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Who's In and Who's Out? CFTC and SEC Finalize the Swap Entity Definitions

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I. Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") contains definitions for the new terms "swap dealer," "security-based swap dealer," "major swap participant" and "major security-based swap participant" (together, "Regulated Swap Entities") and an amended definition for the term "eligible contract participant" ("ECP"). As directed by that statute, on April 18, 2012, the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") (collectively, the "Commissions") adopted a final rule (the "Final Rule") that clarifies these Dodd-Frank Act definitions, particularly in terms of scope and applicability to market participants.[1] The Final Rule revises proposed definitions published on December 21, 2010 (the "Proposed Rule"). In this Alert, we focus on the major differences between the Proposed Rule and the Final Rule.[2]

The Final Rule will generally be effective July 23, 2012.[3] However, registration of Regulated Swap Entities will not be mandatory, and the substantive regulatory provisions applicable to them will not be enforced, until after the effective date of a joint final rule of the Commissions further defining the terms "swap" and "security-based swap." That rule is commonly expected to be adopted sometime in the summer or fall of 2012.[4]

The Final Rule is of great importance for participants in derivatives markets for several reasons. Entities that fall within the Regulated Swap Entity definitions will be required to register with, and will be regulated by, the CFTC, the SEC or both.[5] Entities that become Regulated Swap Entities will also be subject to the panoply of substantive rules and regulations that are being proposed, or have been issued, under the Dodd-Frank Act's new swap market regulatory scheme, including capital and margin requirements, business conduct rules, conflict of interest rules, chief compliance officer requirements, reporting obligations, and recordkeeping requirements.[6] While the number of potentially affected entities appears to be considerably smaller than many had feared during consideration of the proposed rule, it is still significant.[7]

II. Definitions of "Swap Dealer" and "Security-Based Swap Dealer"

1. Dodd-Frank Act Definitions

The Dodd-Frank Act defines the terms "swap dealer" and "security-based swap dealer" in a functional manner by focusing on how a person holds itself out in the market, the nature of the person's conduct, and the market's perception of the person's activities.[8] Subject to certain exclusions, the Dodd-Frank Act's definitions of "swap dealer" and "security-based swap dealer" generally encompass any person that holds itself out as a dealer in swaps or security-based swaps, makes a market in swaps or security-based swaps, regularly enters into swaps or security-based swaps with counterparties in the ordinary course of business for its own account, or engages in activity that causes it to be commonly known in the trade as a "dealer" or "market maker" in swaps or security-based swaps.

2. Dealer versus Trader Distinction

In the joint release accompanying the Final Rule, the Commissions stated that they will use the "dealer-trader" distinction under the Exchange Act as a framework for deciding who should be regulated as a swap dealer.[9] The Commissions noted, however, that several aspects of the framework will need to be adjusted based on the relevant differences between the market for swaps (including security-based swaps) and the market for securities.

Because the CFTC had not originally adopted the dealer-trader distinction, the Proposed Rule had generated some concern as to whether persons engaged in swap trading activity (including on only one side of the market) could be considered dealers, where they would not be so considered if they were trading security-based swaps. This decision should go far to resolve uncertainty caused by language in the joint release accompanying the Proposed Rule that the CFTC could apply its own criteria for determining whether a person was engaged in activity characteristic of a "swap dealer."

3. The De Minimis Exemption to Swap Dealer Status

The Final Rule will exempt persons whose dealing activities (exclusive of certain hedging of physical positions described below) are sufficiently small that they do not warrant substantive regulation. As originally proposed, a person would have qualified for the *de minimis* exemptions if the aggregate effective notional amount, measured on a gross basis, of swaps or security-based swaps entered into over the prior 12 months in connection with the person's dealing activities was not more than $100 million, or $25 million for swaps entered into with "special entities."[10]

The Final Rule changes these amounts and provides for a phase-in period. During the phase-in period, the *de minimis* thresholds will be:

- $8 billion for CFTC-regulated swaps, including credit default swaps ("CDS") referencing broad based indexes, and for SEC-regulated CDS, specifically CDS on single names and on narrow-based indexes.[11] The $8 billion threshold compares to the $3 billion post-phase-in threshold, which itself was raised from the $100 million threshold originally proposed;
- $400 million for SEC-regulated security-based swaps, other than single-name or narrow-based index CDS. The $400 million threshold compares to the $150 million post-phase-in threshold; and
- $25 million with respect to transactions with special entities, as was originally proposed.

Unless either Commission acts before the end of the phase-in period, the $8 billion threshold will automatically be reduced to $3 billion and the $400 million threshold for non-CDS security-based swaps will automatically be reduced to $150 million. The phase-in period will last approximately three to five years.[12]

As a condition to qualifying for the *de minimis* exemption, the Proposed Rule would have limited the number of counterparties and the number of swaps a person could enter into during a 12-month period. These limitations have been eliminated in the Final Rule.

4. Exclusion for Swaps Entered into to Hedge Physical Positions

The CFTC (but not the SEC) adopted an interim final rule under which swaps entered into for the purpose of hedging a physical position will be excluded from the determination of whether a person is a swap dealer. The CFTC will disregard such a swap for these purposes if the following conditions are met:

- The person enters into the swap for the purpose of offsetting or mitigating its price risks that arise from the potential change in the value of (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,
- The swap represents a substitute for transactions or positions by the person in a physical marketing channel,
- The swap is economically appropriate to the reduction of the person's risks in the conduct and management of a commercial enterprise and is entered into in accordance with sound commercial practices, and
- The swap is not designed to evade designation as a swap dealer.

The interim final rule will be effective, and the comment period for this interim rule will close, on July 23, 2012.

5. Exclusion for Swaps between Majority-Owned Affiliates

Both Commissions adopted new exclusions in the Final Rule for swaps between majority-owned affiliates. Such swaps will be disregarded when determining a person's swap dealer status. The counterparties to a swap will be considered "majority-owned affiliates" if one counterparty directly or indirectly owns a majority interest in the other or if a third party directly or indirectly owns a majority interest in both counterparties. In this context, "majority interest" means the right to vote or to direct the vote of a majority of a class of voting securities of an entity, the power to sell or to direct the sale of a majority of a class of voting securities of an entity, the right to receive a majority of the capital of a partnership upon dissolution or the right to contribution of a majority of the capital of a partnership.

6. Exclusion for Swaps between an Insured Depository Institution and Its Customer in Connection with Originating a Loan

When determining the swap dealer status of an insured depository institution under the Final Rule, swaps entered into with customers in connection with originating loans are excluded by the CFTC (but not the SEC). This exclusion appeared in the Proposed Rule, but in the Final Rule the CFTC added many new conditions that must be met in order for a swap to qualify for the exclusion. The conditions fall into three broad categories.

(i) The swap is considered to have been entered into "in connection with" the loan if all of the following conditions are met:

  - The insured depository institution entered into the swap no earlier than 90 days before and no later than 180 days after the date of execution of the loan agreement, or no earlier than 90 days before and no later than 180 days after any transfer of principal to the customer by the insured depository institution pursuant to the loan

- The rate, asset, liability or other notional item underlying the swap is (or is directly related to) a financial term of the loan. "Financial term of the loan" includes, without limitation, the loan's duration, rate of interest, the currency or currencies in which it is made and its principal amount
- The swap is required, as a condition of the loan under the insured depository institution's loan underwriting criteria, to be in place in order to hedge price risks incidental to the borrower's business and arising from potential changes in the price of a commodity (other than an excluded commodity)
- The duration of the swap does not extend beyond termination of the loan
- The insured depository institution is either (a) the sole source of funds to the customer under the loan, (b) committed to be, under the terms of the agreements related to the loan, the source of at least 10 percent of the maximum principal amount under the loan or (c) committed to be, under the terms of the agreements related to the loan, the source of a principal amount that is at least the aggregate notional amount of all swaps entered into by the insured depository institution with the customer in connection with the financial terms of the loan
- The aggregate notional amount of all swaps entered into by the customer in connection with the financial terms of the loan is, at any time, not more than the aggregate principal amount outstanding under the loan at that time
- If the swap is not accepted for clearing by a derivatives clearing organization, the insured depository institution reports the swap if required to do so under the CEA

(ii) The insured depository institution will be considered to have originated the loan if the institution does at least one of the following:

- Directly transfers the loan amount to the customer
- Is a part of a syndicate of lenders that is the source of the loan amount that is transferred to the customer
- Purchases or receives a participation in the loan
- Otherwise is the source of funds that are transferred to the customer pursuant to the loan or any refinancing of the loan

(iii) The following are not considered loans:

- Any transaction that is a sham, whether or not intended to qualify for the exclusion from the definition of the term "swap dealer"
- Any synthetic loan, including, without limitation, a loan credit default swap or loan total return swap

7. Miscellaneous Exclusions

Exclusion for Agricultural or Financial Cooperatives

When determining swap dealer status under the Final Rule, the CFTC will disregard swaps (a) between an "agricultural cooperative" (as defined by the CEA) and its members or (b) between a person chartered under federal law as a cooperative and engaged in activities that are financial in nature (as defined by the Bank Holding Company Act ("the BHCA"))[13] and its members, provided that certain conditions are met. These include that the swap is subject to policies and procedures of the cooperative and, in the case of an agricultural swap, is not primarily based on rates, indexes or measures based on commodities that lack a cash market.

Exclusion for Swaps Entered into by Floor Traders

As part of the Final Rule, the CFTC adopted a new exclusion for persons registered with the CFTC as floor traders and not affiliated with a registered swap dealer. In determining a person's swap dealer status, a swap entered into by the person in its capacity as a "floor trader" (as defined by the CEA) will be disregarded by the CFTC provided certain conditions are met. These include that the person:

- Enters into swaps with proprietary funds for its own account solely on, or subject to the rules of, a designated contract market or swap execution facility and submits each such swap for clearing to a derivatives clearing organization, and
- Does not directly or through an affiliated person enter into swaps that would qualify for the exemption of hedging physical positions from the CFTC's definition of "swap dealer" or the exemption of hedging or mitigating commercial risk from the CFTC's definition of "major swap participant" (except for any such swap executed opposite a counterparty for which the transaction would qualify as a bona fide hedging transaction).[14]

III. Definitions of "Major Swap Participant" and "Major Security-Based Swap Participant"

1. Dodd-Frank Act Definitions

The Dodd-Frank Act definitions of "major swap participant" and "major security-based swap participant" (collectively referred to as the "major participant" definitions) under the CEA and the Exchange Act, respectively, are very similar,[15] but address instruments that reflect different types of risks.[16] The major participant definitions are intended to focus on entities whose derivatives could pose a high risk to the U.S. financial system activities even though such entities do not fall within the statutory definitions of "swap dealer" or "security-based swap dealer."

The Dodd-Frank Act defines the terms "major swap participant" and "major security-based swap participant" to mean any person that satisfies at least one of the following three tests:

- Major Participant Test No. 1: This test is satisfied by any person that is not a swap/security-based swap dealer, and maintains a substantial position in any of the "major" categories of swaps or security-based swaps, respectively (excluding positions held for hedging or mitigating commercial risk and positions maintained by any employee benefit plan, as defined in ERISA), for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan (the "ERISA Plan Hedging Exclusion"); or
- Major Participant Test No. 2: This test is satisfied by any person that is not a swap dealer or security-based swap dealer, and whose outstanding swaps or security-based swaps (as the case may be) create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or
- Major Participant Test No. 3: This test is satisfied by any person that is not a swap dealer or security-based swap dealer, and is a financial entity that: (i) is highly leveraged relative to the

amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking agency; and (ii) maintains a substantial position in outstanding swaps/security-based swaps in any major category.

2. Safe Harbor Based on Level of Exposure

Revising certain aspects of the Proposed Rule, the Commissions adopted a new safe harbor from the definitions of "major swap participant" and "major security-based swap participant" based on the level of a person's exposure to its swaps counterparties. The safe harbor may be met in any of three situations:

- *Express cap on permitted uncollateralized exposure and maximum amount of notional positions.*

  A person generally satisfies this condition if: (a) the express terms of the person's swap-related agreements or arrangements at no time would permit the person to maintain a total uncollateralized exposure of more than $100 million, (b) the total notional amount of the person's positions in any "major category" of swaps is not more than $2 billion,[17] and (c) the aggregate notional amount across all major categories is not more than $4 billion.

- *Express cap on permitted uncollateralized exposure and maximum outward exposure.*

  A person generally satisfies this condition if: (a) the express terms of the person's swap-related agreements or arrangements at no time would permit the person to maintain a total uncollateralized exposure of more than $200 million, (b) the person's aggregate uncollateralized outward exposure plus aggregate potential outward exposure in any major category of swaps (including hedging positions if the person is a "highly leveraged financial entity" as defined in the Final Rule) does not exceed $1 billion, and (c) the person's aggregate uncollateralized outward exposure plus aggregate potential outward exposure in any major category of swaps (including hedging positions regardless of whether the person is a highly leveraged financial entity) does not exceed $2 billion. The calculations in (b) and (c) must be done on a monthly basis.

- *Other measures respecting outward exposure*.

  A person generally satisfies this condition by satisfying any one of the following tests, where the relevant calculations must be done on a monthly basis.

- **Test 1.** (a) The person's aggregate uncollateralized outward exposure is less than $1.5 billion with respect to positions in the rate swap category and less than $500 million with respect to positions in each of the other major swap categories and (b) the sum of the amount of the person's aggregate uncollateralized outward exposure with respect to each major swap category and the total notional principal amount of the person's swap positions in each such major swap category, adjusted by certain multipliers set forth in the Final Rule intended to gauge future riskiness, on a position-by-position basis reflecting the type of swap, is less than $3 billion with respect to the rate swap category and less than $1 billion with respect to each of the other major swap categories (credit, equity and other (generally, physical) commodities).

- **Test 2.** (a) The person's aggregate uncollateralized outward exposure across all major swap categories is less than $500 million and (b) the sum of the person's aggregate uncollateralized outward exposure and the product of the total effective notional principal amount of the person's swap positions in all major security-based swap categories multiplied by 0.15 is less than $1 billion.

3. Definition of "Highly Leveraged"

Under the Proposed Rule and the Final Rule, a "financial entity" that is "highly leveraged" would under certain circumstances be considered a "major swap participant" or a "major security-based swap participant." Both Commissions decided in the Final Rule that a financial entity is "highly leveraged" if the ratio of its total liabilities to equity is in excess of 12:1. This represents a midpoint between the alternative values of 8:1 and 15:1 that originally were proposed.

In the Final Rule, an "employee benefit plan," as defined in ERISA, may exclude obligations to pay benefits to plan participants from the calculation of liabilities and substitute the total value of plan assets for equity.

4. "Hedging or Mitigating Commercial Risk"

Under the Proposed Rule and the Final Rule, a swap entered into to hedge or mitigate a commercial risk will be excluded for purposes of determining whether the entity has a "substantial position" in a "major swap category" or a "major security-based swap category." In the Final Rule, both Commissions have further expressly excluded swaps designed to hedge risks of a majority-owned affiliate (as defined above).

The SEC, but not the CFTC, provided in the Final Rule certain examples of security-based swap positions that, depending on the facts and circumstances, could be expected to be held for the purpose of hedging or mitigating commercial risk. These positions include:

- Positions established to manage the risk posed by a customer's, supplier's or counterparty's potential default in connection with the sale or lease of real property or a good, product or service
- Positions established to manage the default risk posed by certain financial counterparties
- Positions established to manage equity or market risk associated with certain employee compensation plans
- Positions established to manage equity market price risks connected with certain business combinations, such as a corporate merger or consolidation or similar plan or acquisition
- Positions established by a bank to manage counterparty risks in connection with loans the bank has made
- Positions to close out or reduce any of the positions described above

In addition, the SEC eliminated its originally proposed requirement that a person must identify and document the risks being hedged or mitigated, establish and document a method of assessing the effectiveness of the hedge and regularly assess the effectiveness of the hedge. The CFTC did not propose such a requirement.

5. Exclusion of Swaps with Majority-Owned Affiliates

Under the Proposal and the Final Rule, whether a person maintains a "substantial position" in a "major swap category" or a "major security-based swap category" is important to determining whether the person is a "major swap participant." The Final Rule provides that, when calculating a person's level of exposure to its swaps counterparties for purposes of determining whether it has such a "substantial position," swaps with majority-owned affiliates will be disregarded by both Commissions. Here, the definition of "majority-owned affiliate" is the same as that used in the "swap dealer" context.

6. Exclusion for Derivatives Clearing Organizations

A person that is registered as a derivatives clearing organization with the CFTC is excluded from the CFTC's definition of "major swap participant."

7. Exclusion for Asset Managers with respect to Managed Accounts and Treatment of Beneficial Owners

Consistent with the approach set forth in the Proposed Rule, the Commissions do not believe that it is necessary to attribute the swap or security-based swap positions held in client accounts to asset managers or investment advisers that manage those accounts for purposes of determining whether those asset managers and investment advisers are major swap participants. However, unlike their position in the Proposed Rule, the Commissions decided that swaps held in managed accounts should not always be attributed to the accounts' beneficial owners. Rather, the Commissions concluded that the major swap participant analysis that should apply to beneficial owners of swap positions held in managed accounts "should focus on where the risk associated with those positions ultimately resides." As a result, if a swap counterparty has recourse only to managed account assets in the event of a default, the position should not be attributable to the beneficial owners. As recognized by the Commissions, the result of this position, for example, is that "there would not be recourse to the owners of shares in a registered investment company that maintains swap or security-based swap positions." However, if the swap counterparty has recourse to both account assets and to the beneficial owners of the account, the position would be attributed to the beneficial owners for purposes of determining each beneficial owner's major swap participant status.

8. No Entity-Specific Exclusions from Swap Dealer or Major Swap Participant Definitions

Although requested by several market participants, the Commissions generally rejected requests for entity-specific exclusions from the swap dealer and major swap participant definitions. In so doing, the Commissions stated that entity-specific exclusions from the swap dealer definition "would have no basis in the statutory text and would be inconsistent with the activity focus of the dealer definition." In addition, the Commissions concluded that entity-specific exclusions from the major swap participant definition would be inappropriate "because entities that meet the thresholds of the rules may pose high risk to the U.S. financial system regardless of how they are organized." However, the CFTC does provide an exclusion to foreign governments, foreign central banks and international financial institutions. Foreign corporate entities and sovereign wealth funds were not treated so favorably, nor were entities with only legacy portfolios (open swaps, but no longer entering into new transactions) or otherwise-regulated entities.

The Commissions restated this conclusion with respect to major swap participant determinations in response to the specific request by the registered investment company industry to exclude all registered funds from major swap participant status, notwithstanding the comprehensive regulatory scheme governing such funds. The Commissions explained that risk to the overall financial system was not a focus of investment company regulation, and further stated that, based on available data, they generally did not expect registered investment companies to meet the thresholds of the major swap participant definition. The Commissions do expect, however, that roughly 350 registered investment company sponsors will have to at least run the major swap participant safe harbor calculations.

IV. Extraterritorial Reach of Regulated Swap Entity Regulation

Section 722(d) of the Dodd-Frank Act, contained in Section 2(i) of the CEA, mandates that the reforms of the swaps and security-based swaps markets shall apply to activities outside the United States if those activities have “a direct and significant connection with activities in, or effect on, commerce” of the United States.

On June 29, 2012 the CFTC approved for public comment proposed interpretive guidance (the “proposed cross-border guidance”) to help determine when the registration requirements of Title VII may apply to non-U.S. persons that are swap dealers or major swap participants.[18] The proposal will be open for public comment for 45 days after its publication in the Federal Register. The CFTC’s proposed cross-border guidance is intended to help swap market participants determine: (1) whether a non-U.S. person’s swap dealing activities are sufficient to require registration as a “swap dealer”; (2) whether a non-U.S. person’s swap positions are sufficient to require registration as a “major swap participant”; and (3) the treatment for registration purposes of foreign branches, agencies, affiliates, and subsidiaries of U.S. swap dealers and of U.S. branches of non-U.S. swap dealers. The proposed cross-border guidance defines the term “U.S. person” by reference to the extent to which swap activities or transactions involving one or more such person has relevant effect on the United States.

Under the proposed cross-border guidance, while such swap dealers or major swap participants would be required to register with the CFTC, they would be subject to a limited set of requirements at the entity level, while the full substantive regulatory requirements would apply only to transactions with persons or entities operating in the United States, transactions with foreign affiliates of a U.S. person and transactions that operate as conduits for a U.S. entity’s swap activity. Entity-level requirements under the proposed guidance would include capital adequacy, risk management and recordkeeping. Requirements uniquely applicable to transactions with U.S. persons would include clearing, margin, real-time public reporting, trade execution and sales practices. The proposed cross-border guidance also addresses the circumstances when the CFTC would permit a non-U.S. swap dealer or non-U.S. major swap participant to comply with comparable and comprehensive foreign regulatory requirements, in order to satisfy applicable statutory and regulatory requirements under the Dodd-Frank Act. It describes a process by which a non-U.S. applicant for swap dealer or major swap participant registration may seek the CFTC’s recognition of substituted compliance with a comparable and comprehensive foreign regulatory requirement and the general scope of the CFTC’s review in making the requisite comparability.

The proposed cross-border guidance also addresses the application of aspects of central clearing to swap transactions that are cleared outside the United States.

The SEC is expected to issue its own cross-border policy for security-based swaps later in the summer. We do not know what the SEC’s cross-border policy would propose for foreign security-based swap dealers and foreign major security-based swap participants. However, the registration requirements of the SEC are different in some respects from those of the CFTC for foreign entities, including with respect to degree of access required by the regulator to customer information.

V. Amendments to Definition of Eligible Contract Participant

The Final Rule clarifies that Regulated Swap Entities are within the ECP definition. Inclusion of Regulated Swap Entities into the definition of an ECP is important for the following reasons. If a person is not an ECP, the Dodd-Frank Act makes it unlawful for that person to (1) enter into a swap other than on, or subject to the rules of, a designated contract market; (2) enter into a security-based swap unless effected on a national securities exchange; or (3) enter into a security-based swap unless a registration statement is in effect.

In addition, the Final Rule also clarifies the ability of commodity pools that engage in certain foreign currency transactions to fall within the ECP definition, as discussed below.

1. Treatment of Commodity Pools that Engage in Retail Forex

A commodity pool generally qualifies under CEA Section 1a(18)(A)(iv) as an ECP if it has total assets exceeding $5 million; however, as the ECP definition was revised by Dodd-Frank, the operator of a commodity pool that engages in certain foreign currency transactions[19] is required to look-through to the status of the pool's investors to determine the pool's ECP status. Pursuant to this look-through, if any of the pool's investors is a non-ECP, then the commodity pool ("forex commodity pool") itself does not qualify as an ECP under Section 1a(18)(A)(iv). However, another provision of the ECP definition, Section 1a(18)(A)(v), would permit a forex commodity pool to qualify as an ECP provided it has total assets exceeding $10 million. In the Proposed Rule, the Commissions proposed to limit a forex commodity pool to the provision of the ECP definition that required a look-through and preventing use of the provision that required only a higher asset level. In the Final Rule, the Commissions changed course and concluded that a forex commodity pool could rely on either provision in determining its ECP status. To rely on the $10 million in total assets provision, a forex commodity pool must be formed and operated by a registered commodity pool operator (a "CPO") or by a CPO exempt from registration pursuant to CFTC Rule 4.13(a)(3),[20] and must not be formed for the purpose of evading regulation.

In addition to the interpretation above, the Commissions also altered their proposal that a look-through under Section 1a(18)(A)(iv) required an examination of the ECP status of both direct and indirect pool owners. Under the Final Rule, a look-through is required only to direct owners, even where the direct owner of the forex commodity pool is another pool, as in a fund-of-funds arrangement (unless either of the pools is structured to evade the requirements of the look-through provision). Further, the Final Rule permits a forex commodity pool to fall within the ECP definition without looking through to the ECP status of its direct investors, provided that its forex transactions are limited to bona fide hedging transactions as determined under CFTC Rule 1.3(z).[21]

2. Including Net Worth of Owners of an Entity to Meet $1 Million Threshold

Under the CEA, any entity with a net worth exceeding $1 million is deemed to be an ECP for purposes of entering into a transaction in connection with the conduct of its business or to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by the entity in the conduct of its business (a "proprietorship ECP"). The Final Rule allows an entity to count the net worth of any of its owners toward the $1 million threshold for purposes of entering into a swap (but not a security-based swap, security-based swap agreement or mixed swap) used to hedge or mitigate commercial risk, provided that all the owners of the entity are ECPs.

Generally, for these purposes an owner is any person holding a direct ownership interest. An individual will be considered a proprietorship ECP only if he or she (a) has an active role in operating a business other than the entity, (b) directly owns all of the assets and is responsible for all of the liabilities of the business and (c) acquires his or her interest in the entity in connection with the operation of the individual's proprietorship or to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by the individual in the operation of the individual's proprietorship.

VI. Conclusion

The adoption of the Final Rule is one of the last steps needed to make Title VII of the Dodd-Frank Act fully effective. It is of great moment to swap market participants because it provides firm definitional guidance on the criteria that make one a Regulated Swap Entity subject to registration with the CFTC and/or the SEC and the many responsibilities, obligations, and restrictions that come with substantive regulation. These include capital and margin requirements, business conduct rules, conflict of interest rules, chief compliance officer requirements, reporting obligations, and recordkeeping requirements. The definitions and the related substantive requirements will shape the swap and security-based swap markets in years to come and, therefore, will have a profound effect on all participants in those markets.

However, the interpretation and impact of the Final Rule is still subject to two “known unknown” factors. The first of these relates to the uncertainty about the types of swaps and security-based swaps that will be relevant to determining status as a Regulated Swap Entity, which will not be known before the Commissions adopt final rules on swap product definitions. The second, of relevance only to entities and activities outside the United States, has to do with how the Commissions will interpret the extraterritorial scope of Title VII of the Dodd-Frank Act. Therefore, while the Final Rule is a necessary step in completing the edifice of Title VII, it is not sufficient to complete the project.

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[1] Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant,” 77 Fed. Reg. 30596 (May 23, 2012).

[2] To view K&L Gates’ prior Alert on the Proposed Rule, please click here.

[3] Certain provisions governing the applicability of the definition of “eligible contract participant” to commodity pools will be effective December 31, 2012.

[4] For the joint proposed rules and interpretive guidance of the CFTC and the SEC with respect to the swap product definitions, *see* 76 Fed. Reg. 29818. To view K&L Gates’ Alert on that proposed rule, please click here.

[5] The Dodd-Frank Act provides that a person may be considered a swap dealer, security-based swap dealer, major swap participant, or major security-based swap participant for one or more types, classes, or categories of swaps, security-based swaps, or activities without being designated a swap dealer, security-based swap dealer, major swap participant, or major security-based swap participant for other types, classes or categories or activities. The Commissions state that they view this grant of authority as permissive, and under the Final Rule, a Regulated Swap Entity will generally be considered as such for all swap transactions. However, the Final Rule affords persons an opportunity to seek, on appropriate showing, a limited designation based upon the facts and circumstances applicable to their particular activities, which could be filed concurrently with, or subsequent to, a registration application.

[6] To view K&L Gates' companion Alerts on the proposed registration and substantive requirements, please click here and here. To view K&L Gates' 2012 Annual Outlook on the CFTC's proposals for expanded duties and liability for chief compliance officers, please click here.

[7] The CFTC estimates that approximately 125 entities will be covered by the definition of the term "swap dealer" and that six or fewer entities will be covered by the definition of "major swap participant." The SEC estimates that only 50 or fewer entities may be required to register as "security-based swap dealers" and fewer than five entities as "major security-based swap participants." The Commissions also noted, however, that because of the uncertainty still remaining in the definitions of these terms, approximately 450 entities will need to incur costs to determine whether they come within the swap dealer definition and approximately 20 entities will need to incur costs to determine whether they come within the major swap participant definition; the corresponding numbers for the definitions of security-based swap dealer and major security-based swap participant are 166 and 12, respectively.

[8] *See* Dodd-Frank Act Section 721 (defining "swap dealer" in new Section 1a(49) of the Commodity Exchange Act ("CEA")) and Section 761 (defining "security-based swap dealer" in new Section 3(a)(71) of the Securities Exchange Act of 1934 ("Exchange Act")).

[9] *See* Securities Exchange Act Release No. 47364 (Feb. 13, 2003). Under the regimen that evolved under the Exchange Act, "dealers" are distinguished from "traders" in that, unlike traders, dealers: (a) normally have regular clientele; (b) hold themselves out as buying or selling securities at a regular place of business; (c) have a regular turnover of inventory (or participate in the sale or distribution of new issues, such as by acting as an underwriter); and (d) generally provide liquidity services in transactions with investors (or, in the case of dealers who are market makers, for other professionals).

[10] The term "special entity" is defined in Sections 731(h)(2)(C) and 764(h)(2)(C) of the Dodd-Frank Act to mean (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 ("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. The CFTC, in adopting a regulatory definition of the term "special entity" in Regulation 23.401(c), refined the third prong of the statutory definition so that it covers "any employee benefit plan *subject to* Title I of [ERISA]" (emphasis added). The CFTC believed this was necessary to avoid rendering the fourth prong of the statutory definition, which separately refers to government plans, superfluous. Nevertheless, the regulatory definition of the term "special entity" also includes a provision whereby plans not subject to Title I of ERISA, such as church plans and public and private foreign pension plans, may opt in to be treated as special entities. 77 Fed. Reg. 9734, 9776, 9822-23 (February 17, 2012).

[11] In explaining the higher *de minimis* threshold for security-based CDS than for other security-based swaps, Chairman Mary Schapiro of the SEC stated that data showed "that the size of [the non-CDS security-based swap] market is only a small fraction of the size of the CDS market." Opening Statement at SEC Open Meeting: Defining Swaps-Related Terms (Apr. 18, 2012).

[12] Nine months after each Commission publishes a staff report assessing market experience, each may promulgate an order setting forth an end date of the phase-in period and also may request further public comment on modifying the *de minimis* thresholds. The CFTC will publish its report within two and one-half years after it begins collecting the relevant swap data; the SEC, within three years after it begins doing so. The phase-in period will end, in any event, no later than five years after the start of the collection of the swap data.

[13] Activities that are generally considered to be "financial in nature" under Section 4(k) of the BHCA include, among others: lending, exchanging, transferring, investing for others, or safeguarding money or securities; insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities, and acting as principal, agent, or broker for purposes of the foregoing; providing financial, investment, or economic advisory services; issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly; and underwriting, dealing in, or making a market in securities. Cooperative financial entities in this context refer to entities such as Farm Credit System institutions and Federal Home Loan Banks. Because the SEC does not regulate such institutions, there is no comparable SEC provision.

[14] The CFTC's general definition of "bona fide hedging transaction" applies to "excluded commodities" such as interest rates or exchange rates, but not to physical positions. *See* 17 C.F.R. § 1.3(z). In the context of hedging commodities that are not excluded commodities, "bona fide hedging transaction" presumably means a transaction that would satisfy the exclusion for hedging physical positions described in the text (17 C.F.R. §1.3(ggg)(6)(iii)). *See* 77 Fed. Reg. 30612 n.216 (explaining why the definition of "bona fide" hedging at 17 C.F.R. § 1.3(z) is not relevant to physical positions).

[15] One exception – for any "entity whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures" – is available only in connection with the definition of "major swap participant." *See* CEA Section 1a(33)(D). Also, as discussed below, the definitions of "major swap participant" and "major security-based swap participant" encompass separate instruments that reflect different types of risks, and subjects each category to different specific thresholds.

[16] *See* Dodd-Frank Act Section 721 (defining "major swap participant" in new Section 1a(33) of the CEA) and Section 761 (defining "major security-based swap participant" in new Section 3(a)(67) of the Exchange Act).

[17] The four "major categories" of CFTC-regulated swaps are rate swaps, credit swaps, equity swaps and other commodity swaps. The two "major categories" of security-based swaps are debt security-based swaps and other security-based swaps.

[18] *See* "Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act," RIN 3038-AD57, __ Fed. Reg. __ (2012) (to be codified at 17 C.F.R. Chapter 1).

[19] The relevant foreign currency transactions are: (a) off-exchange foreign currency futures, (b) off-exchange options on foreign currency futures, (c) off-exchange options on foreign currency, (d) leveraged or margined foreign currency transactions and (e) foreign currency transactions that are financed by the offeror, the counterparty or a person acting in concert with the offeror or counterparty.

[20] The CFTC recently amended Regulation 4.13(a)(3), which limits the amount of commodity interest trading that a pool may undertake if the CPO thereof wishes to be exempt from registration, and rescinded the registration exemption that had been available if the CPO limited participants in the pool to highly sophisticated investors (no trading limits applied in those circumstances). At the same time, the CFTC imposed commodity interest trading limits on registered investment companies if the operators thereof wish to be excluded from the definition of a CPO. To view K&L Gates' Alerts on these topics, please click here and here.

[21] The provisions described in this paragraph will be effective December 31, 2012.

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