financial reform matters

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CFTC and SEC Exclude Most Non-Dealers from OTC Swap Registration Requirement

The *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Dodd-Frank Act") directs the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) to identify the OTC market participants required to register with the CFTC and/or SEC and adhere to a wide variety of new requirements, including capital, margin, and business conduct requirements.

The Dodd-Frank Act split oversight of OTC derivatives between the SEC and CFTC. The SEC will regulate "security-based swaps," which include swaps based on a single security or single loan or narrow-based security or loan index and credit default swaps based on a single issuer of securities or issuers of securities in a narrow-based index. The CFTC will oversee other derivatives, including swaps based on interest rates, broad-based security and credit default swap indexes, foreign currencies, and commodities.

The CFTC has proposed definitions of the terms "swap dealer" and "major swap participant," the entities that must register with the CFTC under the Dodd-Frank Act[1]. Simultaneously, the SEC has proposed definitions of the terms "security-based swap dealer" and "major security-based swap participant," the entities that must register with the SEC under the Dodd-Frank Act.

The proposed rules set a high bar for the "major swap participant" (MSP) and "major security-based swap participant" (MSSP) categories, excluding most non-dealers from the registration requirement.

In addition, both regulators construe the "dealer" definition narrowly, thereby including for the most part only traditional dealers in the OTC derivatives market.

The proposed rules ask OTC market participants for input on these definitions. The deadline for comments is 60 days following the publication of the proposed rules in the Federal Register.

CFTC and SEC Limit Registration for Non-Dealer OTC Market Participants

The Dodd-Frank Act statutory definition of MSPs/MSSPs includes:

(1) entities that maintain a ***substantial position*** in any swap or security-based swap category (a "Substantial Position Entity");

[1] These requirements are in addition to possible registration with the CFTC as a "commodity pool operator" and/or "commodity trading adviser" for entities and advisers using swaps, subject to CFTC regulations to be proposed under the Dodd-Frank Act.

(2) entities whose derivatives create ***substantial counterparty exposure*** that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets (a "Substantial Counterparty Exposure Entity"); and

(3) financial entities that are ***highly leveraged*** relative to capital held and maintain a ***substantial position*** in any swap or security-based swap category (a "Highly Leveraged Entity").

The definitions of MSP and MSSP proposed by the CFTC and the SEC are likely to capture only a few very large non-dealer entities, due to the high thresholds established in the proposed rules for what is a "substantial position" and what is "substantial counterparty exposure."

Substantial Position Entity. The definitions proposed by the CFTC and the SEC consider both current swap exposure and potential future swap exposure in determining whether an entity is a MSP/MSSP.

An entity is a MSP under the Substantial Position Entity test set forth in the proposed CFTC rule if that entity maintains a substantial position in swaps in any one of four major swap categories: rate swaps (which includes interest rate and currency swaps), credit swaps, equity swaps or other commodity swaps (a catch-all category that includes any swap not covered in the other three categories). Under the CFTC proposed rule, a substantial position is a position that equals or exceeds $1 billion in current exposure or $2 billion in current exposure plus "aggregate potential outward exposure" for credit, equity or other commodity swaps, or $3 billion in current exposure or $6 billion in current exposure plus "aggregate potential outward exposure" for rate swaps.

An entity is a MSSP under the Substantial Position Entity test set forth in the proposed SEC rule if that entity maintains a substantial position in swaps in either of two categories: security-based credit derivatives (for example, credit default swaps and loan total return swaps) or all other security-based swaps (for example, equity swaps). Under the SEC proposed rule, a substantial position is one that equals or exceeds $1 billion in current exposure or $2 billion in current exposure plus "aggregate potential outward exposure."

Current Exposure. For purposes of both the CFTC and the SEC rules, current exposure is equal to the uncollateralized out-of-the-money exposure an entity has with respect to each swap category, aggregated across counterparties. Since most funds are required to provide collateral to their counterparties to secure their out-of-the-money exposure (and the amount of collateral required is likely to increase for those swaps that become cleared), the number of funds with uncollateralized current exposure that meets the thresholds in the proposed rules is likely to be small. Moreover, the current exposure calculation would take into account the effects of netting agreements (such as ISDA Master Agreements), permitting a calculation of net exposure across swaps, security-based swaps, and other securities financing transactions (repurchase, margin lending and securities borrowing and lending transactions) with the particular counterparty, which is likely to further limit current exposure. Contractual rights to net with other assets (for example, fully paid positions in a fund's prime brokerage account) or with transactions with or assets held by a counterparty's affiliate may not be used to reduce current exposure, although the CFTC and the SEC have requested comment on this issue.

Potential Future Exposure. For purposes of both the CFTC and the SEC rules, an entity's "aggregate potential outward exposure" is calculated as follows:

- The gross notional amount of each swap/security-based swap with a particular counterparty is multiplied by a conversion factor, ranging from 0% (for interest rate swaps with a residual maturity of one year or less) to 15% (for non-precious metal commodity swaps with a residual maturity over five years);

- If the relevant swap/security-based swap is subject to a master netting agreement (such as an ISDA Master Agreement), the product from the initial step of the calculation is further reduced by multiplying such amount by 40% and adding to that product an amount equal to 60% of the product from the initial step of the calculation multiplied by a fraction, the numerator of which is the net current exposure to such counterparty and the denominator of which is the gross current exposure to that counterparty (this step can reduce the aggregate potential outward exposure by up to an additional 60%); and
- If the relevant swap/security-based swap is subject to daily mark-to-market margining or clearing, the result of the calculation described above is further reduced by 80%.

Unlike the calculation of current exposure, aggregate potential outward exposure is not reduced by any collateral provided to secure such exposure, such as an independent amount under an ISDA Credit Support Annex. The CFTC and the SEC have asked for comment as to whether credit should be given for such collateral. However, even without reductions for collateral, the thresholds are set sufficiently high that it seems unlikely that many funds will have enough potential future exposure to meet the definition of "major swap participant" or "major security-based swap participant."

Hedging Positions. Solely for purposes of the Substantial Position Entity test, both regulators exclude from the calculation of current and potential future exposure any swaps/security-based swaps that are "hedging or mitigating commercial risk," regardless of the nature of the entity (whether a financial or non-financial entity). The rules proposed by both agencies specify that such term means positions that are economically appropriate to the reduction of commercial risk, where such risk arises from changes in the value of assets owned, liabilities incurred, or services provided or purchased. The release for the proposed rules explains that such positions include (but are not limited to) hedges qualifying for hedge accounting treatment. Both agencies exclude from this definition positions entered into for purposes of speculation or trading. The SEC's proposed rule further requires an entity to document the underlying risks being hedged as well as to assess the effectiveness of the hedge in relation to the hedged item.

Substantial Counterparty Exposure Entity. An entity is a MSP under the Substantial Counterparty Exposure Entity test set forth in the proposed CFTC rule or a MSSP under the Substantial Counterparty Exposure Entity test in the proposed SEC rule if that entity maintains a substantial position in swaps calculated by reference to all the entity's positions in aggregate, across counterparties and across all categories of swaps under the jurisdiction of either the CFTC or the SEC, respectively. Under the CFTC's proposed rules, a substantial position for this purpose is one that equals or exceeds $5 billion in current exposure or $8 billion in current exposure plus potential future exposure (each calculated as described above). Under the SEC's proposed rules, a substantial position for this purpose is one that equals or exceeds $2 billion in current exposure or $4 billion in current exposure plus potential future exposure (each calculated as described above). Positions held to hedge or mitigate commercial risk are not excluded for purposes of this test. Since few funds are likely to maintain a "substantial position" in swaps as discussed above, few funds are likely to be captured by this definition.

Highly Leveraged Entity. An entity is a MSP under the Highly Leveraged Entity test set forth in the proposed CFTC rule or a MSSP under the Highly Leveraged Entity test set forth in the proposed SEC rule if it (i) is a financial entity, including a commodity pool, private fund, employee benefit plan or person predominantly engaged in banking or financial activities as defined in the Bank Holding Company Act of 1956; (ii) maintains a substantial position in one or more categories of swaps or security-based swaps, respectively, calculated as discussed above; and (iii) has a ratio of liabilities to equity that exceeds a ratio to be established by rule, as measured at the end of each fiscal quarter. The CFTC and the SEC have requested comment as to whether this ratio should be 8 to 1 or 15 to 1. Positions held to hedge or mitigate commercial risk are not excluded for purposes of this test. Given that few funds are likely to maintain a "substantial position" in any category of swaps, as discussed above, funds are unlikely to meet the definition of a MSP/MSSP under this category, even if they have a high degree of leverage.

Other Issues. The release accompanying the proposed rules clarifies that the MSP/MSSP is the entity who actually maintains the swap position (for example, a fund rather than its investment adviser). The release also states that, as a preliminary matter, the regulators do not believe that accounts managed by an investment adviser should be aggregated to determine whether the adviser itself is a MSP/MSSP, although it notes that the CFTC/SEC have the authority to adopt anti-evasion rules to address this issue. The CFTC and SEC have also solicited comment as to if and when positions held by affiliated entities should be aggregated for purposes of these tests. The proposed rules do not provide for any aggregation across entities.

The CFTC and SEC have also solicited comment as to whether certain types of entities should be excluded from MSP/MSSP status, including registered investment companies, ERISA plans, registered broker-dealers and futures commission merchants, banks, and sovereign wealth funds.

CFTC and SEC Draw on Traditional Definitions of "Dealer"

The Dodd-Frank Act statutory definitions of a swap dealer and security-based swap dealer list four activities that could subject an entity to registration: (1) holding itself out as a dealer in swaps or security-based swaps; (2) making a market in swaps or security-based swaps; (3) regularly entering into swaps or security-based swaps with counterparties in the ordinary course of business for its own account; or (4) engaging in any activity causing it to be commonly known as a dealer or market maker.

The third prong of the statutory definition has concerned some buy-side participants, since it covers activities that are not traditionally limited to dealers. The release for the proposed rules states that this prong should be read together with other language in the Dodd-Frank Act, which excludes from the definition of swap dealer/security-based swap dealer an entity who regularly enters into swaps for its own account but not as a part of a regular business. When discussing the definition of "swap dealer," the release states that entities that enter into swaps as part of a regular business are entities that accommodate demand for swaps from other parties and enter into swaps in response to interest expressed by other parties, which does not appear intended to include buy-side participants.

Both regulators propose that these statutory definitions be applied on a facts and circumstances basis, without a set of criteria determinative in all cases but instead relying on a range of factors. The following relevant factors are listed in the release with respect to the proposed rules:

<u>Distinguishing characteristics of Swap Dealers and Security-Based Swap Dealers</u>

- a tendency to accommodate demand for swaps/security-based swaps from other parties;
- availability to enter into swaps/security-based swaps to facilitate other parties' interest in entering into those instruments;
- a tendency not to request that other parties propose the terms of swaps/security-based swaps but to enter into such instruments on their own standard terms; and
- a tendency to be able to customize terms for swaps/security-based swaps upon request or to create new types of swaps on their own initiative.

Indicators that an entity is holding itself out or is commonly known as a Swap Dealer or Security-Based Swap Dealer

- contacting potential counterparties to solicit interest in swaps/security-based swaps;
- developing new types of swaps/security-based swaps (including financial products that contain swaps), informing potential counterparties of the availability of such swaps/security-based swaps, and expressing a willingness to enter into such swaps/security-based swaps;
- 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/security-based swaps that one is willing to enter into with other parties; or
- generally expressing a willingness to offer or provide a range of financial products that would include swaps/security-based swaps.

The proposed rules caution that, although many factors link swap dealers with security-based swap dealers, the CFTC and SEC will differentiate a swap dealer from a security-based swap dealer. When evaluating a person as a potential security-based swap dealer, the SEC will consider the same factors relevant to determine whether a person is a "dealer" under the Securities Exchange Act of 1934, including providing liquidity services in transactions with investors, having a regular clientele, receiving customer property, and furnishing incidental advice in connection with transactions. By contrast, a touchstone for the CFTC in identifying a swap dealer will be the functional role the party fulfills in the market, specifically, in accommodating demand for swaps from other parties and entering swaps in response to interest expressed by other parties.

The proposed rules also exempt from the dealer definition entities with *de minimis* swap/security-based swap activity (with low thresholds) as well as insured depository institutions entering swaps/security-based swaps in connection with loan originations.

In sum, the proposed rules identifying swap dealers/security-based swap dealers seem focused on traditional dealers in the OTC derivatives market and do not generally appear intended to cast a wider net to include buy-side entities who are not undertaking traditional dealer activities.

If you have questions about the proposed rules or their impact on your business, please contact Ropes & Gray Derivatives Practice co-heads Tim Diggins and Leigh Fraser, Deborah Monson, or your usual contact at the firm.