



Commodity Futures Trading Commission

Office of Public Affairs

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Q & A – Final Rulemaking Regarding Further Defining “Swap Dealer,” “Major Swap Participant” and “Eligible Contract Participant”

What is the goal of the final rulemaking?

The final rulemaking further defines the terms “swap dealer,” “major swap participant” and “eligible contract participant.” The terms “swap dealer” and “major swap participant” were added to the Commodity Exchange Act (CEA) by Section 721 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Section 712(d)(1) of the Dodd-Frank Act requires the Commission and the SEC, in consultation with the Federal Reserve Board, to jointly further define those terms. In addition, the final rulemaking, as required by Section 712(d)(1) and as authorized by Section 721(d)(2)(A), includes changes to the term “eligible contract participant,” which is currently defined in Section 1a(18) of the CEA.

Persons that meet the definitions of “swap dealer” or “major swap participant” will be subject to certain statutory requirements that are the subject of other separate rulemakings, including, registration, margin, capital and business conduct standards. With respect to the term “eligible contract participant,” the Dodd-Frank Act makes it unlawful for a person that is not an eligible contract participant to enter into a swap other than on, or subject to the rules of, a designated contract market.

How should a person apply the rules and guidance further defining the term “swap dealer”?

The person should begin with the statutory definition and the provisions of the rule which implement the four statutory tests and the exclusion of activities that are not part of “a regular business,” in order to determine if the person is engaged in swap dealing activity. In that review, the person would apply the interpretive guidance in the release that provides for consideration of all of the relevant facts and circumstances. As part of this consideration, the person could apply elements of the SEC’s dealer-trader distinction.

The rule provides that certain swaps may be excluded from the determination – swaps entered into between an insured depository institution and a customer in connection with originating a loan, swaps between majority-owned affiliates, swaps between a cooperative and its members, and swaps entered into for hedging physical positions.

If this review shows that the person is engaged in swap dealing activity, the next step is to determine if the person is engaged in more than a de minimis quantity of swap dealing. If so, the person must register as a swap dealer. In doing so, the person may apply to limit its designation to specified categories of swaps or specified activities of the person in connection with swaps.

What are some of the principles that apply in determining if a person is a swap dealer?

The adopting release gives further interpretive guidance on concepts from the proposing release. It explains that whether a person’s activities cause it to be covered by the swap dealer definition should be determined in the context of the four parts of the statutory definition. For example, the guidance provides that market making is appropriately described as routinely standing ready to enter into swaps at the request or demand of a counterparty, and it clarifies that it is possible for a person making a one-way market in swaps to be a market maker. On whether a person’s swap activity constitutes “a regular business,” and is therefore potentially indicative of swap dealing, the guidance focuses on activities that are usual and normal in the person’s course of business and identifiable as a swap dealing business. Also, the release explains that although the CFTC is not formally adopting the SEC’s dealer-trader precedents, those precedents may be applied to determine if a person is a swap dealer.

How are hedging swaps relevant in the swap dealer determination?

The statutory definition does not specifically address hedging activity. However, the CFTC believes it is appropriate to provide, in an interim final rule, that swaps a person enters into for the purpose of hedging price risks related to physical positions are inconsistent with swap dealing, and are excluded from the swap dealer determination. The interim final rule draws upon principles in the Commission's long standing interpretation of bona fide hedging. It excludes swap activity for the purpose of portfolio hedging and anticipatory hedging. However, the CFTC is not adopting a per se exclusion of all swaps that hedge or mitigate risk. If a swap is not entered into for the specific hedging purposes identified in the rule, then all relevant facts and circumstances about the swap would be considered in determining if the person is a swap dealer. The CFTC is looking forward to receiving comment on whether the interim final rule appropriately excludes swaps for hedging.

When are swaps between an insured depository institution and a customer in connection with the origination of a loan excluded from the dealer analysis?

The rule balances the need for flexibility in lending practices, the constraints of the statutory text providing for this exclusion, and the risk of creating a gap in swap dealer regulation. It provides that the exclusion applies to a swap that is connected to the financial terms of a loan or is required to hedge the borrower's commodity price risks, if the swap is entered into within 90 days before or 180 days after the execution of the loan agreement or any principal draw under the loan. The loan must be within the common law meaning of the term "loan" and the insured depository institution must be the sole lender or, if it is in a loan syndicate, be responsible for at least 10% of the loan. Other incidental conditions also apply.

What is the threshold for determining if a person is engaged in a de minimis quantity of swap dealing?

The rule provides that a person shall not be deemed a swap dealer if its swap dealing activity over the preceding 12 months results in swap positions with an aggregate gross notional amount of no more than \$3 billion, and an aggregate gross notional amount of no more than \$25 million with regard to swaps with a "special entity" (which includes municipalities, other political subdivisions and employee benefit plans). Swaps that are not connected to swap dealing activity, as defined in the rule and interpretive guidance, do not count against the de minimis threshold.

The rule also provides for a phase-in of the de minimis threshold to facilitate orderly implementation of swap dealer requirements. During the phase-in period, the de minimis threshold would effectively be \$8 billion (while the \$25 million threshold for swaps with special entities would apply). Two and one-half years after data starts to be reported to swap data repositories, the Commission's staff will prepare a study of the swap markets, including data and information that becomes available about the de minimis threshold. Nine months after this study, the Commission may end the phase-in period, or propose new rules to change the de minimis threshold (either up or down). If the Commission period does not take action to end the phase-in period, it will terminate automatically five years after data starts to be reported to swap data repositories.

What are the threshold levels adopted in the final rules further defining "major swap participant" (MSP) for determining whether a person has a "substantial position" or "substantial counterparty exposure"?

For a person to have a "substantial position" in a major category of swaps, the final rules require a daily average current uncollateralized exposure of at least \$1 billion (or \$3 billion for the rate swap category), or a daily average current uncollateralized exposure plus potential future exposure of \$2 billion (or \$6 billion for the rate swap category).

For a person's swap positions to pose "substantial counterparty exposure," the final rules require positions that present a daily average current uncollateralized exposure of \$5 billion or more, or present daily average current uncollateralized exposure plus potential future exposure of \$8 billion or more.

The final rules further defining "major swap participant" (MSP) include rules on the calculation of "substantial position." How do the final rule on substantial position account for the effect of central clearing?

The method of calculating substantial position as adopted accounts for the risk-mitigating effects of central clearing. First, the method deducts from current exposure the value of any collateral posted with respect to a swap position. Since centrally cleared swaps are typically subject to full mark-to-market margining, the swaps would generally be eliminated from the calculation of current exposure. Also, in the calculation of potential future exposure, centrally cleared swaps are subject to a 90% discount in value.

How do the final rules on substantial position account for potential short-term variations in the value of a person's swap positions?

The calculations in the substantial position test would be applied as the mean of the amounts measured at the close of each business day in a calendar quarter. This method takes into account concerns that swap positions should not be evaluated based on a single point in time because short-term market fluctuations may not fairly reflect risks. The Commission expects that use of a daily average approach should also help preclude the possibility that a person may use short-term transactions to distort the measure of substantial position.

Why do the final rules on substantial position include an element to account for potential future exposure?

The Commission believes that rules which focus solely on current uncollateralized exposure could be overly narrow by failing to identify risky entities until after they begin to pose risk. Because exposure can change quickly over short periods of time, swaps may already pose significant risk even before uncollateralized mark-to-market exposure increases up to the applicable threshold.

Did the Commission consider other tests for determining if a person has a substantial position in swaps for purposes of the "major swap participant" (MSP) definition?

Yes. The Commission considered several other types of tests that, but does not believe their advantages justify their disadvantages. For example, a test based on the number of a person's counterparties could identify highly interconnected entities, but a large number of counterparties also means that the losses from that person's default may be more easily absorbed by the market. A threshold based on a person's financial strength would not address risks that arise before the person defaults, such as price movements caused when an MSP faces a large margin call. A threshold based on the financial strength of a person's counterparties could encourage concentration of swaps within a few counterparties.

Is the definition of "hedging or mitigating commercial risk" limited to positions that qualify for hedge accounting treatment or bona fide hedging treatment?

No. Although the final rule includes swaps that are recognized as hedges for accounting purposes or as bona fide hedging under Commission rules, the swaps included within the proposed exclusion for hedging or mitigating commercial risk are not limited to those categories. Rather, the final rule covers swaps hedging or mitigating any of a person's business risks, regardless of their status under accounting guidelines or the bona fide hedging rule.

What are swap positions held for a purpose that is in the nature of speculation, investing or trading for purposes of the definition of "hedging or mitigating commercial risk"?

The definition of substantial position excludes positions held for "hedging or mitigating commercial risk." The final definition of hedging or mitigating commercial risk, however, does not encompass any swap position that is held for a purpose that is in the nature of speculation, investing or trading. The Commission believes that the meaning of "speculation, investing or trading" is apparent when read in the overall context of the definition of "hedging or mitigating commercial risk." As a result, swap positions executed for the purpose of speculating, investing, or trading are those positions executed primarily to take an outright view on market direction or to obtain an appreciation in value of the swap position itself and not primarily for hedging or mitigating underlying commercial risks. For example, swaps positions held primarily for the purpose of generating profits directly upon closeout of the swap, and not to hedge or mitigate underlying commercial risk, are speculative or serve as

investments. Further, as an alternative example, swaps executed for the purpose of offsetting potential future increases in the price of inputs that the entity reasonably expects to purchase for its commercial activities serve to hedge a commercial risk.

How would a person be designated as a “major swap participant” (MSP)?

Similar to a swap dealer, a person that meets the definition of major swap participant must register with the Commission. This would require each market participant whose swap activities exceed any of the thresholds for “substantial position” or “substantial counterparty exposure” to register. In addition, the final rules permit persons to apply to be designated as a major swap participant with respect to only specified categories of swaps or activities.

Does the final rule regarding “major swap participant” (MSP) provide for an implementation process in connection with registration?

Yes. A person would be deemed to be a major swap participant upon the earlier of the date on which it submits a complete application for registration, or two months after the end of the quarter in which it meets the major swap participant criteria. In addition, if any person meets the criteria for qualifying as a major swap participant, but does not exceed any applicable threshold by more than 20 percent in that particular quarter, the person will not immediately be subject to the timing requirements noted above, but will become subject to the timing requirements at the end of the next fiscal quarter if such person exceeds any of the applicable daily average thresholds in that next fiscal quarter. The final rules also provide that a person retains major swap participant status until it does not exceed any of the applicable thresholds for four consecutive quarters following registration.

Does the final rule defining “major swap participant” (MSP) provide for safe harbor(s) so that market participants would be relieved of daily calculations?

Yes. The final rules regarding major swap participant provide for three (3) alternative safe harbors. First, a person will not be deemed to be a major swap participant if: (1) the express terms of the person’s arrangements relating to swaps with its counterparties at no time would permit the person to maintain a total uncollateralized exposure of more than \$100 million to all such counterparties, including any exposure that may result from the application of thresholds or minimum transfer amounts established by credit support annexes or similar arrangements; and (2) the person 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 aggregate.

Second, a person will not be deemed to be a major swap participant if: (1) the express terms of the person’s arrangements relating to swaps with its counterparties at no time would permit the person to maintain a total uncollateralized exposure of more than \$200 million to all such counterparties, including any exposure that may result from thresholds or minimum transfer amounts; and (2) the person performs the major swap participant (e.g., the “substantial position” and “substantial counterparty exposure” calculations associated with the major swap participant tests) as of the end of every month, and the results of each of those monthly calculations indicate that the person’s swap positions lead to no more than one-half of the level of current exposure plus potential future exposure that would cause the person to be a major swap participant.

Third, a person will not be deemed to be a major swap participant if the person’s current uncollateralized exposure is in connection with a 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 person performs certain modified major swap participant 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 person’s swap positions in each major category of swaps are less than one-half of the substantial position threshold.

What is the significance of meeting the definition of “eligible contract participant” for purposes of Title VII of the Dodd-Frank Act?

ECPs can enter into swaps other than on or subject to the rules of a designated contract market. ECPs and their counterparties also are not subject to the retail forex regime of the CFTC or other federal regulators.

Will I still be able to rely on the Swap Policy Statement in connection with the definition of “eligible contract participant”?

No, but the core of the swap policy statement —hedging or mitigating commercial risk using swaps in connection with a line of business — is incorporated into the final rules, along with a new condition regarding ownership and a new way of determining net worth for the limited purpose of the new line of business prong of the ECP definition.

Will swap dealers, major swap participants, security-based swap dealers and major security-based swap participants be per se eligible contract participants?

Yes, irrespective of whether they are registered as such.

If a commodity pool cannot satisfy the terms of CFTC Regulation § 1.3(m)(5), can it instead qualify as an ECP under CFTC Regulation § 1.3(m)(8)?

Yes. Under Commission Regulation § 1.3(m)(5), a commodity pool that is the counterparty to retail forex transactions (a transaction-level pool) and that has one or more non-ECP participants is not itself an ECP under either prong (iv) or prong (v) of the ECP definition for purposes of CEA sections 2(c)(2)(B) and (C) of the CEA. In determining whether a pool that is a direct participant in a transaction-level pool (investor pool) is an ECP for purposes of the transaction-level pool's retail forex transactions, the investor pool's investors will not count unless the transaction-level pool, any direct or indirect investor pool, or any commodity pool in which the transaction-level pool holds a direct or indirect interest, has been structured to evade subtitle A of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act by permitting non-ECPs to participate in retail forex transactions.

Notwithstanding the look-through language in Section 1a(18)(A)(iv) of the CEA and Commission Regulation § 1.3(m)(5), a commodity pool that enters into a retail forex transaction is an ECP with respect thereto, regardless of whether each participant in the pool is an ECP, if all of the following conditions are satisfied:

- the pool is not formed for the purpose of evading regulation under Section 2(c)(2)(B) or Section 2(c)(2)(C) of the Act or related Commission rules, regulations or orders;
- the pool has total assets exceeding \$10,000,000; and
- the pool is formed and operated by a registered CPO.

When does the look through become effective?

Not until December 31, 2012, consistent with the compliance date for CPOs who previously claimed exemption from CPO registration pursuant to now-withdrawn CFTC Regulation § 4.13(a)(4).

How can a CPO comply with the element of CFTC Regulation § 1.3(m)(8)(iii) requiring formation and operation by a registered CPO if the relevant pool was formed by a person other than a registered CPO?

Compliance with the formation element of CFTC Regulation § 1.3(m)(8)(iii) is not required of any person seeking to rely on CFTC Regulation § 1.3(m)(8)(iii) with respect to a commodity pool formed prior to December 31, 2012. Such compliance will be required with respect to a commodity pool formed on or after December 31, 2012, however, for any person seeking to rely on CFTC Regulation § 1.3(m)(8)(iii).

If a CPO is located outside the United States, its territories or possessions and operates a commodity pool whose participants are limited solely to non-U.S. persons, is the pool subject to the look through for purposes of determining whether it is an ECP for purposes of CFTC Regulation § 1.3(m)(5)?

In such circumstances, the pool will be considered an ECP for purposes of CFTC Regulation § 1.3(m)(5) irrespective of the ECP status of its participants. For this purpose, a pool participant is a non-U.S. person if it satisfies the definition of “Non-United States person” in CFTC Regulation § 4.7(a)(1)(iv); provided, however, that, if a participant is an entity organized principally for passive investment, such as a pool, investment company or other similar entity, unlike in CFTC Regulation § 4.7(a)(1)(iv)(D) (which permits any amount of beneficial interests in such an entity up to 10% to be held by U.S. persons), all units of participation in such passive investment vehicle participant must be held by Non-United States persons for such passive investment vehicle participant to be a Non-United States person for purposes of determining the ECP status of a commodity pool in which such passive investment vehicle participates.