Commodity Futures Trading Commission

Office of Public Affairs

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Frequently Asked Questions (FAQ) - Division of Swap Dealer and Intermediary Oversight ("DSIO") Responds to FAQs About Swap Entities

The Commission has prescribed rules addressing certain definitions under section 1a of the Commodity Exchange Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act. See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 Fed. Reg. 30596 (May 23, 2012) (hereinafter "Adopting Release"). This document contains staff interpretive responses to Frequently Asked Questions concerning swap entities. In the future, Commission staff will continue to evaluate the interpretive questions that are received from interested persons and will release additional clarifying information as appropriate.

The views expressed herein are solely the views of the staff of the Commodity Futures Trading Commission and do not necessarily reflect the views of the Commission, any Commissioner, or any other Federal regulatory agency.

I. Calculating Notional Amounts

For purposes of calculating the notional amount of physical commodity swaps, when and how does one measure the value of the physical underlying?

When calculating the notional amount of a physical commodity swap, the value of the physical underlying is the fair market value of the physical underlying at the time of the execution of the swap.

What if prices fluctuate in connection with the physical underlying (i.e., physical commodities) of swaps? How would that affect the dollar notional amount calculation? (For example, what if crude oil prices fall and what was a notional amount of $5 billion in one month decreases to a notional amount of far less than that in subsequent months?)

In swaps with physical underlyings, the notional amount is calculated using the fair market value of the underlyings at the time of the execution of the swap, even if there are price fluctuations in the underlyings subsequent to the execution of the swap.

How is the notional amount calculated for locational basis swaps referencing only one physical commodity?

For locational basis swaps referencing only one physical commodity, the notional amount should be calculated using the difference in fair market value of the physical commodity at the two locations, multiplied by the number of units referenced in the swap. For example, in a basis swap for 10,000 units of a physical commodity as delivered to Location A and 10,000 units of the same physical commodity as delivered to Location B in which one unit of the physical commodity at Location A has a fair market value of $110 per unit and one unit of the physical commodity at Location B has a fair market value of $100 per unit, the notional value of the swap will be $10 multiplied by 10,000 units, or $100,000.

Is hedging activity included in calculating the de minimis amount for swap dealers?

Depending on the circumstances, hedging activity may be included in the de minimis amount calculations. As stated in the Adopting Release, the relevant question in determining whether swaps count as dealing activity against the de minimis

thresholds is whether the swaps fall within the swap dealer definition under the statute and the final rules, as further interpreted by the Adopting Release. In other words, a person must consider the swap in light of all other relevant facts and circumstances to determine whether such hedging activity is swap dealing activity (e.g., accommodating demand for swaps, making a market for swaps, etc.). If hedging or proprietary trading activities do not fall within the definition, including because of the application of CFTC Regulation § 1.3(ggg)(6), they would not count against the de minimis thresholds.

For example, hedging of physical positions—as outlined in interim Commission regulation 1.3(ggg)(6)(iii)—is not included in calculating the de minimis amount for swap dealers. If a swap does not satisfy Commission regulation 1.3(ggg)(6)(iii), other exclusions may nonetheless be applicable, such as Commission regulations 1.3(ggg)(2), 1.3(ggg)(5), 1.3(ggg)(6)(i), 1.3(ggg)(6)(ii), and 1.3(ggg)(6)(iv).

The Division of Swap Dealer and Intermediary Oversight does not anticipate that it would recommend that the Commission take an enforcement action against a swap dealer that, during the period through December 31, 2012, is following its internal policies and procedures that are reasonably designed to ensure that all swaps are appropriately classified for purposes of calculating the de minimis threshold required pursuant to the swap dealer definition.

Are back-to-back swaps included in calculating the de minimis amount for swap dealers?

Depending on the circumstances, a back-to-back swap may be included in the de minimis calculation.

For instance, if the swap is entered into with a majority-owned affiliate in order to allocate risk within a corporate group or to transfer risks within a corporate group to a central hedging or treasury entity such that it satisfies the requirements of Commission regulation 1.3(ggg)(6)(i), then such swap will not be included in the de minimis amount calculation. Otherwise, the swap may be counted in the de minimis amount calculation as part of a person's swap dealing activity, based on the relevant facts and circumstances, unless it satisfies the exceptions to swap dealing activity provided in Commission regulations 1.3(ggg)(2), 1.3(ggg)(5), and 1.3(ggg)(6)(i)-(iv).

If the swap reverses the terms of a previously agreed-upon swap with the same counterparty, which effectively cancels the previously agreed-upon swap, then whether the notional amounts should be included in the de minimis calculation depends on whether the first swap is excluded from the de minimis calculation by virtue of Commission regulations 1.3(ggg)(2), 1.3(ggg)(5), or 1.3(ggg)(6)(i)-(iv), or based on relevant facts and circumstances. If the first swap satisfies such Commission regulations or is not swap dealing activity based on facts and circumstances (and is thereby excluded from the de minimis calculation), then the notional amount of the subsequent, back-to-back swap does not need to be included in the de minimis calculation. If the first swap does not satisfy such Commission regulations and is swap dealing activity based on relevant facts and circumstances (and is thereby included in the de minimis calculation), then the notional amount of the subsequent swap must be included in the de minimis calculation, unless the second swap otherwise is excluded from the calculation under Commission regulations or is not swap dealing activity based on relevant facts and circumstances.

What constitutes "leveraging" for purposes of Regulation 1.3(ggg)(4)(i), which requires the use of "effective notional amount?" And how does "leveraging" affect the calculations of the notional amount?

Commission regulation 1.3(ggg)(4)(i) states that the calculation of the de minimis notional amount "shall be based on the effective notional amount of the swap rather than on the stated notional amount" if the "swap is leveraged or enhanced by the structure of the swap." An example of this is if a multiplier is inserted into the swap terms.

For example, if an interest rate swap has a stated notional amount of $10 million and requires that the swap pays four times the difference between the LIBOR and a fixed interest rate, then the effective notional amount will be $40 million. In this example, assuming that the swap constitutes swap dealing activity, the notional amount used for purposes of calculating the de minimis amount will not be the stated $10 million notional amount, but the $40 million effective notional amount, because of the leverage built into the terms of the swap.

Does the time-period associated with the underlying affect the calculation of the notional amount? For example, if a swap is based on a notional amount of $10 million in connection with an interest rate with a one-year term compared to the same swap with a two-year term, would

the swap based on a two-year term have double the "effective notional amount" under Regulation 1.3(ggg)(4)(i)?

No. For example, if two interest rate swaps are executed by a person, each with a notional amount of $10 million, in which one swap has a one-year term and the other swap has a two-year term, and in which all other terms of the swaps are identical, then the notional amounts of the swaps would be identical. The two-year swap would not have an "effective notional amount" that is double the amount of the one-year swap.

Are "leveraged" and "enhanced" used as synonyms or antonyms when discussing the use of an effective notional amount instead of a stated notional amount? What would be an example of an "enhanced" structure?

Commission regulations 1.3(ggg)(4)(i), 1.3(hhh)(6)(iv), and 1.3(jjj)(3)(ii)(A)(2) reference an "effective notional amount" that is to be used in making notional amount calculations when the "stated notional amount" of swap/position is "leveraged or enhanced by the structure" of the swap/position. In these contexts, the terms "leveraged" and "enhanced" should be interpreted as synonyms.

For example, if an interest rate swap has a stated notional amount of $10 million and requires that the swap pays four times the difference between the LIBOR and a fixed interest rate, then the effective notional amount will be $40 million. In this example, assuming that the swap constitutes swap dealing activity, the notional amount used for purposes of calculating the de minimis amount will not be the stated $10 million notional amount, but the $40 million effective notional amount, because of the leverage built into the terms of the swap.

How is the notional amount calculated for physical commodities that are designated in units such as barrels, tons or shares? As of which date is the calculation made?

The notional amount calculation is made at the time of the execution of the swap transaction and is based on the fair market value of the physical underlyings at the time of the execution of the swap, regardless of price fluctuations in the physical underlyings subsequent to the execution of the swap transaction.

Are all hedges of non-dealer activity excluded from the calculation of the de minimis exception?

The Commission adopted an interim final rule providing that swaps that are entered into for the purpose of hedging physical positions in accordance with the requirements of Commission Regulation 1.3(ggg)(iii) are excluded for purposes of determining whether a person is a swap dealer. For a more detailed discussion of hedging activity in the context of the de minimis exception, review the response to Question 4 above.

Can a person rely on the Commission's Second Amendment to the July 14, 2011 Order for Swap Regulation (the "Exemptive Order")[1] to exclude swaps from the application of the swap dealer registration rules?

No. Section (4)c of the Exemptive Order states that the relief provided in the Order shall not "[a]ffect any effective or compliance date set forth in any rulemaking issued by the Commission to implement provisions of the Dodd-Frank Act." In other words, as particular Dodd-Frank Act-implementing rulemakings become effective, any applicable exemption or exclusion ceases and compliance with that new regulatory requirement begins.

With the swap definition final rulemaking's October 12, 2012 effective date, all swaps entered into by a person after October 12th in connection with the person's swap dealing activities are relevant in determining whether the person is within the swap dealer definition.

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[1] 77 Fed. Reg. 41260 (July 13, 2012).

The Exemptive Order has generally permitted parties to continue to rely on the various exclusions and exemptions that the Commodity Exchange Act ("CEA") established for swaps (i.e., CEA Sections 2(d), 2(e), 2(g), 2(h) and 5d) prior to its amendment by the Dodd-Frank Act, notwithstanding the fact that as of July 16, 2011, those provisions were removed from the CEA by the Dodd-Frank Act and replaced by various provisions that subjected swap activity to Commission oversight. The phasing-in approach under the Exemptive Order is consistent with the Commission's goal of ensuring a smooth transition from the pre-Dodd-Frank regulatory regime to the new regulatory regime.

If a swap is executed as part of an exchange-of-futures-for-swaps ("EFS") transaction in which a swap transaction is executed and subsequently exchanged for a futures contract, pursuant to the rules of a designated contract market ("DCM"), and the resulting position is then cleared as a futures position, does the swap count toward the de minimis exception from swap dealer registration?

Yes. As noted above, all of a person's swap dealing activities after October 12th are relevant in determining whether the person meets the swap dealer definition, even if it is a swap that might be exchanged for a DCM futures contract as part of an EFS transaction.

II. Aggregation of the Swap Positions of Affiliates

In calculating the aggregate notional amount of the relevant swap dealing activities, the Adopting Release states that the swap dealing activities of two affiliates under common control must be aggregated when applying the de minimis test. Is this requirement consistent with language in the Adopting Release that states that one entity's swap dealer designation will not be imputed to other non-dealer affiliates or to the group as whole?

Yes, the language is consistent.

As noted in the Adopting Release, "the notional thresholds to the de minimis exception encompass swap and security-based swap dealing positions entered into by an affiliate controlling, controlled by or under common control with the person at issue." This language describes the operation of Regulation 1.3(ggg)(4)(i), which requires a person to aggregate the swap positions (connected with its dealing activities) "into which the person – or any other entity controlling, controlled by or under common control with the person – enters over the course of the immediately preceding 12 months."

In a separate section of the Adopting Release (addressing "Application of Dealer Definitions to Legal Persons and to Inter-Affiliate Swaps and Security-Based Swaps"), the Commission noted the following:

"Within an affiliated group of companies, however, only those legal persons that engage in dealing activities will be designated as dealers; that designation will not be imputed to other non-dealer affiliates or to the group as a whole. A single affiliate group may, however, have multiple swap or security-based swap dealers."

77 Fed. Reg. at 30624 n. 345. In other words, the swap dealing activities of a legal person are not imputed to affiliated entities that do not engage in swap dealing activities. However, to the extent that two or more swap dealing affiliates are controlling, controlled by, or under common control with a person, then the swap positions of the affiliated swap dealing entities are aggregated with one another. The control relationship between the swap dealing entities is critical to determining whether the swap positions of affiliates must be included when calculating whether the de minimis threshold has been exceeded. However, a person's designation as a swap dealer will not be imputed to non-dealer affiliates

Should affiliates who were in operation prior to publication of the final rules have their notional amounts aggregated for purposes of the de minimis test?

Yes. In calculating the notional amounts for purposes of the de minimis threshold, a person should not include swap dealing activities that occurred prior to October 12, 2012. However, a person should aggregate the swap dealing activities of affiliates

subsequent to that date, for purposes of the de minimis test if they are controlling, controlled by or under common control with the person.

Should affiliates who are otherwise regulated in their home country jurisdiction have their notional amounts aggregated for purposes of the de minimis test?

The Commission recently published proposed guidance in the Federal Register on the cross-border application of certain swaps provisions in the Commodity Exchange Act. See Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 Fed. Reg. 41214 (July 12, 2012). The Commission has not yet issued final guidance.

III. Identifying Swap Dealing Activity

In the preamble to the final rule, the CFTC says that a person who treats "swap activity as a profit center" generally can be viewed as a swap dealer. What does it mean to treat "swap activity as a profit center?" What factors or characteristics would evidence that an entity is doing so?

The Adopting Release discusses factors applicable to assessing whether a person is treating its swap activity as "a separate profit center" for purposes of determining if the person falls within the statutory definition of a "swap dealer."

Two provisions of the definition of "swap dealer," as prescribed at section 1a(49)(A)(iii) of the Commodity Exchange Act, are instructive. First, section 1a(49)(A)(iii) provides one of the four statutory tests for determining whether a person is a swap dealer, stating that the term "swap dealer" encompasses a person that "regularly enters into swaps with counterparties as an "ordinary course of business for its own account." Second, section 1a(49)(C) excepts from the definition of "swap dealer" a person who "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 Adopting Release states that the phrases "ordinary course of business" and "a regular business" are "essentially synonymous" for purposes of the "swap dealer" definition. In this context, the phrases focus "on activities of a person that are usual and normal in the person's course of business and identifiable as a swap dealing business." The Adopting Release includes the following additional guidance about the types and levels of activities that constitute having "a regular business" of entering into swaps:

> "[A]ny one of the following activities would generally constitute both entering into swaps 'as an ordinary course of business' and 'as a part of a regular business': (i) Entering into swaps with the purpose of satisfying the business or risk management needs of the counterparty (as opposed to entering into swaps to accommodate one's own demand or desire to participate in a particular market); (ii) maintaining a separate profit and loss statement reflecting the results of swap activity or treating swap activity as a separate profit center; or (iii) having staff and resources allocated to dealer-type activities with counterparties, including activities relating to credit analysis, customer onboarding, document negotiation, confirmation generation, requests for novations and amendments, exposure monitoring and collateral calls, covenant monitoring, and reconciliation."

Further, the Adopting Release identified "an objective indicator" of when the "regular business" criterion is met: "when the person accounts for the results of its swap activities separately, by maintaining a separate profit and loss statement for those activities or by treating them as "a separate profit center." The Commission also identified other indicia of swap dealer activity, including:

- "[A]llocating staff and technological resources to swap activity, deriving revenue and profit from swap activity, or responding to customer-initiated orders for swaps can all be indicative of having 'a regular business' of entering into swaps and, therefore, an indicator of a person being a swap dealer."
- "[S]eeking to profit by providing liquidity to the market is an indication of dealer activity" under the dealer-trader distinction that is used to determine whether a person falls within the "making a market in swaps" prong of the statutory definition.

- "[W]hether the person is seeking, through presence in the market, compensation for providing liquidity, compensation through spreads or fees, or other compensation not attributable to changes in the value of the swaps it enters into."

A person should consider all of the foregoing activities and factors relative to its facts and circumstances to determine whether it treats swap activity as "a separate profit center."

The Adopting Release also indicated that "deriving revenue and profit from swap activity" is indicative of being a swap dealer. How will the CFTC measure this in determining whether an entity is a swap dealer?

The Commission will apply an "activity-based" approach to determine whether particular types of persons fall within the "swap dealer" definition. Thus, "deriving revenue and profit from swap activity," is but one of several indicia to consider when assessing whether a person has "'a regular business' of entering into swaps" that is "indicative of being a swap dealer." When making such assessment, a person must determine whether they satisfy the de minimis exception that excludes certain persons from the definition of a swap dealer.

If proprietary trading, by itself, does not constitute swap dealing activity, what is the difference between proprietary trading and "deriving revenue and profit from swap activity," or treating "swap activity as a profit center?"

As noted in the Adopting Release, the swap dealer activities set forth in section 1a(49) of the Commodity Exchange Act are enumerated in the disjunctive, meaning that a person who engages in any one of the activities under the four statutory tests is a swap dealer under the Act, even if such person does not engage in one or more of the other identified activities. The concepts of "deriving revenue and profit from swap activity" and treating "swap activity as a profit center" are indicia of "swap dealer" activity that should be assessed against the person's particular facts and circumstances, in addition to any other relevant indicia.

> As the Commission acknowledged in the Adopting Release:
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> "[R]outine presence in the swap market is not necessarily indicative of making a market in swaps. For example, persons may be routinely present in the market in order to engage in swaps for purposes of hedging, to advance their investment objectives, or to engage in proprietary trading."

Therefore, engaging in proprietary trading might not be indicative of making a market in swaps, depending on a person's particular facts and circumstances, and thus might not be a basis for concluding that a person is engaged in "swap dealer" activity.

The notional amounts associated with certain hedging activity are not included in the de minimis calculation. But what if the hedge itself was swap dealing activity (e.g., back-to-back swap dealing)?

Depending on the circumstances, a back-to-back swap entered into for hedging purposes may be included in the de minimis calculation. For a more detailed discussion of this issue, review the responses to Questions 4 and 5 above.

Can a person relying on the de minimis exception to the definition of swap dealer exclude the swap positions of any affiliate that registers as a swap dealer?

No. For a more detailed discussion of this issue, review the response to Questions 13 and 14 above.

IV. Insured Depository Institution Loan Exception

In regards to the insured depository institution carve out of the swap dealer definition, is an insured depository institution able to offer a swap for the total amount of a loan, even if it is not

the source of all of the loan funds? For example, if an insured depository institution has a 10 percent participation in a $50 million syndicated loan facility, can it offer a swap for the full $50 million?

Yes, in certain circumstances, an insured depository institution may offer a swap for the total amount of a loan, and not include the notional amount of such swap in the de minimis calculation, even if it is not the source of all of the loan funds. The person intending to offer the swap at the full amount of the loan must have substantial participation in the loan in order to offer a swap totaling more than its commitment percentage of the loan. In order to satisfy the "substantial participation" requirement, the Commission has determined that "a 10 percent commitment constitutes a substantial participation in the loan which supports offering of a swap up to the loan's full amount."

In determining if someone qualifies for the insured depository institution exception to the swap dealer definition, is the limitation on the maximum notional amount of the swap tied to the actual principal amount that was drawn by the customer (borrower) in connection with the loan in question? In other words, is the maximum notional amount of the swap tied to the amount that is outstanding at the time the swap is executed or to the total amount that the customer could receive from the loan, if the customer eventually decided to take the entire amount?

Yes, the limitation on the maximum notional amount of a swap that qualifies for the insured depository institution exception is tied to the aggregate principal amount outstanding under the loan at that time.

For example, if the amount of a loan is $50 million, but the borrower has only drawn $25 million on that loan, then the maximum notional amount subject to the exception (in connection with that loan) may total no more than $25 million. As stated by the Commission in the Adopting Release, "application of the exclusion requires that the aggregate notional amount of all swaps entered into by the borrower with any person in connection with the financial terms of the loan at any time [may] not [be] more than the aggregate principal amount outstanding under the loan at that time."

Are insured depository institutions eligible for the de minimis exception?

Yes, insured depository institutions are eligible for the de minimis exception. To the extent that an insured depository institution enters into swaps that that are not subject to the insured depository institution exception, such non-excepted swaps are calculated in the same manner as other swap dealing entities.

Pursuant to the final rules, the swap dealing activities of affiliates under common control must be aggregated when applying the de minimis test. Does the aggregation requirement mandate inclusion of the swap activities of an insured depository institution's registered swap dealer affiliates? How does the insured depository institution's reliance on the exception alter the manner in which the institution counts the swap positions of its affiliates?

Yes, the aggregation requirement mandates inclusion of the swap activities of an insured depository institution's swap dealer affiliates. Any swap that qualifies for the insured depository institution exception is not included in the de minimis calculation, both for the insured depository institution and for its affiliates. However, any swap that does not qualify for the exception must be included in the de minimis calculation for an insured depository institution or any of its swap dealing affiliates.

What is the scope of the term "loan" in the insured depository institution exception? What if an insured depository institution extends credit to a customer in a transaction that is economically identical to a loan, but documents it as a security? Can a swap entered into in connection with the origination of the extension of credit – regardless of whether it is classified as a loan – qualify for the exception?

In the Adopting Release, the Commission described the types of transactions that will be treated as loans for purposes of the insured depository institution exception. The categorization or classification of the transaction is not relevant; rather, a person must examine whether the transaction comports with the classic definition of loan, as described in In Re Renshaw, 222 F.3d

82, 88 (2d Cir. 2000) (citing In re Grand Union Co., 219 F. 353, 356 (2d Cir. 1914)): "To constitute a loan there must be (i) a contract, whereby (ii) one party transfers a defined quantity of money, goods, or services, to another, and (iii) the other party agrees to pay for the sum or items transferred at a later date." However, the exclusion does not apply to a "sham" loan, meaning one that is actually a synthetic loan such as a loan credit default swap or loan total return swap, as described in the final regulations.

If an insured depository institution extends credit to a customer by issuing a letter of credit with a corresponding reimbursement agreement (e.g., using a structure common in tax-exempt financings), can a swap entered into in connection with the origination of the extension of credit qualify for the insured depository institution exception?

As discussed in the response to Question 25, in the Adopting Release the Commission described the types of transactions that will be treated as loans for purposes of the insured depository institution exception.

Note that, as discussed in the response to Question 22, the maximum notional amount of a swap subject to the insured depository exception is tied to the principal amount outstanding under the loan at that time.

If the term of a loan initially matches the duration of a swap executed in connection with that loan, what effect does the voluntary prepayment or acceleration of the loan have on the swap dealer status of the insured depository institution that provided the swap?

The voluntary prepayment or acceleration of the loan does not affect the swap dealer status of the insured depository institution that executed the swap in connection with the origination of the loan. Thus, if an insured depository institution enters into a swap in connection with originating a loan with a customer, and the notional amount of the swap does not exceed the aggregate principal amount outstanding under the loan at the time of the execution of the swap, the insured depository institution is not required to unwind the swap in the event that the loan subsequently is prepaid or accelerated. Notwithstanding that general principle, transactions should not be structured to evade the requirements of the Commodity Exchange Act and its implementing regulations.

If an unfunded risk participation is considered a swap under Commission Regulations, will the insured depository institution providing the unfunded risk participation be able to rely upon the insured depository institution exception?

Yes, provided that the other conditions of the exception are satisfied. Among other conditions, a person intending to offer a swap at the full amount of the loan must have substantial participation in the loan in order to offer a swap totaling more than its commitment percentage of the loan.

Given that (i) the notional amount of a swap entered into under the insured depository exception cannot exceed the outstanding principal amount of the loan, and (ii) the exception contemplates that swaps may be entered into as much as 90 days in advance of the loan, can a swap entered into in advance of the loan have a notional amount that matches the anticipated loan amount as long as the swap does not become effective until the loan has been funded?

Yes, under Regulation 1.3(ggg)(5)(i), a swap into which an insured depository institution enters -- up to 90 days before the execution of the applicable loan agreement or up to 90 days before any transfer of principal to the customer pursuant to that loan -- and which has an aggregate notional amount that does not exceed the anticipated amount of the loan (assuming that such amount becomes the actual amount of the loan) will qualify for the exception, so long as the other conditions to qualify for the exception are satisfied.

If an insured depository institution enters into a swap agreement with a borrower in anticipation of funding a loan within the following 90 days, and the loan (for whatever reason) does not fund within the following 90 days, how would that swap agreement be treated under the insured depository institution exception?

If an insured depository institution enters into a swap with a customer, but the institution does not execute a loan agreement with that customer or transfer principal to that customer within 90 days after execution of the swap, then the swap does not qualify for the exception.

Would the renewal of an outstanding swap, such as a commodity swap with a one-year term, still receive the benefit of the insured depository institution exception if the renewal falls outside the timing parameters established for the exception?

No, a swap renewed outside of the timing parameters established for the exception (i.e., a swap entered into within 90 days before or 180 days after the date of the execution of the loan agreement) will not qualify for the exception.

Would a modification of an outstanding/existing swap still receive the benefit of the insured depository institution exception if the modification falls outside the timing parameters established for the exception?

No, a swap modified outside of the timing parameters established for the exception (i.e., a swap entered into within 90 days before or 180 days after the date of the execution of the loan agreement) will not qualify for the exception.

Are insured depository institutions limited as to the categories of swaps that are covered by the insured depository institution exception?

Yes. Commission Regulation 1.3(ggg)(5)(i) enumerates the characteristics of swaps that are covered by the exception. As the Commission noted in the Adopting Release, the types of swaps covered by the exception are directly related to repayment of the loan with which a swap is connected.

Commission Regulation 1.3(ggg)(5)(i)(B) includes two subparagraphs (i.e., (1) and (2)) describing certain types of swaps. Those subparagraphs are alternatives – swaps with the characteristics of either subparagraph would satisfy this particular condition. That is, the rule should be read as if the word "or" appeared between subparagraphs (1) and (2).

Will insured depository institutions entering into swaps in reliance on the insured depository institution exception be able to rely on the representations, warranties or covenants from their borrowers that the amount of the swap does not exceed the amount of the loan?

No, the final rules do not contemplate permitting an insured depository institution to rely merely on the representations, warranties, or covenants from their borrowers in that regard.

V. Special Entities

If a non-dealer enters into a swap on a swap execution facility ("SEF") or designated contract market ("DCM") through a broker, and thus does not know the identity of its counterparty, how does the non-dealer calculate its $25 million de minimis threshold for swaps with special entities? Can non-dealers enter into swaps without knowing the identity of their counterparties?

Section 4s(h)(7) of the Commodity Exchange Act addresses the applicability of section 4s to certain transactions with special entities:

> "(7) APPLICABILITY.—This section shall not apply with respect to a transaction that is—
> (A) initiated by a Special Entity on an exchange or swap execution facility; and
> (B) one in which the swap dealer or major swap participant does not know the identity of the counterparty to the transaction."

In light of that statutory limitation, any swap transactions meeting both conditions prescribed in section 4s(h)(7) need not be included in the $25 million de minimis calculation for swap dealing activities with special entities. However, such swap transactions must be included in the de minimis calculation for the person's swap dealing activities with all counterparties.

VI. Options and Swaptions

Can a collar, which consists of a put option and a call option, be treated as having a single notional amount, or is the notional amount doubled to account for the put and the call?

For purposes of calculating the notional amount, a collar should be treated as having a single notional amount.

What is the proper method for calculating swaption gross notional amounts?

Consistent with the treatment of futures and equity options, the notional value of a swaption looks through the option contract to the underlying swap for purposes of determining the notional. The notional value of the underlying swap should be determined consistent with Part 45 of the Commission's Regulations. The notional value should then be taken in its absolute value position and summed similarly with all other such positions.

VII. Major Swap Participants

When must a person start to "count" swap positions in considering whether it meets the criteria to be a major swap participant? When must a person register as a major swap participant? On what date will a person be deemed a major swap participant?

> Commission Regulation 1.3(hhh)(3) states as follows:
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> "A person that is not registered as a major swap participant, but that meets the criteria in this rule to be a major swap participant as a result of its swap activities in a fiscal quarter, will not be deemed to be a major swap participant until the earlier of the date on which it submits a complete application for registration as a major swap participant pursuant to Section 4s(a)(2) of the Act, 7 U.S.C. 6s(a)(2), or two months after the end of that quarter."

The definition of the term "swap" in Commission Regulation 1.3(xxx) is effective on October 12, 2012. Thus, a person should begin to calculate its daily average exposures for purposes of the major swap participant definition on that date. If a person meets the criteria during the 4th Quarter of 2012, that person must register within 2 months after the end of that Quarter (i.e., the end of February 2013). That person will be deemed a major swap participant on the earlier of that date or the date on which it submits a complete application for registration.

The Division of Swap Dealer and Intermediary Oversight does not anticipate that it would recommend that the Commission take an enforcement action against a major swap participant that, during the period through December 31, 2012, is following its internal policies and procedures that are reasonably designed to ensure that all swaps are appropriately classified for purposes of making the applicable calculations required pursuant to the major swap participant definition.

The Adopting Release stated that the calculations for the second (Commission Regulation 1.3(hhh)(6)(ii)) and third (Commission Regulation 1.3(hhh)(6)(iii)) safe harbors of the major swap participant definition are to be done at the end of each month. Should the calculations for the first safe harbor also be done at the end of each month?

Although Commission Regulations 1.3(hhh)(6)(ii)(B) and 1.3(hhh)(6)(iii) state that certain calculations in the safe-harbor thresholds (as relevant to safe harbors 2 and 3) shall be based on an entity's positions, and that such calculations shall be done as of the end of each month, Commission Regulations 1.3(hhh)(6)(i) and 1.3(hhh)(6)(ii)(A) (as relevant to safe harbors 1 and 2) reference a contractual limitation on positions, not an actual measure of such positions. As such, to satisfy the elements in Commission Regulations 1.3(hhh)(6)(i) (for safe harbor 1) and 1.3(hhh)(6)(ii)(A) (for safe harbor 2), the contractual limitation

on total uncollateralized outward exposure and the maximum notional amount of swap positions must be maintained at all times.

What happens if an entity relying on a safe harbor exceeds the threshold in the middle of a quarter? Can an entity rely on the safe harbor for two months after the safe harbor threshold is breached? Could an entity instead only complete the safe harbor calculations at the end of each quarter, as opposed to the end of each month?

For an entity to avail itself of the safe-harbor provisions, the conditions of the safe harbor must be satisfied on a monthly basis or a continuous basis, as discussed above in the response to Question 39. Once the safe-harbor thresholds are exceeded, an entity is no longer permitted to avail itself of such protection. However, Commission Regulation 1.3(hhh)(6)(v) states that "[n]o presumption shall arise that a person is required to perform the calculations needed to determine if it is a major swap participant, solely by reason that the person does not meet the conditions specified in paragraph (hhh)(6)(i), (ii) or (iii) of this section." As such, even though a safe-harbor threshold may be breached, that breach does not necessarily trigger registration requirements, or a requirement that an entity perform major swap participant calculations.

When a person guarantees a swap position of an affiliate, the swap position is attributed to the guarantor for purposes of the major swap participant calculation. What about circumstances in which a person insures (as opposed to guaranteeing) a swap position of an affiliated person?

As noted in the Adopting Release, the swap position of an affiliate will be attributable to "a parent, other affiliate or guarantor for purposes of the major participant analysis to the extent that the counterparties to those positions would have recourse to that entity in connection with the position. Positions would not be attributed in the absence of recourse." To the extent that an insurance contract similarly provides recourse from the insurer to the holder of the position, such position should be attributed to the insurer for purposes of the calculation. This is consistent with the risk focus of the major swap participant definitions as stated in the preamble, in that such definitions are intended to capture entities as major swap participants "when they pose a high level of risk in connection with the swap and security-based swap positions they guarantee." The Commission noted in the Adopting Release that, notwithstanding the presence of a guarantee, "a person's swap or security-based swap positions need not be attributed to a parent or other guarantor "if the person already is subject to capital regulation by the CFTC or SEC . . . or if the person is a U.S. entity regulated as a bank in the United States."

If a monoline insurer acts as a guarantor for a third party (which could be an affiliate of the monoline insurer, or not) with respect to the third party's interest rate swap with its own counterparty, and if that counterparty therefore has recourse to the monoline insurer in the event that the third party fails to perform its obligations under the swap, will the swap position be attributed to the monoline insurer/guarantor for purposes of determining its status as a major swap participant?

Yes, under certain circumstances. As noted in the Adopting Release, the swap position of an affiliate will be attributable to "a parent, other affiliate or guarantor for purposes of the major participant analysis to the extent that the counterparties to those positions would have recourse to that entity in connection with the position. Positions would not be attributed in the absence of recourse." The Adopting Release also stated that:

> "[W]hen an insurer guarantees the performance of other parties' swap or security-based swap positions, in an amount that is greater than the applicable major participant thresholds, it would be appropriate to regulate that entity as a major participant. When the guaranteed positions are large enough, the risks associated with those positions and the repercussions of the guarantor's default would appear to be within the ambit of the risks that that the major participant definitions were intended to capture."

This statement in the Adopting Release is not limited to affiliate relationships, so it includes situations where an insurer guarantees the performance of an unaffiliated third party.

The Commission noted in the Adopting Release that, notwithstanding the presence of a guarantee, "a person's swap or security-based swap positions need not be attributed to a parent or other guarantor "if the person already is subject to capital regulation by the CFTC or SEC . . . or if the person is a U.S. entity regulated as a bank in the United States."

Additionally, the Commission has discussed certain issues surrounding operational compliance that may arise in the context of attribution of swap positions to a parent or guarantor. See 77 Fed. Reg. at 30689.

Commission Regulation 1.3(hhh)(6)(ii)(B)(2)(i) addresses certain safe-harbor calculations. Does the phrase "related positions" in that Regulation include ERISA plan positions? Further, does the language of Regulation 1.3(hhh)(6)(ii)(B)(2)(ii)—which addresses a different calculation—mean that neither hedging positions nor ERISA plan positions will be excluded from the (ii) calculation? Also, is the reference in Commission Regulation 1.3(hhh)(6)(iii)(A)(2) to paragraph (jjj)(3)(ii)(1) correct?

Commission Regulation 1.3(hhh)(6)(ii)(B)(2)(i) provides that, for purposes of the safe-harbor calculation, "this analysis shall exclude the same hedging and related positions that are excluded from consideration pursuant to paragraph (jjj)(1)(i) of this section." This calculation is of the "substantial position" of that entity, which includes a statutory exclusion of both ERISA plan hedging and hedging or mitigating a commercial risk. As such, both ERISA plan hedging and hedging to mitigate a commercial risk are excluded from that calculation.

To the extent that Regulation 1.3(hhh)(6)(ii)(B)(2)(ii) requires the calculation of a substantial counterparty exposure, as contrasted with the substantial position calculated in Regulation 1.3(hhh)(6)(ii)(B)(2)(i), no statutory exclusion for either ERISA hedging or hedging or mitigating a commercial risk exists. As such, all swap positions are to be included for purposes of calculating this safe harbor threshold.

In Regulation 1.3(hhh)(6)(iii)(A)(2), the reference should be to paragraph (jjj)(3)(ii)(A)(1).

Does the word "outward" have a meaning that is legally significant? Does the use of the word "outward" in describing exposure mean that the exposure is only with respect to out-of-the-money positions?

"Outward exposure" is a proxy for risk that an entity poses externally, through amounts that such entity owes, or may owe as a result of such positions. This is the inverse of traditional models for positional risk, where such risks are generally viewed as "inward" to the entity, in that such models consider amounts owed to the entity.