

## **Dodd-Frank: SEC and CFTC Jointly Propose Definitions of Swaps-Related Terms**

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Act”)<sup>1</sup> establishes a framework for governing the over-the-counter (“OTC”) swaps market through requirements such as reporting and clearing of swaps,<sup>2</sup> and registration of certain individuals qualifying as dealers or major participants in swaps. Title VII provides that the authority to regulate swaps is divided between the Securities and Exchange Commission (“SEC”), regulating security-based swaps,<sup>3</sup> and the Commodity Futures Trading Commission (“CFTC,” and together with the SEC, the “Commissions”), regulating all other swaps. In order to ensure that the rules and regulations of the two agencies are comparable, the Act requires the SEC to work jointly with the CFTC to further develop definitions of certain related terms contained in the Act.<sup>4</sup>

On December 7, 2010, the Commissions issued a release (the “Release”)<sup>5</sup> describing proposed joint rules to further define and interpret the terms “swap dealer,” “security-based swap dealer,” “eligible contract participant,” “major swap participant” and “major security-based swap participant.” While definitions of these terms are contained in Title VII, the Act provides that the definitions must be more fully developed “for the purpose of including transactions and entities that have been structured to evade Title VII.”<sup>6</sup> The Release offers insight into how the Commissions will interpret these terms to determine whether an entity qualifies as one or more of the classes of swap participants.

### **I. “Swap Dealer” and “Security-based Swap Dealer”**

Title VII specifies that a dealer<sup>7</sup> in swaps is a person who:

- (i) holds itself out as a dealer in swaps;
- (ii) makes a market in swaps;
- (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or
- (iv) engages in activity causing itself to be commonly known in the trade as a dealer or market maker in swaps.<sup>8</sup>

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<sup>1</sup> The Dodd-Frank Act is available at <http://www.govtrack.us/congress/billtext.xpd?bill=h111-4173>.

<sup>2</sup> For further detail on swap clearing requirements and the end user exception, see our Firm Memorandum *Dodd-Frank: End User Exception to Swap Clearing Requirements* (October 18, 2010). For a summary of certain other swaps-related provisions of Title VII see our Firm Memorandum *Dodd-Frank Title VII: Reforms for the Swaps Marketplace* (August 13, 2010).

<sup>3</sup> A security-based swap is a swap based on (1) a single security, (2) a loan, (3) a narrow-based group or index of securities or (4) events relating to a single issuer or issuers of securities in a narrow-based security index. The Act, Sec. 721(a)(21).

<sup>4</sup> The Act, Sec. 712(d).

<sup>5</sup> The Release is available at <http://sec.gov/rules/proposed/2010/34-63452.pdf>.

<sup>6</sup> *Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act*, 75 Fed. Reg. 51,429-30 (Aug. 20, 2010).

<sup>7</sup> References to “dealers” include both “swap dealers” and “security-based swap dealers” unless otherwise indicated. Similarly, references to “swaps” include “security-based swaps” and all other “swaps,” and references to “major participants” include both “major swap participants” and “major security-based swap participants,” unless otherwise indicated.

The Commissions' interpretation of "swap dealer" and "security-based swap dealer" will focus on the functional roles that dealers fulfill. With respect to security-based swap dealers, the SEC will rely on the dealer-trader distinction currently used in other types of securities to make its determination of whether an entity qualifies as a security-based swap dealer.<sup>9</sup> In general, dealers accommodate demand and are available to enter into swaps to facilitate other parties' interest. Characteristic activities of dealers include soliciting interest in swaps from potential counterparties, providing marketing material for swaps, providing standard terms for swaps or arranging for customized terms upon request, developing new types of swaps, and maintaining a membership in swap associations reserved for dealers.

Entities satisfying these definitions are subject to requirements including registration, margin, capital and business conduct.<sup>10</sup> While dealers must register with the Commissions, the Act provides that dealers may register only with respect to specified categories of swaps or activities.<sup>11</sup> However, the Commissions will generally take the approach that requirements for dealers are the same regardless of registration for specific categories. In other words, as applied, a specific categorical designation will not have any practical effect on the dealer's obligations under the Act.

### *De minimis exemption from dealer definition*

The Act provides an exemption from the definition of a dealer for an entity that participates as a dealer in limited amounts while engaged in "transactions with or on behalf of its customers."<sup>12</sup> To qualify for the exemption, the entity must meet the following requirements with respect to its activities in the past 12 months:

- The aggregate effective notional amount, on a gross basis, of the swaps entered into must not exceed \$100 million;
- The aggregate effective notional amount of swaps with "special entities"<sup>13</sup> entered into must not exceed \$25 million;
- The entity must not enter into swaps as a dealer with more than 15 counterparties (other than security-based swap dealers); and
- The entity must not have entered into more than 20 swaps as a dealer.<sup>14</sup>

There is also an exclusion from the definition of swap dealer, but not the definition of security-based swap dealer, for an "insured depository institution" which "offers to enter into a swap with a customer in connection with originating a loan with that customer," but only to the extent that the swap is directly related to

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<sup>8</sup> Release at 7.

<sup>9</sup> "[T]he SEC previously has noted that the dealer-trader distinction: recognizes that dealers normally have a regular clientele, hold themselves out as buying or selling securities at a regular place of business, have a regular turnover of inventory (or participate in the sale or distribution of new issues, such as by acting as an underwriter), and generally provide liquidity services in transactions with investors (or, in the case of dealers who are market makers, for other professionals)." Release at 16 [citation omitted].

<sup>10</sup> Release at 7.

<sup>11</sup> Release at 34.

<sup>12</sup> Release at 24.

<sup>13</sup> As defined in Section 4s(h)(2)(C) of the Commodity Exchange Act and Section 15F(h)(2)(C) of the Securities Exchange Act of 1934, "special entities" include, among others, federal and state agencies, municipalities, certain employee benefit plans and endowments. Release at 27.

<sup>14</sup> Release at 26-28.

the financial terms of the loan.<sup>15</sup> Among other things, this exclusion would cover an interest rate swap of a sort frequently entered into to hedge interest rate exposure in a loan transaction with a bank.

## II. “Eligible Contract Participant”

Title VII provides that a person may not enter into a swap unless such person is an “eligible contract participant,” or unless the swap is governed by a designated contract market. The Release proposes to amend the definition of eligible contract participant to explicitly include dealers and major participants.<sup>16</sup>

The Release also clarifies the requirements for commodity pools. If a commodity pool is unable to meet the monetary and regulatory status conditions required for qualification as an eligible contract participant, it will be precluded from relying on other criteria in the definition which are intended for other types of entities to meet the statutory requirements.<sup>17</sup>

## III. “Major Swap Participant” and “Major Security-based Swap Participant”

The Act provides that an entity satisfying any one of the following will be considered a major participant in swaps:

- An entity maintaining a “substantial position” in any of the major swap categories, 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.
- An entity 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.”
- Any “financial entity”<sup>18</sup> that is “highly leveraged”<sup>19</sup> 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 that maintains a “substantial position” in any of the major swap categories.<sup>20</sup>

With respect to interpretation of these definitions, the Release focuses on the market impacts and risks associated with an entity’s swap or security-based swap positions. Using this approach, the Release addresses the interpretation of substantial position, hedging or mitigating commercial risk, counterparty exposure, and the terms financial entity and highly leveraged.

As is the case with dealers, major participants must register with the Commissions, but they may choose to register only with respect to specified categories of swaps or activities.

### *Calculation of “Substantial Position”*

The Act requires the Commissions to determine a level at which “substantial position” could be defined as a threshold for effective monitoring and management of major participants.<sup>21</sup> The Act’s definition excludes positions held for hedging commercial risk and employee benefit plans.

<sup>15</sup> Release at 31-32.

<sup>16</sup> Release at 44.

<sup>17</sup> Release at 46.

<sup>18</sup> The definition of financial entity will be the same as that used in the end user exception to mandatory clearing of swaps.

<sup>19</sup> “For the definition of ‘highly leveraged,’ the Commission proposes two possible definitions – either a ratio of total liabilities to equity, as determined in accordance with U.S. GAAP, of 8 to 1, or a ratio of 15 to 1 measured in the same way.” See SEC Press Release and Fact Sheet, SEC Proposes Joint Rules with CFTC to Define Swap Related Terms, December 3, 2010, available at <http://sec.gov/news/press/2010/2010-237.htm> (“SEC Fact Sheet”).

<sup>20</sup> SEC Fact Sheet.

The rules therefore propose two tests for determining substantial position which account for current uncollateralized exposure and potential future exposure. If either test is satisfied, an entity's position would qualify as a substantial position.

***Uncollateralized Exposure Test.*** The first test measures current uncollateralized exposure by marking the positions to market using industry standard practices. This test allows the deduction of the value of any collateral posted with respect to the swap position, and it would calculate exposure on a net basis, taking into account the effect of any master netting agreement that may apply. The proposed threshold would be a daily average<sup>22</sup> exposure of \$1 billion in the applicable category of swaps, with the exception of rate swaps, which would have a threshold of \$3 billion.

***Uncollateralized and Potential Future Exposure Test.*** The second proposed test would measure both current uncollateralized exposure, as calculated in the first test, as well as potential future exposure. Potential future exposure would be determined by:

- multiplying the total notional principal amount of a party's swap positions by specified risk factor percentages (ranging from 6% to 15% in the case of security-based swaps, and ½% to 15% for other swaps) based on the type of swap and the duration of the position;
- discounting the amount of positions subject to master netting agreements by a factor ranging between zero and 60%, depending on the effects of the agreement; and
- if the swaps are cleared or subject to daily mark-to-market margining, further discounting the amount of the positions by 80%.<sup>23</sup>

The threshold would be a daily average exposure of \$2 billion in the applicable major swap category for the sum of current uncollateralized exposure and potential future exposure. In the case of rate swaps, the threshold would be \$6 billion.

The tests would apply to the major categories of swaps, as such categories are designated by the Commissions. In the case of security-based swaps, the proposed categories are security-based credit derivatives and other security-based swaps. In the case of nonsecurity-based swaps governed by the CFTC, the proposed categories are rate swaps, credit swaps, equity swaps and other commodity swaps.<sup>24</sup>

The Commissions believe that the proposed tests account for the risk-mitigating effects of central clearing. By deducting from current exposure the value of any collateral posted, the tests would generally eliminate centrally cleared swaps, which are subject to full mark-to-market margining, from current exposure. Centrally cleared swaps are also subject to a substantial discount in the calculation of potential future exposure.<sup>25</sup>

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<sup>21</sup> Release at 55.

<sup>22</sup> The mean of value as measured at the close of business each day in a calendar quarter will be used for calculation. This method will account for potential short-term variation in the value of swaps. See *Questions and Answers: Further Defining "Swap Dealer," "Major Swap Participant" and "Eligible Contract Participant,"* available at [http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/defs\\_qa.pdf](http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/defs_qa.pdf) ("CFTC Q&A").

<sup>23</sup> See SEC Fact Sheet and *Fact Sheet: Proposed Rules Further Defining "Swap Dealer," "Major Swap Participant" and "Eligible Contract Participant,"* available at [http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/defs\\_factsheet.pdf](http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/defs_factsheet.pdf) ("CFTC Fact Sheet").

<sup>24</sup> Release at 52-54.

<sup>25</sup> CFTC Q&A.

## *Hedging or Mitigating Commercial Risk*

The definition of “substantial position” excludes positions held for the purpose hedging or mitigating commercial risk. The rules propose an analysis of the facts and circumstances at the time an entity enters into the swap to determine whether the position can be considered as hedging. The definition is not limited to positions qualifying for hedge accounting treatment or bona fide hedging, but would include any swap position that is “economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise.”<sup>26</sup>

## *Substantial Counterparty Exposure*

The Commissions must assess whether a major participant could create exposure that could have serious adverse effects on financial stability. The definition of “substantial counterparty exposure” would use a similar calculation as that used to calculate substantial position, except that the definition would not be limited to major categories of swaps, and it would not exclude hedging or employee benefit plan positions. The proposed threshold is a current uncollateralized exposure of \$5 billion, or a sum of current and potential future exposure of \$8 billion.<sup>27</sup>

## **IV. Conclusion**

The Commissions will be seeking public comment on the proposed rules for 60 days following their publication in the Federal Register. There are several areas of the proposed rules which will continue to develop based on the Commissions’ discussions with swap participants during the public comment period. In addition to the definitions summarized above, the proposed rules will also seek to address several related issues, including the identification of major categories of swaps and security-based swaps. With regard to dealers, other open issues include the treatment of swaps between persons under common control, parties that aggregate the swap positions of other parties, and the application of the definitions in physical commodity markets.<sup>28</sup> With regard to major participants, open issues include the treatment of ERISA plans, sovereign wealth funds, legacy portfolios of swaps in “run off” mode, registered investment companies, and end users subject to various restrictions on their use of swaps.

The proposed rules offer some insight into the way that the new requirements of the Act will be implemented. However, the rules will continue to evolve as the Commissions receive further comments from the public and continue to promulgate new rules pertaining to other areas of the Act.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Jon Mark at 212.701.3100 or [jmark@cahill.com](mailto:jmark@cahill.com); John Schuster at 212.701.3323 or [jschuster@cahill.com](mailto:jschuster@cahill.com); or Lynn Schmidt at 212.701.3641 or [lschmidt@cahill.com](mailto:lschmidt@cahill.com).

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<sup>26</sup> SEC Fact Sheet.

<sup>27</sup> Release at 93-94.

<sup>28</sup> CFTC Q&A.