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CFTC Proposes Definitions for Swap Participants Under the Dodd-Frank Act

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On December 1, 2010, the Commodity Futures Trading Commission (CFTC) held a public meeting to consider the issuance of proposed rulemaking under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. In particular, the CFTC proposed rules that would clarify which types of swaps traders would be subject to the new derivatives regulations.

Title VII of Dodd-Frank, among other things, (i) divides regulatory authority over swaps between the Securities and Exchange Commission (SEC) and the CFTC (with the SEC having regulatory authority over security-based swaps, the CFTC having regulatory authority over all other swaps, and joint regulatory authority over mixed swaps), (ii) creates new categories for market participants who are subject to new registration, capital and margin requirements, record keeping, reporting and other regulatory requirements and (iii) requires that certain swaps be accepted by a clearing organization for clearing. Under Dodd-Frank, the Federal Reserve and prudential regulators will be responsible for setting capital and margin for bank swap dealers, while the SEC and the CFTC will be responsible for the non-bank swap dealers and major swap participants.

At the public meeting, the CFTC further clarified the proposed categories of market participants that would be considered “Swap Dealers” and “Major Swap Participants,” two critical terms at the heart of the new regulatory regime. The CFTC proposed the rule in a 3-2 vote, but the rule must be considered by the SEC, which is scheduled to vote on the measure on December 3, 2010, before it can be subject to public comment. In the meantime, the CFTC has issued some Q&A guidance.

Dodd-Frank defines a “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 any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps. The looseness of language in clause (iii) has particularly concerned the market.

The CFTC proposed a four-part test to determine if a firm could be considered a Swap Dealer or exempt from such classification. Under the proposed test, a firm could be considered a Swap Dealer if it meets demand for transactions, enters swaps to facilitate other parties’ interests, tends not to ask that other parties propose terms and tends to arrange customized swap terms. Indicia that a person is holding itself out as a swap dealer or is commonly known in the trade as a swap dealer would include:

- Contacting potential counterparties to solicit interest in swaps,
- Developing new types of swaps and informing potential counterparties of their availability,
- Membership in a swap association in a category reserved for dealers,
- Providing marketing materials (such as a web site) that describe the types of swaps one is willing to enter into with other parties, and
- Generally expressing a willingness to offer or provide a range of financial products that would include swaps.

Under Dodd-Frank, there is a de minimis level of activity which would not require registration as a swap dealer. The CFTC proposal would exempt firms whose notional aggregate amount of swaps on their books in the past year has not exceeded $100 million (of which no more than $25 million can be with “special entities,” defined in the Commodity Exchange Act to include certain governmental entities) and that have traded only up to 20 swaps with no more than 15 counterparties as a dealer within a 12-month period.

Dodd-Frank defines a “Major Swap Participant” as any person who is not a Swap Dealer and: (i) maintains a substantial position in swaps (except for positions that are held for hedging or mitigating commercial risk); (ii) whose swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United State banking system or financial markets; or (iii) is highly leveraged relative to the amount of capital it holds.

To further clarify the definition of Major Swap Participant, the CFTC proposed that a firm would be considered to have a “substantial position” in swaps if (i) it has a daily average of current uncollateralized exposure of at least $1 billion on a net basis for credit, equity or commodity swaps, and $3 billion for rate swaps, or (ii) it has a daily average of current uncollateralized exposure and future exposure of at least $2 billion for credit, equity or commodity swaps, or $6 billion for rate swaps. A firm would be considered to have “substantial counterparty exposure” if it has uncollateralized exposure of more than $5 billion or current and future exposure exceeding $8 billion. To classify a firm as “highly leveraged,” the CFTC proposed 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. Calculation for purposes of the substantial position and substantial counterparty exposure tests would be determined as the mean of the amounts measured at the close of each business day in a calendar quarter. The CFTC declined to use measurements based on the number of counterparties or on financial strength of the swap party or its counterparties.

The proposed rule amplifies the exclusion of the hedging transaction from the substantial position test to include all swaps hedging or mitigating any of a person's commercial risks, regardless of their status under accounting guidelines (FASB 133) or the CFTC's bona fide hedging rule. Under the proposed rule, such excluded "commercial risk" hedging transactions would include hedging transactions that are 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 (i) a potential change in the value of (x) assets that a person owns, produces, manufactures, processes, or merchandises, (y) liabilities that a person incurs, or (z) services that a person provides or purchases; (ii) a potential change in value related to any of the foregoing arising from foreign exchange rate movements; or (iii) a fluctuation in interest, currency, or foreign exchange rate exposures arising from a person's assets or liabilities. It remains to be seen how such exceptions are applied to commercial enterprises whose business is substantially comprised of the managing of financial risks in the ordinary course of business (e.g., insurers).

The CFTC's proposed rulemaking also permits clearinghouses to provide portfolio margining of futures and securities in futures accounts and requires Swap Dealers and Major Swap Participants to maintain daily trading records of swaps and all related records, including electronic mail, instant messages, and recordings of telephone calls. Such records would be open to inspection by the CFTC.

The proposed rule, once published, will be open for public comment for 60 days. The CFTC and the SEC are scheduled to vote on a final rule in July 2011.

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