

## **A DEFINING MOMENT: SEC AND CFTC RELEASE JOINT PROPOSED RULE ON KEY DEFINITIONS IN TITLE VII OF THE DODD-FRANK ACT**

December 28, 2010

To Our Clients and Friends:

On December 21, 2010, the Commodity Futures Trading Commission (the “CFTC”) and the Securities and Exchange Commission (the “SEC”, together with the CFTC, the “Commissions”), in consultation with the Board of Governors of the Federal Reserve System, jointly published in the Federal Register proposed rules and interpretative guidance on the definitions of “swap dealer,” “security-based swap dealer,” “major swap participant,” “major security-based swap participant” and “eligible contract participant.” The CFTC and the SEC are seeking comments on all aspects of the proposed rules and suggestions to alternative approaches on or before February 22, 2011.

These definitions are important to derivatives market participants as under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Title VII”), swap dealers, security-based swap dealers, major swap participants and major security-based swap participants will have to register with the appropriate Commissions and will become subject to a new regulatory regime of minimum capital, margin posting, recordkeeping, reporting, business conduct and other requirements.

### **DEFINITIONS OF SWAP DEALER AND SECURITY-BASED SWAP DEALER**

In the proposing release, the Commissions have adopted the definitions of “swap dealer” and “security-based swap dealer” as set forth in Title VII.

Under Title VII, a person is a “swap dealer” if it:

- holds itself out as a dealer in swaps;
- makes a market in swaps;
- regularly enters into swaps with counterparties as an ordinary course of business for its own account; or

- engages in any activity causing it to be commonly known in the trade as a dealer or market maker in swaps.

The definition of “security-based swap dealer” is the same as that of “swap dealer,” with the only difference being the replacement of the term “swaps” with “security-based swaps.”

In the discussion accompanying the proposed rules, the Commissions have provided further guidance on how they intend to apply this definition. Generally, the Commissions note that the Title VII definition ought to be applied based on a “functional approach,” as it focuses on the interaction a person has with other participants in the swaps market and should be flexible enough to deal with the evolution of the market. In light of this, the proposing release lists a number of characteristics typical of a dealer:

- A dealer tends to accommodate demand for swaps from other parties;
- A dealer is generally available to enter into swaps to facilitate other parties’ interest in entering into swaps;
- A dealer tends not to request that other parties propose the terms of swaps but tends to enter into swaps on its own standard terms or on terms it arranges in response to other parties’ interest; and
- A dealer tends to arrange customized terms for swaps upon request of other parties and to create new types of swaps on its own.

The Commissions also recognize that there could be a functional distinction between a swap dealer and a security-based swap dealer that results from the different ways swaps and security-based swaps are used by the market participants; they note that security-based swaps are typically used as a hedge to or an indirect investment in the underlying assets while other swaps are used in a multitude of situations. The CFTC will thus focus on whether a particular person functions as a connecting point in the swaps market, while the SEC will rely on its experience in determining whether a particular person is a dealer or a trader in securities.

The part of the definition, which captures a person that “regularly enters into swaps with counterparties as an ordinary course of business for its own account,” has raised the concern of many participants in the swaps market that have not historically viewed themselves as “swap dealers.” In particular, most swap traders in the physical commodities and electricity markets do not function as dealers as defined in the other two prongs of the definition but may be treated as such under this one. The CFTC acknowledges the uniqueness and complexity of the physical commodities and power markets and is seeking comments on

whether the CFTC ought to adopt modified standards in its treatment of participants in those markets.

As to the part of the definition based on a person “holding itself out” and being “commonly known in the trade” as a dealer, the proposing release lists a number of non-exhaustive factors that the Commissions deem to be indicative of a person that is “holding itself out” as a dealer or is “commonly known in the trade” as a dealer:

- contacting potential counterparties to solicit interest in swaps or security-based swaps;
- developing new types of swaps or security-based swaps and informing potential counterparties of their availability;
- membership in a swap association in a category reserved for dealers;
- providing marketing materials (including a website) that describe the types of swaps or security-based swaps one is willing to enter into with other parties; and
- generally expressing a willingness to offer or provide a range of financial products that would include swaps or security-based swaps.

With respect to interpreting “market-making” activities, the Commissions note that they received a number of comments suggesting that the “making a market” test for a dealer ought to require that a person consistently or continuously provide two-sided quotes or express willingness to trade on both buy and sell sides. However, the Commissions have decided to reject any such suggestion on the ground that it was not part of the Congressional intent in its drafting of the “swap dealer” definition in Title VII.

The definitions of “swap dealer” and “security-based swap dealer” raise a significant amount of uncertainty, compared with the definition of “major swap participant” or “major security-based swap participant,” as the former is based on the facts and circumstances of each market participant and its activities in the markets, while the latter is mostly based on certain numerical tests. Difficulty in defining a dealer in the context of the swap markets partly stems from the absence of an inventory of instruments to be carried by a swap dealer unlike a dealer in the cash market. For example, an experienced trader in the swap market is in frequent contact with both actual and potential counterparties on both sides of the market, a swap transaction may sometimes be initiated by such trader or its counterparty, and such trader often provides a two-way quote and is willing to enter into swaps on either side depending, among other things, on the proposed terms of the swaps and its view of the direction of the

market. Such a trader is not; however, making a market in swaps but merely seeks trading profits.

**Limited purpose designations.** Title VII mandated the Commissions to designate a person as a swap dealer or a security-based swap dealer for “a single type or single class or category” of swap or security-based swap, but not for other types, classes or categories of swaps or security-based swaps. However, the proposed rules would require that a person who satisfies the definition of swap dealer or security-based swap dealer in any category of swaps must register as a dealer for all types, classes or categories of swaps or security-based swaps, or activities involving swaps or security-based swaps, in which such person is engaged, but such person would be permitted to seek a limited designation based on the facts and circumstances applicable to its particular activities.

**Affiliates.** The proposing release states that affiliated groups of entities under common control could include more than one dealer. Within such a group, only those entities that engage in swap or security-based swap dealing activities would be a swap dealer or security-based swap dealer, as applicable, but a trading desk or other discrete business unit would not be viewed as a swap dealer, unless organized as a separate legal entity.

#### **De minimis exemption**

With respect to the de minimis exemption, which is mandated by Title VII, the Commissions have proposed to exempt from the “swap dealer” and “security-based swap dealer” definitions, respectively, a person that meets all of the following conditions:

- **Limitation on notional amounts of outstanding swaps.** Its swap positions, entered into over the course of the immediately preceding 12 months, have an aggregate gross notional amount of no more than \$100 million. Further, it has an aggregate gross notional amount of no more than \$25 million with regard to swaps in which its counterparty is a “special entity.” A “special entity” is a Federal agency, a State, State agency, city, country, municipality, other political subdivision of a State, an employment benefit plan, a governmental plan or endowment. The notional amount shall be determined based on the effective notional amount of a swap and not the stated notional amount if the stated notional amount is “leveraged or enhanced by the structure of the swap.”
- **No more than 15 counterparties.** It has not entered into swaps with more than 15 counterparties, other than swap dealers, over the course of the immediately preceding 12 months. All counterparties that are members of a single group of persons under common

control shall be considered to be a single counterparty, for the purposes of this determination.

- **No more than 20 swaps.** It has not entered into more than 20 swaps over the course of the immediately preceding 12 months. An amendment to an existing swap in which the counterparty remains the same and the underlying asset remains substantially the same shall not constitute a new swap, for the purposes of this determination.

#### **Exclusion for loan-origination related swap activities**

The CFTC also proposed some clarification with respect to the exclusion of swap dealer activities for swaps entered into between an insured depository institution and its customers in connection with loan origination:

- such swaps shall be deemed to have entered into in connection with loan origination only if the rate, asset, liability or other notional item underlying the swap is, or is directly related to, a financial term of the related loan; and the financial terms of a loan shall include, without limitation, the loan's duration, rate of interest, currency and principal amount.
- such insured depository institution shall be considered to have originated the loan if it (A) directly transfers the loan amount to the customer, (B) is part of a syndicate of lenders that is the source of the loan, (C) purchases or receives a participation in the loan, or (D) otherwise is the source of funds that are transferred to the customer pursuant to the loan or the refinancing of any loan. Any synthetic loan, such as a loan CDS or a loan total return swap, would not qualify as a loan for this exclusion.

This exclusion applies only to "insured" depository institutions; therefore, as currently drafted, it does not apply to foreign banks with uninsured U.S. branches and agencies of foreign banks.

#### **DEFINITIONS OF MAJOR SWAP PARTICIPANT AND MAJOR SECURITY-BASED SWAP PARTICIPANT**

The Commissions have proposed to adopt the definitions of "major swap participant" and "major security-based swap participant" set forth in Title VII, which stated that a "major swap participant" is a person that is not a swap dealer and:

- that maintains a substantial position in swaps for any of the major swap categories, excluding both positions held for hedging or mitigating commercial risk, and positions maintained by any employee benefit plan (or any contract held by such a plan) as defined in paragraphs (3) and (32) of Section 3 of the Employee Retirement Income Security Act

of 1974 (“ERISA”) for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan; or

- 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
- that is a financial entity that (a) 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 (as defined in Section 1a(2) of the Commodity Exchange Act (the “CEA”)) and (b) maintains a substantial position in outstanding swaps in any major swap category.

The definition of “major security-based swap participant” is similar to that of “major swap participant,” with the only difference being the replacement of the term “swaps” with “security-based swaps.”

### **FIRST DEFINITION: SUBSTANTIAL POSITION IN SWAPS OR SECURITIES-BASED SWAPS, EXCLUDING CERTAIN HEDGING TRANSACTIONS**

Under the first definition, the determination of whether a person is a major swap participant or major security-based swap participant fundamentally revolves around whether the quantity of swap and security-based swap positions that it maintains is deemed to be substantial enough to be regulated, as further described by the Commissions in these proposed rules.

A person’s substantial position in swaps and security-based swap is determined based on the calculation of its (1) “aggregate uncollateralized outward exposure,” which is essentially an amount, to be determined daily and on a counterparty-by-counterparty basis, of a person’s uncollateralized out-of-the-money swap or security-based swap positions and (2) “aggregate potential outward exposure,” which is a measure of a person’s potential out-of-the-money amount determined as a specified percentage of the notional principal amount of each swap or security-based swap. According to the release, the first amount is intended to capture the current uncollateralized exposure, and the second amount is intended to capture the future, potential exposure. A person will be considered a swap dealer or securities-based swap dealer, if either (1) its current uncollateralized outward exposure exceeds the thresholds set forth in the rules or (2) the combined amount of such current exposure and its future potential outward exposure exceeds the thresholds set forth in the rules. In other words, a person will be a swap dealer or securities-swap dealer if either of the two tests is met.

## CATEGORIES OF SWAPS

In calculating the current uncollateralized outward exposure and the future potential outward exposure of a person, the first step is to assign all swap transactions of such person among categories of swaps and categories of securities-based swaps. With respect to the allocation of swaps that could be assigned to more than one category, the discussion in the release states “[e]ach swap would be in the category that most closely describes the primary item underlying the swap. If a swap is based on more than one underlying item of different types, the swap would be in the category that describes the underlying item that is likely to have the most significant effect on the economic return of the swap.”

The CFTC has proposed the four following major categories of swaps to be used in connection with the definitions of “swap dealer” and “major swap participant”:

- **Rate Swaps.** Any swap which is primarily based on one or more reference rates, including but not limited to any swap of payments determined by fixed and floating interest rates, currency exchange rates, inflation rates or other monetary rates, any foreign exchange swap, as defined in Section 1a(25) of the CEA, and any foreign exchange option.
- **Credit Swaps.** Any swap that is primarily based on instruments of indebtedness, including but not limited to any swap primarily based on one or more broad-based indices related to debt instruments, and any swap that is an index credit default swap or total return swap on one or more indices of debt instruments.
- **Equity Swaps.** Any swap that is primarily based on equity securities, including but not limited to any swap based on one or more broad-based indices of equity securities and any total return swap on one or more equity indices.
- **Other Commodity Swaps.** Any swap that is not included in the rate swap, credit swap or equity swap categories.

The SEC has proposed the two following categories of security-based swaps to be used in connection with the definitions of “security-based swap dealer” and “major security-based swap participant”:

- **Security-based credit derivatives.** Any security-based swap that is based, in whole or in part, on one or more instruments of indebtedness (including loans), or on a credit event relating to one or more issuers or securities, including but not limited to any security-based

swap that is a credit default swap, total return swap on one or more debt instruments, debt swap, debt index swap, or credit spread.

- **Other security-based swaps.** Any security-based swap that is not a security-based credit swap.

### **CALCULATION OF “SUBSTANTIAL POSITION”**

With respect to “substantial position,” both Commissions have proposed a two-part numerical test, and a person will be deemed to have a substantial position if the amount calculated with respect to its swaps or security-based swaps exceeds the levels set out in either of the two tests.

The first test measures whether a person’s “aggregate uncollateralized outward exposure” (*i.e.*, uncollateralized and out-of-the-money swap positions, as further discussed below) exceeds the following thresholds:

- For rate swaps: \$3 billion or more in daily average aggregate uncollateralized outward exposure.
- For each of credit swaps, equity swaps, other commodity swaps and security-based swaps: \$1 billion or more in daily average aggregate uncollateralized outward exposure.

The second test measures whether the sum of a person’s (a) “aggregate potential outward exposure” (*i.e.*, a percentage of the notional amount of such transactions, specified depending on the type of transactions, as further discussed below) and (b) “aggregate uncollateralized outward exposure” exceeds the following thresholds:

- For rate swaps: \$6 billion or more in the sum of daily aggregate uncollateralized outward exposure and daily average aggregate potential outward exposure.
- For each of credit swaps, equity swaps, other commodity swaps and security-based swaps: \$2 billion or more in the sum of daily aggregate uncollateralized outward exposure and daily average aggregate potential outward exposure.

**Aggregate uncollateralized outward exposure**

A person's aggregate uncollateralized outward exposure is the sum of its current out-of-the-money amounts, obtained by marking-to-market using industry standard practices, of its swaps or security-based swaps in any given major swap or security-based swap category, net of the value of any collateral such person has posted in connection with such swaps or security-based swaps.

The following applies to this calculation:

- **Counterparty-by-counterparty.** The amount is determined on a counterparty-by-counterparty basis. In calculating this amount, netting is permitted between in-the-money and out-of-the-money positions of swaps in the same category that are outstanding with the same counterparty, but netting is not permitted between the out-of-the-money positions with one counterparty against the in-the-money positions with another counterparty. In other words, this amount is solely based on the sum of the net negative value of the swaps with each counterparty separately, and the net positive value of the swaps with other counterparties is disregarded.
- **Netting.** A person can measure its out-of-the-money amounts by applying the master netting agreement that it has in place with each of its counterparties. The Commissions specified that the master netting agreements may permit the offset of various transactions, including securities financing transactions, such as securities lending and borrowing, securities margin lending and repos and reverse repos.
- **Major swap categories.** The amount is to be determined for each major swap category; however, as the Commissions permit the application of master netting agreements, it is not clear whether one could apply in-the-money amounts against out-of-the-money amounts with the same counterparty when such amounts are for swaps and security-based swaps in different categories of swaps and security-based swaps.
- **Collateral valuation.** In these proposed rules, the Commissions have not specified how to value the collateral posted if it is not cash. It is also not clear how to allocate the collateral posted with respect to the resulting out-of-the-money amounts to each swap category after one nets in-the-money amounts against out-of-the-money amounts of swaps in different categories with the same counterparty. The discussion in the proposed rules gave an example of collateral allocation, but it assumes that there is an out-of-the-money amount in each swap category.

**Aggregate potential outward exposure**

A person's aggregate potential outward exposure in any major swap or security-based swap category is the sum of its aggregate potential outward exposure for all of its swaps and security-based swaps in that category. However, the Commissions treat transactions that are subject to daily marking-to-market (or are cleared) differently from those that are not subject to daily marking-to-market and are not cleared; in applying this test, transactions that are subject to daily marking-to-market (or are cleared) shall benefit from a further 80% discount.

A swap is deemed to be subject to daily marking-to-market when the counterparties "follow the daily practice of exchanging collateral to reflect changes in the current exposure" after taking into account applicable netting agreement between them. If a person has a threshold amount under which it is not required to post collateral with respect to its out-of-the-money position, the amount of the threshold is deemed part of the uncollateralized amount.

The "potential outward exposure" for swaps or security-based swaps in the same category is determined by adjusting the total notional principal amounts of such swaps with the following multipliers:

Residual maturity	Interest rate	Foreign exchange rate and gold	Precious metals (except gold)	Other commodities / Other
One year or less	0.00	0.01	0.07	0.10
Over one to five years	0.005	0.05	0.07	0.12
Over five years	0.015	0.075	0.08	0.15

Residual maturity	Credit	Equity
One year or less	0.10	0.06
Over one to five years	0.10	0.08
Over five years	0.10	0.10

In applying "Residual maturity" to a swap, if it is periodically closed out and its terms reset so the market value of the swap is reset to zero, the remaining maturity is the time until the next reset date.

- Netting adjustment.** If a person has a master netting agreement with a counterparty, then swap and security-based swaps with that counterparty can benefit from an adjustment and will equal the weighted average of the potential outward exposure, reduced by a ratio of the net current exposure to gross current exposure determined in accordance with the

formula:  $PNet = 0.4 * PGross + 0.6 * NGR * PGross$ , where PNet is the potential outward exposure adjusted for bilateral netting; PGross is the potential outward exposure without any adjustment for bilateral netting, and NGR is the ratio of net current exposure to gross current exposure. As the future potential exposure amount is based on the notional amounts of swaps, collateral posted or positive value of swaps will not reduce the amount calculated under this formula.

- **Pre-payment adjustment.** Swap positions, under which a person has prepaid or otherwise satisfied all of its payment obligations (e.g., options for which all premiums have been paid) are excluded from the calculation of potential outward exposure for such person.

### **HEDGING OR MITIGATING COMMERCIAL RISK**

Under the first definition, swap and security-based swap positions held by any employee benefit plan (or contract held by such a plan) as defined in paragraphs (3) and (32) of Section 3 of ERISA for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan can be excluded from the determination of a plan's "substantial position."

Further, solely with respect to the first definition of "major swap participant" or "major security-based swap participant," as the case may be, the Commissions have proposed that a position that is held in accordance with the following criteria shall be deemed to be held for "hedging or mitigating commercial risk" and may be excluded from the determination of "substantial position":

- if the position is not held for a purpose that is in the nature of speculation, investing or trading, and
- if the positions is not held for hedging or mitigating the risk of another swap or security-based swap position (unless that other swap or security-based swap is held for hedging or mitigating commercial risk), and
- if the position is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where the risks arise from a potential change in the value of the following items in the ordinary course of business of such enterprise:

- assets that it owns, produces, manufactures, processes, or merchandises or reasonably anticipates owning, producing, manufacturing, processing or merchandising;
  - liabilities that it has incurred or reasonably anticipates incurring in the ordinary course of business of the enterprise;
  - services that it provides, purchases or reasonably anticipates providing or purchasing;
  - assets, services, inputs, products or commodities that it owns, produces, manufactures, processes, merchandises, leases, or sells or reasonably anticipates owning, producing, manufacturing, processing, merchandising, leasing, or selling; or
  - in relation to any of the foregoing, a potential change in value arising from foreign exchange rate movements associated with such assets, liabilities, services, inputs, products or commodities, or any fluctuation in interest, currency or foreign exchange rate exposures arising from the person's current or anticipated assets or liabilities.
- The CFTC have also clarified any transaction that qualifies as *bona fide* hedging for the purposes of the exemptions from position limits under the CEA and any transaction that qualifies for hedging treatment under FASB Accounting Standards Codification Topic 815 (formerly known as Statement No. 133) shall be deemed to be held for the purposes of "hedging or mitigating commercial risk."
  - The SEC has established similar standards for the determination of "hedging or mitigating commercial risk," but it has further required that each person must (1) identify and document the risks being reduced by the hedging security-based swaps, (2) establish and document a method of assessing the effectiveness of such swaps and (3) regularly assess their effectiveness.

## **SECOND DEFINITION: SUBSTANTIAL COUNTERPARTY EXPOSURE**

Under the second definition, if a person's outstanding swap or security-based swap position is deemed to create "substantial counterparty exposure that could have serious adverse effects on

the financial stability of the United States banking system or financial markets,” it will be treated as a major swap participant or major securities-based swap participant.

Under the CFTC’s proposed rules, a person will be a major swap participant, if (1) its daily average aggregate uncollateralized outward exposure across all major swap categories exceeds \$5 billion, or (2) the sum of its daily average aggregate uncollateralized outward exposure and daily average aggregate potential outward exposure, across all major swap categories exceeds \$8 billion.

Under the SEC’s proposed rules, a person will be a major security-based swap participant, if (1) its daily average aggregate uncollateralized outward exposure across all major security-based swap categories exceeds \$2 billion, or (2) the sum of its daily average aggregate uncollateralized outward exposure and daily average aggregate potential outward exposure, across all major security-based swap categories exceeds \$4 billion.

In calculating the amounts for this definition, all swaps and security-based swaps of a person must be included, and there is no exclusion for transactions that are held for the purposes of “hedging or mitigating commercial risk.”

### **THIRD DEFINITION: HIGHLY LEVERAGED FINANCIAL ENTITY WITH SUBSTANTIAL POSITION IN SWAPS OR SECURITIES-BASED SWAPS**

Under the third definition, a person that is a highly leveraged financial entity and is not subject to the capital requirements of a federal banking agency will be a major swap participant or major securities-based swap participant if it holds and maintains substantial positions in swaps or securities-based swaps.

The Commissions have proposed to define “highly leveraged” with respect to a person as a ratio of its total liabilities to equity in excess of “[8 to 1 or 15 to 1]” as measured at the close of business on the last day of the applicable fiscal quarter, with liabilities and equity as determined in accordance with US generally accepted accounting principles.

A “financial entity” is any of the following: (a) a swap dealer or a security-based swap dealer; (b) a major swap participant or a major security-based swap participant; (c) a commodity pool as defined in Section 1a(10) of the CEA; (d) a private fund as defined in Section 202(a) of the Investment Advisers Act of 1940; (e) an employee benefit plan as defined in paragraphs (3) and (32) of Section 3 of ERISA; and (f) a person predominantly engaged in activities that are in the business of banking or financial in nature as defined in Section 4(k) of the Bank Holding Company Act of 1956.

In calculating the amounts for this definition, all swaps and security-based swaps of a person must be included, and there is no exclusion for transactions that are held for the purposes of “hedging or mitigating commercial risk.”

### **DIFFERENCES IN THE APPLICATION OF THE NUMERICAL TESTS TO MARKET PARTICIPANTS**

In summary, the application of these numerical tests to each swap and security-swap participant depends on such participant’s business activities:

- If a person is a highly leveraged financial entity, it will be required to determine its substantial position, taking into account all swaps and security-based swaps, including those that it holds for the purpose of hedging or mitigating commercial risk.
- If a person is not a highly leveraged financial entity, it shall determine its substantial position in each major category of swaps and security-based swaps, excluding swaps and security-based swaps that are held for the purpose of hedging or mitigating commercial risk.
- If a person is an employee benefit plan as defined in paragraphs (3) and (32) of ERISA, it shall determine its substantial position in each major category of swaps and security-based swaps, excluding swaps and security-based swaps that are maintained for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan.
- However, a person that passes the numerical tests of substantial position with the adjustments applicable to it as specified above<sup>1</sup> will need to conduct another numerical test to determine whether the quantity of swaps or security-based swaps that it holds, in the aggregate across all major swap or security-based swap categories, as the case may be, exceeds certain levels determined by either the CFTC for swaps or the SEC for security-based swaps as having the potential of causing “serious adverse effect on the financial stability of the United States banking system or financial markets.”

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<sup>1</sup> For example, a person that is not a highly leveraged financial entity and that (a) only holds swaps or security-based swaps for the purpose of “hedging or mitigating commercial risks” or (b) holds large quantities of swaps in multiple major swap categories such that the swaps or security-based swaps held with respect to each major category separately do not exceed the category-specific thresholds.

### **TIMING REQUIREMENT AND GRACE PERIOD**

A person that is not registered as a major swap participant or a major security-based swap participant, but that meets the criteria set out in the rules to be a major swap participant or a major security-based swap participant with respect to its swaps or security-based swaps activities in a particular fiscal quarter, will not be regulated as a major swap participant until the earlier of (a) the date on which it submits a registration application and (b) two months after the end of that fiscal quarter. Further, if a person meets the criteria to be a major swap participant or a major security-based swap participant in a fiscal quarter, but does not exceed any applicable threshold by more than 20%, then it will not be deemed to be a major swap participant or a major security-based swap participant until it has exceeded any of the applicable thresholds for two consecutive quarters. In proposing such grace periods, a person may be able to avoid registration and regulation as a major swap participant or major security-based swap participant if it reduces its swap and security-based swap positions to be below the applicable thresholds by the end of a fiscal quarter.

### **SCOPE OF DESIGNATION FOR APPLICANTS**

With respect to the designation of swap dealer, security-based swap dealer, major swap participant, and major security-based swap participant, both Commissions proposed to clarify that a person who is captured by any such definition shall be deemed to be so designated for each swap or security-based swap that it enters into, without regard to the category of such swap or security-based swap. This appears to be inconsistent with the intent of Title VII, which specified that a person could be deemed to be a swap dealer, a security-based swap dealer, a major swap participant or a major security-based swap participant in one category or type of swap or security-based swap but not be so designated in other categories or types of swaps or security-based swaps. However, both Commissions further propose to permit a person who is subject to designation as a swap dealer, a security-based swap dealer, a major swap participant or a major security-based swap participant to apply to the appropriate Commission to limit its designation to one or more specified categories or types of swaps or security-based swaps.

### **POSSIBLE EXTRATERRITORIAL APPLICATION**

The Commissions have not directly addressed the issue of extraterritorial application of the definitions in these proposed rules; however, the CFTC has raised the issue of the extraterritorial application of the various requirements of Title VII in a proposed rulemaking commenced on November 23, 2010, relating to the requirement for “swap dealers” and

“major swap participants” to register with the CFTC.<sup>2</sup> The discussion in the Federal Register accompanying the November 23 proposed rule specifically raised the question of the application of the proposed rule to non-U.S. persons. The relevant discussion from the Federal Register stated that:

The [CFTC] generally would not require a person to register as a swap dealer if their only connection to the U.S. was that the person uses a U.S.-registered swap execution facility, designated clearing organization or designated contract market in connection with their swap dealing activities, or reports swaps to a U.S.-registered swap data repository. On the other hand, a person outside the U.S. who engages in swap dealing activities and regularly enters into swaps with U.S. persons would likely be required to register as a swap dealer.

This statement suggests that the CFTC will take a broad view of its ability to apply the registration and other requirements of Title VII to non-U.S. persons. As part of the proposed rulemaking commenced on November 23, 2010, the CFTC asked for comment as to what level of swap dealing activity outside the U.S. would qualify as having a direct and significant connection with activities in or effect on commerce of the U.S. The CFTC asked, for example, to what extent do persons outside the U.S. who engage in swap dealing activity with non-U.S. affiliates of U.S. persons (such as a non-U.S. subsidiary of a corporate parent headquartered in the U.S.) engage in swap dealing activity that has a direct and significant connection with activities in, or effect on, U.S. commerce.

The discussion in the release also noted that the registration of non-U.S. persons as “major swap participants” raises different jurisdictional issues than the registration of non-U.S. persons as “swap dealers.” For “major swap participants” the analysis would turn, among other things, upon the size of the swap positions with U.S. persons, the use of a U.S. swap clearing agency or swap execution facility, and whether the swap activity involves the use of any means or instrumentalities of U.S. interstate commerce (a technical legal test that would undoubtedly be met in most instances).

### **ELIGIBLE CONTRACT PARTICIPANT**

Title VII made it unlawful for any person, other than an eligible contact participant, to enter into a swap or a security-based swap unless such swap is traded on an exchange or other designated contract market.

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<sup>2</sup> 75 *Fed. Reg.* 71379 (Nov. 23, 2010).

In this release, the CFTC has proposed a number of clarifying amendments to the definition of “eligible contract participant,” notably:

- swap dealers, security-based swap dealers, major swap participants and major security-based swap participants are automatically deemed to be eligible contract participants, and
- for certain purposes of trading and entering into foreign exchange transactions, a commodity pool, with one or more direct or indirect participants that is not an eligible contract participants, will not be deemed to be an eligible contract participant.

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Please feel free to contact us with any questions.

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