatory requirements applicable to a swap dealer will apply to all of the swap dealer's swap or security-based swap activities. However, the definitions of the terms "swap dealer" and "security-based swap dealer" provide that the Commissions may designate a person as a swap dealer for one type or category of swaps or security-based swaps, or specified swap or security-based swap activities, without subjecting that person's other swaps or swap activities to the requirements that apply to swap dealers.

The Commissions have clarified that a person may apply for a limited purpose registration either when he or she submits a registration application or at any time thereafter, and that they will consider each such application on an individualized basis. However, regardless of the type of limited registration being requested, the Commissions will not permit a person to register as a limited purpose swap dealer unless that person can demonstrate that he or she can fully comply with the requirements applicable to swap dealers. For example, certain requirements, such as the requirements relating to trading records, documentation and confirmations, apply to specific transactions, and an applicant for a limited purpose registration would have to demonstrate how it would satisfy these transaction-specific requirements. Other requirements, such as registration, capital, risk management and supervision, focus on the entity itself, and an applicant for a limited purpose registration would have to demonstrate how it would satisfy those requirements in this context.[12]

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[9] The Proposed Rules limited the number of swaps or security-based swaps that an entity could enter into in a dealing capacity, and the number of counterparties with which an entity could transact in a dealing capacity. The Final Rules do not include these limitations.

[10] For these purposes, "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.

[11] This notional test will be based on a person's dealing activity during the first year following the effective date of the final rules implementing the statutory definitions of "swap" and "security-based swap" as set forth in Section 1a(47) of the CEA and Section 3(a)(68) of the Exchange Act, respectively.

[12] Although the swap dealer capital requirements apply on an entity level basis, the Commissions have indicated that a company that registers one of its business units as a limited purpose swap dealer may not be required to take the swaps it effects outside of this business unit into consideration for purposes of calculating its capital requirements.

IV. MAJOR SWAP PARTICIPANTS

A. General Overview

Under the Act, a person will be an MSP or a major security-based swap participant if he or she satisfies any of the following three requirements:

i. The person maintains a substantial position in any of the major swap categories,[13] not including any positions held for hedging or mitigating commercial risk or positions maintained by certain employee benefit plans for hedging or mitigating risks in the operation of the plan (the Substantial Position Test);

ii. Its 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 (the Substantial Counterparty Exposure Test); or

iii. It is a financial entity that is highly leveraged in relation to the amount of capital it holds, is not subject to capital requirements promulgated by a federal banking agency and maintains a substantial position in any of the major swap categories (the Highly Leveraged Financial Entity Test).

B. Substantial Position Test

The Final Rules set forth two alternative tests for determining whether a person satisfies the Substantial Position Test.

1. Current Exposure Test

Under the Final Rules, a person will have a substantial position in a major swap category if that person's daily average net current uncollateralized exposure in the relevant swap category exceeds $1 billion (other than the rate swap category, for which the threshold is $3 billion). Under the Final Rules, market participants would apply this test on a major category-by-major category basis. Thus, for each counterparty, a person would determine his or her aggregate current exposure by marking his or her swap positions to market and then deduct the aggregate value of collateral posted with respect to such positions. The aggregate uncollateralized current exposure would be the sum of those uncollateralized amounts across all counterparties in each applicable major swap category.

The Final Rules would permit a person to calculate his or her current exposure on a net basis and thus give effect to any master netting agreements he or she has in place with his or her counterparties. Further, when calculating his or her net current exposure to a counterparty, a person may include unrelated positions (e.g., securities lending and borrowing transactions, repurchase and reverse repurchase agreements, and other financial instruments and agreements for which offset is permissible under applicable bankruptcy law) in the netting calculation to the extent permissible under the master netting agreement. A person who has not fully collateralized his or her net current exposure to a particular counterparty must allocate such uncollateralized exposure pro rata in a manner that reflects the exposure associated with each of his or her out-of-the-money swap and non-swap positions with that counterparty.

2. Current Exposure Plus Potential Future Exposure Test

Under the Final Rules, a person will also have a substantial position in a major swap category if the sum of such person's daily average net current uncollateralized exposure plus potential future exposure in the applicable major swap category exceeds $2 billion (other than the rate swap category, for which the threshold is $6 billion). A person's potential future exposure is determined by multiplying the total notional principal amount[14] of his or her swap positions by specified risk factor percentages (ranging from 0.5% to 15.0%, based on the type of swap and the residual maturity of the position).[15]

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[13] The CFTC has designated four major categories of swaps for purposes of the MSP definition. These four categories are rate swaps, credit swaps, equity swaps and other commodity swaps. The SEC has designated two major categories of swaps for purposes of security-based swaps. These two categories are debt security-based swaps and other security-based swaps. Debt security-based swaps are those security-based swaps that are based, in whole or in part, on one or more instruments of indebtedness (including loans), or a credit event relating to one or more issuers or securities, including but not limited to, any security-based swap that is a credit default swap, a total return swap on one or more debt instruments, a debt swap or a debt index swap. The second category includes swaps on equity securities or narrow-based indices comprised of equity securities.

[14] For positions in which the stated notional amount is leveraged or enhanced by the particular structure, this calculation would be based on the position's effective notional amount.

[15] If the terms of a swap provide for the periodic settlement of amounts due so that the market value of the swap resets to zero, then the remaining maturity of the swap is the time until the next reset date.

The Final Rules contain downward adjustments for certain types of positions that pose relatively low potential risks. Thus, the potential future exposure for long options positions for which the premium has been paid in full would be zero. Similarly, the potential future exposure associated with a long credit default swap position or any options for which a person retains any additional payment obligations would be capped at the net present value of any unpaid premiums.

The Final Rules provide that the potential future exposure calculation required thereunder will be reduced for parties that have master netting agreements in place, and discount such exposure by a factor ranging between zero and 60% depending on the effects of the agreement. Further, the calculation of future exposure is subject to further downward adjustments to account for the risk mitigation effects of central clearing and mark-to-market margining. In particular, if a swap or security-based swap is cleared by a registered clearinghouse or subject to daily mark-to-market margining,[16] the potential future exposure calculation otherwise required for such swaps would be discounted by 90% or 80%, respectively. However, the Final Rules do not modify the measure of potential future exposure to reflect collateral that a person has posted to its counterparty in excess of its current exposure.

3. Hedging or Mitigating Commercial Risk

As noted above, the Substantial Position Test excludes positions held for hedging or mitigating commercial risk. The definition encompasses any swap position that (i) is recognized as a hedge for accounting purposes; (ii) is recognized as a bona fide hedge for purposes of the CFTC's position limit requirements; or (iii) hedges or mitigates a person's business risks. Swaps held for the purpose of investment, speculation or trading would not satisfy the requirements described above. Further, swaps that hedge or mitigate the risk of another swap (the "first swap") would not satisfy these standards unless the first swap is held for the purpose of hedging or mitigating commercial risk. Unlike the Proposed Rules, the Final Rules do not require persons that trade security-based swaps to document their hedging transactions as such and periodically assess the effectiveness of these transactions.

C. Substantial Counterparty Exposure Test

The Substantial Counterparty Exposure Test is designed to include entities whose swaps and security-based swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets. Unlike the Substantial Position Test, this test is not applied on a category-by-category basis and does not explicitly exclude hedging positions.

Under the Substantial Counterparty Exposure Test, a person would be a major swap participant if that person has current uncollateralized exposure of $5 billion or current uncollateralized exposure and potential future exposure of $8 billion across all of its swap positions. Similarly, a person would be a major security-based swap participant if that person has current uncollateralized exposure of $2 billion or current uncollateralized exposure and potential future exposure of $4 billion across all of its security-based swap positions. Under this test, substantial counterparty exposure would be calculated in the same manner as the calculation of substantial position noted above, except that such exposure would be measured on an aggregate basis rather than on a category-by-category basis.

D. Highly Leveraged Financial Entity Test

Under the Highly Leveraged Financial Entity Test, a person would be a major swap participant or a major securities-based swap participant if (i) it is a financial entity; (ii) it is not subject to capital requirements established by an appropriate federal banking agency;[17] (iii) it is highly leveraged relative to the amount of capital it holds; and (iv) it maintains a substantial position in a major category of swaps or security-based swaps. This test does not provide an exclusion for positions held for hedging or risk mitigation purposes.

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[16] For these purposes, a swap or security-based swap would be considered to be subject to daily mark-to-market margining if, and for as long as, the counterparties exchange collateral on a daily basis to reflect changes in exposure (after taking into account any other positions addressed by a netting agreement between the parties). If a person is permitted to maintain an uncollateralized threshold amount under such an agreement, that amount (regardless of actual exposure) would be considered current uncollateralized exposure for purposes of this test. Also, if such agreement provides for a minimum transfer amount in excess of $1 million, the entirety of that amount would be considered current uncollateralized exposure.

[17] The Commissions interpret the phrase "subject to capital requirements established by an appropriate federal banking agency" to specifically apply to persons for whom a federal banking agency directly sets capital requirements. Thus, this term does not apply to persons that are part of a holding company that is subject to these capital requirements, or that are affiliated with persons that are subject to these capital requirements.

The Act does not define the term "financial entity" for purposes of this test. However, the Act defines the term "financial entity" for purposes of the end user exception from mandatory clearing, and the Commissions generally intend to use the same definition of this term for purposes of this test. The definition of the term "substantial position" described above also will be utilized in this test.

The Final Rules provide that a person would be highly leveraged if the ratio of that person's total liabilities to equity is in excess of 12 to 1. This determination would be made at the close of business on the last business day of a fiscal quarter. Entities that file quarterly reports on Form 10-Q and annual reports on Form 10-K with the SEC would determine their total liabilities and equity based on the financial statements included in these filings. All other entities would make this determination based on generally accepted accounting principles.

E. Interpretations Relating to MSPs

1. Limited Registration

In general, the regulatory requirements that apply to an MSP will apply to all of its swap activities. However, as is the case with swap dealers, a person who is an MSP with respect to certain swaps may apply for limited registration status either when it submits a registration application or at any time thereafter. The same principles discussed above in the context of limited purpose swap dealer registration are also relevant to the limited registration of MSPs.

2. Exclusion for Affiliate Transactions

The Final Rules provide that a person may exclude swaps or security-based swaps from the analysis of whether that person is an MSP if the counterparties to those swaps or security-based swaps are majority-owned affiliates.

3. ERISA Plans

As noted above, the first statutory test of the MSP definitions excludes swap and security-based swap positions that are maintained by any employee benefit plan. The Commissions stated that they interpret the term "maintain" to include positions held by a trust or pooled vehicle that holds plan assets. Thus, for example, the exclusion would be available to trusts or pooled vehicles that only hold plan assets. Further, this exclusion may be available to entities that hold plan assets and other assets, but only to the extent that the entity enters into swap or security-based swap positions for the purpose of hedging risks associated with the plan assets.

The Final Rules also modify the leverage test that applies to employee benefit plans and provides that plans that undertake this leverage calculation may (i) exclude obligations to pay benefits to plan participants from their measure of liabilities for purposes of the leverage calculation, and (ii) substitute the total value of plan assets for equity for purposes of this calculation.

4. Captive Finance Companies

The Final Rules implement the statutory exclusion for captive subsidiaries whose primary business is providing financing for the sale of products of their parent companies and that use derivatives for purposes of hedging commercial risk with respect to interest rate and foreign currency exposures. This exclusion applies when the subsidiary's financing activity "finances the purchase of products sold by the parent company in a broad sense, including service, labor, component parts and attachments that are related to the products."

5. Attribution Test

The Final Rules clarify that a person's swap or security-based swap positions generally would be attributed to a parent, other affiliate or guarantor for purposes of the major swap participant analysis to the extent that the counterparties to those positions would have recourse to such entities. However, even if a person's swap positions are guaranteed, these positions will not be attributed to the guarantor if the guarantor is subject to capital regulation by the CFTC or SEC or if it is a U.S. entity that is regulated as a bank under federal or state law.

6. Treatment of Regulated Entities

The Commissions declined to exclude from potential MSP status entities that are already subject to another regulatory regime. However, the Commissions stated that they would attempt to coordinate their regulatory oversight in order to avoid unnecessary regulatory duplication if an MSP is also separately registered with and regulated by the CFTC or SEC. Separately, the Commissions also determined that it would not be appropriate to require derivatives clearing organizations and securities clearing agencies to be registered or regulated as major swap participants.

7. Investment Managers

The Commissions have adopted the interpretation that investment advisers and other asset managers are not required to include the swap positions of their managed accounts in determining whether they are major swap participants. Separately, the Commissions have stated that they would not attribute swap positions to the owner of an account if the swap counterparty's recourse were limited to the assets in that account. Conversely, to the extent that the swap counterparty has recourse to the assets of the beneficial owner, such owner must include these positions in its analysis of whether it is an MSP.

F. Implementation Provisions

1. General

To preclude the registration of persons who may inadvertently exceed the size thresholds noted above due to unforeseen circumstances, the Final Rules provide that a person who exceeds these thresholds by less than 20% would not be required to register as a major swap participant immediately. Instead, that person would become subject to those requirements if he or she exceeded any of these applicable daily average thresholds in the next fiscal quarter. Under the Final Rules, a person who satisfies the MSP requirements described above during a fiscal quarter would not be deemed to be a major swap participant until the earlier of (i) the date on which that person submits a complete application for registration to the CFTC or the SEC, or (ii) two months after the end of that quarter.

2. Calculation Safe Harbors

The Final Rules provide for three alternative safe harbors that are designed to reduce the compliance burdens to which market participants would otherwise be subject regarding whether they are major swap participants.

First, a person will not be deemed to be an MSP if (i) the express terms of its swap agreements would not permit that person to maintain total uncollateralized exposure of more than $100 million to all swap counterparties, including any exposure that may result from the application of thresholds or minimum transfer amounts established by credit support annexes or similar arrangements, and (ii) that person does not maintain notional swap or security-based swap positions of more than $2 billion in any major category of swaps or security-based swaps, or more than $4 billion in the aggregate.

Second, a person will not be deemed to be an MSP if (i) the express terms of its swap agreements would not permit that person to maintain a total uncollateralized exposure of more than $200 million to all swap counterparties, including any exposure that may result from thresholds or minimum transfer amounts, and (ii) the person performs the substantial position and substantial counterparty exposure calculations at the end of every month, and the results of each of those monthly calculations indicate that the person's swap positions do not exceed one-half of the level of current exposure plus potential future exposure that would cause the person to be an MSP.

Finally, a person will not be deemed to be an MSP if (x) that person's aggregate uncollateralized outward exposure at the end of the month with respect to all of his or her swap positions across all categories is less than $500 million, and (y) the sum of (i) such exposure and (ii) the product of the total effective notional principal amount of his or her swap positions in all categories multiplied by 0.15 is less than $1 billion.

V. ELIGIBLE CONTRACT PARTICIPANT AND RETAIL FOREIGN EXCHANGE LOOK-THROUGH

A. Retail Forex Transactions

1. General

The Act narrowed the scope of commodity pools that will be deemed to be ECPs in connection with retail forex transactions. Accordingly, the Final Rules provide that a commodity pool that enters into retail forex transactions (a Forex Pool) will not qualify as an ECP if it has one or more direct participants that are not ECPs. Further, the status of indirect participants in the Forex Pool may be disregarded unless such Forex Pool or any commodity pool that owns or is owned by such Forex Pool has been structured to evade the provisions of the Act.[18]

[18] One example of a scheme to evade would be if a commodity pool tier has been included in the structure of the Forex Pool primarily to provide non-ECP participants exposure to retail forex transactions rather than to achieve any other legitimate business purpose. One example of a legitimate business purpose is a fund-of-funds (FOF) operated primarily for the purpose of investing in underlying funds and using retail forex transactions solely to hedge the currency risk posed by an unfavorable change in the exchange rate between the currency in which underlying funds accept investments and the currency in which its investors pay for their investments in the FOF.

The CFTC will permit CPOs and retail forex transaction counterparties to rely on written representations from pool participants or Forex Pool counterparties regarding their ECP status so long as they have a reasonable basis for doing so. A CPO or retail forex transaction counterparty will have a reasonable basis to rely on such written representations unless it has information that would cause a reasonable person to question the accuracy of the representation.

The subsequent loss of a participant's ECP status would not cause a Forex Pool to lose its own ECP status so long as its operating agreement or subscription agreement requires the participant to so advise the CPO of the Forex Pool promptly thereafter. In such event, the CPO would be required to redeem the non-ECP from the Forex Pool at the first opportunity following notification to avoid the loss of ECP status.

2. Foreign Pools

Under the Final Rules, Forex Pools whose participants are limited solely to non-U.S. persons and which are operated by CPOs located outside the United States, its territories or possessions will be ECPs without regard to whether these non-U.S. persons themselves are ECPs. For this purpose, a Forex Pool participant is a non-U.S. person if it satisfies the definition of "Non-United States person" in CFTC Regulation 4.7. However, if a Forex Pool participant is an entity organized principally for passive investment, it will be considered to be a Non-United States person only if all of its investors are Non-United States persons.

The restriction against any U.S. participation in an offshore Forex Pool is fairly strict, and the CFTC recognizes that despite its best efforts, a Forex Pool may inadvertently have U.S. participants. Accordingly, the CFTC stated that it would not expect to bring an enforcement action against a counterparty for entering into a retail forex transaction with a Forex Pool which claims that all of its participants are non-U.S. persons if less than 10% of the Pool's beneficial owners are U.S. persons and the counterparty has reasonable policies and procedures in place to verify the ECP status of the Forex Pool.

3. Exception to Look-Through Test for Large Forex Pools

The Final Rules provide an exception to the look-through test described above for a Forex Pool if (i) it was not formed for the purpose of evading CFTC regulations relating to retail forex transactions; (ii) it has total assets exceeding $10 million; and (iii) it is formed and operated by a registered CPO or by a CPO who is exempt from registration as such pursuant to CFTC Regulation 4.13(a)(3) (a Qualifying CPO). Further, because many CPOs will be registering as such for the first time due to the CFTC's recent repeal of certain CPO exemptions, commodity pools formed prior to December 31, 2012, do not need to have been formed by a Qualifying CPO in order to be qualified as ECPs under this exemption so long as they are operated by such CPOs on or before such date.

B. Expansion of Line of Business Test

The CEA provides that the term "eligible contract participant" includes a corporation, partnership, proprietorship, organization, trust, or other entity . . . that (i) has a net worth exceeding $1 million, and (ii) enters into an agreement, contract or transaction in connection with the conduct of the entity's line of business. The Final Rules provide that for purposes of this provision, an entity may determine its net worth by reference to the net worth of its owners if all such owners are ECPs.[19]

VI. CROSS-BORDER ISSUES

The Commissions intend to separately address the issue of whether and to what extent the requirements that are applicable to swap dealers and major swap participants apply to Non-United States persons. However, the Commissions made it clear that foreign governments, foreign central banks and international financial institutions should not be required to register as swap dealers or as major swap participants.

VII. EFFECTIVE DATE

The Final Rules will be effective 60 days following publication in the Federal Register. As the CFTC noted, the effective date will not have a substantive effect on persons that are swap dealers or MSPs because they will be subject to an implementation or compliance period based on other requirements that are the subject of separate rulemakings by the CFTC. Separately, persons that are security-based swap dealers or major security-based swap participants will not have to register with the SEC until the dates provided in the SEC's final rules regarding the registration requirements for security-based swap dealers and major security-based swap participants.

[19] The Final Rules also provide that market participants can no longer rely on the CFTC's 1989 Swap Policy Statement.

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