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C H A N C E

Client Memorandum May 2012

CFTC and SEC Adopt Final Entity Definition Rules for Swap Dealers, Major Swap Participants and Eligible Contract Participants

At meetings held on April 18, 2012, the Commodity Futures Trading Commission ("**CFTC**") and Securities and Exchange Commission ("**SEC**" and together, the "**Commissions**") adopted final rules ("**Final Rules**") adding further details to and guidance on the definitions of:

- swap dealer ("**SD**")
- security-based swap dealer ("**SBSD**"),
- major swap participant ("**MSP**"),
- major security-based swap participant ("**MSBSP**"), and
- eligible contract participant ("**ECP**")

as required under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank Act**").

While the Commissions generally declined to create categorical exclusions from the entity definitions, they did establish de minimis thresholds for determination of SD and SBSD status and established thresholds for the tests determining MSP and MSBSP status. In this discussion we focus on each of the three main entity definitions adopted by the Commissions as well as the exclusions and safe harbours described in the Final rules and interpretive guidance that was included in the adopting release ("**Interpretive Guidance**").

The Final Rules will be effective 60 days after publication in the Federal Register. However, registration as an SD or MSP will not be required until the CFTC's final rule defining the term "swap", which has not yet been issued, becomes effective. Registration as an SBSD or MSBSP will not be required until a date to be specified in the SEC's registration rule, which has not yet been issued.

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Swap Dealer and Security-based Swap Dealer

Final Rule

The SD and SBSD definitions in the Dodd-Frank Act focus on whether a person engages in certain specified activities involving swaps (which for purposes of this discussion will include security-based swaps unless specified). The Final Rules track the statutory definitions of the Dodd Frank Act and provide that a person engaging in just one of the types of activities enumerated in the SD definitions will have to register as an SD. Specifically, the Final Rules define SD and SBSD to include any person who does one of the following:

- Holds itself out as a dealer in swaps;
- Makes a market in swaps;
- Regularly enters into swaps with counterparties as an ordinary course of business for its own account; or
- Engages in activity causing itself to be or commonly known in the trade as a dealer or market maker in swaps.

However, the Final Rules provide that a swap dealer does not include an entity that enters into swaps for its own account, but not as a part of regular business.

The Interpretive Guidance from the Commissions on different aspects of the Final Rules explains how to analyze and apply the above factors. We discuss the Interpretive Guidance in more detail below.

Interpretive Guidance: SD Definitions

Use of the Dealer-Trader Distinction

The Interpretive Guidance states that an appropriate framework for interpreting the definition of swap dealer is provided by the "Dealer-Trader Distinction". The Dealer-Trader Distinction is the analysis that has been used to distinguish between securities traders and securities dealers. The Interpretive Guidance provides that the following activities, which are indicative of dealing under the Dealer-Trader Distinction, similarly are indicative that a person is acting an SD:

(i) providing liquidity by accommodating demand for swaps, holding oneself out as willing to enter into swaps, or being known in the industry as being available to accommodate demand for swaps;

(ii) advising a counterparty as to how to use swaps;

(iii) having a regular clientele and actively advertising or soliciting clients in connection with swaps;

(iv) acting as a market maker on an organized exchange or trading system; and

(v) helping to set the prices offered in the market rather than taking those prices.

In addition, the Interpretive Guidance notes that the following considerations, which are generally consistent with the Dealer-Trader Distinction, will also apply when determining SBSD status:

(i) a willingness to enter into swaps on either side of the market is not a prerequisite to swap dealer status;

(ii) the swap dealer analysis does not turn on whether a person's swap dealing activity constitutes that person's predominant business;

(iii) a customer relationship is not a prerequisite to swap dealer status; and

(iv) in general, entering into a swap for the purpose of hedging, absent other activity, is unlikely to be indicative of dealing.

The Interpretative Guidance explains that the Dealer-Trader Distinction as used to determine the status of securities dealers will need to be modified to apply to swap activities due to the special characteristics of swaps and differences between the securities "dealer" definition in the Securities Exchange Act of 1934 ("**Exchange Act**") and the SD and SBSD statutory definitions and

Final Rules. The swaps markets are characterized by less activity than securities markets, so the concept of "regularity" in the swaps context should account for a person's level of activity in the market relative to the total size of that market. In addition, since the statutory SD definitions do not require that a person buy ***and*** sell swaps in order to be a dealer, the concept of a two-sided market may be less relevant for identifying SDs than it would be for identifying securities dealers. Further, and in contrast to some cash market securities, swaps are not significantly traded on exchanges or other trading systems, and the Commissions expect a significant amount of OTC swap activity to continue even after implementation of the Dodd-Frank trade execution requirement.

Holding Oneself Out or Being Commonly Known in the Trade as a Dealer

The Interpretive Guidance includes factors to be considered in determining whether an entity holds itself out as a dealer in swaps or engages in any activities that cause the entity to be commonly known in the trade as a dealer or market maker in swaps. These factors include:

- contacting potential counterparties to solicit interest;
- developing new types of swaps and informing potential counterparties of their availability and of the person's willingness to enter into the swap;
- membership in a swap association in a category reserved for dealers;
- providing marketing materials describing the type of swaps the party is willing to enter into; and
- generally expressing a willingness to offer or provide a range of products or services that include swaps.

Market Making

Routinely standing ready

The Interpretive Guidance provides that the relevant indicator of market maker status is the willingness of a person to routinely stand ready to enter into swaps at the request or demand of a counterparty (as opposed to entering into swaps to accommodate one's own demand), either on one or both sides of the market, and then to enter into offsetting positions (whether in the swaps market or in other markets). For the purposes of this prong of the SD definition, "routinely" means more frequently than "occasionally", but not necessarily "continuously".

Exception for Activities not Part of a Regular Business

Under the Final Rules, a person that enters into swaps for its own account, either individually or in a fiduciary capacity, but not as part of a regular business, is not an SD. The Interpretive Guidance provides that the phrase "a regular business" relates to activities that are usual and normal in the person's course of business and identifiable as a swap dealing business. It is not necessary that the person conduct its swap activities in a dedicated subsidiary, division, department or trading desk, and it is not relevant whether the swaps activities are the person's primary or ancillary business, so long as the person's swap dealing business is identifiable.

The Interpretive Guidance lists the following examples of activities that would generally constitute entering into swaps "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; and

(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.

Exclusions from Swap Dealer Definition

Interim Final Rule Excluding Swaps Hedging Physical Positions

The CFTC adopted an Interim Final Rule along with the Final Rules, to provide that swaps entered into for the purpose of hedging physical positions that meet the requirements set out in the Interim Final Rule will be excluded from the swap dealer analysis. The SEC does not adopt a similar rule and thus there is no hedging exemption for SBSDs.

Under the Interim Final Rule, swaps will be excluded from the determination of whether a person is an SD if all of the following factors apply:

(i) the person enters into the swap for the purpose of offsetting or mitigating the person's price risks that arise from the potential change in the value of one or several (a) assets that the person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising, (b) liabilities that the person owns or anticipates incurring, or (c) services that the person provides, purchases, or anticipates providing or purchasing;

(ii) the swap represents a substitute for transactions made or to be made or positions taken or to be taken by the person at a later time in a physical marketing channel;

(iii) the swap is economically appropriate to the reduction of the person's risks in the conduct and management of a commercial enterprise;

(iv) the swap is entered into in accordance with sound commercial practices; *and*

(v) the person does not enter into the swap in connection with activity structured to evade designation as a swap dealer.

Swaps entered into by persons registered as Floor Traders

In determining whether a person is an SD, the Final Rules provide that each swap that a person enters into in its capacity as a floor trader or on or subject to the rules of a Swap Execution Facility ("**SEP**") will not be considered as part of the SD analysis. A person will only qualify for this exemption if the person:

(i) is registered with the CFTC as a floor trader;

(ii) enters into swaps with proprietary funds for its own account solely on a Designated Contract Market ("**DCM**") or SEF and submits each swap for clearing to a Derivatives Clearing Organization ("**DCO**");

(iii) is not affiliated with a registered SD;

(iv) does not negotiate the terms of swap agreements, other than price and quantity or to participate in a DCM/SEF request for quote process;

(v) does not offer or provide swap clearing services to third parties;

(vi) does not enter into swaps that would qualify as hedging physical positions pursuant to the SD Hedging Exemption or the hedging exemption for MSPs (except for any such swap executed opposite a counterparty for which the transaction would qualify as a bona fide hedging transaction);

(vii) does not participate in a DCM/SEF market making program; and

(viii) complies with the recordkeeping and risk management requirements under the relevant CFTC rules.

Exclusion for Swaps Entered into in Connection with Loan Origination.

For purposes of determining whether an entity is a SD (but not an SBSD), the Dodd-Frank Act excludes swaps entered into between an insured depositary institution ("**IDI**") and a customer "in connection with originating a loan with that customer". Newly adopted CFTC Rule 1.3(ggg)(5) establishes the requirements that must be satisfied in order for the statutory exclusion to apply.

Entities Entitled to Claim the Benefit of the Exclusion

Consistent with the Dodd-Frank Act, the new rule limits availability of the exclusion to "insured depository institutions", as defined in Section 3 of the Federal Deposit Insurance Act.[1] In taking this approach, the CFTC expressly rejected suggestions that the term be read expansively to avoid conferring a competitive advantage to one type of lender over others that do not qualify as "insured depository institutions".

Loan Origination Requirement

An IDI can only claim the benefits of the exclusion if it "originated" the loan, which means that it:

(i) directly transferred the loan amount to the customer,

(ii) was part of a syndicate that was the source of the loan amount transferred to the customer,

(iii) purchased or received a participation in the loan, or

(iv) otherwise was the source of funds transferred to the customer pursuant to the loan, or a refinancing of the loan.

In order to allow syndicated lenders to allocate among themselves swaps provided to their customers as they see fit, there is no requirement that the amount lent by an insured depository institution correspond to the notional amount of the swap subject to the exclusion, except that a participating insured depository institution with a participation of less than ten percent of the loan can only claim the exclusion for swaps with a notional amount not in excess of its participation in the loan. For these purposes, only loans in the common-law sense of the term qualify (*i.e.,* a transfer of a defined quantity of money that the recipient agrees to repay at a later date). The new rule expressly rules out application of the exclusion to synthetic loans, such as loan credit default swaps or loan total return swaps.

Limitations Regarding Swaps to be Excluded

To benefit from the exclusion, swaps with loan customers must satisfy several requirements as follows:

(i) **With respect to the time of entering into the swap:** The swap must be entered into no earlier than 90 days before, and no later than 180 days after, (1) the date of execution of the loan agreement, or (2) the date of any transfer of principal to the customer under the loan.

(ii) **With respect to the nature of the connection between swap and loan:** Rejecting suggestions that any type of swap entered into in connection with a loan "as a matter of prudent lending" should benefit from the exclusion, the CFTC limited the exclusion to two types of swaps: (i) swaps with financial terms are connected to the financial terms of the loan (*i.e.,* the

[1] "Insured depository institution" is defined in the Federal Deposit Insurance Act as "any bank or savings corporation the deposits of which are insured by the [Federal Deposit Insurance] Corporation". 12 U.S.C. 1813 (2011).

terms governing its repayment), such as the loan's duration, currency, interest rate or principal amount; and (ii) swaps which the lender's loan underwriting criteria require to be in place as a condition of the loan in order to hedge commodity price risks incidental to the borrower's business (other than risks related to an excluded commodity, which are interest rates, foreign exchange rates or other financial rates or indicia). If the swap meets one of the foregoing requirements, it is irrelevant whether it relates to the entire amount of the loan or to only a portion of it. In addition, swaps entered into by an insured depository institution for the purpose of hedging or laying off the risk arising under an excluded swap with a loan customer are also excluded from consideration when determining whether the lender is a swap dealer.

(iii) With respect to the duration of the swap: Excluded swaps cannot have a duration that extends beyond the maturity date of the related loan.

(iv) Limitation on the aggregate notional amount: The aggregate notional amount of all swaps entered into by the customer in connection with the financial terms of the loan may not, at any time, be more than the outstanding principal amount of the loan at that time. The Adopting Release clarifies that the rule is meant to include swaps entered into by the borrower "with any person". It is not clear why the notional amount of derivatives transactions entered into by the borrower should have an impact on the lender's ability to claim the exclusion or, more importantly, what will be the consequences of a lender belatedly becoming aware that transactions entered into by its customer (perhaps even in violation of covenants to the contrary) have impaired the lender's ability to rely on the exclusion. The ongoing nature of this requirement is also at odds with the interpretation adopted elsewhere by the CTFC according to which if a swap qualifies for exclusion at the time of its inception, the fact that the loan is subsequently transferred by the insured depository institution is irrelevant.

(v) Transparency: if the swap is not cleared, the insured depository institution must report the swap to a swap data repository or the CFTC, as applicable, under Section 4r of the Commodity Exchange Act (unless the borrower is a swap dealer or major swap participant, in which case the borrower must report the transaction).

Exclusion of Inter-Affiliate Swaps

For purposes of determining whether an entity is a SD or SBSD, the Final Rules exclude transactions between such entity and its "majority-owned affiliates". The parties to a swap are "majority-owned affiliates" if one of them, directly or indirectly, owns a majority interest in the other, or if a third party, directly or indirectly, owns a majority interest in both. Ownership of a majority interest, under the new rules, is determined by:

(i) the ability to vote or sell, or to direct the vote or sale, "of a majority of a class of voting securities of an entity", or

(ii) the contribution of, or the right to receive upon dissolution, a majority of the capital of a partnership.

Interestingly, the definition does not look at actual ability to determine the actions of an entity; ownership of a majority of *any* class of voting securities (including, for example, debt securities) appears to suffice.

Exclusion for Certain Swaps Between Cooperatives and Their Members

For purposes of determining whether a cooperative (see definition below) is a SD (but not a SBSD), swaps entered into between the cooperative and its members are disregarded if:

(i) the swap is subject to policies and procedures that require the cooperative to monitor its risks thereunder,

(ii) the swap is reported as provided above for swaps of insured depository institutions with its customers, and

(iii) if the cooperative is a cooperative association of producers, the swap is primarily based on a commodity that is not an excluded commodity, which is a financial asset or indicia, such as interest rates.

A cooperative is a "cooperative association of producers", as defined in Section 1a(14) of the Commodity Exchange Act, or a cooperative that is chartered under federal law and that is predominantly engaged in activities that are financial in nature, as defined under the Bank Holding Company Act.

De Minimis Exception

De minimis exception - Notional Amount Threshold

Swap Dealer ("**SD**") - The final rule provides that an entity that has entered into no more than $3 billion in aggregate gross notional amount of swaps within the preceding twelve months shall be deemed not to be a swap dealer. During an initial phase-in period of up to 5 years, this cap will be superseded by a phase-in threshold level of $8 billion in swap activity over the prior twelve (12) months.

Security-Based Swap Dealer ("**SBSD**") – The final rule provides the same activity thresholds of $3 billion and phase-in threshold of $8 billion for credit default swaps ("**CDS**") that are security-based swaps ("**SBS**"). For other, non-CDS SBS activity, the threshold is $150 million, with a phase-in threshold of $400 million.

Special Entities – For both SDs and SBSDs, the de minimis exception caps activity at aggregate gross notional of $25 million in swaps or SBS, respectively, with special entities. There is no phase-in period for the threshold on swaps and SBS with special entities, which include government agencies, municipalities and employee benefit plans.

Calculation of threshold activity

Inclusions

Affiliate activity – For purposes of calculating the de minimis threshold, the dealing acitivities of any entity will be aggregated with the dealing activities of the entity's affiliates. Affiliates for these purposes means "any other entity controlling, controlled by or under common control with the person". The commentary to the final rule clarifies that for these purposes, control means "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract or otherwise."

"*Effective notional*" – The final rule provides that, if the stated notional amount of the swap or SBS entered into by the entity is leveraged or enhanced by the structure of the swap or SBS, then the notional amount of that transaction will be included in the aggregate activity for that entity on the basis of the enhanced notional amount, the "effective notional".

Exclusions

The final rule excludes swap and SBS transactions from the calculation of aggregate notional amount if such swaps or SBS are not dealing activities for purposes of the swap dealer determination. As a result, the following activities will not be counted towards the threshold for the de minimis exception: inter-affiliate swaps and SBS; swaps between a cooperative and its members (SD only); swaps for hedging physical positions (SD only); floor trader transactions (SD only); and swaps in connection with loans originated by an insured depository institution (SD only).

Phase-in period, staff report and modification to exception criteria

Phase-in period – The phase-in period (a) for swaps, will end on or before five years after the date on which a swap data repository ("**SDR**") first receives swap data, and (b) for SBS, will end on or before five years after the later of the date that is (i) the last compliance date for registration and regulatory requirements for SBSDs and MSBSPs, or (ii) the first compliance date for reporting requirements for credit-related and equity-related SBS to an SBS data repository ("**SBSDR**") ("**data collection initiation date**") .

Staff report – Both the CFTC and the SEC provide that the staff of the respective commissions will analyze the data on swap and SBS activity gathered by the SDRs and SBSDRs and publish a report of their analysis of the data in relation to the definitions of SD and SBSD, the de minimis exception and excluded activity. The CFTC staff is to analyze approximately 2 years of data and publish the report within 30 months after the date on which an SDR first receives swap data. The SEC staff is to publish their report within 3 years of the data collection initiation date.

Both reports will be published and made available for public comment. Nine months after publication of the respective reports and based on the report and public comment received, the relevant commission may either (i) set an end date for the phase-in period by published order or (ii) propose, by rulemaking, different post phase-in period thresholds for the de minimis exception.

Modifications by rule or regulation – The final rule provides that the Commissions may also modify the de minimis exception criteria by rule or regulation.

Registration

Grace period for entities that exceed the threshold – Both Commissions provide a grace period in which an unregistered entity that no longer qualifies for the de minimis exception may register as a SD or SBSD. The final rule provides 2 months after the end of the month in which the entity no longer qualifies for the exception.

Application for exception – A registered SD or SBSD that becomes qualified for the de minimis exception may apply to withdraw its registration, provided that the entity has been registered for at least twelve months.

Timeframe for De Minimis Test - During the first year following implementation of the Final Rule, the de minimis test will only include dealing activity after the date upon which the final rule defining the terms "swap" and "security-based swap," becomes effective. There will be no "lookback" to swaps entered into prior to the effective date. No person will have to register as a SD until after the swap product definition rules become effective and after the person exceeds the de minimis thresholds, after which the person will have two months after the month it exceeds the threshold to register as an SD.

Other Issues

Limited Purpose Dealer Designation

Under the final definitions of SD and SBSD, a registered entity is presumptively deemed a dealer "with respect to each [swap] [security-based swap] it enters into, regardless of the type, class, or category of the [swap] [security-based swap] or the person's activities in connection with the [swap] [security-based swap]." However, the definitions also provide that the relevant Commission may limit the scope of the dealer designation at the Commission's discretion. The commentary suggests that the Commissions would consider limitations customized to the entity's individual circumstances.

Acting as a Swap (or Security-based Swap) Broker

The Interpretive Guidance indicates that acting as a broker for swaps will not trigger the SD requirements, but will result in the application of other requirements under the securities and commodities laws. Specifically, the Exchange Act, as amended by the Dodd-Frank Act, excludes persons who engage in security-based swaps with ECPs from the definition of a securities "dealer", but there is no similar exclusion for such persons from the definition of a securities "broker". Thus, absent an exemption, a person who acts as a broker in connection with security-based swaps must register as a broker under the Exchange Act. Similarly for swaps, a person who enters into swaps as an agent for customers must register with the CFTC as either a futures commission merchant ("**FCM**"), introducing broker ("**IB**"), commodity pool operator ("**CPO**"), or commodity trading advisor ("**CTA**"), depending on the nature of the person’s activity.

International Implications

The Commissions indicated that they intend to separately address the application of the SD and SBSD definitions to non-US persons.

Major Swap Participant and Major Security-Based Swap Participant

Under the Dodd-FrankAct and the Final Rules, an MSP or MSBSP is defined as a person who:

- is not a SD;
- has a "substantial position" in any one or more of the four major categories of swaps (or, in the case of an MSBSP, has a substantial position in one of the two categories of security-based swaps);
- has outstanding swaps that, taken together, create "substantial counterparty exposure"; or
- is a "financial entity" that is "highly leveraged" that maintains a "substantial position" in any category of swaps.

Not a Swap Dealer

Under the statutory definitions, SD and MSP, and SBSD and MSBSP, are mutually exclusive categories. However, the Final Rules do not fully explain how this will work in practice. For example, many entities will be exempt from registration as a Swap Dealer, either initially or in the long term, on the basis of the *de minimis* thresholds. Also, dealers in foreign exchange swaps and foreign exchange forwards are not likely to register as Swap Dealers on the expectation that those instruments are likely to be exempt from regulation as swaps. While the Final Rules state that entities that are not registered as swap dealers will be deemed not to be swap dealers if they meet the *de minimis* test, the rules do not provide any guidance as to whether those entities, or entities that rely on other exemptions from registration as swap dealers, need to be concerned about whether they are MSPs or MSBSPs instead.

Major Categories of Swaps

For the purposes of calculating the objective measures of MSP or MSBSP Status, both the CFTC and the SEC divide swaps into various categories.

CFTC Swap Categories

The CFTC divides swaps into four categories, with the intention that all CFTC-regulated swap types will fall into one of the categories. Where a swap could fit into more than one category, the most appropriate category is used. The categories are:

1. Rate Swaps (including interest rate swaps, currency swaps, foreign exchange swaps and NDFs and any other swaps based upon one or more reference rates);
2. Credit Swaps;
3. Equity Swaps;
4. Other commodity swaps.

It is significant to note that the Rate Swap Category includes foreign exchange swaps even though they are expected to be exempt from regulation and even through foreign exchange forwards are not included. As a consequence, a dealer that opts to limit its swap business solely to foreign exchange swaps and forwards may be avoid the CFTC's registration requirements, as discussed above, but it or its counterparty may qualify as an MSP with respect to the same contracts.

SEC Swap Categories

For the purposes of determining an entity's status as an MSBSP, the SEC has established two categories

1. debt security-based swaps, and
2. other security-based swaps.

A person with a substantial position in either of the security-based swap categories is an MSBSP, and positions in security-based swaps are subject to different, lower thresholds for purposes of the "substantial position" and "substantial counterparty exposure" tests.

Substantial Position Test

The "substantial position" test evaluates exposure using thresholds based on "daily average aggregate uncollateralized outward exposure" and "daily average aggregate potential outward exposure".

Daily average aggregate uncollateralized outward exposure

"*Daily average aggregate uncollateralized outward exposure*" is calculated for each major swap category as an entity's present exposure under swaps in that category, calculated by marking to market using industry-standard procedures, reduced by the amount of collateral posted against the exposure represented by those swaps.

Positions with a single counterparty can be netted but not similar positions with other counterparties, with the result that not all positions of the same type are netted on a portfolio-wide basis. On the other hand, cross-product exposure to a counterparty may be netted to the extent that such netting is permitted under the applicable master agreements, for example to take into account exposures arising under securities-lending, securities margin, repo or reverse repo transactions. For purposes of this test, a net in-the-money position with a particular counterparty would be counted as an exposure of zero, rather than reducing overall exposure by the in-the-money amount. After giving effect to such netting, any remaining uncollateralized exposure is allocated pro rata among the categories in which the entity had outstanding swaps with that counterparty.

Cleared, fully-collateralized or in-the-money positions are not specifically excluded from present uncollateralized exposure because collateralized exposures and positions with a current net exposure of zero would not count towards present uncollateralized exposure.

Daily average aggregate potential outward exposure

"*Daily average aggregate potential outward exposure*" is intended to reflect the risk presented by changes in the value of swap positions over time, and it does so by incorporating and building upon tests used by bank regulators for the purpose of setting capital requirements.

The potential outward exposure for each major swap category is calculated separately for swaps that are subject to daily mark-to-market margining or that are cleared and for swaps that are not marked to market daily or that are not cleared, and the aggregate potential outward exposure is the sum of the two amounts.

For swaps that are not marked to market daily or that are not cleared, the potential outward exposure is the product of the notional amount of each swap in the relevant category multiplied, on a position-by-position basis, by the relevant conversion factor taken from the relevant matrix set out below. Note that the CFTC swap matrix set out in Table 1A does not exactly correspond to the major swap categories. Any swap type that does not correspond to the descriptions in Table 1A below should be treated as falling within the "Other commodities" category:

Table 1A – CFTC Swap Conversion Factor Matrix

Residual maturity	Interest Rate	Foreign exchange and gold	Precious metals (except gold)	Other commodities
One year or less	0.00	0.01	0.07	0.10
Over one to five years	0.005	0.05	0.07	0.12
Over five years	0.015	0.075	0.08	0.15

Table 1B – SEC Security-based Swap Conversion Factor Matrix

Residual maturity	Credit	Equity
One year or less	0.00	0.01
Over one to five years	0.005	0.05
Over five years	0.015	0.075

If the stated notional amount of any swap is leveraged or enhanced, the notional amount used for the calculation must be adjusted to reflect the effective notional amount. Initial margin or over-collateralization do not have the effect of reducing potential outward exposure, as the Commissions have determined that although such collateral would reduce risk, there is no certainty as to the extent of the mitigation.

Positions for which all obligations have already been paid, such as prepaid options, are excluded from potential outward exposure. The exposure of a buyer of protection under a credit default swap is capped at the present value of future premiums payable. Potential outward exposure also excludes positions, which, pursuant to regulatory requirements, reserves have been established which cannot be accessed.

However, potential outward exposure is reduced by a number of adjustments. Potential outward exposure may be reduced by up to 60% to reflect risk mitigation of netting agreements with such reduction applied pro rata among multiple categories of swaps (if applicable) as with present exposure.

The daily average aggregate potential outward exposure of swaps that are subject to daily mark-to-market margining or of cleared swaps is calculated by taking the exposure calculated for uncleared or unmargined swaps, as described above, and applying a multiplier of 0.2 for mark-to-market margined swaps or 0.1 for cleared swaps.

Thresholds

A person will be considered an MSP if (i) their daily average aggregate uncollateralized outward exposure, calculated quarterly, is **$1 billion** (**$3 billion** in the case of rate swaps) or more, or (ii) their daily average aggregate uncollateralized outward exposure plus daily average aggregate potential outward exposure is **$2 billion** (**$6 billion** in the case of rate swaps) or more.

A person will be considered an MSBSP if (i) their daily average aggregate uncollateralized outward exposure to a category of security-based swaps is **$1 billion** or more, or (ii) their daily average aggregate uncollateralized outward exposure plus average daily average aggregate potential outward exposure is **$2 billion** or more.

Commercial Hedging Exception

The "substantial exposure" limb of the test contains an exception for swaps that are made for the purpose of hedging or mitigating commercial risk. Both the CFTC and the SEC have adopted a standard based on whether the hedge is "economically appropriate" as proposed in the Proposed Rule. This approach is somewhat subjective, and takes into account the facts and circumstances at the time of entry into the swap. For security-based swaps, the SEC has added the limitation that security-based swap positions cannot be used to over-hedge the underlying risk such that it could have a speculative effect. The Commissions acknowledge comments noting that not exempting positions that hedge speculative risks would create a disincentive to reduce risk; however the Commissions conclude that this result is an unavoidable result of the legislative decision to regulate MSPs and MSBSPs.

Significantly, the economic appropriateness test does not include safe harbors; the fact that a trade qualifies for hedge accounting, for example, will not necessarily satisfy the economic appropriateness test. Conversely, the presence of residual risk, or a mismatch between the hedging instrument and the risk being hedged will mean that the trade automatically does not qualify for the exception, provided that the hedge is economically appropriate and does not create any new basis risk or other type of risk (aside from counterparty risk) beyond what is reasonably necessary to manage the identified risk, or otherwise create a speculative position. The SEC has provided the following examples of hedges that would fall within the commercial hedging exception with respect to security-based swaps:

(a) Hedging of the risk posed by customers or suppliers relating to sale of property, leases, agreements to provide goods or services in the future, and similar agreements;

(b) Positions established to manage the default risk of a financial counterparty in connection with swap that itself falls within the commercial hedging exception;

(c) Positions established to manage market risk associated with certain employee compensation plans, including market price risk associated with stock-based compensation plans;

(d) Positions established to manage equity market price risks in connection with certain business combinations, such as mergers or consolidations, where securities are used as consideration;

(e) Positions established by banks in connection with loans it has made; and

(f) Positions to close out any of the positions above.

The exception is available to financial entities. Further, commercial hedging by financial entities is not limited to the hedging of non-financial risks, but hedging of speculative or "trading" risks does not benefit from the exclusion. However, if the financial entity is "highly leveraged" (as discussed below), its exposure would be evaluated under the third tranche of the MSP test, where the commercial hedging exception does not apply. In effect, the application of this exception is limited to financial entities that are not highly leveraged.

Commercial hedging conducted on behalf of affiliates is exempt; this mirrors the exclusion of such positions on behalf of majority-owned affiliates towards the substantial exposure threshold.

Although the proposed rule suggested the possibility of recordkeeping requirements for reliance on the commercial hedging exemption, the final rule imposes no such requirements.

Substantial Counterparty Exposure Test

The substantial counterparty exposure test is intended to encompass persons holding exposure sufficiently large that it could have serious adverse effects on the stability of the US banking system or the financial markets. It is essentially an "entity" level test, rather than a "product" test and differs from the "substantial position" test in two important ways:

- The test evaluates the cumulative exposure across all categories of swaps and security-based swaps; and

- the test does not exclude commercial hedging positions or ERISA hedging positions.

The thresholds for "substantial counterparty exposure" are:

(a) For outward swaps: (i) daily average aggregate uncollateralized outward exposure of $5 billion, or (ii) daily average aggregate uncollateralized outward exposure plus daily average aggregate potential outward exposure of $8 billion.

(b) For security-based swaps: (i) daily average aggregate uncollateralized outward exposure of $2 billion, or (ii) daily average aggregate uncollateralized outward exposure plus daily average aggregate potential outward exposure of $4 billion.

Financial Entities that are Highly Leveraged

The financial entity definition mirrors that used for the purpose of the end-user exception from mandatory clearing. As defined in section 2(h)(7) of the Commodities Exchange Act, the term "financial entity" is broad and includes, commodity pools, private funds as defined in s. 202(a) of the Investment Advisers Act of 1940, ERISA benefit plans, and persons predominantly engaged in the business of banking or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956. Centralized hedging entities hedging on behalf of their majority-owned affiliates (that are not themselves financial entities) will not fall within this definition solely due to hedging on behalf of such affiliates.

"High leverage" is specified to be a ratio of 12 to 1 or higher for liabilities to equity, calculated on the last business day of the applicable business quarter. In recognition of the impact of this test on employee benefit plans, the rules provide that certain employee benefit plans may, for the purpose of the leverage calculations, (i) exclude obligations to pay benefits from their liabilities, and (ii) substitute the total value of plan assets for equity.

A highly leveraged financial entity which has exposure meeting any of the "substantial exposure" thresholds outlined above would be considered an MSP or an MSBSP. The primary effect of falling within the third limb of the test is that financial entities employing high leverage cannot take advantage of the commercial hedging and ERISA-risk hedging exclusions.

Exclusions

The Final Rules exclude certain types of swap and security-based swap positions for the purpose of determining wither a person is required to register as an MSP or an MSBSP.

ERISA Hedging Positions

The Dodd-Frank Act provides that ERISA plan swap and security-based swap positions are excluded for calculating whether or not an entity's swaps constitute a "substantial position" if such positions are maintained by an ERISA plan "for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan". In the Final Rules the Commissions clarified that "hedging" will be determined broadly for the purposes of this exclusion, and will apply to positions that "are intended to reduce disruptions or costs in connection with…the anticipated inflows or outflows of plan assets, interest rate risk, and changes in portfolio management and strategies". However, the Commissions noted that positions that are intended to replicate exposure to a certain asset class or market would not be considered "hedging" for the purposes of this exclusion.

The Final Rules also provide that the exclusion of swap and security-based swap positions used for hedging purposes will apply if such positions are maintained by trusts or pooled vehicles rather than ERISA plans directly. This exclusion will also apply to entities that hold both ERISA plan and non ERISA plan assets, but only to the extent that such positions hedge risk with respect to ERISA plan assets.

Inter-Affiliate Positions

Similar to the guidance given for SDs and SBSDs, the Final Rules provide that swap or security-based swap positions with a majority owned affiliate are excluded for the purposes of determining whether or not such person is an MSP or an MSBSP for all three quantitative tests.

Guarantee and Affiliated Entity Positions of Regulated Subsidiaries

Swap and security-based swap positions of subsidiaries will be attributed to the parent for the purpose of determining if it is required to register as an MSP or an MSBSP if such positions provide for recourse to the parent (for instance, by way of a guarantee or a credit support annex). However, such positions will not be attributed to the parent (even if there is recourse) if the relevant subsidiary is already subject to SEC or CFTC capital rules or is regulated as a bank in the United States. The Final Rules permit a parent that is required to register as an MSP or an MSBSP as a result of attributed subsidiary positions to delegate its transaction-focused compliance to its subsidiaries, but not its entity-level compliance.

Managed Accounts

The Final Rules provide that swap or security-based swap positions managed by an investment manager should be excluded in determining whether such investment manager is required to register as an MSP or an MSBSP.

In addition, the swap or security-based swap positions managed by an investment manager will be attributable to the beneficial owner of such position for the purpose of the MSP or MSBSP definition only to the extent that the risk of such position resides with the beneficial owner. Therefore, a position would not be attributable to the owner of a share in a registered investment company, but would be attributable to the beneficial owner of a managed account that has recourse to the beneficial owner.

Financing Subsidiaries

The Dodd-Frank Act excluded from registration as MSPs or an MSBSPs entities whose primary business is providing financing for the sale or lease of products on behalf of a parent and that uses swaps or security-based swaps to hedge currency or interest rate risk, at least 90% of which is related to any good manufactured by the parent or service provided by the parent. The Final Rules clarify that this exemption applies to financing activities that finance the purchase of products in a "broad sense" – including service, labor, component parts and attachments that are related to the products.

Foreign Entities

The Commissions declined to exempt foreign entities generally from registration as MSPs or an MSBSPs. The CFTC did give some guidance that foreign governments, central banks and international financial institutions that fall within the definition of Swap Dealer or MSP will not be required to register as such. However, the CFTC guidance also stated that non-US corporate entities and sovereign wealth funds "act in the market in the same manner as private asset managers" and therefore may be subject to registration and regulation by the CFTC if their activities have a direct and significant connection with activities in, or effect on, commerce in the United States or contravene the Act or any Title VII-related CFTC rules. The SEC declined to give equivalent guidance, stating that it will address cross-border issues in a release later this year.

Safe Harbor

A person will not be deemed to be an MSP or an MSBSP if it meets any of the following three tests:

Restricted Uncollateralized Exposure and Notional Amounts

If (i) the terms of the person's arrangements with its counterparties prohibit the person from having uncollateralized exposure (including under credit support annexes) of more than $100 million to all such counterparties, and (ii) the person does not maintain 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.

Restricted Uncollateralized Exposure and Monthly Calculation

If (i) the terms of the person's arrangements with its counterparties prohibit the person from having uncollateralized exposure (including under credit support annexes) of more than $200 million to all such counterparties, and (ii) the person performs the "substantial position" and "substantial counterparty exposure" calculations each month and those calculations produce

thresholds that are no greater than half of the level of current exposure plus potential outward exposure that would require the person to register as an MSP or an MSBSP.

All hedging positions can be excluded from this calculation (in the same way they are excluded from the "substantial position" test) unless the person is a "highly leveraged entity" as described above.

Calculation Based on Certain Information

If: (i) (A) the person's aggregate uncollateralized exposure in each major swap category is less than $1.5 billion with respect to rate swaps and less than $500 million with respect to each other major swap category, and (B) the sum of the amount in (A) and the total notional amount of the person's swap positions, adjusted by the multipliers in the relevant conversion factor matrix set out in Table 1A and Table 1B above is less than $3 billion with respect to rate swaps and less than $1 billion with respect to the other major swap categories, or

(ii) (A) the person's aggregate uncollateralized exposure across all major swap categories is less than $500 million, and (B) the sum of the amount in (A) and the total effective notional amount of such person's swap positions across all major security-based swap categories multiplied by 0.15 is less than $1 billion.

For the purposes of this calculation, the aggregate uncollateralized exposure for positions held with swap dealers will be equal to the exposure reported on the most recent report from such swap dealers, and the aggregate uncollateralized exposure that is not in any report from a swap dealer (including positions not held with swap dealers) will be calculated in accordance with the "substantial position" test.

For calculations with respect each of the three tests, the effective notional amount will be used if the notional amount of any position is leveraged or structurally enhanced.

Limited Designation as an MSP or MSBSP

The Final Rules provide that any person that is required to register as an MSP or an MSBSP will be deemed to be an MSP or an MSBSP for all major categories of swaps. A person may apply to be an MSP or an MSBSP with respect to only one class of swaps at any time (including upon registration), which will be within the relevant Commission's discretion to grant. The Commissions noted that they would not designate any person a limited purpose MSP or MSBSP unless that person demonstrates compliance with respect to the transactional MSP or MSBSP requirements (business conduct standards and documentation requirements) as well as entity level requirements, such as capital rules and risk management.

Implementation

A person will be deemed to be an MSP or an MSBSP on the earlier of the date it submits an application for registration or two months after the end of the first quarter on which it meets the criteria to be an MSP or an MSBSP. However, if a person meets the criteria to be an MSP or an MSBSP without exceeding any threshold of an MSP or an MSBSP test ("substantial position", "significant counterparty exposure" or "highly leveraged entity") by more than 20%, it will only be an MSP or an MSBSP if it exceeds any threshold the following fiscal quarter. A person will cease to be an MSP or an MSBSP if it does not meet any of the three tests for four consecutive quarters.

Eligible Contract Participant

General Concept

The concept of an "eligible contract participant" (an "**ECP**") is generally used to distinguish retail counterparties from wholesale. The Dodd-Frank Act introduced certain requirements that are applicable exclusively to transactions with counterparties that are not ECPs. For example, under the Dodd-Frank Act, all swaps and security-based swaps with a non-ECP counterparty must be executed on an exchange. In addition, The Dodd-Frank Act imposes a special regulatory regime for non-spot foreign exchange transactions, including swaps, forwards and rolling spot contracts ("**Currency Transactions**"), entered into with entities that are not ECPs ("**Retail FX Transactions**"), and makes it unlawful for a dealer to enter or offer to enter into any such Retail FX Transactions other than in accordance with the retail foreign exchange rules promulgated by the relevant regulator, such as the Office of Currency Comptroller, the CFTC, the SEC or the Federal Deposit Insurance Corporation ("**Retail FX Rules**"). Importantly, a non-US financial institution would be prohibited from entering into any Retail FX Transactions with non-ECPs unless it is registered with the CFTC as a "retail foreign exchange dealer" and complies with Retail FX Rules promulgated by the CFTC in October 2010, which impose a host of requirements, including margin collection, reporting, recordkeeping, and customer protection rules.

The Dodd-Frank Act Amendments to ECP Definition

The Dodd-Frank Act amended the ECP definition by:

1. Raising the monetary qualifying threshold for governmental entities from $25 million to $50 million in investments owned and invested on a discretionary basis;
2. Replacing the "total asset" standard for individuals to qualify as ECPs with an "amounts invested on a discretionary basis" standard; and
3. Adding a look-through provision for commodity pools that enter into Currency Transactions (each, a "**Forex Pool**"), whereby a Forex Pool that directly enters into a Currency Transaction ("**Transaction-Level Pool**") would qualify as an ECP for the purposes of determining whether such Currency Transaction qualifies as a Retail FX Transaction only if each direct investor in the Transaction-Level Pool is itself an ECP (the "**Look-Through Provision**").

Other than for the purposes of entering into Currency Transactions, a commodity pool would qualify as an ECP irrespective of the status of its individual investors if its total assets exceed $5 million and it is operated by a person that is excluded from the definition of a commodity pool operator under the Commodities Exchange Act, registered as a commodity pool operator with the CFTC or properly exempt from registration.

Clarification of the ECP Definition under the Final Rules

The Final Rules further clarify the ECP definition under Dodd-Frank.

Generally Applicable Provisions

Inclusion of SDs and MSPs:

Under the Final Rule, SDs, SBSDs, MSPs and MSBSPs are automatically included in the ECP definition under the Final Rules.

Qualification as an ECP with Respect to Swaps Used to Hedge or Mitigate Commercial Risk

Section 1a(18)(A)(v)(III) of the Commodity Exchange Act provides that any entity that (i) has a net worth exceeding $1,000,000 and (ii) enters into a regulated commodity transaction in connection with the conduct of the entity's business or to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by the entity in the conduct of the entity's business, will qualify as an ECP. In response to comments requesting greater flexibility for end users

hedging or mitigating commercial risk, the Final Rules provide that, in the context of a swap (but not a security-based swap) used to hedge or mitigate commercial risk, an entity may include the net worth of any owner of the entity, provided that all owners of the entity are themselves ECPs.

Provisions Applicable to Forex Pools

Exemption from the Look-Through Provision

The Final Rules provide that a Forex Pool with direct non-ECP investors would qualify as an ECP notwithstanding the Look-Through Provision if it:

i. has total assets exceeding $10 million,
ii. is formed and operated by a commodity pool operator registered with the CFTC or exempt from registration under CFTC Rule 4.13(a)(3) (a "**Qualifying Pool Operator**"); and
iii. is not formed for the purpose of evading regulation applicable to Retail FX Transactions under the Commodities Exchange Act

(the "**Look-Through Exemption**").

A commodity pool formed before December 31, 2012 may take advantage of the Look-Through Exemption even if it was formed by an entity other than a Qualifying Pool Operator.

Look-Through Provision Applies only to Commodities Exchange Act Section 1a(18)(A)(iv) Forex Pools

The Commissions expressly stated that the Look-Through Provision will apply exclusively to commodity pools operated by commodity pool operators that are subject to CFTC regulation and described under Section 1a(18)(A)(iv) of the Commodities Exchange Act and will not include any funds that are employee benefit plans qualifying as ECPs under Section 1a(18)(A)(vi) (i.e., with total assets exceeding $5 million and managed by a qualified adviser) or registered investment companies.

Indirect Investors in the Forex Pool Disregarded Absent Evasion

The Final Rules also provide that in determining whether a direct investor in a Transaction-Level Pool is an ECP, the indirect participants in the Transaction-Level Pool will not be considered unless such Transaction-Level Pool or any other commodity pool holding direct or indirect interest in such Transaction-Level Pool has been structured to evade regulation applicable to Retail FX Transactions under the Commodities Exchange Act, such as to primarily provide non-ECP investors with exposure to Retail FX Transactions as an asset class, investment strategy, or an end in itself, rather than to achieve any other legitimate business purpose. The Commissions state that a legitimate business purpose in this context would include using foreign exchange transactions to hedge currency risk or for any other bona fide hedging purposes or creating a master-feeder structure for tax efficiency purposes.

Exchange-Traded Funds

The Commissions stated that in the context of exchange-traded Forex Pools ("**ETFs**"), any person that acquires an interest in the ETF in the secondary market would be deemed a direct investor for the purposes of the Look-Through Provision. As a result, unless an ETF is structured in a manner in which the ETF will be able to verify the ECP status of each investor in the secondary market, the presumption would be that such ETF will not qualify as an ECP for the purposes of entering into Retail FX Transactions.

Safe Harbor: Reliance on Investor Representations

For purposes of the Look-Through Provision, a commodity pool operator of a Forex Pool will be permitted to rely on written representations from prospective or existing investors as to their ECP status. The Forex Pool would continue to qualify as an

ECP even if an investor ceases to be an ECP as long as the relevant operating or subscription agreement requires each investor to notify the commodity pool operator. The commodity pool operator is then required to redeem the non-ECP from the Forex Pool at the first opportunity following the notice from the investor

Forex Pools Limited to Non-U.S. Investors

The Commissions stated that commodity pools with no U.S. investors and operated by non-U.S. entities would qualify as ECPs for purposes of the Look-Through Provision. An investor will qualify as a non-U.S. person if it satisfies the definition of a "Non-United States person" under CFTC Rule 4.7(a)(1)(iv); provided that a direct investor that is a passive investment vehicle would be deemed a Non-United States person only if all of the ownership interest in such direct investor are owned by Non-United States persons.

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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