December 17, 2010

CFTC and SEC Propose Definitional Tests for Swap Dealers and Major Swap Participants

I. Executive Summary

This Client Advisory summarizes significant aspects of the Proposed Rules issued jointly by the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") (collectively, the "Commissions") on December 7, 2010, to define the terms "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant" and "Major Security-Based Swap Participant"[1]. As a centerpiece of the new regulatory regime for derivatives, the Dodd-Frank Act (the "Act")[2] requires persons that fall within those definitions to register as such with the CFTC and/or the SEC and subjects such persons to extensive regulation, including margin, capital and business conduct requirements. The highlights of the Proposed Rules are as follows:

- Swap Dealer status has been defined from a functional perspective with the key element being whether an entity tends to accommodate demand.
- The Major Swap Participant definition is based on objective calculations designed to measure the systemic significance of the swap activity of the relevant entity. The calculations have many variations, but the lowest threshold for designation is $1 billion in "daily average aggregate uncollateralized outward exposure," which is the amount the party would owe if it defaulted on all its swaps. (The definition is not expected to cover many companies, but the process of determining whether it applies may itself be burdensome).
- The Proposed Rules introduce the concept of major swap categories, which are "Rate Swaps", "Credit Swaps", "Equity Swaps" and "Other Commodity Swaps" for Swaps and "Security-Based Credit Derivatives" and "Other Security-Based Swaps for Security-Based Swaps". A person can be a dealer or a major participant with respect to any one of these major swap categories.
- The Proposed Rules also make a change to the existing definition of Eligible Contract Participant that may disqualify some commodity pools from engaging in OTC swaps altogether.

The Proposed Rules should be of interest to anyone engaged in significant swap market activity because these definitions will determine the relative rights and obligations of parties in swap transactions after the effective date of the Act (July 16, 2011). The

[1] See Securities Exchange Act Release No. 34-63452 (Dec. 7, 2010) (the "Release").

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

For more information, please contact your Katten Muchin Rosenman LLP attorney, or any of the following members of Katten's **Financial Services Practice**.

Ross Pazzol
312.902.5554 / ross.pazzol@kattenlaw.com

Guy C. Dempsey, Jr.
212.940.8593 / guy.dempsey@kattenlaw.com

Kevin M. Foley
312.902.5372 / kevin.foley@kattenlaw.com

Kenneth M. Rosenzweig
312.902.5381 / kenneth.rosenzweig@kattenlaw.com

Commissions have called for comments on an extraordinarily broad range of questions relating to the definitions that are discussed in the release accompanying the Proposed Rules.

II. 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 it engages in any of the following types of activities:

(i) holds itself 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 its own account; or

(iv) engages in activity causing it to be commonly known in the trade as a dealer or market maker in swaps or security-based swaps.[3]

Under the Act, persons that enter into swaps or security-based swaps for their own accounts either individually or in a fiduciary capacity, but not as a part of a regular business, are excluded from this definition. Further, as discussed below, the Act requires the Commissions to exempt from these definitions persons that engage in *de minimis* amounts of swap dealing activity. The Act also provides that a person may be designated as a swap dealer for one or more categories of swaps or security-based swaps without being designated as such for other categories of swaps.

In the Release, the Commissions note that the Act defines the terms "swap dealer" and "security-based swap dealer" in a functional manner. Thus, an analysis of whether a person is a swap dealer depends on how a person holds itself out in the market, the nature of its activities and how the market perceives the person's activities. According to the Commissions, swap dealers tend to accommodate demand and are available to enter into swaps in response to interest expressed by other parties. Further, the Commissions noted that swap dealers can often be identified by the nature of their relationships with counterparties. In this regard, swap dealers tend to have a broader range of counterparties than non-dealers, and tend to refrain from engaging in swap transactions with other swap dealers. In addition, swap dealers tend to arrange customized terms for swaps or security-based swaps upon request.

With respect to security-based swap dealers, the SEC noted in the Release that the same factors that are relevant to determining whether a person is a "dealer" under the Securities Exchange Act of 1934 also are relevant to determining whether a person is a security-based swap dealer. The SEC further noted that it has traditionally interpreted the term "dealer" so as to distinguish between "dealers" and "traders," and stated that it would continue to make this distinction in determining whether a person is a security-based swap dealer as well.

The SEC also stated that a person may be deemed to be a security-based swap dealer if the transactions it effects in security-based swaps are integrally related to its 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.

B. De Minimis Exemption

As noted above, the Act requires the Commissions to exempt persons who engage in *de minimis* amounts of swaps from the definition of "swap dealer" and "security-based swap dealer." Under the Proposed Rules, a person will not be deemed to

[3] The definitions are disjunctive, and a person that 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.

be a swap dealer or a security-based swap dealer if the transactions he or she enters into in a dealer capacity are limited as follows:

(i) the aggregate gross notional amount of the swaps it has effected over the past 12 months does not exceed $100 million (with an additional sublimit of $25 million for swaps with special entities);[4]

(ii) such person has not entered into swaps with more than 15 counterparties (excluding other swap dealers) in the past 12 months; and[5]

(iii) such person has not entered into more than 20 swaps in the past 12 months.[6]

As the foregoing factors make clear, the *de minimus* test is designed to measure a person's swap dealing activities on a gross basis and thus reflect overall dealing activity. Accordingly, this test does not take any collateral held by or provided by a person into account.

C. Statutory Exclusion for Swaps in Connection with Loan Origination

The "swap dealer" definition excludes an insured depository institution ("IDI") that offers to enter into a swap with a customer in connection with originating a loan with that customer.[7] Under the Proposed Rules, this statutory exclusion would apply only to a swap with borrower that relates to the financial terms of a loan, such as, for example, its duration, interest rate, currency or principal amount, and would not include a swap that relates to the borrower's general business activities. Because this exclusion is available only to IDIs, non-IDIs who may hold participations in a loan originated by an IDI would not be able to utilize this exclusion.

D. Transactions Among Affiliates

In the Release, the Commissions address the issue of whether it would be appropriate to deem a person to be a swap dealer or security-based swap dealer based on the swap transactions it effects with its affiliates. In this regard, the Commissions noted that swap transactions between and among an affiliated group of commonly controlled entities may merely represent an allocation of risk within such group. As a result, such transactions may not involve the kind of interaction with unaffiliated persons that the Commissions believe is indicative of the type of activities that were intended to be regulated under the Act.

III. Major Swap Participants

A. General Overview

Under the Act, a person will be a "major swap participant" or a "major security-based swap participant" if it satisfies any of the following requirements:

(i) it maintains a "substantial position" in any of the major swap categories, 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").

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[4] The term "special entity" includes federal agencies, states, state agencies and political subdivisions (including cities, counties and municipalities), "employee benefit plans" as defined under the Employee Retirement Security Act of 1974 ("ERISA"), "governmental plans" as defined under ERISA and endowments.

[5] For purposes of this requirement, all counterparties that are members of an affiliated group will be treated as a single counterparty.

[6] For purposes of this requirement, each transaction entered into under a master agreement will constitute a distinct swap.

[7] This exclusion does not appear in the definition of "security-based swap dealer."

B. Substantial Position Test

The Commissions are proposing two alternative tests for determining whether a person satisfies the Substantial Position Test:

1. Current exposure test

Under the Proposed Rules, a person will have a "substantial position" in a major swap category if his or her 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 Proposed Rules, market participants would apply this test on a major-category-by-major-category basis. Thus, for each counterparty, a person would determine the aggregate current exposure by marking his or her swap positions to market and then deducting 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 Proposed 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 such person has in place with counterparties. Further, when calculating the net current exposure to a counterparty, a person may include unrelated positions (*e.g.*, securities lending and borrowing transactions and repurchase and reverse repurchase agreements) in the netting calculation to the extent permissible under the master netting agreement. A person that 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 Proposed Rules, a person also will 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[8] 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).[9]

The Proposed Rules contain downward adjustments for certain types of positions that pose relatively low potential risks. Thus, the potential of 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 would be capped at the net present value of any unpaid premiums.

The Proposed Rules provide that the potential future exposure calculation required thereunder will be reduced for parties that have master netting agreements in place. Further, the calculation of future exposure would be 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,[10] the potential future exposure calculation otherwise required for such swaps would be discounted by eighty percent (80%).

[8] 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.

[9] 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.

[10] 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 the agreement, that amount (regardless of actual exposure) would be considered current uncollateralized exposure for purposes of this test. Also, if the agreement provides for a minimum transfer amount in excess of $1 million, the entirety of that amount would be considered current uncollateralized exposure.

3. "Hedging or mitigating commercial risk"

As noted above, the Substantial Position Test excludes positions held for hedging or mitigating commercial risk. In general, the Proposed Rules provide that a position will be deemed to satisfy this requirement if it: (x) is recognized as a hedge for accounting purposes; (y) is recognized as a bona fide hedge for purposes of the CFTC's position limit requirements; or (z) hedges or mitigates a person's business risks. Positions in security-based swaps would be subject to additional requirements that would require market participants to document their hedging transactions as such and periodically assess the effectiveness of their hedging transactions. Swaps held for the purpose of investment, speculation or trading would not satisfy the above requirements. 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.

4. Calculation Issues

A significant practical problem with the new definitions is that a party must, in order to determine if it has a "substantial position" that brings it within the definition of Major Swap Participant ("MSP"), make calculations of swap exposure that are different from those routinely made by swap market participants. This problem is caused by the fact that the definition of MSP assumes that the market already differentiates among the new major categories of swaps established by the rule for risk, documentation and collateral purposes when, of course, the opposite is true. The vast majority of parties to OTC derivative transactions attempt to reduce their credit risk by placing all the trades, regardless of their possible categorization, into single master agreements with legally enforceable netting provisions and a margining process that matches collateral against the net exposure, not exposure by different categories of swaps. As a result, it will require significant effort for a person to make the artificial calculations necessary to determine whether the MSP definition applies and, moreover, the determinations will not necessarily reflect real risk considerations.

A simple example illustrates the problem: Assume that Party A has one swap counterparty (Party B) and that they have entered into four swaps, one in each of the four major categories of swap identified by the CFTC, and have documented the swaps under an ISDA master agreement with a credit support annex. Assume further that swaps 1 and 2 are each in-the-money to Party A by $2 billion and that swaps 3 and 4 are each in-the-money to Party B by $2 billion (and the exposures have been constant for each day of the prior calendar quarter). Under these circumstances, if all the swaps were terminated as a result of an event of default, the amount payable between the parties under the master agreement would be zero. Nevertheless, under the new definitions Party A and Party B would both be MSPs with respect to at least one category of swaps because they have substantial positions that exceed the relevant thresholds (which is $1 billion for all the categories except rate swaps). The credit support annex does not affect this outcome except to the extent that the parties have exchanged initial margin (additional amounts, in ISDA parlance) since such margin can be identified with particular swaps and can provide an offset to the categorized exposure in terms of the MSP definition. Variation margin does not have a similar effect, however, since it is calculated on the net risk of the entire portfolio of trades and cannot be traced to individual swaps in any meaningful way.

The same type of computational problem arises with respect to the exclusion for swaps that are entered into for purposes of hedging or mitigating commercial risk since swap counterparties typically do not distinguish such trades from others for documentation and netting purposes. A potential MSP that identifies and excludes such trades from its position calculations could find that it is left with a larger exposure for definitional purposes than it has in reality. To illustrate this phenomenon, adjust the example from the prior paragraph by assuming that one of the two trades that is in-the-money to Party A is in fact a hedging transaction and should be excluded from consideration. The effect of doing so is to create a definitional net exposure of $2 billion after giving effect to netting under the master agreement (because there are now only three swaps that count for the computation). This notional net exposure does not actually effect the result of the example, but it can hardly be the type of outcome Congress intended by adding the hedging exclusion to the statute.

The CFTC hints at these issues in Footnote 102 and the accompanying text in the Release with respect to the Proposed Rules that deal with the narrower problem of allocating collateral to transactions in different major categories. The proposed solution introduces even more artificial calculations that do not materially advance the goal of identifying swap market

participants that should be regulated because of the sizes of their positions. It is also noteworthy that the substance of the footnote does not appear in the Proposed Rules themselves.

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 United States 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 Contemporary Exposure Test, a person would be a major swap participant if he or she 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 participant if such person has current uncollateralized exposure of $2 billion or current uncollateralized exposure and potential future exposure of $4 billion across all of his or her security-based 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 a global basis rather than on a category-by-category basis.

D. "Highly Leveraged Financial Entity Test"

Under the Highly Leverage Financial Entity Test, a person will be a major swap participant or a major securities-based swap participant if it: (1) is a "financial entity," (2) is not subject to capital requirements established by an appropriate federal banking agency; (3) is highly leveraged relative to the amount of capital it holds; and (4) 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.

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.[11] The definition of the term "substantial position" described above also will be utilized in this test.

The Proposed Rules contain two alternatives for determining whether a person is highly leveraged. A person would be "highly leveraged" if the ratio of his or her total liabilities to equity is in excess of 8 to 1, or is in excess of 15 to 1. In either case, 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. Implementation Provisions

To preclude the registration of persons who may inadvertently exceed the size thresholds noted above due to unforeseen circumstances, the Proposed 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 Proposed Rules, a person that satisfies the major swap participant requirements described above during a fiscal quarter would not be deemed to be a major swap participant until the earlier of: (x) the date on which such person submits a complete application for registration to the CFTC or the SEC; or (y) two months after the end of that quarter.

Comments on the Proposed Rules are due within 60 days of publication in the Federal Register.

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[11] Under Section 723 of the Act, the term "financial entity" includes hedge funds, commodity pools and ERISA plans.

Katten
Katten Muchin Rosenman LLP

www.kattenlaw.com

CHARLOTTE CHICAGO IRVING LONDON LOS ANGELES NEW YORK WASHINGTON, DC

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