

CFTC and SEC Define “Swap Dealer” and “Major Swap Participant”

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The Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) adopted highly anticipated final rules yesterday to further define the terms “swap dealer,” “security-based swap dealer,” “major swap participant,” “major security-based swap participant” and “eligible contract participant” (Final Entity Rules). The Final Entity Rules are significant because entities that meet one of the aforementioned dealer or major participant definitions will be required to register with the CFTC or SEC and comply with a myriad of substantive regulatory requirements.¹ The Final Entity Rules are considered a key component of the new regulatory regime that the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) imposes on over-the-counter derivatives. In addition, the CFTC adopted a final rule that will subject commodity options, other than those that are physically settled, to the same regulatory regime as other types of swaps (Commodity Options Rule).²

The Final Entity Rules and the Commodity Options Rule are not yet publicly available but both will be published in the Federal Register in the coming days. The following discussion is based on statements made by CFTC Commissioners and staff at an open meeting that was held yesterday and on CFTC fact sheets and Q&As that are available on the CFTC’s [website](#).

The “Swap Dealer” and “Major Swap Participant” Definitions³

1. Swap Dealers

The Final Entity Rules closely follow the statutory language of the Dodd-Frank Act in defining the term “swap dealer” as any person who: (a) holds itself out as a dealer in swaps; (b) makes a market in swaps; (c) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (d) engages in activity causing itself to be commonly known in the trade as a dealer or market maker in swaps.

According to CFTC staff, a person, in determining whether it could be designated as a swap dealer, should begin by looking to the statutory and regulatory definitions of the term, bearing in mind that a

¹ Registration will not be required until 60 days after the effective date of a CFTC/SEC rule to further define the term “swap.”

² The CFTC adopted the Final Entity Rules by a 4 to 1 vote, with Commissioner Scott O’Malia dissenting. The Commodity Options Rule was unanimously approved.

³ Swap dealers and major swap participants will be regulated by the CFTC, whereas security-based swap dealers and major security-based swap participants will be regulated by the SEC. This discussion focuses on CFTC-regulated swap dealers and major swap participants, but it is our understanding that the security-based swap dealer and major security-based swap participant definitions are substantively the same as the swap dealer and major swap participant definitions. A fact sheet pertaining to the security-based swap dealer and major security-based swap participant definitions is available on the SEC’s [website](#).

person that enters into swaps solely for its own account (either in an individual or fiduciary capacity), but not as a part of its regular business, is automatically excluded. Thereafter, a person should look to interpretive guidance contained in the Final Entity Rules adopting release. This guidance addresses the concepts included in the definitions and provides for consideration of all of the relevant facts and circumstances – the SEC’s dealer-trader distinction may be applied as part of this consideration.

Pursuant to the Final Entity Rules, certain swaps may be excluded from the swap dealer determination altogether, including swaps entered into by an insured depository and a customer in connection with originating a loan, swaps between majority-owned affiliates, and swaps between an agricultural or financial cooperative and its members. In addition, the CFTC has adopted an interim final rule in connection with the Final Entity Rules which: (a) stipulates that swaps entered into for hedging physical positions are also excluded from the swap dealer determination and (b) defines “hedging” in a manner akin to the CFTC’s long standing interpretation of bona fide hedging. This definition is significantly more narrow than the “hedging or mitigating commercial risk” standard used in the major swap participant definition (discussed below) and, for example, would not include swaps entered into for the purpose of portfolio hedging or anticipatory hedging. Several CFTC Commissioners expressly invited market participants to comment on the interim final rule.

Persons whose activities could cause them to fall within the swap dealer definition may nonetheless be exempt from regulation as such if the person’s swap positions fall below a *de minimis* threshold, which the Final Entity Rules set at an aggregate gross notional amount of no more than \$3 billion over the preceding 12 months.⁴ The *de minimis* threshold will be phased-in over a three-year period, however, during which time the *de minimis* threshold will effectively be \$8 billion. As a result of the *de minimis* threshold, the CFTC expects that approximately 125 entities will be deemed “swap dealers.” Moreover, a person that is covered by the “swap dealer” definition and is required to register as such may apply to the CFTC to limit its designation as a swap dealer to specified categories of swaps or specified activities. In an attempt to regulate persons engaged in significant trading activity that falls short of requiring registration as a swap dealer, the Final Entity Rules also provide new requirements for “floor traders.” According to the CFTC staff, such persons could include high frequency traders.

2. Major Swap Participants

The Final Entity Rules define a “major swap participant” as:

- (a) a person that maintains a “substantial position” in any of the major swap categories (rate swaps, credit swaps, equity swaps and any other commodity swaps), excluding positions held for hedging or mitigating commercial risk and positions maintained by certain employee benefit plans for hedging or mitigating risks in the operation of the plan;
- (b) a person whose outstanding swaps create “substantial counterparty exposure” that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or
- (c) any financial entity, that maintains a “substantial position” in any of the major swap categories, that is highly leveraged to the amount of capital such entity holds and that is not subject to capital requirements established by a federal banking regulator. For an entity to be deemed “highly leveraged,” the Final Entity Rules adopt a ratio of total liabilities to equity of 12 to 1, as determined in accordance with U.S. Generally Accepted Accounting Principles.

⁴ There is an exception to this threshold for swaps with “special entities,” as defined in Section 731 of the Dodd-Frank Act. For swaps with special entities, the threshold is an aggregate gross notional amount of no more than \$25 million.

With respect to the first and third prongs of the major swap participant definition, under the Final Entity Rules, a person maintains a “substantial position” in a major swap category if it holds: (a) daily average uncollateralized outward exposure of \$1 billion in the major category of swaps (\$3 billion if rate swaps); or (b) daily average uncollateralized outward exposure plus potential future exposure of \$2 billion in the major category of swaps (\$6 billion if rate swaps) across all categories of swaps. It should be noted that the calculation of potential future exposure has been refined from the original proposal.

As to the second prong of the “major swap participant” definition, “substantial counterparty exposure” is defined as holding \$5 billion in daily average uncollateralized outward exposure or \$8 billion in daily average uncollateralized outward exposure plus potential future exposure.

Lastly, the Final Entity Rules clarify that whether swaps are entered into to “hedge or mitigate commercial risk” is a facts and circumstances determination that takes a person’s overall hedging and risk mitigation strategies into account and is made at the time a swap is entered into. The Final Entity Rules adopting release lists swap positions that would qualify as “hedging or mitigating commercial risk” which include, among others, those that qualify as bona fide hedges. The CFTC expects that approximately 6 entities will be deemed “major swap participants.”

Eligible Contract Participants

Under the Commodity Exchange Act, a person that is not an eligible contract participant cannot enter into a swap except on, or subject to, the rules of a designated contract market. The Final Entity Rules adopt a number of changes to the eligible contract participant definition that, among other things: (a) add swap dealers and major swap participants to the list of entities that are deemed eligible contract participants; and (b) are intended to prevent evasion of Commodity Exchange Act provisions and CFTC regulations pertaining to retail foreign exchange transactions.

Commodity Options

Currently, commodity options are permissible only if transacted in accordance with Part 32 of the CFTC’s rules, which imposes several conditions for commodity option transactions including that: (a) commodity options only be offered to producers, processors, commercial users or merchants handling the commodity which is the subject of the commodity option (or the products or byproducts thereof); and (b) that such producer, processor, commercial user or merchant is entering into the commodity option transaction solely for business purposes.

Title VII of the Dodd-Frank Act expressly designated commodity options as swaps. The Commodity Options Rule revises and rescinds portions of Part 32 of the CFTC’s regulations so as to make commodity options subject to the same regulatory regime that the Dodd-Frank Act mandates for other types of swaps. In response to public comments, however, the Commodity Options Rule includes an interim final rule that will exempt physically settled commodity options (so-called “trade options”) from certain Dodd-Frank Act requirements. Pursuant to the interim final rule, such physically-settled commodity options will only be subject to recordkeeping and reporting obligations, position limits and antifraud and anti-manipulation regulations.



In light of the significant implications that being designated a swap dealer or major swap participant would have, market participants may want to carefully analyze the Final Entity Rules once they are published in the Federal Register.

If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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