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From our Task Force on Modernizing Financial Services Regulation

Key Swaps Definitions Begin To Take Shape

December 17, 2010 -- The CFTC and SEC (the "Commissions") last week issued a joint release (available here) that begins to clarify who will be regulated as a "swap dealer" or a "major swap participant" under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").

Dodd-Frank gives primary responsibility to the CFTC for regulating "swap dealers" and "major swap participants" and to the SEC for regulating "security-based swap dealers" and "major security-based swap participants." In most respects, however, the Proposing Release would treat swap dealers and security-based swap dealers the same and would treat major swap participants and major security-based swap participants the same. For simplicity, this Alert generally refers only to "swap dealers" or "major swap participants" and, except as otherwise indicated, we mean the term "swap" also to include "security-based swap."

Swap dealers and major swap participants will be subject to substantial, though different, registration, regulatory and disclosure requirements that are being implemented pursuant to Dodd-Frank. Accordingly, last week's proposals are of considerable importance for persons who enter into significant derivative transactions in connection with their investment or non-investment activities. This includes, for example, mutual funds, hedge funds, and insurance companies.

This Alert discusses many of the Commissions' proposals for defining swap dealers and major swap participants. It must be emphasized, however, that the Proposing Release also requests comments on numerous other ideas that the Commissions did not specifically propose. It seems quite possible, therefore, that the rules and interpretations that the Commissions ultimately adopt may vary considerably from what they have at this point proposed.

The deadline for submitting comments on the proposals is 60 days after publication in the Federal Register.

I. Swap Dealers

Consistent with the definitions in Dodd-Frank itself, the rules that the Commissions now propose would define a swap dealer to mean any person that:

- holds itself out as a dealer in swaps or makes a market in swaps;

- engages in any activity causing it to be commonly known in the trade as a dealer or market maker in swaps; or
- regularly enters into swaps with counterparties as an ordinary course of business for its own account.

Without more, this definition would be potentially troublesome for persons who enter into large numbers or large amounts of swap transactions, including many mutual funds, hedge funds, and insurance companies. For example, the definition could be read to mean that such users of swaps in the ordinary course of their investment or insurance business would be swap dealers.

The Proposing Release, however, goes a long way toward allaying any such concerns. Consistent with the definitions in Dodd-Frank, the Commissions' proposed rules provide a specific exception from swap dealer status for "a person that enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business." The Proposing Release makes clear, moreover, that a person will not be disqualified from relying on this exception merely by the fact that it enters into its swap positions in the ordinary course (or as a regular part) of its investment or insurance business.

Rather, the Proposing Release contains extensive discussion of a proposed "facts and circumstances" analysis to differentiate between persons who have the characteristics of a dealer or market maker (and who are therefore within the definition of a swap dealer) from those who are merely traders or significant users of swaps in the course of their investment or other business activities. For the most part, this analysis would be based on interpretive principles set out in the Proposing Release, rather than based on specific provisions in the proposed rules.

For example, the Commissions clarified that:

- dealers tend to accommodate demand for swaps from other parties;
- dealers are generally available to enter into swaps to facilitate other parties' interest in entering into those instruments. (The Commissions recognized, however, that dealers also may advance their own investment and liquidity interests by entering into swaps);
- dealers tend not to request that other parties propose the terms of swaps; rather, dealers tend to enter into those instruments on their own standard terms or on terms they arrange in response to other parties' interest; and
- dealers tend to be able to arrange customized terms for swaps upon request, or to create new types of swaps at the dealer's own initiative.

The Commissions propose to apply these general principles slightly differently, depending on whether the swaps in question are security-based swaps. This is summarized in subparts A. and B. immediately below.

A. Swaps that are not Security-Based

With respect to transactions in swaps that are not security-based, the Proposing Release observes that dealers tend to enter into swaps with a larger number of different counterparties than do non-dealers, and, in some markets,

non-dealers tend to constitute a large proportion of the swap dealers' counterparties. In contrast, the Proposing Release notes that non-dealers tend to enter into swaps with swap dealers more often than with other non-dealers.

The Proposing Release summarizes that, with respect to a person entering into non-securities-based swaps, the Commissions would consider the person's activities in relation to the other parties with which the person interacts in the swap markets. If the person is available to accommodate demand for swaps from other parties, tends to propose terms, or tends to engage in the other activities discussed above, then the person is likely to be a swap dealer. Persons that rarely engage in such activities are less likely to be deemed swap dealers.

B. Security-Based Swaps

The Proposing Release states that the factors the SEC has historically considered to determine whether a person is a "dealer" under the Securities Exchange Act of 1934 (the "Exchange Act") would generally be relevant for determining whether a person is a security-based swap dealer. In this connection, the release emphasizes the historic distinction the SEC has drawn between securities "dealers" and "traders" under the Exchange Act. The SEC would apply some of the same principles for purposes of identifying security-based swap dealers. In particular, factors that could indicate security-based swap dealer status include:

- having a regular clientele;
- holding oneself out as buying or selling securities (including entering into securities-based swaps) at a regular place of business;
- participating in activities akin to the functions of distributors and underwriters of conventional securities;
- providing liquidity services in transactions with investors or other professionals;
- receiving customer property; or
- providing incidental advice in connection with transactions.

The Commissions make the further observation that a person who uses security-based swaps to hedge its business risks would likely not be a security-based swap dealer, absent other conduct that caused the definition to apply.

C. Certain Caveats

As noted above, a person that holds itself out or becomes commonly known in the trade as a swap dealer will fall within the definition thereof. The Commissions warn that this may include the following activities:

- contacting potential counterparties to solicit interest in swaps;
- developing new types of swaps (or financial products that include swaps) and informing potential counterparties of a willingness to enter into such instruments;
- membership in a swap association in a category reserved for dealers;
- providing marketing materials (such as a web-site) that describe the

types of swaps that one is willing to enter into; or
- generally expressing a willingness to offer or provide a range of financial products that would include swaps.

The Proposing Release also notes that any securities dealer offering a security-based swap to any of its customers likely would thereby become a security-based swap dealer.

As noted above, a person who makes a market in swaps will be a swap dealer. There is some cause for concern that the Commissions may interpreted "market making" for this purpose somewhat broadly.

In this connection, the Proposing Release rejected some commenters' suggestion that a person could be deemed to make a market in swaps only if the person was willing, on a continuous basis, to enter into swaps on either the long or the short side of such transactions. The Proposing Release concludes, however, that such continuous activity is not a *sine qua non* of swap dealer status.

II. Major Swap Participant

The Commissions propose a complex three-pronged definition of "major swap participant," and that definition itself depends on various other terms that would be defined in complex ways. A person would be a major swap participant if it satisfies any of the three alternative prongs that are discussed in subparts A., B., and C., below.

A. The First Prong -- Maintaining a "Substantial Position"

Under the first prong, a person would be a major swap participant if that person maintains a "substantial position" in any of the "major categories" of swaps (*see* subpart 1. below). For purposes of this test, however, a person is to exclude (i) positions held for hedging or mitigating commercial risk (*see* subpart 2. below) and (ii) positions maintained or contracts held by any employee benefit plan (as defined in paragraphs (3) and (32) of ERISA Section (3)) for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan.

In determining whether a person maintains a "substantial position" under this prong, consideration would be given to two tests: (i) current uncollateralized exposure (*see* subpart 3. below) and (ii) current uncollateralized exposure *plus* estimated potential future exposure (*see* subpart 4. below). A position that satisfies *either* of these two tests would be a substantial position.

1. "Major Categories" of Swaps

The test under the first prong of the major swap definition is struck separately for each major category of swaps.

For swaps that *are not* security-based swaps, the Commissions propose four major categories:

- rate swaps--encompassing any swap that is primarily based on one or more reference rates, such as swaps of payments determined by fixed and floating interest rates, currency exchange rates, inflation rates, or

other monetary rates;

- credit swaps--encompassing any swap that is primarily based on instruments of indebtedness, such as (i) swaps primarily based on one or more broad-based indices related to debt instruments, (ii) index credit default swaps, and (iii) total return swaps on one or more indices of debt instruments;
- equity swaps--encompassing any swap that is primarily based on equity securities, such as (i) swaps based on one or more broad-based indices of equity securities and (ii) any total return swap on one or more equity indices; and
- other non-security-based swaps--encompassing all non-security-based swaps that are not within the above-described categories of rate, credit or equity swaps.

For swaps that *are* security-based swaps, the Commissions propose two major categories:

- security-based credit derivatives--encompassing any security-based swap that is based, in whole or in part, on one or more instruments of indebtedness (including loans) or on a credit event relating to one or more issuers of securities, including any security-based swap that is a credit default swap, total return swap on one or more debt instruments, debt swap, debt index swap, or credit spread; and
- other security-based swaps--encompassing all security-based swaps that are not within the above-described category of security-based credit derivatives.

2. Exclusion for Hedging or Mitigating Commercial Risk

The first prong of the major swap participant definition excludes swaps held for "hedging or mitigating commercial risk" from the substantial position analysis. The Proposing Release makes clear that the Commissions believe that "commercial risk" for this purpose would include both financial and non-financial risk. This makes it easier for financial companies (such as mutual funds, hedge funds, and insurance companies) to potentially rely on the exclusion.

However, the exclusion for hedging or mitigating commercial risk would not be available for swaps held for the purpose of speculation or trading, and the Commissions recognize that in some cases it may be difficult to draw the line between those swaps that can rely on this exclusion and those that cannot. The proposed positions of the CFTC and SEC on this subject differ in some of their details, and the Proposing Release (and the proposed rules) therefore provide a somewhat different treatment depending upon whether the swaps in question are security-based or non-security-based. In general, however, the proposals of the CFTC and SEC are quite similar.

For example, the Commissions both propose that a swap would be deemed to be for the purpose of hedging or mitigating commercial risk if it is economically appropriate to the reduction of risks in the conduct and management of the commercial enterprise. In addition, the Commissions both would specify an extensive list of the types of risks that could so qualify. Moreover, a swap could qualify for the hedging/mitigating exclusion notwithstanding that it (i)

does not qualify for the "bona fide hedging" exemption from position limits under the Commodity Exchange Act or (ii) is not recognized as a hedge for accounting purposes. Both Commissions also propose that a swap held for the purpose of hedging or mitigating a person's risk pursuant to another swap could not rely on the exclusion, unless that other swap itself were held to hedge or mitigate that person's commercial risk.

The SEC proposes, however, that in order to rely on the hedging/mitigation exclusion with respect to a security-based swap, the person holding the swap position would be required to:

- identify and document the risks that are being reduced by the security-based swap position;
- establish and document a method of assessing the effectiveness of the security-based swap as a hedge; and
- regularly assess the effectiveness of the security-based swap as a hedge.

No specific requirements of this type have been proposed for swaps that are not security-based.

3. Test for Current Uncollateralized Exposure

Under the proposed rules, a person would measure its current uncollateralized exposure in a major category of swaps by adding together its uncollateralized exposure (obtained by marking to market) arising from each of the person's positions with negative value in that major category (other than swaps qualifying for the above-described exclusions for risk hedging/mitigating). The fact that any exposure for which the person has posted collateral is excluded from this calculation will in many cases greatly reduce the possibility that the person will have a "substantial position" under this test. In this connection, to the extent that the marked-to-market negative exposure under transactions subject to central clearing is fully collateralized, centrally-cleared transactions would effectively be excluded from the current uncollateralized exposure test.

This proposed test would permit a person to use certain positive positions to offset any negative exposure to a given counterparty, in accordance with any netting agreement between the person and that counterparty. Specifically, the amount of a person's positive position with that counterparty involving swaps and certain securities financing transactions could be offset against the negative swap position, to the extent consistent with the offsets provided by the netting agreement. Again, this will in many cases greatly reduce the possibility that a person will have a "substantial position" under the test for current uncollateralized exposure. Apart from such offsetting through netting agreements, however, any swap positions that a person has with positive values generally do not enter into the test for current uncollateralized exposure.

Under the test for current uncollateralized exposure, the threshold for a substantial position (calculated as discussed above) in a major category of swaps would be an average daily amount of $1 billion, except that the threshold for the rate swap category would be an average daily amount of $3 billion. A person would generally be deemed to be maintaining a substantial

swap position, and thus be a major swap participant, if it exceeds such applicable amount for any major swap category.

4. Test for Current Uncollateralized Exposure Plus Potential Future Exposure

This test would add the person's potential future exposure in a major swap category to the person's current uncollateralized exposure (as computed under subpart 3. above) in that category. The potential future exposure with respect to a swap category is the notional principal amount of the person's swap positions in that category (other than swaps qualifying for the above-described exclusions for risk hedging/mitigating), multiplied by risk factors that are specified in the proposed rules. (Unlike the current uncollateralized exposure component of this test, the potential future exposure component does not exclude positions that are collateralized.)

The risk factor multipliers would vary based on the type and duration of the swap. For example, the Commissions propose that the multiplier for equity swaps would range from .06 for equity swaps of one year or less to .10 for equity swaps with a maturity more than five years. The multiplier for security-based swaps based on the credit of a reference entity would be .10.

For positions whose stated notional amount is leveraged or enhanced by the particular structure, the potential future exposure calculation would be based on the position's effective notional amount. On the other hand, the calculated amount of potential future exposure would be adjusted downward (and in some cases eliminated) (i) for certain types of positions that pose relatively lower potential risks and (ii) to reflect the risk mitigation effects of master netting agreements with counterparties. Under this test, any such adjustments for netting agreements would be pursuant to a formula consistent with that used for such purposes for bank capital standards.

Moreover, if a swap position is subject to central clearing or subject to daily mark-to-market margining, the amount of potential future exposure for that position would be reduced to only 20% of that calculated as discussed above.

Under the proposed test for current uncollateralized exposure *plus* potential future exposure, the threshold for a substantial position in a major category of swaps (calculated as discussed above) would be an average daily amount of $2 billion, except that the threshold for the rate swap category would be an average daily amount of $6 billion. A person would generally be deemed to be maintaining a substantial swap position, and thus be a major swap participant, if it exceeds such applicable amount for any major swap category.

It is not likely that the test summarized in this subpart 4. would result in major swap participant status for very many persons who would not already be major swap participants as a result of the test summarized in subpart 3. above. That is because (i) the test for current uncollateralized exposure *plus* potential future exposure allows an additional $1 billion ($3 billion for rate swaps) over and above the amount allowed for current uncollateralized exposure alone (as discussed in subpart 3. above), and (ii) the effect of the above-discussed exclusions, risk factor multipliers, and other adjustments will tend to make a person's potential future exposure with respect to any major swap category

less than $1 billion ($3 billion for rate swaps) in most cases.

B. The Second Prong -- Creating Substantial Counterparty Exposure

Under the second prong, a person would be a major swap participant if that person's swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets. The Commissions propose that, in order to identify persons whose swap positions present the requisite level of counterparty risk, the same tests (with certain modifications) be applied for determining a "substantial position," as discussed above in subpart A.3. (the test for current uncollateralized exposure) and subpart A.4. (the test for current uncollateralized exposure *plus* potential future exposure).

In applying these tests for purposes of the second prong of the major swap participant definition, the Commissions propose the following variations from the manner in which those tests would be applied in connection with the first prong of the definition:

- rather than being applied separately to each major swap category, the tests would be applied to all of a person's swaps that are not security-based swaps on an aggregate basis and to all of such person's security-based swaps on an aggregate basis;
- the first prong's exclusion for positions that hedge or mitigate commercial risks would not apply;
- the first prong's exclusion for positions held by certain ERISA plans to hedge or mitigate plan risks would not apply;
- under the second prong, the test for current uncollateralized exposure would be $5 billion for the aggregate of a person's swaps that are not security-based and $2 billion for the aggregate of a person's security-based swaps; and
- under the second prong, the test for current uncollateralized exposure *plus* potential future exposure would be $8 billion for the aggregate of a person's swaps that are not security-based and $4 billion for the aggregate of a person's security-based swaps.

C. The Third Prong -- Highly Leveraged Financial Entities

The third prong of the major swap participant definition would apply only to a "financial entity" that (i) is not subject to capital requirements established by an appropriate federal banking agency and (ii) is highly leveraged. The test under the third prong would be essentially the same as that under first prong (discussed in part II.A. above), except that:

- the first prong's exclusion for positions that hedge or mitigate commercial risks would not apply; and
- the first prong's exclusion for positions held by certain ERISA plans to hedge or mitigate plan risks would not apply.

Thus, the third prong of the major swap participant definition, in effect, replaces the first prong with a more expansive definition that is applicable to

highly leveraged financial entities that are not subject to capital requirements established by a federal bank regulator.

1. Financial Entities Under the Third Prong

The Commissions propose to define the term "financial entity" for this purpose to include, among other things, any fund that relies on the exclusions in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, certain employee benefit plans, and any person predominantly engaged in activities that are in the business of banking or are financial in nature, as defined in Section 4(k) of the Bank Holding Company Act of 1956. This definition is broad enough that, for example, mutual funds and insurance companies, as well as hedge funds, can easily fall within it.

2. Leverage Standard Under the Third Prong

The Commissions proposes that a financial entity would be considered to be "highly leveraged" for purposes of the third prong, if the ratio of the entity's total liabilities to equity exceeds 8 to 1 or, as an alternative proposal, 15 to 1. The Proposing Release includes a discussion of the relative merits of the proposed 8 to 1 and 15 to 1 standards and solicits comments on which standard would be more appropriate.

This Alert does not constitute legal or other professional advice or service by Jorden Burt LLP and/or its attorneys.

For additional information:

Jorden Burt has formed a special Task Force to monitor Dodd-Frank and other developments relating to reform of financial services regulation. To obtain additional information about particular developments that might have an impact on the insurance or reinsurance industries, you may contact Roland Goss (rcg@jordenusa.com or (202) 965-8148). To obtain additional information about particular developments that might have an impact on the investment adviser and fund industries, you may contact Tom Lauerman (tcl@jordenusa.com or (202) 965-8156). Or you may contact any of Jorden Burt's other regulatory attorneys.

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