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Alert

SEC and CFTC Publish Entity Rule Definitions: Impact on Private Investment Funds

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Final Rule Related to Dealer, Major Participant and Eligible Contract Participant Published
On April 27, 2012, the Commodity Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission (the "SEC" and, together with the CFTC, the "Agencies") published their joint final "entity definitions" rule (the "Entity Rule") in a release (the "Entity Rule Release") defining the terms "Swap Dealer" and "Security-Based Swap Dealer" ("SBS Dealer" and, together with Swap Dealer, "SD"), "Major Swap Participant" and "Major Security-Based Swap Participant" (together, "MSP") and "Eligible Contract Participant" ("ECP").[1] The final rules related to the product definitions of "swap" and "security-based swap" are expected to be published by the Agencies in the coming months. The Entity Rule together with the pending product definitions are important because effective dates of many of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") implementing regulations are keyed off of the finalization of the definitions. SD and MSP registration will not be required until 60 days after the product definitions are finalized. The changes to the ECP definition will be effective on Dec. 31, 2012.

Impact of the Entity Definitions on Private Investment Funds
Most private investment funds are not expected to fall into the definitions of SD or MSP and therefore are not likely to be directly subject to the Entity Rule related to these definitions.[2] However, private investment funds will be indirectly affected because of the obligations of SDs, for example, to request additional collateral from their fund counterparties. The Agencies also indicated they will issue separate releases addressing the application of Title VII of the Dodd-Frank to non-U.S. persons.

Definitions of "Swap Dealer" and "Security-Based Swap Dealer"
Most private investment funds are not likely to be SDs and therefore will not be subject to the various SD requirements. The statutory term SD is defined in Dodd-Frank as any person who: (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in activity causing itself to be commonly known in the trade as a dealer or market maker in swaps. If an entity satisfies any of the prongs of the definition, it will be an SD. However, there is a statutory exclusion for swap activities that are not part of "a regular business" and a *de minimis* exemption.

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[1] The rule also provides an interim final rule related to activities that qualify as "hedging," for which the Agencies seek additional comments. The definition of "hedging" is not discussed in this *Alert* because it is not generally relevant to private investment funds.

[2] Although there is no categorical exemption for private investment fund managers, the Entity Rule applies to the entity actually entering into the swaps and swaps entered into by the private investment funds managed by the manager are not attributed to the manager. Therefore, private investment fund managers which do not themselves enter into swaps should not be subject to registration under the Entity Rule.

The Entity Rule and the Entity Rule Release provide interpretive guidance to the statutory framework. The guidance makes clear that the Agencies are taking a policy-based approach to determining which entities are covered as SDs, and there are no bright-line tests. In general, application of the framework first requires review of the facts and circumstances of each entity, and if any of the swap dealer provisions are satisfied, the second step is to review whether the entity satisfies one of the specified exemptions.

The facts and circumstances test will enable the Agencies to apply a policy-based approach. The Entity Rule provides that the traditional "dealer-trader" distinction (used in the Securities Exchange Act of 1934 (the "Exchange Act") with respect to broker-dealers) is an appropriate set of principles to apply in determining what entities should be treated as SDs, although the differences between the swap market and the market for securities (other than security-based swaps) prevent the Agencies from applying the traditional "trader-dealer distinction" in full. Provisions of the Entity Rule that are relevant to the SD analysis include whether the entity (i) provides liquidity by accommodating demand for or facilitating interest in swaps; (ii) has clientele and actively advertises or solicits clients; (iii) acts as a market maker on an organized exchange or trading system; and (iv) helps to set pricing, among other provisions. Private investment funds would not generally satisfy these requirements. The fact that an entity is "commonly known in the trade as a dealer or a market maker" or "holds itself out as a dealer" also would be indicia of SD qualification. One factor mentioned in the Entity Rule Release, for example, is that any entity which is a primary member of the International Swaps and Derivatives Association — which excludes entities that participate in derivative transactions solely for the purposes of asset management — may be an SD. Also outlined by the Entity Rule as a factor to consider is whether an SD "makes a market in swaps" which means that it is an entity that is "routinely standing ready to enter into swaps at the request or demand of a counterparty" and that is compensated through spreads or fees and not for the change in the value of the swaps it enters into.

As noted above, there is a statutory exception for activities that are not part of "a regular business."[3] (The Agencies state that the phrases "ordinary course of business" and "a regular business" are "essentially synonymous.") The Entity Rule Release provides that "a regular business" includes: (i) entering into a swap for 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 credit analysis, customer onboarding, and confirmation generation, among other factors. These criteria generally do not cover private investment funds, but note that the Agencies declined to provide any categorical exemptions for private investment funds or any other type of business from coverage as an SD.

If an entity satisfies the SD definition, the entity would not be an SD if it were to satisfy the *de minimis* exemption. The Entity Rule Release provides that any entity that engages in a *de minimis* quantity of dealing in connection with swaps will not have to register as an SD. There is a phase-in period for application of the *de minimis* threshold which would allow the Agencies to study the markets as they evolve in the new regulatory framework.

During the phase-in period, the threshold for SDs will initially be $8 billion for both swaps and security-based swaps; provided that security-based swaps that are not credit default swaps will have a threshold of $400 million. The Agencies believe that for special entities — such as municipalities, endowments and employee benefit plans — a $25 million gross notional threshold is appropriate (there is no phase-in period). For swaps and security-based swaps subject to a phase-in period, over the course of the phase-in period, the threshold would be reduced from $8 billion to $3 billion for swaps and security-based swaps that are credit default swaps; security-based swaps that are not credit default swaps will have a threshold reduced from $400 million to $150 million. The *de minimis* exemption takes into account the notional amount of an entity's swap or security-based swap positions (not taking into account any netting or offsetting positions) over the prior 12 months.

[3] There are other exclusions not discussed in this *Alert* because they are unlikely to be relevant to private investment funds, such as: (i) exclusions for entities that are floor traders; (ii) exclusions for insured depository institutions that originate loans with customers; (iii) exclusion for inter-affiliate swaps and security-based swaps; and (iv) exclusions for cooperatives that enter into swaps or security-based swaps with their members, among others.

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The phase-in will not be longer than five years. The Agencies will each conduct a study regarding the appropriate threshold for SD registration. The CFTC will consider market data addressing swap dealing activity over a period of approximately two years. It will produce a report which is required to be completed by no later than 30 months following the date that a swap data repository first receives swap data under the CFTC's regulations and the report will be published for public comment. The SEC will also produce a report required to be completed by no later than three years following a "data collection initiation date" that is the later of: the last compliance date of the registration and regulatory requirements for SBS Dealers under the Exchange Act or the first date on which compliance with the trade-by-trade reporting rules for credit-related and equity-related security-based swaps to a registered security-based swap data repository is required. The Entity Rules provide that nine months after publication of the report, each of the CFTC and the SEC may promulgate an order that the phase-in period will end as of the date set forth in that order, or issue for public comment a notice of proposed rulemaking to modify the *de minimis* threshold. The final rules also provide that each Agency may change the requirements of the *de minimis* threshold by rule or regulation if data suggests that different *de minimis* thresholds would be appropriate.

The SD definition provides that the Agencies may designate an entity as a dealer for one type, class or category of swap or security-based swap, or specified swap or security-based swap activities, without the entity being considered a dealer for other types, classes, categories or activities.

Definitions of "Major Swap Participant" and "Major Security Based Swap Participant"
Private investment funds generally are not likely to fall within the objective numerical criteria of the definition of MSP. The Entity Rule Release states that the number of persons covered by the definition of "major swap participant" is estimated to be six or fewer and the number of "security-based swap participants" is estimated to be fewer than five and, the Entity Rule Release continues, "in actuality, may be zero."

A private investment fund would be considered an MSP if it meets any one of the following tests:

(i) Maintains a "substantial position" in any of the major swap categories, excluding positions held for hedging or mitigating commercial risk and positions maintained by certain employee benefit plans for hedging or mitigating risks in the operation of the plan. "Substantial position" is determined by using objective numerical criteria. The tests adopted by the Agencies account for both current uncollateralized exposure and potential future exposure. In general, uncollateralized exposure is the current net exposure to each counterparty, obtained by marking-to-market positions using industry standard practices, and subtracting the value of the collateral the entity has posted in these positions. The thresholds adopted for the first test are the daily average current uncollateralized exposure in a calendar quarter of $1 billion in the applicable "major"[4] category (except that the threshold for the rate swap category is $3 billion);

(ii) Holds outstanding swaps which create "substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets." The determination of a "substantial counterparty exposure" is for both current uncollateralized exposure (as discussed above, but instead of "major" categories, the uncollateralized exposure for all the entity's positions) and the potential future exposure associated with an entity's positions. In general, potential future exposure is calculated based upon risk factors; for example, the duration of the position, whether there are daily marks and whether the position is cleared, among other factors, are all taken into account. The thresholds adopted for the second test are $2 billion in daily average current uncollateralized exposure plus potential future exposure in the applicable major category of swap or security-based swap (except that the threshold for the rate swap category is $6 billion); <u>or</u>

(iii) Is a "financial entity" that is "highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking agency" and that maintains a "substantial position" in any of the major swap categories.

[4] The "major" categories are, with respect to swaps: rate swaps, credit swaps, equity swaps and other commodity swaps and, with respect to security-based swaps: debt security-based swaps and "other" security-based swaps.

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With respect to the MSP analysis for beneficial owners of managed swap and security-based swap positions, the Entity Rule Release states that the analysis relates to the where the risk associated with those positions resides. For example, if the counterparties to a swap or security-based swap position within a managed account have recourse only to the assets of that account in the event of default — and lack recourse to the other assets of the beneficial owners — the beneficial owner would not have to count those swaps and security-based swaps for their MSP analysis.[5]

The final rules provide that if an entity meets the criteria for qualifying as a MSP, but does not exceed the relevant threshold by more than 20 percent in a particular quarter, it will not have to register unless at the end of the next fiscal quarter, the entity exceeds the related threshold.

The Agencies acknowledged that only a limited number of entities would have positions with sufficient size to qualify them as an MSP and commenters expressed concern about the costs and burdens associated with performing the MSP calculations on a daily basis, particularly given the complexity of the calculations. Therefore, the Agencies developed three safe harbors. The first safe harbor does not require the MSP calculations to be performed by an entity. An entity will not be an MSP and not have to perform calculations if: (i) the express terms of an entity's arrangements relating to swaps and security-based swaps with its counterparties at no time would permit the entity 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 (ii) 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. The second and third safe harbors require the same calculations to be performed, but on a less frequent basis than daily.

Changes to the ECP Definition

Dodd-Frank imposes a new requirement that all swaps and security-based swaps with non-eligible contract participants ("ECPs") must be executed on a designated market or securities exchange, that a registration statement be in effect for any security-based swap entered into with a non-ECP and that entities that deal in securities-based swaps with non-ECPs must register with the SEC as broker dealers. Dodd-Frank revised the definition of ECP, and the Entity Rule and Entity Rule Release provide further definition and guidance. The term ECP has also been modified. Prior to Dodd-Frank, a commodity pool was an ECP it if had $5 million in total assets, regardless of whether all of the participants in the commodity pool were ECPs. For retail foreign exchange transactions, Dodd-Frank imposes a requirement that all direct participants in commodity pools would need to be ECPs (a look-through provision). This is important because commodity pools with direct participants that are not ECPs would be permitted to enter into retail foreign exchange transactions only in specific enumerated circumstances.

There is a carve-out to the look-through provision, however. The participant in the commodity pool that is a direct participant in the transaction-level commodity pool will not be considered for purposes of the ECP test unless the transaction-level commodity pool, any commodity pool holding a direct or indirect interest in such commodity pool, or any commodity pool in which such transaction-level commodity pool holds a direct or indirect interest, was put in place to evade the restrictions placed on non-ECPs.

If a private investment fund wishes to take advantage of the $5 million ECP test, it has certain responsibilities to ensure that its investors are ECPs themselves. All investors in the fund will have to certify initially and at the time of each investment that it is an ECP. A private investment fund may rely on this representation, so long as it has a reasonable basis to do so. If an investor loses its ECP status, the CFTC provides a private fund with time to remedy the situation, so long as it is done in as timely a manner as possible.

The CFTC also provides private investment funds with a safe harbor which would not require private investment funds to look through to their investors. A commodity pool that enters into a retail forex transaction does not have to look through to its investors to confirm ECP status if: (i) the pool is not formed to evade this new definition; (ii) the pool has more than $10 million in total assets; and (iii) the pool is formed and operated either by a registered commodity pool operator ("CPO") or a CPO that qualifies for the *de minimis* 4.13(a)(3)

[5] The Entity Rule Release provides that the swaps or security -based swaps of the client accounts managed by private investment fund managers do not need to be considered when determining whether private investment fund managers are MSPs.

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exemption. Given the recent repeal of Rule 4.13(a)(4) by the CFTC and the inclusion of swaps in the definition of "commodity interests," more private investment fund managers will be required to register as a CPO. The adopting Entity Rule Release also provides that offshore commodity pools that have only non-U.S. persons are automatically considered ECPs for purposes of retail forex transactions.

Conclusion

Sixty days after the publication of the product definitions, SDs and MSPs will be required to register. In addition, if an entity passes the SD threshold, the entity must register within a two-month period. The changes to the ECP definition will be effective on Dec. 31, 2012 and compliance with the retail forex look-through is Dec. 31, 2012.

Authored by Craig Stein and Kristin Boggiano.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

New York
Schulte Roth & Zabel LLP
919 Third Avenue
New York, NY 10022
+1 212.756.2000
+1 212.593.5955 fax

Washington, DC
Schulte Roth & Zabel LLP
1152 Fifteenth Street, NW, Suite 850
Washington, DC 20005
+1 202.729.7470
+1 202.730.4520 fax

London
Schulte Roth & Zabel International LLP
Heathcoat House, 20 Savile Row
London W1S 3PR
+44 (0) 20 7081 8000
+44 (0) 20 7081 8010 fax

www.srz.com

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