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CFTC and SEC adopt joint final rule defining "swap dealer," "security-based swap dealer," "major swap participant" and "major security-based swap participant"

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On May 23, 2012 the Commodity Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission (the "SEC" and together with the CFTC, the "Commissions") published final rules (the "Final Rules")[1] and interpretive guidance (the "Adopting Release") under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") defining "swap dealer," "security-based swap dealer," "major swap participant," and "major security-based swap participant." The Final Rules in some cases adopt and in other cases modify the rules (the "Proposed Rules") and guidance (the "Proposing Release") proposed by the Commissions in December 2010.[2] Taking into account comments received from various commenters, the Final Rules will capture a smaller number of market participants than would have been covered by the Proposed Rules. The SEC estimates that 50 or fewer market participants will be classified as security-based swap dealers and that five – and possibly zero – market participants will be classified as major security-based swap participants. The CFTC estimates that approximately 125 market participants will be covered by the definitions of swap dealer and major swap participants.[3]

While the Final Rules will become effective on July 23, 2012, market participants are not required to register as swap dealers or major swap participants before the effective date of final rules defining "swap" and "security-based swap." On July 9, 2012, the SEC voted to adopt final rules defining, among other terms, "swap" and "security-based swap." On July 10, 2012, the CFTC adopted the same final rules. The definitional rules will be effective 60 days following publication in the federal register, which publication has not yet occurred. Market participants will not be required to register as security-based swap dealers or major security-based swap participants until dates are provided by the SEC in its final rules for registration. These rules have not been finalized yet.

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[1] Further Definition of "Swap Dealer," "Security-based Swap Dealer," "Major Swap Participant," "Major Security-based Swap Participant" and "Eligible Contract Participant," 77 Fed. Reg. 30596 (May 23, 2012), http://cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-10562a.pdf.

[2] Further Definition of "Swap Dealer," "Security-based Swap Dealer," "Major Swap Participant," "Major Security-based Swap Participant" and "Eligible Contract Participant," 75 Fed. Reg. 80174 (December 21, 2010), http://cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2010-31130a.pdf.

[3] Unless otherwise specified, references to "swap dealer" include security-based swap dealer, and references to "major swap participant" include "major security-based swap participant."

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I. SWAP DEALER AND SECURITY-BASED SWAP DEALER

The Final Rules, as in the Proposed Rules and the Dodd-Frank Act, define a "swap dealer" as any person that:

- 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 Dodd-Frank Act defines "security-based swap dealer" substantially the same, with the term "security-based swaps" replacing "swaps." Both swap dealers and security-based swap dealers will be subject to certain requirements, including registration, margin, minimum capital and business conduct.

The Final Rules provide exemptions from the requirement to register as a swap dealer for a person who enters into swaps but not as part of its "regular business" and whose swap dealing is below a *de minimis* threshold. The Final Rules also provide exemptions for swaps that, among other things, hedge physical positions, are entered into between affiliates or are in connection with a loan from an insured depository institution ("IDI").

A. Swap Dealer interpretive guidance

In determining whether a person is a swap dealer, the Commissions intend that a person should first apply the statutory definition, taking into account the interpretive guidance in the Adopting Release. The person should then exclude from the swap dealer determination any swaps that do not arise from swap dealing (e.g., swaps hedging physical positions). Third, if the person determines that it is engaged in swap dealing, it should determine whether its swap dealing activity exceeds the *de minimis* threshold. Only if its activities exceed such threshold will the person be subject to regulation as a swap dealer.

1. Dealer-trader distinction

The Commissions believe that the "dealer-trader" distinction used to identify which persons are "dealers" under the Securities Exchange Act of 1934 (the "Exchange Act") provides the appropriate basic framework for interpreting the definition of swap dealer. While there are differences between the definitions of "dealer" under the Exchange Act and "swap dealer" under the Dodd-Frank Act, "their parallels…warrant analogous interpretive approaches for distinguishing dealers from non-dealers" and the Commissions believe that the dealer-trader distinction can be adapted here with certain modifications. The Commissions do not intend to codify the dealer-trader distinction in the Final Rules.

The Commissions noted that the following activities, which are indicative of dealing activity in the application of the dealer-trader distinction, are indicative that a person is acting as a swap dealer:

- providing liquidity by accommodating demand for or facilitating interest in swaps or security-based swaps;
- holding oneself out as being willing to enter into swaps or being known in the industry as being available to accommodate demand for swaps;
- advising a counterparty as to how to use swaps to meet the counterparty's hedging goals or structuring swaps on behalf of a counterparty;
- having a regular clientele and actively advertising or soliciting clients in connection with swaps;
- acting in a market-maker capacity on an organized exchange or trading system for swaps; or

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- helping to set the prices offered in the market rather than taking those prices (although the fact that a person regularly takes the market price does not foreclose the possibility that the person may be a swap dealer).

Because the Commissions are employing an interpretive approach to the determination of swap dealers, whether a person is acting as a swap dealer will turn on the facts and circumstances applicable to each person.

2. "Holding oneself out as a Dealer in Swaps" or being "commonly known in the trade as a dealer"

The Final Rules provide that a swap dealer is a person who "holds itself out as a dealer in swaps" or is "commonly known in the trade as a dealer or market-maker in swaps." The Proposing Release identified a number of factors as indicia that a person satisfied these prongs of the swap dealer definition and the Commissions believe these continue to be relevant to the determination. The indicia include:

- contacting potential counterparties to solicit interest in swaps;
- developing new types of swaps and informing potential counterparties of their availability and of the person's willingness to enter into the swaps;
- membership in a swap association (e.g., ISDA) in a category reserved for dealers;
- providing marketing materials describing the type of swaps the party is willing to enter into; and
- expressing a willingness to offer or provide a range of products or services that include swaps.

Comments received in response to the Proposing Release noted that commercial end users could trigger these factors. For example, end users often seek out and negotiate swaps. Taking these comments into account, these factors are not per se conclusive of swap dealing and should be considered in the context of all of a person's activities.

3. "Market-making"

In response to some of the comments received in response to the Proposing Release, the Adopting Release clarifies that "making a market in swaps" can be described as "routinely standing ready to enter into swaps at the request or demand of a counterparty." "Routinely" means that the person must do so more frequently than occasionally, but there is no requirement that the person do so continuously. Many comments sought guidance regarding which activities are indicative of "routinely standing ready," and the Adopting Release provides the following non-exclusive list:

- quoting bid or offer prices, rates or other financial terms for swaps on an exchange;
- 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;
- placing limit orders for swaps; or
- receiving compensation for acting in a market-maker capacity on an organized exchange or trading system for swaps.

The dealer-trader distinction is useful in this determination. Under the dealer-trader distinction, seeking to profit by providing liquidity to the market is an indication of dealer activity. The Commissions believe that the determination should consider whether a person is seeking 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 the person is not seeking such compensation, these activities would not be indicative of market-making. The Commissions disagreed with those commenters who stated that being a market-maker in swaps requires a person to make a two-way market in swaps and that swaps executed on an exchange should be disregarded in the swap dealer determination.

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B. Exceptions from swap dealer

The Final Rules provide certain exceptions from the designation as a swap dealer. A person who satisfies the definition of swap dealer may nevertheless not be required to register as a swap dealer or follow the regulations applicable to swap dealers if it can make use of one or more of the exceptions. These exceptions include, among other things, (i) activities not part of a “regular business”; (ii) swaps entered into in connection with certain loans from IDIs; and (iii) swaps entered into between affiliates.

1. Exception for swap dealing activities not part of a “regular business”

In keeping with the Proposing Release, the Commissions consider the phrases “ordinary course of business” and “regular business” to be essentially synonymous and the 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. 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” business or an “ancillary” business, so long as the person’s swap dealing business is identifiable. The Adopting Release lists the following activities as indicative of entering into swaps as both “an ordinary course of business” and “as a part of a regular business”:

- entering into swaps with the purpose of satisfying the business or risk management needs of the counterparty (as opposed to entering into swaps to accommodate one’s own demand or desire to participate in a particular market);
- maintaining a separate profit and loss statement reflecting the results of swap activity or treating swap activity as a separate profit center; or
- having staff and resources allocated to dealer-type activities with counterparties, including activities relating to credit analysis, customer onboarding, document negotiation, confirmation generation, requests for novations and amendments, exposure monitoring and collateral calls, covenant monitoring, and reconciliation.

The Commissions recognize that some end users may have staff and resources dedicated to these activities and, therefore, believe this factor should be applied in a reasonable manner, taking into account all appropriate circumstances. This factor does not depend on a specific percentage of staff or resources being dedicated to dealer-type activities, but using staff and resources to a significant extent in conducting credit analysis, opening and monitoring accounts and the other activities listed above is indicative that the person is engaged in “a regular business” of entering into swaps.

2. Exclusion for swaps in connection with originating a loan

The Final Rules exclude from the definition of swap dealer an IDI to the extent it offers to enter into a swap with a customer in connection with originating a loan (using the common law meaning of “loan” and including 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) to that customer. Note that this exclusion does not appear in the definition of security-based swap dealer. The Adopting Release clarifies that only swaps that are directly connected with the IDI’s process of originating a loan to a customer would be excluded. The exclusion will not apply to swaps where the purpose of the swap is not linked to the financial terms of the loan, where the IDI enters into a “sham” loan or where the loan is actually a synthetic loan such as a loan credit default swap or loan total return swap.

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The exclusion will apply to a swap that is entered into within 90 days before or 180 days after (i) the date of execution of the loan agreement or (ii) any transfer of principal (i.e., a draw of principal) to the borrower from the IDI pursuant to the loan, so long as the aggregate notional amount of the swaps is at no time more than aggregate borrowings under the loan and the tenor of the swap does not extend beyond the termination of the loan. The IDI must be the source of money to the borrower either directly or the source of at least 10% of the entire amount of the loan if through a syndicate, participation or assignment. The IDI must report the swap to a swap data repository ("SDR").

The exclusion is available in situations where the IDI requires the borrower to enter into a swap and where the customer asks the IDI to enter into a swap.

3. Exclusion for inter-affiliate swaps

The Final Rules provide an exclusion from the dealer definitions for swaps between persons who are majority-owned affiliates. Counterparties are majority-owned affiliates if one party directly or indirectly holds a majority ownership interest in the other party or if a third party directly or indirectly holds a majority interest in both. A "majority interest" is the "right to vote or direct the vote of a majority of a class of voting securities of an entity, the power to sell or direct the sale of a majority of a class of voting securities of an entity, or the right to receive upon dissolution or the contribution of a majority of the capital of a partnership."

C. *De minimis* exception

The Dodd-Frank Act requires that the Commissions exempt from designation as a swap dealer or security-based swap dealer any entity "that engages in a *de minimis* quantity" of dealing "in connection with transactions with or on behalf of customers."

Responding to comments that the *de minimis* thresholds in the Proposing Release were set too low, the Commissions substantially increased the thresholds except in connection with swaps entered into with "special entities," in addition to eliminating restrictions on the number of counterparties and swaps. A "special entity" is a Federal agency, State, State agency, city, county, municipality, other political subdivision of a State, employment benefit plan, government plan or endowment. The Final Rules provide that a person is exempt from the definition of swap dealer or security-based swap dealer where the aggregate effective notional amount of dealer activity (including dealer activity by such person controlling, controlled by or under common control with such person) over the preceding 12 months (subject to the phase-in described below) does not exceed:

- with respect to swaps, $3 billion subject to a phase-in level of $8 billion;
- with respect to security-based swaps that are credit default swaps, $3 billion subject to a phase-in level of $8 billion;
- with respect to security-based swaps that are not credit default swaps, $150 million subject to a phase-in level of $400 million; and
- with respect to swaps or security-based swaps entered into with "special entities," $25 million.

The thresholds only look at activity that would be dealing activity. Thus, for example, swaps between affiliates would not be counted towards a person's threshold, not would swaps entered into by an IDI in connection with a loan.

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1. Notional amounts

Consistent with the Proposing Release, the notional amounts of a person's swaps must be based on the "effective notional" amounts when the stated notional amount is leveraged or enhanced by the structure of the swap or security-based swap. In addition, when calculating its notional amounts, a person may not take into account netting or collateral offsetting arrangements.

2. Phase-in period

To allow the markets to familiarize themselves with the regulations and give dealers time to adjust their business practices, the *de minimis* thresholds are subject to a phase-in period prior to the permanent thresholds taking effect. During the phase-in period, the *de minimis* threshold applicable to (i) swaps and security-based swaps that are credit default swaps is $8 billion over the preceding 12 months and (ii) security-based swaps that are not credit default swaps is $400 million over the preceding 12 months. There is no phase-in period for *de minimis* thresholds applicable to special entities.

3. Grace period

If a person is no longer able to rely on the *de minimis* threshold exemption because its dealing activities have exceeded the relevant threshold, such person will have two months, following the end of the month in which it is no longer able to rely on the exemption, to submit a completed application to register as a swap dealer or security-based swap dealer.

4. Withdrawal of registration

To ensure that persons are not required to move in and out of dealer status based on short-term fluctuations in their dealing activities, a person registered as a swap dealer may apply to withdraw its registration, while continuing to engage in a limited amount of dealing activity in reliance on the *de minimis* exception, if that person has been registered as a dealer for at least twelve months.

D. Limited purpose designation and floor traders

The Final Rules retain the presumption from the Proposed Rules that a person who meets one of the dealer definitions will be deemed to be a dealer with respect to all of its swap or security-based swap activities. A person may apply for a limited designation when it submits its registration application, or at a later time, and the CFTC or SEC may choose to exercise its authority to limit such person's designation as a dealer to specified categories of swaps or security-based swaps or to specified activities. The Commissions will consider such limited designation applications on a case-by-case basis, but will not designate a person as a limited purpose dealer unless it can demonstrate that it can fully comply with the requirements applicable to dealers, including the preparation and recordkeeping of trading records, documentation and confirmations and requirements related to registration, capital, risk management, supervision and chief compliance officers.

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II. MAJOR SWAP PARTICIPANTS AND MAJOR SECURITY-BASED SWAP PARTICIPANTS

The Commissions adopted the definitions of "major swap participant" and "major security-based swap participant" (together, "major participants") as set forth in the Dodd-Frank Act. A "major swap participant" is a person, other than a dealer, that meets any of the following tests:

- that maintains a substantial position in swaps or security-based swaps for any of the major swap or security-based swap categories as determined by the CFTC or SEC, as applicable, excluding positions held for hedging or mitigating commercial risk, and positions maintained by any employee benefit plan (or any contract held by such 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 or security-based swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or
- that is a financial entity that (i) 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 (ii) maintains a substantial position in outstanding swaps or security-based swaps in any major swap or security-based swap category as determined by the CFTC or SEC, as applicable.

While the calculations used to determine a person's status as a major swap participant are substantially similar to those in the Proposing Release, the Commissions have responded to commenters and included three safe harbors from the major swap participant designation. The CFTC anticipates that only six entities will be required to register as major swap participants and the SEC anticipates that fewer than five (and possibly zero) entities will be required to register as major security-based swap participants.

A decision tree that analyzes the dealer and major participant designations is attached at Annex A.

A. Major swap and security-based swap categories

The first and third tests in determining whether a person is a major swap participant require the person first to assign all of its swaps or security-based swaps into the appropriate major categories of swaps and securities-based swaps. The Commissions have adopted the categories set forth in the Proposing Release and stated that they believe any further parsing of categories would only result in confusion among market participants. Mixed swaps should be placed in the category of swaps or security-based swaps that are consistent with the underlying attributes that cause such instrument to be a mixed swap. Swaps and security-based swaps that are based on more than one item, instrument or risk should be placed in the category that most closely describes the primary underlying item, instrument or risk.

1. Major swap categories

The CFTC adopted Final Rules creating the following four major categories of swaps for use in the definition of "major swap participant":

- **Rate swaps.** Any swap that is primarily based on one or more reference rates, including swaps of payments determined by fixed and floating interest rates, currency exchange rates, inflation rates or other monetary rates, any foreign exchange swap and any foreign exchange option other than an option to deliver currency.

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- **Credit swaps.** Any swap that is primarily based on default, bankruptcy and other credit-related risks related to, or the total returns on, instruments of indebtedness (including loans), 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 a broad-based index credit default swap or total return swap.
- **Equity Swaps.** Any swap that is primarily based on equity securities, such as any swap primarily based on one or more broad-based indices of equity securities, including any total return swap on one or more broad-based equity indices.
- **Other commodity swaps.** Any swap not included in any of the first three categories, such as any swap for which the primary underlying item is a physical commodity or the price or any other aspect of a physical commodity.

2. Major security-based swap categories

The SEC adopted Final Rules creating the following two major categories of security-based swaps for use in the definition of "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 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 swaps, or debt index swaps.
- **Other security-based swaps.** Any security-based swap that is not a debt security-based swap.

B. Substantial position in swaps or securities-based swaps, excluding certain hedging positions

Under the first major swap participant and major security-based swap participant tests, a person will qualify as a major participant if it maintains a "substantial position" (subject to certain exclusions) in any of the major swap or security-based swap categories. Whether a person maintains a substantial position is based on a two-part test that examines the person's "aggregate current uncollateralized exposure" to its counterparties and its "aggregate potential future exposure" to its counterparties.

1. Calculation of substantial position

Under the two-part test, a person will have a substantial position if the amount of its swaps or securities-based swaps exceed certain specified thresholds in either part of the test. The first part of the test examines whether the person's "aggregate uncollateralized outward exposure" (i.e., its uncollateralized, out-of-the-money positions) 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.

The second part of the test examines whether the sum of the person's (i) aggregate uncollateralized outward exposure and (ii) "aggregate potential outward exposure" (i.e., the potential exposure of the person's swap and security-based swap positions) exceeds the following thresholds:

- **Rate swaps:** $6 billion or more in the sum of the daily average aggregate uncollateralized outward exposure

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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 the daily average aggregate uncollateralized outward exposure and daily average aggregate potential outward exposure.

a. Aggregate uncollateralized outward exposure

A person determines its aggregate uncollateralized outward exposure by calculating, for each major category of swaps or security-based swaps and for each of its counterparties, the dollar value of its aggregate current exposure arising from each of its swap or security-based swap positions with a negative value in that major category of swaps or security-based swaps by marking-to-market using industry standard practices, net of the aggregate value of collateral the person has posted with respect to those swaps or security-based swaps and taking into account any applicable netting arrangements.

b. Aggregate potential outward exposure

A person's potential outward exposure is the potential exposure of the person's swap or security-based swap positions in the applicable major category of swaps or security-based swaps, subject to certain adjustments. The intent of this calculation is to identify market participants who could pose a high level of risk but whose current uncollateralized outward exposure would not subject them to regulation as major participants. The Final Rules provide different adjustments for swaps that are cleared, marked-to-market daily and subject to netting arrangements. In addition, certain types of swaps and security-based swaps are excluded entirely from the calculation.

For swaps or security-based swaps that are not subject to daily mark-to-market margining or are not cleared by a registered or exempt clearing agency or DCO, the potential outward exposure equals the total notional principal amount of those positions multiplied by risk multiples that vary according to the tenor and types of swaps or security-based swaps (e.g., swaps with a longer maturity have a lower multiple and credit derivatives have a higher multiple than interest rate swaps). The exact multiples are set forth in the decision tree attached at Annex A.

If the person has a master netting agreement with a counterparty, the potential outward exposure is reduced by the ratio of net current exposure to gross current exposure.

2. Hedging or mitigating commercial risks

The first test of the major participant definitions excludes positions held for "hedging or mitigating commercial risk" from the substantial position analysis. The Final Rules maintain the Commissions' original proposal that the exclusion be available to both non-financial entities and financial entities.

a. Major swap participants

Whether a swap hedges or mitigates commercial risk must be made by analyzing the facts and circumstances at the time the swap is entered into and also by looking at the person's hedging and risk control strategies. Swaps may be excluded from the determination of "substantial position" where:

- the swap is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise (or a majority-owned affiliate of the enterprise), where the risks arise from the potential change in the value of the following items in the ordinary course of business of such enterprise:

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- 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 in the ordinary course of business of the enterprise,
  - assets, services, inputs, products or commodities that it does, or reasonably anticipates it will, own, produce, manufacture, process, merchandise, lease, or sell in the ordinary course of business of the enterprise, or
  - in relation to any of the foregoing, any 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 a person's current or anticipated assets or liabilities;
- the swap qualifies as bona fide hedging for purposes of an exemption from position limits under the CEA; or
- the swap qualifies for hedging treatment under Government Accounting Standards Board Statement 53, Accounting and Financial Reporting for Derivative Instruments or Financial Accounting Standards Board Accounting Standards Codification Topic 815, Derivatives and Hedging (formerly known as FASB Statement No. 133).

Swaps that are held for the purpose of speculation, investing or trading are not eligible for the exclusion. Swaps held primarily to take an outright view on market direction, including positions held for short term resale or to obtain arbitrage profits, will be treated as being held for speculation, investing or trading. In addition, the exclusion is not available for swap positions that hedge or mitigate the risk of another swap or security-based swap position unless that other swap or security-based swap position is held for hedging or mitigating commercial risk.

b. Major security-based swap participants

Security-based swaps may be excluded from the determination of "substantial position" where the security-based swap:

- is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where the risks arise from the potential change in the value of:
  - assets that a person owns, produces, manufactures, processes, or merchandises in the ordinary course of business of the enterprise; or
  - liabilities that a person has incurred or reasonably anticipates incurring in the ordinary course of business of the enterprise; or
  - services that a person provides, purchases, or reasonably anticipates providing or purchasing in the ordinary course of business of the enterprise.

Consistent with the Proposing Release, the SEC interprets "economically appropriate" to mean that the security-based swap position cannot materially over-hedge the underlying risk such that the hedge could have a speculative effect, and that the hedging position cannot introduce any new basis risk or other type of risk (other than counterparty risk) to a degree greater than is necessary to manage the risk.

The Final Rules incorporate examples of security-based swap positions that, based on the applicable facts and circumstances, may satisfy the "economically appropriate" standard. These examples are:

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- positions established to manage default risk posed by a customer, supplier or counterparty in connection with (i) financing provided to a customer in connection with the sale of real property or a good, product or service; (ii) a customer's lease of real property or a good, product or service; (iii) a customer's agreement to purchase real property or a good, product or service in the future; or (iv) a supplier's commitment to provide or sell a good, product or service in the future;
- positions established to manage a financial counterparty's default risk with respect to a separate transaction;
- positions established to manage equity or market risk associated with stock-based employee compensation plans;
- positions established to manage equity price risks with respect to certain business combinations;
- positions established by a bank to manage counterparty risks in connection with loans it has made; and
- positions to close out or reduce any of the above positions.

As with swaps, security-based swaps that are held for the purpose of speculation, investing or trading are not eligible for the exclusion, nor are security-based swap positions that hedge or mitigate the risk of another swap or security-based swap position unless that other swap or security-based swap position is held for hedging or mitigating commercial risk.

Procedural requirements. In contrast to the Proposed Rules, the Final Rules do not require that a person identify and document the risks it is hedging and evaluate the effectiveness of its hedges from time to time. The Adopting Release does note, however, that such supporting documentation could help support a person's contention that its security-based swap positions should be excluded, should the legitimacy of the exclusion become an issue.

c. Hedging of affiliates' positions

The hedging or mitigating of commercial risks extends to the hedging of risks of a person's majority-owned affiliates. The Commissions adopted this position to reflect the reality that many corporate organizations use a single entity to face the market and engage in hedging activities. The exclusion still will only be available for those positions that would have been eligible for the exclusion if the affiliate had entered into the swap or security-based swap on its own.

3. Exclusion for positions held by ERISA plans

The first test of the major participant definition excludes swap and security-based swap positions maintained by any employee benefit plan as defined in paragraphs (3) and (32) of section 3 of ERISA. The ERISA hedging exclusion is broader than that test's commercial risk hedging exclusion. Nevertheless, the Commissions state in the Adopting Release that they expect swap or security-based swap positions to have a primary purpose of hedging or mitigating risks directly associated with the operation of the types of plans identified in the statutory definition. The exclusion is also available to trusts or pooled vehicles that hold plan assets in conjunction with other assets, but only to the extent that the entity enters into swap or security-based swap positions for the purpose of hedging risks associated with the plan assets. The exclusion does not extend to positions that hedge risks of other assets, even if those are managed in conjunction with plan assets.

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C. Substantial counterparty exposure

Under the second major participant test, a person will qualify as a major participant if its outstanding swap or security-based swap positions are 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." The calculations for this test are done identically to those for the "substantial position" test, except that this test looks at a person's positions across all of the major categories and there are no exclusions for positions that hedge or mitigate commercial risk or hedge or mitigate risks directly associated with the operation of ERISA plans.

Under the CFTC's Final Rules, a person will qualify as a major swap participant if (i) its daily average aggregate uncollateralized outward exposure across all major swap categories exceeds $5 billion or (ii) the sum of its daily average aggregate uncollateralized outward exposure and daily average uncollateralized potential outward exposure across all major swap categories exceeds $8 billion.

Under the SEC's Final Rules, a person will qualify as a major swap participant if (i) its daily average aggregate uncollateralized outward exposure across all major swap categories exceeds $2 billion or (ii) the sum of its daily average aggregate uncollateralized outward exposure and daily average uncollateralized potential outward exposure across all major swap categories exceeds $4 billion.

D. Highly leveraged financial entity with a substantial position in swaps or security-based swaps

Under the third major participant test, a person will qualify as a major participant if it is a "highly leveraged" "financial entity" that is not subject to the capital requirements of a Federal banking agency and holds and maintains substantial positions in swaps or security-based swaps. As with the second major participant test, this third test does not provide exclusions for positions that hedge or mitigate commercial risk or hedge or mitigate risks directly associated with the operation of ERISA plans.

1. "Highly leveraged"

A person will be considered to be "highly leveraged" where the ratio of its liabilities to equity exceeds 12 to 1, as determined in accordance with U.S. generally accepted accounting principles as of the last business day of a fiscal quarter. This differs from the approaches offered in the Proposing Release which had ratios of 8 to 1 and 15 to 1. The Adopting Release notes that the ratio of 12 to 1 was adopted in consideration of the broker-dealer capital regulations that apply special provisions when a broker-dealer's leverage exceeds 12 to 1.

2. "Financial entity"

Under the Final Rules, a "financial entity" is any of the following: (i) a swap dealer or security-based swap dealer; (ii) a major swap participant or major security-based swap participant; (iii) a commodity pool as defined in section 1a(10) of the CEA; (iv) a private fund as defined in section 202(a) of the Investment Advisers Act of 1940; (v) an employee benefit plan as defined in paragraphs (3) and (32) of section 3 of ERISA; and (vi) 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.

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3. Subject to capital requirements

The Adopting Release clarifies that the phrase "subject to capital requirements established by an appropriate Federal banking agency" applies only to persons for whom a Federal banking agency directly sets banking requirements and does not apply to persons who are part of a holding company that is subject to those capital requirements.

E. Additional issues

1. Inter-affiliate swaps and security-based swaps

The Final Rules for determining a person's major participant status do not include a person's swaps or security-based swaps where the counterparty is a majority-owned affiliate. The Commissions took into account commenters' views and concluded that companies use inter-affiliate swaps for a variety of purposes and such swaps do not pose a high likelihood of risk to the broader market.

2. Application to positions of affiliated entities and guarantees

The Commissions, in response to comments, have provided guidance on the attribution of swap positions among affiliated entities. In a change from the Proposing Release, the Commissions now believe that a subsidiary's swaps should not necessarily be attributed to its parent. A subsidiary's swaps should only be attributed to its parent, another affiliate or a guarantor for purposes of the major participant analysis to the extent that the counterparties to those swap positions would have recourse to that other entity in connection with those swap positions. Further, even in the presence of a guarantee, it is not necessary to attribute a person's swap or security-based swap positions to a parent or other guarantor if the person already is subject to capital regulation by the CFTC or SEC (i.e., swap dealers, security-based swap dealers, major swap participants, major security-based swap participants, futures commission merchants and broker-dealers).

F. Major participant safe harbors

The Commissions have included three safe harbors for persons whose swap or security-based swap positions are so substantially below the major participant thresholds that they will not be required to conduct the various daily and quarterly determinations necessary for the major participant tests. Any person that satisfies one of the safe harbors will not be deemed to be a major participant.

1. First safe harbor: caps on uncollateralized exposure and notional positions

A person will not be deemed to be a major participant if the terms of the person's swap or security-based swap contracts with its counterparties at no time would permit the person to maintain a total uncollateralized exposure of more than $100 million to all such counterparties (including any exposure that may result from the application of thresholds or minimum transfer amounts established by credit support annexes or similar arrangements) and the person does not maintain notional amounts of more than $2 billion in any major category of swaps or security-based swaps or more than $4 billion in the aggregate.

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2. Second safe harbor: caps on uncollateralized exposure plus monthly calculations

A person will not be deemed to be a major participant if the terms of the person's swap or security-based swap contracts with its counterparties at no time would permit the person to maintain a total uncollateralized exposure of more than $200 million to all such counterparties (including any exposure that may result from the application of thresholds or minimum transfer amounts) and the person performs the "substantial position" and "substantial counterparty" calculations of the major participant test as of the end of every month (these calculations are not a daily average, but rather are just as of that day), and the results of those monthly calculations indicate that the person's swap or security-based swap positions are no more than (i) $1 billion in aggregate uncollateralized outward exposure plus aggregate potential outward exposure in any major category of swaps (excluding positions held for hedging and mitigating commercial risk) or (ii) $2 billion in aggregate uncollateralized outward exposure plus aggregate potential outward exposure (without any exclusions).

3. Third safe harbor: low uncollateralized outward exposure

A person will not be deemed to be a major participant if at the end of each month, the person's aggregate uncollateralized outward exposure with respect to its swap or security-swap positions in each major category of swaps or security-based swaps is less than $500 million (or less than $1.5 billion with respect to the rate swap category) and at the end of each month, for each major category of swaps or security-based swaps, the sum of: (i) the person's aggregate uncollateralized outward exposure with respect to its swap or security-based swap position in the applicable major category, and (ii) the total notional principal amount of the person's swap or security-based swap positions in the category (adjusted on a position-by-position basis by the CFTC's or SEC's multipliers) as appropriate, is less than $1 billion (or less than $3 billion in the rate swap category).

The Final Rules include an alternative simplified version of this third safe harbor test. Under this simplified test, a person will not be deemed to be a major participant if at the end of each month, the person's aggregate uncollateralized outward exposure with respect to its swap or security-based swap positions across all major categories of swaps or security-based swaps is less than $500 million and at the end of each month, the sum of (i) the person's aggregate uncollateralized outward exposure with respect to its swap or security-based swap positions across all major categories of swaps or security-based swaps, and (ii) the product of (x) the total effective notional principal amount of the person's swap or security-based swap positions and (y) (A) 0.15 for swaps or (B) 0.10 for security-based swaps, is less than $1 billion.

The aggregate uncollateralized outward exposure for positions held with swap dealers is the exposure reported on the most recent reports received from such swap dealers. For positions not held with swap dealers, exposure should be calculated as it is normally calculated under the "substantial positions" test.

G. Limited designation as a major participant

A person who satisfies the definition of a major participant will be deemed to be a major participant for all major categories of swaps or security-based swaps. A person may apply for a limited designation for only the major category or categories in which it meets the major participant designation, but the person will need to demonstrate that it has the ability to comply with the requirement of a major participant in all categories. Thus, it is unclear what the benefit would be for a limited designation.

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III. EFFECTIVE DATE AND IMPLEMENTATION

The Final Rules become effective on July 23, 2012. Any requirement to register as a dealer or major participant, however, will not be effective until the Commissions adopt other final rules, including those rules defining "swap" and "security-based swap." On July 9, 2012, the SEC voted to adopt final rules defining, among other terms, these terms. On July 10, 2012, the CFTC did the same. It is expected that the effective date of provisions in the Final Rules that specifically relate to "swap" will be 60 days following publication in the federal register of the "swap" and "security-based swap" definition rules. These rules have not yet been published in the federal register. Persons will not be required to register as security-based swap dealers or major security-based swap participants until dates are provided by the SEC in its final rules for registration. These rules have not been finalized yet.

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ANNEX A

Decision tree for swap dealer/major swap participant

1. Does the person have any swaps with “special entities”?

   If no, go to question #2.

   If yes, are its swaps with special entities ≤ $25 million aggregate notional amount?

   If > $25 million with special entities, no *de minimis* swap dealer exception.
   If ≤ $25 million, go to question #2.

2. Is the aggregate notional amount of swaps with all counterparties ≤ $8 billion (in 2012; may reduce to $3 billion by 2017)

   If ≤ $8 billion, can use swap dealer *de minimis* exception, go to question #6.

   If > $8 billion, go to question #3.

3. Are swaps entered into by an insured depositary institution in connection with loans to customers?

   If connected with loans, not a swap dealer, go to question #6.

   If not connected with loans, go to question #4.

4. Are the swaps entered into for purposes of hedging physical positions?

   If hedging physical positions, not a swap dealer, go to question #6.

   If not hedging physical positions, go to question #5.

5. Are the swaps entered into by floor traders?

   If entered into by floor traders, the person is not a swap dealer, go to question #6.

   If not entered into by floor traders and meets statutory definition, the person is a swap dealer.

6. What is the maximum “potential uncollateralized exposure”?

   If the maximum potential uncollateralized exposure ≤ $100 million, go to question #7.

   If the maximum potential uncollateralized exposure > $100 million, but ≤ $200 million, go to question #8.

   If the maximum potential uncollateralized exposure > $200 million, go to question #9.

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7. What is the maximum notional amount of swap positions?

   If the maximum notional amount of swap positions > $2 billion in any major category of swaps or $4 billion in the aggregate across all major categories of swaps, go to question #8.

   If the maximum notional amount of swap positions ≤ 2 billion in any major category of swaps or $4 billion in the aggregate across all major categories of swaps, the person is not a major swap participant.

8. Calculations required to determine if the person has a "substantial position" in swaps or substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets.

   (A) Aggregate uncollateralized outward exposure is the sum of the following across all of the person's swap counterparties in the applicable major swap category:

   (i) the dollar value of swap positions with negative value (subject to netting provisions) in each category with respect to each counterparty by marking-to-market using standard industry practices and applying netting provisions, minus

   (ii) the aggregate value of the collateral posted by the person with respect to the swap positions.

   Master netting agreements between the person and a counterparty may be taken into account for offsetting positions involving swaps (in any swap category), security-based swaps and securities financing transactions (securities lending and borrowing, securities margin lending and repo and reverse repo agreements) and other financial instruments that are subject to netting offsets for purposes of applicable bankruptcy law if permitted under the master netting agreements.

   (B) **Aggregate potential outward exposure** is the sum of the person's aggregate potential outward exposure for all of its swaps and security-based swaps in the applicable major swap category.

   (i) (A) For swaps that are not subject to daily mark-to-market margining and are not cleared by a registered or exempt clearing agency or derivatives clearing organization, potential outward exposure equals total notional principal amount of those positions multiplied by the following conversion factors on a position-by-position basis:

Conversion factors for swaps:

Residual Maturity	Interest Rate	FX and Gold	Precious Metals (except gold)	Other Commodities
One year or less	0.00	0.01	0.07	0.10
Over one year to five years	0.005	0.05	0.07	0.12
Over five years	0.015	0.075	0.08	015

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

Conversion factors for security-based swaps:

Residual Maturity	Debt	Equity and Others
One year or less	0.10	0.06
Over one year to five years	0.10	0.08
Over five years	0.10	0.10

If a swap is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the market value of the swap is zero, the remaining maturity equals the time until the next reset date.

(B) If the person has a master netting agreement with a counterparty, the potential outward exposure is reduced by the ratio of net current exposure to gross current exposure in accordance with the following formula:

$P_{Net} = 0.4 * P_{Gross} + 0.6 * NGR * P_{Gross}$

Where,
P_{Net} = potential outward exposure adjusted for bilateral netting
P_{Gross} = potential outward exposure without adjustment for bilateral netting
NGR = ratio of net current exposure to gross current exposure

(ii) For swaps that are subject to daily mark-to-market margining or that are cleared by a registered or exempt clearing agency or derivatives clearing organization, the potential outward exposure (as calculated above in (i)(A)) is multiplied by (1) 0.1 in the case of positions cleared by a registered or exempt clearing agency or (2) 0.2 in the case of positions that are subject to daily mark-to-market margining but that are not cleared by a registered or exempt clearing agency.

A swap is subject to daily mark-to-market margining if the counterparties follow the daily practice of exchanging collateral to reflect changes in the current exposure arising from the swap.

If the person is permitted to maintain a threshold for which it is not required to post collateral, the total amount of the threshold, less any initial margin posted up to the amount of that threshold, will be added to the entity's aggregate uncollateralized outward exposure.

(iii) Potential outward exposure calculations exclude:
- Positions that constitute the purchase of an option, if the purchaser has no additional payment obligations under the position;
- Other positions for which the person has prepaid or otherwise satisfied all of its payment obligations; and

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- Positions for which, pursuant to law or a regulatory requirement, the person has assigned an amount of cash or U.S. Treasury securities that is sufficient at all times to pay the entity's maximum possible liability under the position, and the person may not use that cash or those Treasury securities for other purposes.

9. Does the person have a "substantial position" in swaps? What is the daily average aggregate uncollateralized outward exposure in each major swap category? Note: The aggregate uncollateralized outward exposure for this test excludes swaps held for hedging or mitigating commercial risk and most swaps held by ERISA plans.

If this aggregate uncollateralized outward exposure in each major swap category > substantial position threshold in such category, the person is a major swap participant.

If this aggregate uncollateralized outward exposure in each major swap category < substantial position threshold in such category, go to question #10.

Substantial position threshold:

Rate swaps - $3 billion
Credit swaps - $1 billion
Equity swaps - $1 billion
Other commodity swaps - $1 billion

A swap is held for hedging or mitigating commercial risk if it:

(A) Is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise where the risks arise from:
    (i) Potential change in value of assets that the person owns, produces, manufactures, processes or merchandises or reasonably anticipates doing any of the foregoing in the ordinary course of its business;
    (ii) Potential change in value of liabilities that the person has incurred or reasonably anticipates incurring in the ordinary course of its business;
    (iii) Potential change in value of services that the person has incurred or reasonably anticipates incurring in the ordinary course of its business;
    (iv) The potential change in the value of assets, services, inputs, products, or commodities that the entity owns, produces, manufactures, processes, merchandises, leases, or sells, or reasonably anticipates owning, producing, manufacturing, processing, merchandising, leasing, or selling in the ordinary course of business of the enterprise;
    (v) Potential change in value related to any of the foregoing arising from interest, currency or foreign exchange rate movements associated with such assets, liabilities, services, inputs, products or commodities; or
    (vi) Any fluctuation in interest, currency or foreign exchange rate exposure arising from the person's current or anticipated assets or liabilities;
(B) Qualifies as bona fide hedging for purposes of an exemption from position limits under the CEA; or
(C) Qualifies for hedging treatment under FASB 815 (formerly Statement No. 133) or GASB 53;

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And such swap is not held:

(D) For a purpose that is in the nature of speculation, investing or trading; or
(E) To hedge or mitigate the risk of another swap or security-based swap position unless that position itself is held for the purpose of hedging or mitigating commercial risk.

10. Does the person have a "substantial position" in swaps? What is the daily average aggregate uncollateralized outward exposure (from question #9) plus the "daily average aggregate potential outward exposure" in each major swap category?

    If the daily average aggregate uncollateralized outward exposure + the daily average aggregate potential outward exposure > combined substantial position threshold for that swap category, the person is a major swap participant.

    If the daily average aggregate uncollateralized outward exposure + the daily average aggregate potential outward exposure ≤ combined substantial position threshold for that swap category, go to question #11.

    Combined substantial position threshold:

    Rate swaps - $6 billion
    Credit swaps - $2 billion
    Equity swaps - $2 billion
    Other commodity swaps - $2 billion

11. Does the person have "substantial counterparty exposure" that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets? What is the daily average aggregate uncollateralized outward exposure? Note: This test does not exclude swaps held for hedging or mitigating commercial risk.

    If the daily average aggregate uncollateralized outward exposure > substantial exposure outward total threshold, the person is a major swap participant.

    If the daily average aggregate uncollateralized outward exposure ≤ substantial exposure outward total threshold, go to question #12.

    Substantial exposure outward total threshold = $5 billion

12. What is the daily average aggregate uncollateralized outward exposure plus daily average aggregate potential outward exposure?

    If the daily average aggregate uncollateralized outward exposure + daily average aggregate potential outward exposure > combined substantial exposure outward and potential outward total threshold, the person is a major swap participant.

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If the daily average aggregate uncollateralized outward exposure + daily average aggregate potential outward exposure ≤ combined substantial total exposure outward and potential outward threshold, go to question #13.

Combined substantial exposure outward and potential outward total threshold = $8 billion

13. Is this person a "financial entity"?

    If not a financial entity, check to see whether it meets other prongs of major swap participant test.

    If it is a financial entity, go to question #14.

14. Is this person "highly leveraged" relative to the amount of capital it holds? Note: This test does not exclude swaps held for hedging or mitigating commercial risk.

    Is the ratio of total liabilities to equity (each determined in accordance with U.S. GAAP) in excess of 12 to 1 measured at the close of business on the last business day of the applicable fiscal quarter?

    If yes, go to question #15.
    If no, check to see whether it meets other prongs of major swap participant definition.

15. Is the entity subject to capital requirements established by an appropriate federal banking agency?

    If no, the person is a major swap participant.
    If yes, check other non-numerical parts of major swap participant definition.

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Definitions

"Special entity" means any of (i) a Federal Agency, (ii) a State, State agency, city, county, municipality or other political subdivision of a State, (iii) any employee benefit plan, as defined in section 3 of the Employee Retirement Income Security Act of 1974, (iv) any employee benefit plan, as defined in section 3 of the Employee Retirement Income Security Act of 1974, or (v) any endowment, including an endowment that is an organization described in section 501(c)(3) of the Internal Revenue Code of 1986.

"Potential uncollateralized exposure" means the total uncollateralized exposure permitted by the express terms of an person's agreements or arrangements with counterparties relating to swaps, including any exposure that may result from thresholds or minimum transfer amounts established by credit support annexes or similar arrangements.

"Daily average" means the arithmetic mean of the applicable measure of exposure at the close of each business day, beginning on the first business day of each calendar quarter and continuing through the last business day of that quarter.

"Financial entity" means any of (i) a swap dealer or security-based swap dealer, (ii) major swap participant or major security-based swap participant, (iii) commodity pools, (iv) private funds, (v) ERISA employee benefit plans, and (vi) persons predominantly engaged in activities that are in the business of banking or financial in nature.

"Appropriate federal banking agency" means (1) the Office of the Comptroller of the Currency, in the case of (A) any national banking association; (B) any Federal branch or agency of a foreign bank; and (C) any Federal savings association; (2) the Federal Deposit Insurance Corporation, in the case of (A) any State nonmember insured bank; (B) any foreign bank having an insured branch; and (C) any State savings association; (3) the Board of Governors of the Federal Reserve System in the case of (A) any State member bank; (B) any branch or agency of a foreign bank with respect to any provision of the Federal Reserve Act which is made applicable under the International Banking Act of 1978; (C) any foreign bank which does not operate an insured branch; (D) any agency or commercial lending company other than a Federal agency; (E) supervisory or regulatory proceedings arising from the authority given to the Board of Governors under section 7(c)(1) of the International Banking Act of 1978, including such proceedings under the Financial Institution Supervisory Act of 1966; (F) any bank holding company and any subsidiary (other than a depository institution) of a bank holding company; and (G) any savings and loan holding company and any subsidiary (other than a depository institution) of a savings and loan holding company.

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