



Commodity Futures Trading Commission

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Proposed Rules Further Defining “Swap Dealer,” “Major Swap Participant” and “Eligible Contract Participant”

The Commodity Futures Trading Commission (Commission) is proposing rules and interpretative guidance to further define the terms “swap dealer,” “major swap participant,” and “eligible contract participant.” This is a joint rulemaking with the Securities and Exchange Commission (SEC).

Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)

Section 721 of the Dodd-Frank Act amends the Commodity Exchange Act (CEA) by adding definitions of the terms “swap dealer” and “major swap participant.” Section 712(d)(1) provides that the Commission and the SEC, in consultation with the Federal Reserve Board, shall jointly further define those terms, and the term “eligible contract participant.”

Definition of “Swap Dealer”

The proposed rules closely follow the text of the Dodd-Frank Act in defining the term “swap dealer” as any person who:

- (i) holds itself out as a dealer in swaps,
- (ii) makes a market in swaps,
- (iii) regularly enters into 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.

The Commission intends to interpret the definition in a manner that would enable it to respond to evolution in the ways that swap dealers operate and that accounts for the diversity of the swap markets. The Commission preliminarily believes that the distinguishing characteristics of swap dealers are that:

- swap dealers tend to accommodate demand for swaps from other parties;
- swap dealers are generally available to enter into swaps to facilitate other parties’ interest in entering into swaps;
- swap dealers tend not to request that other parties propose the terms of swaps; rather, they tend to enter into swaps on their own standard terms or on terms they arrange in response to other parties’ interest; and
- swap dealers tend to be able to arrange customized terms for swaps upon request, or to create new types of swaps at their own initiative.

De Minimis Exemption from the Definition of Swap Dealer

The Dodd-Frank Act provides an exemption for a person who “engages in a de minimis quantity of swap dealing in connection with transactions with or on behalf of its customers.” The proposed rule requires that a person meet all of the following conditions in order to be exempt from the definition on the basis of de minimis activity.

- The aggregate effective notional amount, measured on a gross basis, of the swaps that the person enters into over the prior 12 months in connection with dealing activities must not exceed \$100 million.

- The aggregate effective notional amount of such swaps with “special entities” (as defined in CEA Section 4s(h)(2)(C) to include certain governmental and other entities) over the prior 12 months must not exceed \$25 million.
- The person must not enter into swaps as a dealer with more than 15 counterparties, other than security-based swap dealers, over the prior 12 months.
- The person must not enter into more than 20 swaps as a dealer over the prior 12 months.

Exclusion for Swaps in Connection with Originating a Loan

The Dodd-Frank Act provides an exclusion for an insured depository institution “to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer.” The exclusion in the proposed rule would apply only to swaps that are connected to the financial terms of the loan itself.

Amendments to Definition of Eligible Contract Participant (ECP)

Under section 723(a)(2) of the Dodd-Frank Act, a person who is not an ECP cannot enter into a swap except on a designated contract market. The Commission proposes two minor changes to the definition of ECP. First, since major swap participants and swap dealers are likely to be among the most active and largest users of swaps, the rule proposes that the ECP definition include these new categories. Second, the rule proposes clarifications to the treatment of commodity pools. The clarifications state that in order to be an ECP, a commodity pool must meet the requirements of clause (iv) of the current ECP definition, which is specific to commodity pools. It could not circumvent this requirement by qualifying under a general provision in clause (v) of the current definition.

Definition of “Major Swap Participant” (MSP)

There are three parts to the Dodd-Frank Act definition. A person that satisfies any one of them is an MSP:

- A person that maintains a “substantial position” in any of the major swap categories, excluding positions held for hedging or mitigating commercial risk and positions maintained by certain employee benefit plans for hedging or mitigating risks in the operation of the plan.
- A person whose outstanding swaps create “substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets.”
- Any “financial entity” that 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” and that maintains a “substantial position” in any of the major swap categories.

The statutory definition excludes swap dealers and certain financing affiliates.

Definition of Substantial Position

The Commission proposes to define “substantial position” using objective numerical criteria, which promote the predictable application and enforcement of the requirements governing MSPs. The Commission proposes tests that would account for both current uncollateralized exposure and potential future exposure. A position that satisfies either test would be a “substantial position.” The proposed definition of substantial position would exclude positions hedging commercial risk and employee benefit plan positions.

The proposed tests would apply to a person’s swap positions in each of four major swap categories: rate swaps (any swap based on reference rates such as interest rates or currency exchange rates), credit swaps (any swap based on instruments of indebtedness or related indices), equity swaps (any swap based on equities or equity indices) and other commodity swaps (any swap not included in the first three categories, including any swap based on physical commodities).

First Test of Substantial Position

The first substantial position test in the proposed rules would:

- measure a person's current uncollateralized exposure by marking the swap positions to market using industry standard practices;
- allow the deduction of the value of collateral that is posted with respect to the swap positions; and
- calculate exposure on a net basis, according to the terms of any master netting agreement that applies.

The proposed thresholds for the first test would be a daily average current uncollateralized exposure of \$1 billion in the applicable major category of swaps, except that the threshold for the rate swap category would be \$3 billion.

Second Test of Substantial Position

The second test proposed by the Commission would account for both current uncollateralized exposure (as discussed above) and the potential future exposure associated with a person's swap positions. The second substantial position test would determine potential future exposure by:

- multiplying the total notional principal amount of the person's swap positions by specified risk factor percentages (ranging from ½% to 15%) based on the type of swap and the duration of the position;
- discounting the amount of positions subject to master netting agreements by a factor ranging between zero and 60%, depending on the effects of the agreement; and
- if the swaps are cleared or subject to daily mark-to-market margining, further discounting the amount of the positions by 80%.

The proposed thresholds for the second test would be \$2 billion in daily average current uncollateralized exposure plus potential future exposure in the applicable major swap category, except that the threshold for the rate swap category would be \$6 billion.

Definition of "Hedging or Mitigating Commercial Risk"

The proposed definition of substantial position excludes positions held for "hedging or mitigating commercial risk." The Commission proposes to determine whether a swap hedges or mitigates commercial risk by analyzing the facts and circumstances at the time the swap is entered into, and taking into account the person's overall hedging and risk mitigation strategies. The proposed definition would encompass any swap position that:

- qualifies as bona fide hedging under CEA rules;
- qualifies for hedging treatment under Financial Accounting Standards Board Statement No. 133; or
- is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where the risks arise in the ordinary course of business from:
 - a potential change in the value of (i) assets that a person owns, produces, manufactures, processes, or merchandises, (ii) liabilities that a person incurs, or (iii) services that a person provides or purchases;
 - a potential change in value related to any of the foregoing arising from foreign exchange rate movements; or
 - a fluctuation in interest, currency, or foreign exchange rate exposures arising from a person's assets or liabilities.

The proposed definition of hedging or mitigating commercial risk would not encompass any swap position that is held for a purpose that is in the nature of speculation, investing or trading.

Definition of “Substantial Counterparty Exposure”

The Commission proposes to define substantial counterparty exposure using a calculation method that is the same as the method used to calculate substantial position. However, the definition of substantial counterparty exposure is not limited to the major categories of swaps, and it does not exclude hedging or employee benefit plan positions. Rather it encompasses all of a person’s swap positions.

The proposed thresholds for substantial counterparty exposure are a current uncollateralized exposure of \$5 billion, or a sum of current uncollateralized exposure and potential future exposure of \$8 billion, across the entirety of a person’s swap positions.

Definition of “Financial Entity” and “Highly Leveraged”

The third aspect of the statutory definition of MSP addresses any “financial entity,” other than one subject to capital requirements established by an appropriate Federal banking agency, that is “highly leveraged” relative to the amount of capital it holds, and that maintains a substantial position in a major category of swaps. For this part of the definition, the Commission proposes to use the same definition of substantial position described above, without excluding hedging or employee benefit plan positions.

For this aspect of the definition, the Commission proposes to use the definition of “financial entity” in the Dodd-Frank Act provision for an end-user exception from mandatory clearing in CEA Section 2(h)(7). For the definition of “highly leveraged,” the Commission proposes two possible definitions – either a ratio of total liabilities to equity, as determined in accordance with U.S. GAAP, of 8 to 1, or a ratio of 15 to 1 measured in the same way.