

CFTC and SEC Continue Implementation of Dodd-Frank Swap Market Rules and Regulations

Acting pursuant to their statutory directives under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank),¹ various agencies of the United States government have, in an effort intended to reduce risk, increase transparency and promote market integrity, recently enacted and begun to fully implement sweeping regulation of the swap and derivative markets. As part of this new regulatory regime, the U.S. Commodity Futures Trading Commission (the CFTC) and the U.S. Securities and Exchange Commission (the SEC and, together with the CFTC, the Commissions) have published a release (the Release).² In this Release, the Commissions jointly adopted final rules mandating that swap market participants that qualify as a "swap dealer," a "security-based swap dealer," a "major swap participant" or a "major security-based swap participant" must register with at least one of the Commissions and comply with certain capital, margin, reporting, recordkeeping and business conduct requirements.

Applicability to Pension Plans

Under the Release and its accompanying regulations, pension plans (both domestic and foreign), sovereign wealth funds and other market participants may be required to wade through a morass of complex and various rules to determine whether they are subject to these regulations. This Investor Alert provides preliminary guidance as to whether such institutions may be able to avoid regulation under the available safe harbors, or whether they might be subject to regulation as major swap (or major security-based swap) participants or as swap (or security-based swap) dealers. The applicability of these regulations is important for market participants to understand, not only so that they can properly comply with any applicable rules and requirements, but also because they will be asked to make representations as to their status and compliance as part of their regular business activities (e.g., in connection with entering into ISDAs and other agreements with banks and other financial institutions.)

Major Swap Participant and Major Security-Based Swap Participant

Major Participant Tests. Dodd-Frank regulates non-dealing market participants

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whose participation in the swap market is so extensive as to pose a systemic risk to U.S. financial markets. Under Dodd-Frank, an entity is a major swap participant and a major security-based swap participant, as applicable, if such entity is not a swap dealer or security-based swap dealer and satisfies one of the following three tests:

- The entity maintains a "substantial position" in swaps or security-based swaps for any of the major swap categories or major security-based swap categories,³ as applicable, excluding positions held for hedging⁴ or mitigating commercial risk, and positions maintained by U.S. employee benefit plans for the primary purpose of hedging risk associated with the applicable plan;
- The Substantial Counterparty Exposure Test: The entity's outstanding swaps or security-based swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or
- The Financial Entity Test: The entity is a financial entity⁵ that (1) maintains a substantial position in outstanding swaps or security-based swaps in any major swap category or any major security-based swap category; (2) is highly leveraged relative to the amount of capital it holds;⁶ and (3) is not subject to capital requirements established by an appropriate U.S. banking agency.⁷

The Commissions have adopted two alternative approaches for determining whether an entity maintains a "substantial position" in swaps or security-based swaps under the Substantial Position Test or the Financial Entity Test. Under the first such approach, an entity maintains a substantial position: (1) in swaps if, its daily⁸ average current uncollateralized exposure⁹ is over USD 1 billion in either the credit, equity or commodity swap categories, or over USD 3 billion in the rate swap category;¹⁰ and (2) in security-based swaps, if such exposure exceeds USD 1 billion for either of the security-based swap categories.¹¹ Building upon this approach, the second substantial position test measures both current uncollateralized exposure and potential future exposure.¹² Under this test, an entity maintains a substantial position if its daily average current uncollateralized exposure and its potential future exposure exceeds USD 2 billion in any of the five credit, equity, other commodity, security-based swap or other security-based swap categories or USD 6 billion in the rate swap category.

The Substantial Counterparty Exposure Test utilizes the same building blocks as the Substantial Position Test discussed above: calculations of current and future uncollateralized exposure. Under the Substantial Counterparty Exposure Test, an entity has substantial counterparty exposure if such entity either has (1) current

uncollateralized swap exposure greater than USD 5 billion, or (2) current uncollateralized swap exposure plus potential future swap exposure greater than USD 8 billion.¹³ For security-based swaps, though, an entity has substantial counterparty exposure if such entity either has (1) current uncollateralized security-based swap exposure of greater than USD 2 billion; or (2) current uncollateralized security-based swap exposure plus potential future security-based swap exposure of greater than USD 4 billion.¹⁴ Importantly, the Substantial Counterparty Exposure Test does not exclude swaps held for hedging purposes.¹⁵

Major Participant Safe Harbors. Recognizing that the above enumerated major participant tests require burdensome daily calculations of uncollateralized swap exposure, the Commissions set forth the following three alternative safe harbor tests, any of which, if qualified for, would relieve an entity of its obligation to perform such daily calculations and would preclude designation as a major swap participant or major security-based swap participant:

- First, the entity's swap or security-based swap agreements do not permit a total uncollateralized exposure of more than USD 100 million to all counterparties, and such entity does not maintain swap or security-based swap positions in a notional amount of more than USD 2 billion in any major category of swaps or security-based swaps, or more than USD 4 billion in the aggregate across all major categories of swaps or all major categories of security-based swaps.¹⁶
- Second, (1) the entity's swap or security-based swap agreements do not permit a total uncollateralized exposure of more than USD 200 million to all counterparties; and (2) such entity's current uncollateralized exposure plus its potential future exposure calculated at the end of each month (rather than on a daily basis) is no greater than USD 1 billion in any major category of swaps or security-based swaps, USD 2 billion in the aggregate for all swap categories or USD 2 billion in the aggregate for all security-based swap categories.¹⁷
- Third, (1) the entity's current uncollateralized exposure in connection with all swaps or security-based swaps is less than USD \$500 million; and (2) the sum of such entity's current uncollateralized exposure and the notational amount of the entity's swap positions in all categories multiplied by 0.15 for swap categories and 0.10 for security-based swap categories is less than USD 1 billion.¹⁸

Swap Dealer and Security-Based Swap Dealer

In General. In addition to regulation of major participants, Dodd-Frank also regulates entities conducting certain swap dealing activities. Under Dodd-Frank,

an entity is a swap dealer and a security-based swap dealer, as applicable, if that entity engages in one or more of the following activities:

- holding itself out as a dealer in swaps or security-based swaps;¹⁹
- making a market in swaps or security-based swaps;
- regularly entering into swaps or security-based swaps with counterparties as an ordinary course of business for its own account; or
- engaging in any activities that cause it to be commonly known in the trade as a dealer or market maker in swaps or security-based swaps.²⁰

Regular Business Exception. Dodd-Frank specifically exempts from the definition of swap dealer an entity that enters into swaps for its own account, either individually or in a fiduciary capacity, but not as a part of its regular business.²¹ There is no bright line rule to determine whether a market participant is entering into swaps for its own investment purposes or as part of a regular business of swap dealing.²² To help guide market participants, though, the Commissions have noted that the following factors are indicative of a market participant's engaging in a regular business of swap dealing rather than investing:

- providing liquidity by accommodating demand for or facilitating interest in swaps;
- holding oneself out as willing to enter into swaps (independent of whether another party has already expressed interest);
- 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;
- helping to set the prices of swaps offered in the market rather than accepting such prices;²³
- providing liquidity to market professionals or other persons in connection with security-based swaps and seeking to profit from providing such liquidity;
- providing advice in connection with security-based swaps or structuring security-based swaps;
- using an inter-dealer broker in connection with security-based swap activities;
- acting as a market maker on an organized security-based swap exchange or trading system;²⁴ and
- having regular clientele and actively advertising or soliciting such clientele in connection with swaps or security-based swaps.²⁵

Hedging Activity and Other Exception. As a corollary to the regular business

exception, certain swaps or security-based swaps entered into with the primary goal of hedging a physical position will also not count as swap dealing activities.²⁶ Additionally, the rules note a number of other more discrete categories of swaps that are not considered in the determination of whether a person is a swap dealer. These categories include swaps entered into by an insured depository institution with a customer in connection with originating a loan with that customer, swaps between majority-owned affiliates, swaps entered into by registered floor traders and swaps entered into by a cooperative with its members.²⁷

De Minimis Amount Exception. Dodd-Frank mandates an exemption from the definition of swap dealer and security-based swap dealer for de minimis swap and security-based swap activity.²⁸ The CFTC has determined that the following level of swap activity qualifies for such de minimis exception:

- the aggregate gross notional amount of the swaps entered into over the prior 12 months in connection with dealing activities does not exceed USD 3 billion; and
- the aggregate gross notional amount of the swaps entered into with certain "Special Entities" (e.g., federal, state and local government entities as well as certain employee retirement and pension plans) over the prior 12 months in connection with dealing activities does not exceed USD 25 million.²⁹

Additionally, the SEC has determined that the following level of security-based swap activity qualifies for the de minimis exception:

- the aggregate gross notional amount of security-based swaps entered into over the prior 12 months in connection with dealing activities related to credit default swaps does not exceed USD 3 billion;
- the aggregate gross notional amount of security-based swaps entered into over the prior 12 months in connection with dealing activities other than credit default swaps does not exceed USD 150 million; and
- the aggregate gross notional amount of the security-based swaps entered into with certain "Special Entities" over the prior 12 months in connection with dealing activities does not exceed USD 25 million dollars.³⁰

In order to allow for an orderly implementation of the new regulations and to allow themselves more time to determine the optimal de minimis exception amount, the Commissions have established a phase-in period, the duration of which depends on various studies to be conducted and will likely be in place approximately two to four years, whereby the de minimis threshold is raised from

USD 3 billion to USD 8 billion for swaps, from USD 3 billion to USD 8 billion for credit default swaps and from USD 150 million to USD 400 million for security-based swaps other than credit defaults.³¹ Importantly, swap activity that falls under an exception to the dealing definitions, such as activity outside of the ordinary course of business, activity primarily for hedging certain physical positions or certain other more targeted exceptions, is not counted toward the de minimis threshold because such activity is not considered "dealing activity."

International Market Participants

The reach of Dodd-Frank swap regulation does not stop at the U.S. border and is not applied only to U.S. persons. Title VII of Dodd-Frank and the CFTC regulations thereunder apply to those activities outside the United States that have "a direct and significant connection with activities in, or effect on, commerce of the United States" or contravene the rules necessary to prevent evasion of such Act's swap provisions.³² In May of 2013, the Security Exchange Commission (SEC) issued a proposed rule on the cross border application of its security-based swap regulations,³³ while, in July of 2013, the CFTC, finalized its own interpretive guidance, which provides for broader cross border application of its swap regulations.³⁴ Given the divergent paths taken between the Commissions, the CFTC's issuing of guidance rather than a rule, and the preliminary nature of the SEC rulemaking in the area, the cross-border reach of Dodd-Frank swap regulation is currently a nascent and developing area of law. While such cross-border rules will not be covered herein, international market participants, whose swap activity is of the type and amount necessary for qualification as a swap dealer or a major swap participant and that are involved in swaps in the U.S. or swaps with U.S. persons or foreign branches of U.S. persons, may be subject to the above noted Dodd-Frank regulations and may need to seek professional guidance on the issue.

¹Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

²Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," RIN 33235-AK65, Exchange Act Release No. 66868 77 Fed. Reg. 30596 (May 23, 2012). The rules contained in the Release have been codified at 17 CFR parts 1, 240.

³There are four swap categories—rate swaps, credit swaps, equity swaps and

other commodity swaps—and two major security-based swap categories—debt security-based swaps and other security-based swaps. See Release at 257-59.

⁴Here, the CFTC has adopted a much broader definition of hedging than under the swap dealer regulations. See 17 CFR § 1.3(kkk).

⁵The Release adopts the definition of "financial entity" found in section 2(h)(7) of the Commodity Exchange Act, which includes entities primarily engaged in finance or banking activities, swap dealers, security-based swap dealers, commodity pools, certain private funds, employee benefit plans and U.S. governmental employee benefit plans. See 7 U.S.C. § 2(h)(7).

⁶Highly leveraged is defined as a ratio of total liability to equity in excess of 12 to 1. See 17 CFR §§ 1.3(mmm)(2), 240.3a67-7 (2013).

⁷See Dodd-Frank § 721; Commodity Exchange Act § 1a(33)(A) and Securities Exchange Act of 1934 § 3(a)967(A).

⁸Each of the major participant tests calls for the daily average aggregate uncollateralized outward exposure and/or the daily average aggregate potential outward exposure. This daily average is calculated by taking the arithmetic mean of the relevant 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. See 17 CFR §§ 1.3(jjj)(4), 240.3a67-3(c)(3)(d).

⁹Such current uncollateralized exposure is measured by marking to market swap or security-based swap positions with a negative value using industry standard practices, deducting the value of collateral posted with respect to such positions and giving effect to the terms of any applicable master netting agreement. See 17 CFR §§ 1.3(jjj)(2), 240.3a67-3(b) (2013).

¹⁰See Release at 289-90.

¹¹See *id.* at 290.

¹²Such future potential exposure is calculated by: (a) multiplying a specified risk factor by the total notional principal amount of the entity's swap or security-based swap positions (the risk factor ranges from 0% to 15%, depending on the type of swap and the duration of the position, or 6% to 10%, depending on the type of security-based swap and the duration of the position); (b) discounting positions subject to master netting agreements by a factor ranging between 0% and 60%; and (c) further discounting by 90% the notional principal amount of swaps or security-based swaps that are cleared, or by 80% for swaps and security-based swaps that are subject to daily mark-to-market margining and are not cleared. See 17 CFR §§ 1.3(jjj)(3), 240.3a67-3(c) (2013).

¹³See *Release at 335*.

¹⁴*Id.*

¹⁵*Id. at 336*.

¹⁶See 17 CFR §§ 1.3(hhh)(6)(i), 240.3a67-9(a)(ii).

¹⁷See 17 CFR §§ 1.3(hhh)(6)(ii), 240.3a67-9(a)(2).

¹⁸See 17 CFR §§ 1.3(hhh)(6)(iii), 240.3a67-9(a)(3).

¹⁹"Swap" is defined in section 1(a)(47) of the Commodity Exchange Act and "security-based swaps" is defined in section 3(a)(68) of the Securities Exchange Act of 1934.

Generally, a swap is any transaction that is not settled by delivery of the underlying commodity, including, but not limited to, options, swaps, credit default swaps, foreign exchange swaps, or any combination of such

instruments, and a security-based swap is any transaction that is a swap and is based on: (a) a narrowly-based security index, (b) a single security or loan, or (c) the occurrence or nonoccurrence of an event related to a single issuer of a security or the issuers of securities in a narrowly-based security index. Security-based swaps are primarily credit default swaps.

²⁰See Dodd-Frank §§ 721 and 761.

²¹See Dodd-Frank § 721.

²²See Release at 47–62.

²³For factors 1–5, see *id.* at 54–55.

²⁴For factors 6–9, see *id.* at 89–93.

²⁵See *id.* at 54 and 91–92.

²⁶See *id.* at 67–76 and at 94. For security-based swap activity, the Commissions note that "persons that use security-based swaps to hedge their business risks, absent other activity likely would not be dealers." *Id.* at 94. For swap activity, the CFTC has promulgated a complex regulatory test under which a swap would not be considered in the determination of whether or not a person is a swap dealer if: (a) the person enters into such swap for the purpose of offsetting or mitigating the 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; (b) such swap represents a substitute for transactions made or to be made or positions taken or to be taken by the person at a later time in a physical marketing channel; (c) such swap is economically appropriate to the reduction of the person's risks in the conduct and management of a commercial enterprise; (d) such swap is entered into in accordance with sound commercial practices; and (e) the person does not enter into such swap in connection with activity structured to evade designation as a swap dealer. See *id.* at 67–68.

²⁷17 CFR §§ 1.3(ggg).

²⁸See Dodd-Frank §§ 721 and 761.

²⁹See 17 CFR § 1.3(ggg)(4)(2013). The USD 25 million threshold applies only to swap dealing activity where the counterparty is a "Special Entity." See 17 CFR § 23.401(c) for a full definition of Special Entity.

³⁰See 17 CFR § 2403a71-2 (emphasis added). See note 13 for more information on the definition of "Special Entities."

³¹Such phase-in period does not change the USD 25 million thresholds applicable to swaps and security based swaps entered into with Special Entities. Though promulgated as a temporary increase in the de minimis threshold, the Commissions have stated their intention to study a potentially permanent increase in such threshold to the phase-in levels.

³²Dodd-Frank § 722(d).

³³See Cross-Border Security-Based Swap Activities, Exchange Act Release No. 69,490, 78 Fed. Reg. 30968 (proposed May 23, 2013).

³⁴See Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swaps Regulations, 78 Fed. Reg. 45292 (July 26, 2013).

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