

CLIENT UPDATE

CFTC ISSUES INTERPRETATIONS AND NO-ACTION RELIEF REGARDING ELIGIBLE CONTRACT PARTICIPANT

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Section 2(e) of the Commodity Exchange Act (the “CEA”) provides that “[i]t shall be unlawful for any person, other than an eligible contract participant, to enter into a swap unless the swap is entered into on, or subject to the rules of, a board of trade designated as a contract market.” Earlier this year, the Commodity Futures Trading Commission (the “CFTC”) and the Securities and Exchange Commission (the “SEC”) published final rules¹ amending the definition of “eligible contract participant” (“ECP”). On October 12, 2012, the Office of General Counsel (“OGC”) of the CFTC issued a No-Action and Interpretation Letter (the “ECP Letter”) providing additional interpretative guidance of, and certain no-action relief with respect to, the application of the “eligible contract participant” (“ECP”) definition.²

¹ Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant,” 77 FR 30596 (May 23, 2012).

² CFTC Letter No. 12-17, Staff Interpretations and No-Action Relief Regarding ECP Status: Swap Guarantee Arrangements; Jointly and Severally Liable Counterparties; Amounts Invested on a Discretionary Basis; and “Anticipatory ECPs.”

This ECP Letter provided three interpretations:

- Generally, swap guarantors must be ECPs.
- Cash proceeds from a loan may be included in the calculation of total assets in determining one's ECP status.
- Generally, non-ECPs may not be jointly and severally liable for swap obligations.

In addition, this ECP Letter provided three no-action reliefs:

- A guarantor that satisfies certain conditions may guarantee swap obligations of a third party that is not an ECP.
- Under certain limited circumstances, a non-ECP could enter into a swap prior to achieving ECP status.
- In calculating the "amounts invested on a discretionary basis" for purpose of determining ECP status, one may use the same standards for calculating the amount of "investments" under the Investment Company Act of 1940 (the "ICA") for purposes of determining "qualified purchaser" status.

ECP STATUS: INTERPRETATIVE GUIDANCE

Swap Guarantors Must Be ECPs

In the adopting release of the final rules on "Further Definition of 'Swap,' 'Security-Based Swap,' and 'Security-Based Swap Agreement;' Mixed Swaps; Security-Based Swap Agreement Recordkeeping" published on August 13, 2012, the CFTC interpreted the term "swap" to include the guarantee of a swap. Based on this interpretation, OGC interpreted Section 2(e) of the CEA as requiring guarantors of a swap to also be ECPs. Therefore, OGC stated that non-ECPs cannot guarantee swap obligations, unless (1) the guaranteed swap is entered into on, or subject to the rules of, a designated contract market; (2) an order is issued pursuant to Section 4(c) of the CEA providing a swap guarantor relief from compliance with Section 2(e) of the CEA; or (3) the guaranteed swap is a "trade option" (as set forth in CFTC Regulation 32.3).

This requirement that swap guarantors be ECPs must be satisfied even if the guaranteed swap counterparties are ECPs.³ Further conversations with an OGC attorney confirmed

³ Consequently, only wholly-owned, subsidiary guarantors that are ECPs are permitted to guarantee the swap obligations of an ECP parent.

that this requirement became effective as of October 12, 2012,⁴ and that the ECP status of the guarantor must be determined each time a swap is entered into; therefore, the determination of the ECP status of each swap guarantor with respect to all guarantees is not limited to those guarantees that are entered into on or after October 12, 2012, but includes all outstanding swap guarantees that were entered into prior to October 12, 2012.

OGC provided a temporary no-action relief to a non-ECP swap guarantor and a beneficiary of such a guarantee subject to certain conditions. During the transitional period from October 12, 2012 to March 31, 2013, OGC will not recommend enforcement actions against (1) a beneficiary of a swap guaranteed by a non-ECP for violation of Section 2(e) or 13(a) of the CEA as long as the beneficiary's swap counterparty is an ECP or satisfies the terms of a no-action relief provided in the ECP Letter, or (2) a non-ECP guarantor of a swap for violation of Section 2(e) of the CEA. However, this limited no-action relief does not address the issue of whether swap guarantees provided by non-ECP guarantors are deemed to be unlawful and unenforceable as of October 12, 2012.

CASH PROCEEDS FROM A LOAN COUNT TOWARD TOTAL ASSETS

Section 1a(18)(A)(v)(I) defines an ECP to include any "corporation, partnership, proprietorship, organization, trust or other entity with total assets exceeding \$10 million" (the "Total Asset ECP Test").

In response to the question raised by a commenter as to whether purchase money loan proceeds count toward a borrower's total assets for the purposes of determining ECP status prior to the borrower using such proceeds to purchase the assets for which the loan was taken, OGC explains that to achieve ECP status under the Total Asset ECP Test, a borrower can count loan proceeds that it has received. Section 1a(18)(A)(v)(I) is a test of "total assets," not of "net assets"; therefore, an entity can qualify as an ECP when it has more than \$10,000,000 in total assets, even if it has zero or negative net worth.

NON-ECPs CANNOT BE JOINTLY AND SEVERALLY LIABLE FOR SWAP OBLIGATIONS

Generally, because non-ECPs cannot enter into swaps other than swaps on a designated contract market, ECPs and non-ECPs cannot be jointly and severally liable for swap obligations unless their arrangement benefits from a no-action relief such as the "Swap Guarantee Arrangements" no-action relief described below.

⁴ The exclusion of this interpretation from the list of interpretations and no-action positions with a commencement date of October 12, 2012, on page 15 of this ECP Letter was an oversight.

ECP STATUS: NO-ACTION RELIEF*Swap Guarantee Arrangements*

Section 1a(18)(A)(v)(II) permits an entity to qualify as an ECP if its obligations are guaranteed by certain enumerated ECPs, such as entities with total assets exceeding \$10,000,000, certain financial institutions, state-regulated insurance companies, investment companies subject to regulations under the ICA, certain regulated commodity pools, certain governmental entities and any other person that the CFTC determines to be eligible based on financial or other qualifications.

In response to a number of specific comments requesting the expansion of ECPs eligible to confer ECP status on other persons through guarantees, OGC concluded that there could be circumstances in which certain non-ECP market participants should retain their ability to manage floating interest rate risk of their loans using swaps, if their swap obligations are guaranteed by certain eligible persons. Accordingly, OGC stated that it will not recommend enforcement action against a guarantor guaranteeing the swap obligations of a third party that is not an ECP (the “Guaranteed Party”) for violation of Section 2(e) of the CEA or against a beneficiary of such a swap guarantee (the “Beneficiary”) for violation of Section 13(a) of the CEA if the following conditions are satisfied:

- Guarantor Requirements: the swap guarantor must be:
 - A corporation, partnership, proprietorship, organization, trust or other entity that has a net worth exceeding \$1 million; or
 - An indirect proprietorship⁵ that consists of an individual or, if permitted by applicable state law (of the proprietorship), individuals, with: (1) a net worth (in the aggregate across all indirect co-proprietors, where applicable state law permits proprietorship comprised of more than one individual) exceeding \$1 million; or (2) amounts invested on a discretionary basis, the aggregate of which is in excess of \$5 million (in the aggregate across all indirect co-proprietors, where applicable state law permits proprietorships comprised of more than one individual); and
- Other Requirements: with respect to the guarantor, the Beneficiary and/or the Guaranteed Party:

⁵ An “indirect proprietorship” is defined as any individual with more than \$1 million in net worth or more than \$5 million in amounts invested on a discretionary basis who operates small businesses through legal entities for creditor protection, tax efficiency or other legitimate business reasons. However, OGC specifies that the no-action relief only applies to business activities undertaken by the proprietorship or individual proprietorship and does not apply to the personal hedging activities of the individual that otherwise operates an indirect proprietorship.

- the Guaranteed Party enters into the swaps solely to manage the floating interest rate risk associated with a loan received, or reasonably likely to be received,⁶ by the Guaranteed Party in the conduct of its business;
- in the case of all guarantors (other than a proprietorship guarantor), the guarantor is an owner of the Guaranteed Party and plays an active role in operating the business of such Guaranteed Party (other than performing solely clerical, secretarial or administrative functions);
- in the case of a proprietorship guarantor, if applicable state law contemplates proprietorships with more than one proprietor, the guarantor and the Guaranteed Party are co-proprietors;
- the guarantor computes its net worth or amounts invested on a discretionary basis in accordance with generally accepted accounting principles, consistently applied (provided that the value of real property can be determined using fair market value);
- the Guaranteed Party enters into the guaranteed swap only as a principal; and
- the Beneficiary verifies that the guarantor and the Guaranteed Party satisfy the conditions of this no-action relief.

ANTICIPATORY ECPS

The CFTC has received a number of comments detailing situations in which a person may need to enter into hedging transactions in connection with a loan prior to the full funding of the loan proceeds and, as a result, may not yet qualify as an ECP under the Total Asset ECP Test at the time the initial hedging transactions are entered into. OGC has determined that if a lender has provided a borrower with a bona fide commitment to fund a loan amount greater than \$10 million or such other amount necessary for a borrower to have in excess of \$10 million in total assets to satisfy the Total Asset ECP Test, such an “anticipatory ECP” should be permitted to enter into swaps prior to the full funding of the loan proceeds to permit the borrower to manage its interest rate risk.

With respect to “anticipatory ECPs,” OGC will not recommend enforcement action against (1) a Guaranteed Party or other non-ECP swap counterparty for violation of Section 2(e) of the CEA; (2) a Guaranteed Party’s guarantor for violating Section 2(e) or 13(a); or (3) a Beneficiary or other swap counterparty to a non-ECP swap counterparty for violation of

⁶ “Reasonably likely to be received,” with respect to a loan, means the borrower has received a bona fide loan commitment or bona fide loan agreement (as defined in the ECP Letter) from the lender.

Section 13(a) in connection with a swap entered into by a borrower prior to the receipt of all proceeds of the related loan in an amount sufficient for the borrower to qualify as an ECP based on the Total Asset ECP Test, if the following conditions are satisfied:

- the swap is intended to manage the Guaranteed Party's or other non-ECP swap counterparty's floating rate interest risk on the loan;
- in the case of a swap entered into by a Guaranteed Party or other non-ECP swap counterparty to manage its floating rate interest risk on a loan that would, if disbursed, cause the Guaranteed Party or other non-ECP swap counterparty to qualify as an ECP under the Total Asset ECP Test but that has not yet closed, the Guaranteed Party or other non-ECP swap counterparty has received a bona fide commitment for such loan;
- in the case of a construction loan or other loan disbursed in stages, the lender intends at the time of making the loan, or the related loan commitment, to fund the entirety of the loan, subject only to the satisfaction of commercially reasonable closing conditions and/or the failure to occur, after loan disbursements have commenced, of any events set forth in the loan or swap documentation that would excuse the lender's obligation to continue funding the loan (e.g., the borrower's failure to make a payment), provided that such events are not designed to permit the lender to fail to fund the loan while leaving the swap in place; and
- the loan is funded in an amount causing the Guaranteed Party or other non-ECP swap counterparty to qualify as an ECP under the Total Asset ECP Test, unless it is not funded in such amount as a result of a failure to satisfy a commercially reasonable condition to the closing of the loan set forth in the bona fide loan commitment or an event set forth in the loan or swap documentation that would excuse the lender's obligation to continue funding the loan (e.g., the borrower's failure to make a payment).

In addition, OGC specified that a loan commitment is treated as bona fide if:

- the commitment is in writing,
- the loan closing is subject only to the satisfaction of commercially reasonable conditions to closing, and
- the loan commitment is entered into solely for business purposes unrelated to permit the borrower to qualify as an ECP.

OGC emphasized that this no-action relief will be applied in a way to prevent evasion, and the failure to fund loans will be scrutinized to ensure that the loan commitment was not part of a scheme to permit a non-ECP to enter into a swap in violation of Section 2(e).

Interpretation of “Amounts Invested on a Discretionary Basis”

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) amended the definition of ECP in a number of instances to replace “total assets in an amount” with “assets invested on a discretionary basis, the aggregate of which is in excess of.”

In response to comments seeking interpretative guidance with respect to “assets invested on a discretionary basis,” OGC noted that the ICA uses a similar standard for the definition of “qualified purchaser” (“QP”), providing that a QP is “any person [...] who in the aggregate owns and invests on a discretionary basis [...] not less than \$25,000,000 in investments.” Consequently, OGC has determined that it would not recommend enforcement action against a Guaranteed Party or other non-ECP swap counterparty for violating Section 2(e), against a guarantor for violating Section 2(e) or 13(a) or against a Beneficiary or other counterparty to a swap to a non-ECP swap counterparty for violating Section 13(a) if such persons use the same standards set forth in Rule 2a51-1 under the ICA⁷ to determine whether a person qualifies as an ECP based on a test that requires the calculation of “assets invested on a discretionary basis.”

EFFECTIVE DATE OF THE INTERPRETATIONS AND NO-ACTION RELIEFS

All interpretations and no-action reliefs set forth in this ECP Letter are deemed effective commencing on October 12, 2012.

As we mentioned above, no enforcement action will be taken from October 12, 2012 to March 31, 2013 against (1) a beneficiary of a swap guaranteed by a non-ECP for violation of Section 2(e) or 13(a) of the CEA as long as the beneficiary’s swap counterparty is an ECP or satisfies the terms of a no-action relief provided in the ECP Letter; or (2) a non-ECP guarantor of a swap for violation of Section 2(e) of the CEA.

In addition, to permit the swap market participants to come into compliance with the new ECP definition in an orderly manner without undue market disruption, from October 12, 2012, to December 31, 2012, OGC will not recommend enforcement action against any person for violating Section 2(e) or 13(a) of the CEA with respect to a swap entered into with a non-ECP:

- as long as the non-ECP was (1) an ECP as defined in Section 1a(12) of the CEA prior to the enactment of the Dodd-Frank Act; or (2) prior to October 12, 2012, a person eligible

⁷ ICA Rule 2a51-1 defines what instruments constitute “investments” for the determination of QP status.

to enter into an agreement, contract or transaction in reliance upon the Second Effective Date Extension Order⁸ in accordance with the terms of such order; and

- the party to a swap with a non-ECP swap counterparty is in good faith preparing to come into compliance with the new regulations on determination of whether its counterparty is an ECP (e.g., a SD or MSP in complying with the new external business conduct standards on the determination of its counterparty's eligibility under Section 23.430 of the CFTC regulations).

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Please do not hesitate to contact us with any questions.

October 22, 2012

⁸ CFTC Final Order, Second Amendment to July 14, 2011 Order for Swap Regulation (July 13, 2012) (the "Second Effective Date Extension Order").