CFTC AND SEC RELEASE JOINT FINAL RULE ON KEY ENTITY DEFINITIONS IN TITLE VII OF THE DODD-FRANK ACT

June 8, 2012

To Our Clients and Friends:

On April 18, 2012, the Commodity Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission (the "SEC," together with the CFTC, the "Commissions") have jointly adopted Final Rules (the "Final Rules") on the definitions of "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant" and "eligible contract participant."

These definitions are important to derivatives market participants because, 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 Commission and will become subject to a new regulatory regime of minimum capital maintenance, margin-collecting, recordkeeping, swap data reporting, business conduct and other requirements.

In the adopting release accompanying the Final Rules (the "Adopting Release"), the Commissions generally declined to exclude categorically any person from the definitions of swap dealers or major swap participants.[1] Thus, there is no exclusion for entities with legacy portfolios of swaps, or other regulated entities such as pension plans, banks or insurance companies; however, the Commissions clarified that foreign central banks, foreign governments and international financial institutions are not required to register as swap dealers or major swap participants. The Commissions also declined to provide specific guidance on the extra-territorial reach of these Final Rules by stating that they will "separately address issues related to the application of these definitions to non-U.S. persons in the context of the application of Title VII to non-U.S. persons."

The Final Rules will become effective on July 23, 2012.

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[1] *Unless otherwise specified, references to "swap dealer" in this memorandum include security-based swap dealer, and references to "major swap participant" include major security-based swap participant.*

DEFINITIONS OF SWAP DEALER AND SECURITY-BASED SWAP DEALER

In the Final Rules, just like in the proposed rules, the Commissions have followed closely 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 for security-based swap dealer is the same as the above, with "security-based swaps" replacing the term "swaps."

Interpretative Guidance on Swap Dealer Definition

The Commissions emphasize that the dealer test is primarily a qualitative one based on all relevant facts and circumstances. Generally, they believe that the "dealer-trader" distinction currently used for the determination of "dealer" for the purposes of the Securities Exchange Act of 1934 will provide the basic framework for the interpretation of these new definitions, with some modifications that are appropriate given differences between the securities market and the swap market and between securities trading and swap trading (*e.g.*, the absence of concepts such as "issuer," "inventory" and "buying and selling" in the swap market).

Because of the qualitative nature of the test, the Commissions have provided interpretative guidance in the Adopting Release to the application of the statutory definitions to the facts and circumstances of a person's particular situation, in determining whether such person is a swap dealer. The Commissions outline the following steps, which are to be undertaken in the swap dealer analysis:

- First, one will determine whether its swap-related activities constitute those of a swap dealer as defined in the Final Rules, taking into account the interpretative guidance in the Adopting Release.

- Then, it will determine whether any of its swaps does not arise from swap dealing, and it will exclude such swaps from the swap dealer determination.
- Finally, it will apply the *de minimis* swap dealing test, and only if its swap dealing activities exceed the *de minimis* threshold, will it be determined to be a swap dealer subject to regulations as such.

Swap Dealing Activities

In particular, the Commissions single out the following as indicative of dealing activities:

- Providing liquidity by accommodating demand for or facilitating interests in swaps or security-based swaps.
- Holding oneself out as willing to enter into swaps or security-based swaps or being known in the industry as being available to accommodate demand for swaps or security-based swaps.
- Advising a counterparty on how to use swaps or security-based swaps to meet its hedging goals or structuring swaps or security-based swaps on its behalf.
- Having a regular clientele and actively advertising or soliciting clients in connection with swaps or security-based swaps.
- Acting in a market-maker capacity on an organized exchange or trading system.
- Helping to set the prices offered in the market rather than by taking those prices (although the fact that a person regularly takes the market price is not in itself dispositive in determining that such person is not a swap dealer).

Further, the following are deemed by the Commissions not to be dispositive in the determination of dealing activities:

- Willingness to enter into transactions on either side of the market is not a prerequisite to dealing, as a person can be a dealer in one-sided transactions.
- The determination of swap-dealing activities does not turn on whether such activities constitute a person's sole or predominant business.
- A customer-dealer relationship is not a perquisite to the determination of dealing activities, a person can be a dealer even if its counterparty is not its customer.

The application of the dealer-test is qualitative; therefore, the characterization of various activities is based on the facts and circumstances applicable to a person. For example, the Commissions note that entering into a swap for the purpose of hedging, absent other activity, is unlikely to be indicative of dealing unless the hedging activities were entered into to accommodate swap dealing; similarly, actively seeking out and negotiating swaps may not necessarily constitute dealing activities if a person could otherwise demonstrate that it is a commercial end-user and not a dealer. However, the Commissions explicitly reject the argument that market making requires a person to make a two-way market in swaps, stating that a person may make only one side of market in swaps and become a swap dealer, as such person may offset the market risk from such swaps in other markets, such as futures or cash markets.

For the core dealing activities of "holding oneself out as a dealer," "being commonly known in the trade as a dealer" and "market-making," the Commissions also provided more detailed guidance of what they would consider to be indicia of such activities.

"Holding oneself out as a dealer or being commonly known as a dealer." The Commissions list the following non-exclusive factors as indicative of such activities: (i) contacting potential counterparties to solicit interest in swaps; (ii) developing new types of swaps (which may include financial products that contain swaps) and informing potential counterparties of the availability of such swaps and a willingness to enter into such swaps with the potential counterparties; (iii) membership in a swap association in a category reserved for dealers; (iv) providing marketing materials (such through as a website) that describe the types of swaps that one is willing to enter into with other parties; (v) generally expressing a willingness to offer or provide a range of financial products that would include swaps; or (vi) giving the perception of being a person with substantial experience with and knowledge of the swap market (regardless of whether that person is known as a dealer by persons without such experience or knowledge).

"Market-making." The Commissions describe "making a market in swaps" as "routinely standing ready to enter into swaps at the request or demand of a counterparty". In this context, "routinely" means that the person must do so more frequently than occasionally, but there is no requirement that the person do so continuously. The Commissions list the following activities as those indicative of "routinely standing ready to enter into swaps": (i) quoting bid or offer prices, rates or other financial terms for swaps on an exchange; (ii) responding to requests made directly, or indirectly through an interdealer broker, by potential counterparties for bid or offer prices, rates or other similar terms for bilaterally negotiated swaps; (iii) placing limit orders for swaps; or (iv) receiving compensation for acting in a market maker capacity on an organized exchange or trading system for swaps.

Generally, the Commissions maintain that these lists are neither exclusive nor conclusive, and that even where a particular person is engaged in activities described above, the determination of whether such person is a swap dealer should consider whether such person is seeking, through its presence in the market, compensation for providing liquidity, compensation through spreads or fees, or other compensation not attributable to changes in the value of the swaps it enters into. If not, such activity would not be indicative of market making.

Exception for activities not part of "a regular business." The Commissions view the phrase "ordinary course of business" and "regular business" for purpose of swap dealer determination as essentially synonymous; therefore, this analysis focuses on the activities of a person that are usual and normal in that person's course of business and identifiable as a swap dealing business. They note that it is not necessarily relevant whether the person conducts its swap-related activities in a dedicated subsidiary, division, department or trading desk, or whether such activities are a person's "primary" or an "ancillary" business, so long as the person's swap dealing business is identifiable. They further provide a list of the activities that would generally constitute both entering into swaps "as an ordinary course of business" and "as a part of a regular" business: (i) entering into swaps with the purpose of satisfying the business or risk management needs of its counterparty (as opposed to entering into swaps to accommodate one's own demand or desire to participate in a particular market); (ii) maintaining a separate profit and loss statement reflecting the results of swap activity or treating swap activity as a separate profit center; or (iii) having staff and resources allocated to dealer-type activities with counterparties, including activities relating to credit analysis, customer on-boarding, document negotiation, confirmation generation, requests for novations and amendments, exposure monitoring and collateral calls, covenant monitoring, and reconciliation.

As to the third factor, the Commissions acknowledge that some end-users engage in some of these activities and may even have staff and resources available for these activities; therefore, this factor must be considered in a reasonable manner, taking all appropriate facts and circumstances into account. The Commissions conclude that it is nevertheless appropriate to objectively examine a person's use of staff and resources related to swap activities and that using staff and resources to a significant extent in conducting credit analysis, opening and monitoring accounts and the other activities is an indication of being engaged in a "regular business" of entering into swaps.

Excluded Swap Activities

The CFTC has provided that certain swap activities would be excluded from the swap dealer determination: (i) swaps entered into for hedging physical positions; and (ii) swaps entered into

by persons registered as floor traders. Both Commissions also provided the clarification that inter-affiliated swap activities will be disregarded from the dealer determination.

Swaps entered into for hedging physical positions. The CFTC notes that the statutory definition mandated by the Dodd-Frank Act leaves the treatment of hedging swaps to the discretion of the CFTC, and in response to comments received, the CFTC has issued an interim final rule to exclude swaps used for hedging physical positions from the swap dealer determination on the basis that "entering into a swap for the purpose of hedging is inconsistent with swap dealing."

The criteria used for this safe harbor are not identical to those used for the determination of part 151 *bona fide* hedging transaction on position limits. Under this interim final rules, a swap will be excluded from the dealer determination, if it:

- is entered into for the purpose of offsetting or mitigating a person's price risks that arise from the potential change in the value of one or several (i) assets that the person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising; (ii) liabilities that the person owns or anticipates incurring; or (iii) services that the person provides, purchases, or anticipates providing or purchasing;
- represents a substitute for transactions made or to be made or positions taken or to be taken by a person at a later time in a physical marketing channel;
- is economically appropriate to the reduction of a person's risks in the conduct and management of a commercial enterprise;
- is entered into in accordance with sound commercial practices; and
- is not entered into by a person in connection with activity structured to evade designation as a swap dealer.

The CFTC states that the expression of "one or several" in the first criterion explicitly provides that the hedging activity does not have to be on a transaction-by-transaction basis but can be on a portfolio basis.

The CFTC notes that since OTC swaps have been largely unregulated historically, it has not developed a method to reliably distinguish between swaps used for hedging or mitigating commercial risk from those swaps used for accommodating a person's needs or demands or

otherwise constitute dealer activities but which also have a hedging consequence. Therefore, the CFTC intends this exclusion to be interpreted as a "safe harbor" and designates it as an interim final rule so that interested parties can provide further comments to the CFTC to refine this exclusion. The comment period for this interim rule expires on the effective date of the Final Rules, which is July 23, 2012.

Swaps entered into by persons registered as floor traders. To avoid potentially duplicative regulations of floor traders who also enter into swaps, the CFTC excludes swaps entered into by floor traders, subject to certain conditions enumerated in the rules, from the dealer determination. Without this exclusion, a floor trader who enters into swaps will have to register both as floor trader and swap dealer, which is not the intention of the CFTC.

Inter-affiliate transactions. Both Commissions interpret the term "person" used in the swap dealer definition to mean a "legal person" so dealer-activities are grouped on an entity-level. Further, within a group of affiliated entities, only those legal entities that engage in swap or security-based swap dealing activities would be swap dealers or security-based swap dealers, as applicable.

The Final Rules explicitly exclude from the dealer analysis, swaps or security-based swaps entered into between majority-owned affiliates; the rationale is that the economic interests of majority-owned affiliates are aligned so the swaps and security swaps entered between them serve to allocate and transfer risk to within an affiliated group of parties, not to transfer risks to a third party. For this purpose, two parties to a swap or security-based swap are "majority-owned affiliates" if one party, directly or indirectly, owns a majority interest in the other party, or if a third-party, directly or indirectly, owns a majority interest in both of those parties. And "majority interest" means (i) the right to vote or direct the vote of a majority of a class of voting securities of an entity; (ii) the power to sell or direct the sale of a majority of a class of voting securities of an entity; or (iii) the right to receive upon dissolution or the contribution of a majority of the capital of a partnership.

Exclusion for Loan-Origination Related Swap Activities

The statutory definition of "swap dealer" excludes swaps entered into by an insured depository institution (an "IDI") with a customer in connection with originating a loan from the determination of swap dealer activities. Therefore, swaps that are excluded under this provision should also be disregarded in an IDI's determination of whether its swaps exceed the *de minimis* level of swap activities below which such IDI does not need to register as a swap dealer. Under the Final Rules, the CFTC excludes any swap that complies with the following:

- the IDI must enter into the swap with the customer no earlier than 90 days before and no later than 180 days after the date of execution of the applicable loan agreement, or no earlier than 90 days before and no later than 180 days after any transfer of principal to the customer by the IDI pursuant to the loan;

- the rate, asset, liability or other notional item underlying such swap is, or is directly related, to a financial term of such loan, which includes, without limitation, the loan's duration, rate of interest, the currency or currencies in which it is made and its principal amount; or if the swap is required, as a condition of the loan under the IDI's loan underwriting criteria, to be in place in order to hedge price risks incidental to the borrower's business and arising from potential changes in the price of a commodity (other than an excluded commodity);

- the duration of the swap does not extend beyond the termination of the loan;

- the IDI is (i) the sole source of the funds to the customer under the loan, (ii) committed to be, under the terms of the agreements related to the loan, the source of at least 10% of the maximum principal amount under the loan, or (iii) committed to be, under the terms of the agreements related to the loan, the source of a principal amount that is greater than or equal to the aggregate notional amount of all swaps entered into by the IDI with the customer in connection with the financial terms of the loan;

- the aggregate notional amount of all swaps entered into by the customer in connection with the financial terms of the loan is, at any time, not more than the aggregate principal amount outstanding under the loan at that time; and

- it the swap is not accepted for clearing by a derivatives clearing organization, the IDI must report the swap to a swap data repository ("SDR").

The CFTC has further provided the following guidelines to the application of this final rule:

- The CFTC has expanded the proposed rules to permit the exclusion of any swap between an IDI and a borrower that are "connected to the financial terms of the loan, such as, for example, the loan's duration, interest rate, currency or principal amount, or that are required under the IDI's loan underwriting criteria to be in place as a condition of the loan in order to hedge commodity price risks incidental to the borrower's business." Therefore, this exclusion may be applicable to, for example, certain commodity swaps entered into by the

borrower, even if they are not related to the financial terms of the loan, as long as such swaps are required by the IDI's underwriting criteria and serve to mitigate risks of the borrower that reduces the risks that the loans will not be repaid.

- The CFTC states that the term "loan" will be interpreted based on its settled common law meaning and includes any contract by which a person transfers a defined quantity of money and the other person agrees to repay the transferred amount at a later date.

- In the case of syndicated loans, the CFTC has clarified that the exclusion may apply even when the notional amount of the swap between an IDI and the borrower differs from the amount of the loan actually assigned to that IDI in the lending syndicate. However, the IDI in this situation must be (i) the sole source of funds under the loan, or (ii) is committed to be the source of at least 10% of the maximum principal amount under the loan. If an IDI does not meet at least the 10% test, then the exclusion only applies if the aggregate notional amount of all of that IDI's swaps with the borrower relating to the financial terms of the loan is no more than the amount actual lent by that IDI.

- Certain factors are deemed to be irrelevant for the determination of this exclusion: (i) whether the swap hedges all risk, or only some risks, of the loan, (ii) whether the IDI later transfers the loan or terminates the loan, so long as the original swap qualified for the exclusion and the related loan was originated in good faith.

- This exclusion only applies to the swaps entered into between the IDI and the borrower, it does not include swaps otherwise entered into by the IDI to hedge its own risks with respect to the loan.

De minimis Exemption from the Dealer Definitions.

As mandated by Title VII, the Commissions have provided an exemption from the "swap dealer" and "security-based swap dealer" definitions, parties that have a *de minimis* amount of swap or security-based swap dealing activities.

The *de minimis* thresholds adopted by both Commissions have significantly increased from those set forth in the proposed rules, except with respect to swaps entered into with "special entities," for which the thresholds have remained the same. For this purpose, 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.

***De minimis* threshold amount for swaps.** A person's swap positions in connection with its dealing activities (including swap positions of such entity controlling, controlled by or under common control with such person) would be deemed to be below the threshold if such positions:

- entered into with counterparties over the course of the immediately preceding 12 months (or since the effective date of the final rules implementing the definition of "swap") have an aggregate gross notional amount of no more than $3 billion, subject to a phase-in level of no more than $8 billion; and
- entered into with "special entities" over the course of the immediately preceding 12 months (or since the effective date of the final rules implementing the definition of "swap") have an aggregate gross notional amount of no more than $25 million.

***De minimis* threshold amount for security-based swaps.** A person's security-based swap positions in connection with its dealing activities (including dealing security-based swap positions of such entity controlling, controlled by or under common control with such person) would be deemed to be below the threshold if such positions:

- entered into with counterparties over the course of the immediately preceding 12 months (or since the effective date of the final rules implementing the definition of "security-based swap") have an aggregate gross notional amount of no more than $3 billion, subject to a phase-in level of no more than $8 billion, with respect to credit default swaps that constitute security-based swaps; and
- entered into with counterparties over the course of the immediately preceding 12 months (or since the effective date of the final rules implementing the definition of "security-based swap") have an aggregate gross notional amount of no more than $150 million, subject to a phase-in level of no more than $400 million, with respect to security-based swaps that do not constitute credit default swaps; and
- entered into with "special entities" over the course of the immediately preceding 12 months (or since the effective date of the final rules implementing the definition of "swap") have an aggregate gross notional amount of no more than $25 million.

Use of effective notional amounts. Both Commissions have specified in the Final Rules that the notional amounts 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.

Phase-in period. The threshold amounts are higher during an initial phase-in period that will allow the Commissions to collect and analyze data with respect to the swap markets to determine the appropriate permanent *de minimis* threshold amounts. Under the Final Rules, the Commissions have to publish a report no later than 30 months (for the CFTC) and three years (for the SEC) after swap and security-based swap data have been accepted for reporting to an SDR. (There is no known date yet for when the first SDR or SDRs will become fully functional to accept data.) Then each of the CFTC and the SEC will make a decision on whether the permanent *de minimis* amount should be modified and when to terminate the phase-in period, nine months after the CFTC or the SEC has published its respective report. With respect to the Final Rules adopted by both Commissions, there is a built-in termination date for the phase-in period of five years after an SDR first starts to receive swap data required by the swap data reporting rules.

Grace Period. If a person not registered as a swap dealer in reliance on the *de minimis* exception can no longer rely on the exception due to increased dealing activities, such person will have two months, following the end of the month in which it ceased to be able to rely on the *de minimis* exception, to submit a completed application to register as a swap dealer.

Limited Purpose Designations as a Dealer.

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. In adopting the Final Rules; however, the Commissions have decided to retain the presumption in the proposed rules that a person that 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. If a person has a reason to seek a "limited designation" as a swap dealer for only a particular type, class or category of swaps or security-based swaps, it would have to apply for such "limited designation" when it submits a registration application or at some later time.

The Commissions will determine such applications for "limited designation" on a case-by-case basis, based on analysis of the unique circumstances of each applicant; however, the applicant must demonstrate that it can fully comply with the all requirements applicable to dealers even if such a "limited designation" application is to be granted.

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

The Commissions have adopted 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."

CATEGORIES OF SWAPS

The first step in the major swap participant determination is to assign all swap transactions of a person among major categories of swaps and major categories of securities-based swaps. Consistent with the proposed rules, the Commissions have adopted four major categories of swaps and two major categories of security-based swaps. The Commissions believe that any further divisions of categories would only result in more confusion in the application of the rules.

With respect to swaps (including credit default swaps) on indices or basket of equity or debt securities or loans as their underlying assets, an important piece of information is still missing for

the major participant determination as the Commissions have not finalized the definitions for "narrow-based security-index;" therefore, it is not yet clear whether to classify these transactions as swaps or security-based swaps.

As a general guidance, the Commissions state that they "continue to believe that it is important not to parse the 'major' categories so finely as to base the 'substantial position' thresholds on unduly narrow groupings that would reduce [the] thresholds' effectiveness as risk measures." With respect to mixed swaps that have features of swaps and security-based swaps, the instrument should be placed in the applicable swap or security-based swap categories that are consistent with the underlying attributes that cause the instrument to be a mixed swap. For a swap or security-based swap position that is based on multiple underlying items, instruments or risks, the Commissions state such position should be placed in the category that most closely describes the primary underlying item, instrument, or risk, although this may be difficult to do in practice.

Major Categories of Swaps. The CFTC has adopted 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 other than an option to delivery currency.

- **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.

Major Categories of Security-Based Swaps. The SEC has adopted the two following major categories of security-based swaps to be used in connection with the definitions of "security-based swap dealer" and "major security-based swap participant":

- **Debt security-based swaps.** 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.

GUARANTEES AND AFFILIATED TRANSACTIONS

The Commissions have provided some guidance and interpretation on the attribution of swap positions among affiliated entities. In the Adopting Release, they take the position that a subsidiary's swaps are not necessarily attributed to its majority-owned parent. Rather, a subsidiary's swaps are only attributed to a parent or an affiliate or a guarantor, for the purposes of applying the major swap participant rules, to the extent that the counterparties to those swap positions have recourse to that parent, affiliate or guarantor; otherwise, swap positions will not be attributed to another entity in the absence of such recourse.

Further, the Commissions also state that even when there is a guarantee, they do not believe that attribution to the guarantor is necessary if the person with the swap positions is itself subject to capital requirements by either Commission (*i.e.*, swap dealer, major swap participant, FCMs, broker-dealers) or is a US entity regulated as a bank in the United States.

As a practical matter, the Commissions clarify that a parent or guarantor that becomes subject to major swap participant regulations due to this attribution rule can delegate operational compliance requirements to the entities that are actually parties to the swaps, but it cannot delegate the entity-level requirements applicable to it (*e.g.*, registration and capital maintenance requirements).

MAJOR SWAP PARTICIPANT SAFE HARBORS

In the Final Rules, the Commissions have adopted some safe harbors for persons whose swap positions are so far below the thresholds set forth in the major swap participant tests that they will not need to perform the various daily determinations and quarterly calculations necessary for the tests and will thus be available to benefit from a "major swap participant" exemption under

the safe harbors. The same safe harbors exist for security-based swaps for the determination of a person's status as a "major security-based swap participant." The safe harbors are only meant to provide some relief for certain swap participants from the administrative hassle of constantly determining and tracking various swap position information.

There are three safe harbors. Any person who meets the conditions of a safe harbor will not be deemed to be a major swap participant without having to perform the actual major swap participant tests:

First Safe Harbor: Caps on uncollateralized exposure and notional positions. The terms of a person's swap agreements with all of its counterparties will not permit such person to maintain a total uncollateralized exposure of more than $100 million to all such counterparties at any time (including any exposure resulting from collateral posting thresholds or minimum transfer amounts under the collateral arrangements), and the person does not maintain swaps with notional amounts of more than $2 billion in any major category of swaps or more than $4 billion in all the major categories.

Second Safe Harbor: Caps on uncollateralized exposure plus monthly calculation. The terms of a person's swap agreements with all of its counterparties will not permit such person to maintain a total uncollateralized exposure of more than $200 million to all such counterparties with respect to swaps and all other instruments with such counterparties at any time (including any exposure resulting from collateral posting thresholds or minimum transfer amounts under the collateral arrangements), and (1) at the end of each month, the person must perform the "substantial position" and the "substantial counterparty exposure" calculation of the major swap participant tests, but only as of that day (*i.e.,* the calculations will not require a daily average over a calendar quarter but only require a person to make the calculations once a month); and (2) the results of this monthly calculation indicate that the person's swap positions is no more than (i) $1 billion in aggregate uncollateralized exposure plus aggregate potential outward exposure in any major category of swaps, excluding positions held for hedging and mitigating commercial risks (except for highly-leveraged financial entities that are not subject to capital requirements of an appropriate federal banking agency who must include all swaps in this calculation); and (ii) $2 billion in aggregate uncollateralized outward exposure plus aggregate potential outward exposure (without any exclusion) with regard to all of the person's swap positions.

Third Safe Harbor: Parties with low uncollateralized outward exposure. Two alternative methods to determine whether this safe harbor applies:

- *Standard Test*: At the end of each month, a person's aggregate uncollateralized outward exposure with respect to swaps in each major category is less than $1.5 billion with respect

to the rate swap category and less than $500 million with respect to each of the other major swap categories, and the results of the monthly calculations indicate that the person's swap positions in each of the major categories of swaps are less than one-half of the substantial position thresholds used for the major swap participant determination.

- *Simplified Test*: At the end of each month, a person's aggregate uncollateralized outward exposure with respect to swaps across all major swap categories is less than $500 million, and the sum of that person's aggregate uncollateralized outward exposure for all swaps *plus* the product of the total effective notional principal amount of that person's swap positions in all major swap categories (for the major swap participant determination) or in all major security-based swap categories (for the major security-based swap participant determination) *multiplied* by 0.15 is less than $1 billion.

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 are significant enough that it would be prudent to regulate such a person.

This determination is based on a two-part test that assesses a person's current uncollateralized exposure and potential future exposure to its counterparties:

- first component of the test is the "**aggregate uncollateralized outward exposure,**" 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.

- second component of the test is the "**aggregate potential outward exposure**," an amount that measures a person's potential out-of-the-money exposure determined based on a "risk-adjusted" specified percentage of the notional principal amount of each swap or security-based swap.

A person will be considered a major swap participant or major security-based swap participant, 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 major

swap participant or major security-based swap participant if its swap or security-based swap positions exceed either threshold of this two-part test.

CALCULATION OF "SUBSTANTIAL POSITION"

With respect to "substantial position," both Commissions have adopted 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.

First test of Aggregate Uncollateralized Outward Exposure. 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:

- **Rate Swaps**: $3 billion or more in daily average aggregate uncollateralized outward exposure.
- **Each of credit swaps, equity swaps, other commodity swaps and security-based swaps**: $1 billion or more in daily average aggregate uncollateralized outward exposure.

Second test of sum of Aggregate Potential Outward Exposure and 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:

- **Rate swaps**: $6 billion or more in the sum of daily aggregate uncollateralized outward exposure *and* daily average aggregate potential outward exposure.
- **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, and taking into account the effect of any applicable netting arrangement.

The determination of uncollateralized outward exposure requires a person to first analyze the netting arrangements that it has in place with each counterparty and determine the resulting net credit exposure, then allocate the collateral with respect to the swaps and security-based swaps to determine the uncollateralized swap- and security-based-swap-related exposures. The following factors are relevant to this determination:

- **Counterparty-by-counterparty.** The uncollateralized outward exposure is first determined on a counterparty-by-counterparty basis, and then the results are aggregated for the actual "substantial position" test. In calculating the uncollateralized outward exposure, 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. The Commissions emphasize that this is a credit-risk test, not a market-risk test; therefore, as offsetting swap positions with different counterparties do not reduce the credit-risk of any counterparty, that consideration is irrelevant for this purpose.

- **Netting.** A person can measure its out-of-the-money amounts by applying all relevant master netting agreements that it has in place with each of its counterparties as long as the instruments covered by the netting agreements are permitted to be offset against one another under the applicable bankruptcy law; for instance, swaps and security-based swaps could be offset against each other and against other instruments such as securities lending and borrowing, securities margin lending and repos and reverse repos. The limited amount of guidance provided by the Commissions in the Adopting Release is not specific enough to provide a precise allocation to all the possible scenarios of cross-product netting and collateral posting.

- **Major swap categories.** The amount is to be determined for each major swap category. The Final Rules provide for a formula to allocate net uncollateralized exposure among the relevant major swap categories *pro rata* based on the out-of-money position in each category of swap to the total out-of-the-money exposure in all categories subject to netting arrangement. The Commissions have also provided very limited guidance on the allocation formula for assigning net exposures to the categories of swaps and security-based swaps in a

footnote of the Adopting Release, but the guidance is unclear on how to allocate between swap exposures and non-swap exposures.

- **Collateral valuation.** 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. In the Adopting Release, instead of providing a precise guideline on collateral allocation, the Commissions have stated that the adopted approach is not to "require that any collateral be specifically earmarked to particular swaps or security-based swaps, and can be followed so long as collateral is posted based on the net exposure associated with all instruments subject to the applicable netting agreements with [the] particular counterparty."

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.

Risk Multipliers for Major Categories of Swaps. The "potential outward exposure" for swaps in the same category is determined by adjusting the total notional principal amounts of such swaps with the following risk 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

Risk Multipliers for Major Categories of Security-Based Swaps. The "potential outward exposure" for security-based swaps in the a category is determined by adjusting the total notional principal amounts of such security-based swaps with the following risk multipliers:

Residual maturity	Debt security-based	Other security-based
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 or security-based 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.

After one determines the potential outward exposures by applying the risk-multipliers in the tables set forth above, one can apply a further reduction to those transactions that are subject to daily marking-to-market or are cleared. In the Final Rules, with respect to transactions that are subject to daily marking-to-market, the related potential outward exposure shall benefit from a further 80% discount (*i.e.*, a further risk multiplier of 0.2). Further, with respect to transactions that are cleared by a registered or exempt clearing agency, the related potential outward exposure shall benefit from a further 90% discount (*i.e.*, a further risk multiplier of 0.1). A transaction 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 arising from the swap (after taking into account any other financial positions addressed by a netting agreement between the counterparties)." 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 (as reduced by any initial margin posted up to the amount of that threshold) is deemed part of the uncollateralized outward exposure amount.

- **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. In other words, the discount factor for netting will be somewhere between 0.4 and 1, depending on the relative amounts of potential outward exposure and 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," the Commissions have adopted 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 position 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 has also adopted as part of the Final Rules that 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."

In contrast to the proposed rules, the SEC did not adopt the requirements 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; therefore, the Final Rules do not contain any procedural requirements for a party to benefit from the hedging exclusion. In the Adopting Release and the Final Rules, the SEC has further provided examples of the use of credit default swaps and equity swaps for "hedging or mitigating commercial risks," such as use of credit default swaps in connection with the potential default of a customer, supplier or counterparty or in connection with loans made by a bank or use of equity swaps to manage the risks associated with securities held in a corporate treasury.

Generally, for the purposes of the first definition of the "major swap participant" tests, this hedging exclusion is available to all persons (including financial entities) with respect to all types of swaps.

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 Final 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 Final 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.

After taking into account the various comments they received on the ratio to define "highly leveraged," the Commissions have adopted a ratio of total liabilities to equity in excess of "12 to 1" with respect to a person, as measured at the close of business on the last day of the applicable fiscal quarter, with its 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; (c) a private fund as defined in Section 202(a) of the Investment Advisers Act of 1940; (d) an employee benefit plan as defined in paragraphs (3) and (32) of Section 3 of ERISA; and (e) 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[2] 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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[2] *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 swap 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 unless it continues to exceed the applicable thresholds in the following quarter. In adopting this grace period, the Commissions want to avoid the registration and regulation of a person that is captured by the tests for major participants for a short of period of time due to unusual swap activities.

Limited Designation as Major Swap Participants

With respect to the designation of major swap participant and major security-based swap participant, both Commissions have adopted Final Rules that a person who is captured by the "major swap participant" or "major security-based swap participant" 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. Just as for the swap dealer determination, both Commissions permit a person to apply for "limited designation" when it submits its registration application for major swap participant or major security-based swap participant or at a later time, but it is not clear what the benefit of such a limited designation would be as the Commissions require such applicant to demonstrate that it has the ability to comply with the statutory and regulatory requirements applicable to a major participant on an "entity-level," not just with respect to each transaction.

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