CFTC and SEC Adopt Final Rules Excluding Most Non-Dealers from OTC Swap Registration Requirements

On April 18, 2012, the Commodity Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission (the "SEC", and, together with the CFTC, the "Commissions") adopted final rules defining "swap dealer," "security-based swap dealer," "major swap participant" ("MSP"), and "major security-based swap participant" ("MSSP") under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). These entities generally will be required to register with the CFTC (with respect to swap dealers and MSPs) or the SEC (with respect to security-based swap dealers and MSSPs) and adhere to a wide variety of new requirements, including capital, margin and business conduct requirements.

The final rules adopted by the Commissions generally are consistent with the rules that were proposed in December 2010. The adopting release (the "Adopting Release") for the final rules can be found here. Ropes & Gray's summary of the proposed rules can be found here.

Some key issues addressed in the final rules are as follows:

- As in the proposed rules, the final rules set a high bar for the MSP and MSSP categories, excluding most buy-side participants from the requirement to register as an MSP or an MSSP. The CFTC notes in the Adopting Release that the number of entities expected to be covered by the MSP definition is *six or fewer*, while the SEC notes that *five or fewer entities, and as few as zero*, are expected to be required to register as MSSPs.

- In addition, the "swap dealer" and "security-based swap dealer" definitions are construed narrowly, thereby including for the most part only traditional dealers in the OTC derivatives market and excluding most buy-side participants who are not undertaking traditional dealing activities.

- The CFTC also adopted a revised definition of "eligible contract participant." This final rule exempts most private funds from the requirement that each investor in the fund be an "eligible contract participant" in order for the fund to be able to enter into off-exchange foreign currency transactions without satisfying certain requirements under the CFTC's retail foreign exchange ("forex") rules.

Major Swap Participant Definition

The Dodd-Frank Act statutory definition of MSP/MSSP includes: (i) entities that maintain a ***substantial position*** in any swap or security-based swap category (a "Substantial Position Entity"); (ii) entities whose derivatives positions create ***substantial counterparty exposure*** that could have serious adverse effects on the financial stability of the United States banking system or financial markets (a "Substantial Counterparty Exposure Entity"); and (iii) 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 final rules are likely to capture only a few very large non-dealer entities due to the high thresholds established in the rules. Each category is described in turn below.

Substantial Position Entity. The final rules consider both current swap exposure and potential future swap exposure in determining whether an entity is an MSP/MSSP.

An entity is an MSP under the CFTC's Substantial Position Entity test 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 under CFTC jurisdiction (which includes swaps on a broad-based equity index), or other commodity swaps (a catch-all category that includes any swap not covered in the other three categories). Under the CFTC's final rules, a ***substantial position*** is a position that equals or exceeds $1 billion in ***current exposure*** or $2 billion in ***current exposure plus potential future exposure*** for credit, equity or other commodity swaps, or $3 billion in ***current exposure*** or $6 billion in ***current exposure plus potential future exposure*** for rate swaps.

An entity is an MSSP under the SEC's Substantial Position Entity test if that entity maintains a ***substantial position*** in swaps in either of two categories: debt security-based swaps (for example, single name and narrow-based index credit default swaps and loan total return swaps) or all other security-based swaps (for example, single name and narrow-based index equity swaps). Under the SEC rule, a ***substantial position*** is one that equals or exceeds $1 billion in ***current exposure*** or $2 billion in ***current exposure plus potential future exposure***.

Both the CFTC's and the SEC's tests are measured by reference to the daily average current exposure and, where applicable, potential future exposure, over a calendar quarter.

Current Exposure. Under the CFTC and 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, and once minimum margin requirements for uncleared swaps under the Dodd-Frank Act become effective), 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 and security-based swaps, as well as securities financing transactions (repurchase, margin lending and securities borrowing and lending transactions) and other financial instruments and agreements that are subject to netting offsets for purposes of applicable bankruptcy law, which is likely to further limit current exposure.

Potential Future Exposure. Under the CFTC and SEC rules, an entity's potential future exposure is calculated as follows:

- The total notional principal amount of each swap/security-based swap with a particular counterparty is multiplied by a specified risk factor, ranging from 0% to 15% under the CFTC rules or 6% to 10% under the SEC rules (in each case, depending on the type of swap and the duration of the position);

- 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 a factor ranging between zero and 60%, depending on the effect of the agreement; and

- If the relevant swap is subject to daily mark-to-market margining or clearing, the result of the calculation described above is further reduced by 80% or 90%, respectively.

Options and other positions for which an entity has prepaid or otherwise satisfied its payment obligations are excluded from the calculation of potential future exposure. The rules also cap – at the net present value of unpaid premiums – the potential future exposure associated with positions by which an entity buys credit protection pursuant to a credit default swap and purchases of options with remaining payment obligations.

Unlike the calculation of current exposure, aggregate potential outward exposure generally is not reduced by any collateral provided to an entity's counterparty, such as an independent amount under an ISDA Credit Support Annex. However, even without reductions for such 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 MSP or MSSP. As an example, the SEC notes in the Adopting Release that, in order for an entity to have $2 billion of potential future exposure with respect to credit default swaps, the entity would need to have an outstanding notional amount of at least $100 billion of such swaps (assuming the swaps are subject to mark-to-market collateral requirements but are not cleared), not accounting for the effect of any netting agreements that could reduce potential future exposure by up to 60 percent.

Hedging Positions. The Substantial Position Entity test excludes 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 define such term to mean 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; from changes in value related to any of the foregoing arising from foreign exchange rate movements; or from fluctuations in interest, currency, or foreign exchange rate exposures arising from an entity's assets or liabilities. The rules provide that such positions include (but are not limited to) hedges qualifying for hedge accounting treatment and positions that qualify as "bona fide hedging" under CFTC rules. Positions entered into for purposes of speculation or trading do not meet the definition of "hedging or mitigating commercial risk." In addition, positions that hedge positions held for speculation, investment or trading will not qualify for the exclusion.

Substantial Counterparty Exposure Entity. An entity is an MSP under the CFTC rules or an MSSP under SEC rules under the Substantial Counterparty Exposure Entity test if that entity maintains a substantial position in swaps calculated by reference to all of the entity's positions in aggregate, across counterparties and across all categories of swaps under the jurisdiction of the CFTC or the SEC, respectively. Under the final CFTC 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 final SEC 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 these tests. Since few funds are likely to maintain a "substantial position" in swaps, for the reasons discussed above, few funds are likely to be captured by this definition.

Highly Leveraged Entity. An entity is an MSP under the Highly Leveraged Entity test if it (i) is a financial entity; (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 12 to 1 ratio, as measured at the end of each fiscal quarter. 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 an MSP/MSSP under this category, even if they have a high degree of leverage.

Safe Harbors. While it is expected that very few entities will be required to register as MSPs/MSSPs, many buy side entities have been concerned that they would need to test their compliance with the MSP/MSSP thresholds every day, since the thresholds are measured based on the daily average size of an entity's positions over a calendar quarter. The final rules provide for three safe harbors that would relieve funds and other entities of the obligation to perform daily calculations with respect to the various MSP/MSSP thresholds. An entity will not be deemed an MSP/MSSP if it satisfies any of the following three safe harbors, which are tested separately with respect to swaps and security-based swaps:

- The entity's swap arrangements expressly provide that the entity will at no time maintain total uncollateralized exposure of more than $100 million to all of its swap or security-based swap counterparties with respect to all of its counterparties (in making this calculation, we assume that entities will calculate the sum of all thresholds and minimum transfer amounts under all applicable ISDA Credit Support Annexes and any similar agreements); and the entity does not maintain notional swap or security-based swap positions of more than $2 billion in any major category of swaps or security-based swaps, or more than $4 billion in the aggregate.

- The entity's swap arrangements do not permit the entity to maintain a total uncollateralized exposure of more than $200 million to all of its swap or security-based swap counterparties; and the entity performs the MSP/MSSP calculations (*e.g.*, the "substantial position" and "substantial counterparty exposure" calculations described above) as of the end of every month, and the results of each of those monthly calculations indicate that the entity's swap positions lead to no more than $1 billion in current exposure plus potential future exposure in any major category of swaps or security-based swaps or $2 billion in current exposure plus potential future exposure with regard to all of the entity's swap or security-based swap positions.

- The entity's current uncollateralized exposure in connection with any major category of swaps or security-based swaps is less than $500 million (or $1.5 billion with regard to the rate swap category) and the entity performs certain modified MSP/MSSP calculations (*e.g.*, the "substantial position" and "substantial counterparty exposure" calculations, simplified based on assumptions that are adverse to the person) as of the end of every month, and the results of each of those monthly calculations indicate that the entity's swap positions in each major category of swaps are less than $1 billion with respect to each major swap or security-based swap category (or $3 billion with respect to the rate swap category).

Other Issues. With respect to investment advisers, the Commissions state in the Adopting Release that the swap or security-based swap positions of client accounts should not be attributed to the investment adviser when determining whether the investment adviser is itself an MSP/MSSP. With respect to managed accounts, the Commissions further state that if the counterparties to a swap or security-based swap position within a managed account have recourse only to the assets of that account in the event of default and lack recourse to other assets of the beneficial owners, that position should not be attributed to its beneficial owner. Finally, master funds and feeder funds should be treated as separate entities for purposes of the MSP/MSSP tests, except to the extent counterparties to their swap positions have recourse to the assets of both funds.

The Commissions declined to adopt any categorical exclusions from the MSP/MSSP definitions. Comments had been raised on the proposed rules requesting that the Commissions adopt categorical exclusions for, among others, registered investment companies and related advisers, ERISA plans, pension plans, endowments, end users, and various types of non-U.S. persons, including foreign governments and their agents and instrumentalities, sovereign wealth funds, and non-U.S. entities subject to comparable foreign regulation. The CFTC notes in the Adopting Release that it does not believe that foreign governments, foreign central banks and international financial institutions should be required to register as swap dealers or MSPs.

Swap Dealer and Security-Based Swap Dealer Definition

The definitions of "swap dealer" and "security-based swap dealer" generally track the definitions in the proposed rules and the text of the Dodd-Frank Act, defining such an entity as any person who: (i) holds itself out as a dealer in swaps or security-based swaps; (ii) makes a market in swaps or security-based swaps (interpreted in general as routinely standing ready to enter into swaps at the request of a counterparty); (iii) regularly enters into swaps or security-based swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in activity causing itself to be commonly known in the trade as a dealer or market maker in swaps or security-based swaps. However, an entity that enters into swaps for its own account, either individually or in a fiduciary capacity, but not as a part of a regular business, would not be a swap dealer. The Commissions state in the Adopting Release that the dealer-trader distinction under the Securities Exchange Act of 1934 provides an appropriate framework for identifying dealing activity in connection with interpreting the definitions of the terms "swap dealer" and "security-based swap dealer."

De Minimis Exemption. In accordance with the Dodd-Frank Act, the final rules provide an exemption from the definitions of swap dealer and security-based swap dealer for entities who engage in a *de minimis* amount of swap dealing. While the proposed rules included a three-factor test that took into account the gross notional amount of swaps or security-based swaps entered into over a 12-month period, the number of counterparties, and the number of transactions entered into by a potential swap dealer or security-based swap dealer, the Commissions adopted a test for the *de minimis* exemption that is solely based on the notional amount of an entity's swap or security-based swap positions over the prior 12-month period arising from the entity's dealing activities:

- Under the CFTC rules, during an initial phase-in period (which will last no longer than five years), if the aggregate gross notional amount of swaps that an entity entered into over the prior 12 months in connection with dealing activities does not exceed $8 billion (or $25 million of aggregate gross notional amount of swaps with so-called "special entities," which include, among others, certain governmental entities, employee benefit plans and endowments), then the entity will fall within the *de minimis* exemption from the definition of swap dealer. Following the initial phase-in period, the threshold will fall to $3 billion (or $25 million with respect to swaps with special entities), unless the CFTC takes action to set a different minimum amount.

- The SEC's *de minimis* exemption is structured in a similar manner, except that the minimum amount during the phase-in period will be $8 billion for credit default swaps and $400 million for other types of security-based swaps. Following the initial phase-in period, the threshold will fall to $3 billion for credit default swaps and $150 million for other types of security-based swaps. The SEC rules also include a threshold amount of $25 million for security-based swaps with special entities.

Eligible Contract Participant Definition

Many private funds are currently "eligible contract participants" ("ECP") under the Commodity Exchange Act (the "CEA") by satisfying at least one of the following prongs of the ECP definition under the CEA: (i) a commodity pool with at least $5 million of total assets that is formed and operated by a person subject to regulation under the CEA or foreign regulation; or (ii) an entity with total assets of at least $10 million (or a net worth of at least $1 million entering into transactions for certain purposes). An ECP, among other things, may enter into a swap that is not on a designated contract market. Furthermore, ECPs and their counterparties are exempt from the retail forex rules of the CFTC, which impose certain requirements on off-exchange forex transactions.

Due to concerns regarding certain abuses by operators of pools with retail investors that invested in forex transactions, the Dodd-Frank Act revised the first prong of the ECP definition described above to state that, solely for purposes of the CFTC's retail forex rules, a commodity pool could not satisfy such prong of the definition unless each of its investors was itself an ECP (the "look-through requirement"). The CFTC then proposed rules that went further, providing that a commodity pool with any non-ECP investors would not be an ECP for purposes of the CFTC's retail forex rules (even if the commodity pool could satisfy the second prong of the definition described above). The proposed rules would not have affected registered investment companies, because the CEA provides that a registered investment company is an ECP regardless of whether its investors are ECPs.

The CFTC's proposed rules, if adopted, would have required most commodity pools (such as private funds) with any non-ECP investors to comply with the CFTC's retail forex rules in order to enter into any off-exchange forex transactions. Among other things, this would have limited the types of counterparties such pools could use for such transactions to certain U.S. financial institutions, U.S. broker-dealers, futures commission merchants, and retail foreign exchange dealers, and under certain circumstances, would have required registration of the operators of and advisers to such pools with the CFTC as commodity pool operators and commodity trading advisors, respectively. Many funds have non-ECP investors; for example, the threshold for an individual to qualify as an ECP for non-hedging transactions ($10 million of assets invested on a discretionary basis) is higher than the threshold for an individual to qualify as a "qualified purchaser" under the Investment Company Act of 1940 (the "1940 Act"), and there is no "knowledgeable employee" provision in the ECP definition comparable to those in Rule 3c-5 under the 1940 Act and Rule 205-3 under the Investment Advisers Act of 1940. The proposed rules would have had a significant impact on the ability of private funds with any such non-ECP investors to enter into off-exchange forex transactions.

Exemption from Look-Through Treatment. The final rule adopted by the CFTC exempts most funds from the look-through requirement. Under the final rule, a commodity pool will be deemed an ECP with respect to retail forex transactions, regardless of whether each participant in the pool is an ECP, if the following conditions are satisfied:

- The pool is not formed for the purpose of evading the CEA or CFTC rules;
- The pool has total assets exceeding $10 million; and
- The pool is formed and operated by a registered CPO or a CPO who is exempt from registration under CFTC Rule 4.13(a)(3).

CFTC Rule 4.13(a)(3) exempts from registration operators of commodity pools that enter into no more than a *de minimis* amount of derivatives transactions. Due to the recent rescission of the exemption from CPO registration under CFTC Rule 4.13(a)(4), after December 31, 2012, most private funds are likely to be formed and operated by a registered CPO or by a CPO exempt from registration under CFTC Rule 4.13(a)(3). Further information regarding these requirements is available here. As a result, we expect that most private funds will satisfy the conditions above, and will therefore be exempt from the look-through requirement.

Because many pools will have been formed by CPOs that are exempt from registration, the last condition noted above will not be a requirement with respect to any pool formed before the end of 2012, when the look-through requirement will become effective.

In addition, under the final rules, a pool with no U.S. participants that is operated by a CPO located outside the United States will be considered an ECP irrespective of the ECP status of its participants.

Fund of Funds. In addition, under the final rules, if a commodity pool that is a counterparty to a retail forex transaction (a “transaction pool”) has any investor that is a pool (an “investor pool”), the determination of whether such investor pool is itself an ECP will not require look through to each participant in such investor pool as long as certain conditions are met, including that none of the transaction pool, the investor pool, or any commodity pool in which the transaction pool holds an interest is structured to evade CFTC rules by permitting non-ECPs to engage in retail forex transactions. The Adopting Release clarifies that a fund of funds that invests in underlying funds and uses off-exchange forex transactions solely to hedge the currency risk between the currency in which underlying funds accept investments and the currency in which investors invest in the fund of funds would not be regarded as having been structured to evade these rules.

Effective Date

The new rules generally become effective 60 days after the date of publication in the Federal Register. The ECP look-through requirement becomes effective on December 31, 2012.

Please contact the Ropes & Gray attorney who usually advises you with any questions.