Schulte Roth&Zabel

Client Memorandum

Swap Market Regulation: New Rules for Dealers and Major Participants Proposed by CFTC and SEC

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The Commodity Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission (the "SEC" and, collectively with the CFTC, the "Commissions") have jointly proposed rules to define key terms in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") relating to swaps and security-based swaps ("SBSs"). Private investment funds and their managers seem unlikely to be captured within the proposed definition of "swap dealer" or "security-based swap dealer" (each, a "dealer") though some may have to monitor whether a fund's swap exposure could classify them as a "major swap participant" or "major security-based swap participant" (each, a "major participant" or "MSP"), which would subject them to significant additional oversight.

The proposed rules are being published in the context of the passage of the Dodd-Frank Act on July 21, 2010. The Dodd-Frank Act establishes a comprehensive new regulatory framework for derivatives and provides that the CFTC will regulate swaps and the SEC will regulate SBSs.[1] The proposed rules will be open for public comment until Feb. 22, 2011. The proposed rules with related commentary are available from the SEC's website.[2]

Requirements Imposed on Dealers and Major Participants
Any person that meets any one of the definitions of dealer or major participant is subject to statutory requirements that will be further defined by rules. Some of the key obligations of a dealer or a major participant are as follows:

- The applicable Commission will outline reporting and recordkeeping requirements, capital requirements and initial and variation margin requirements;

- Each major participant and dealer will have to maintain daily trading records and maintain a complete audit trail for conducting comprehensive and accurate trade reconstructions;

- The applicable Commission will promulgate documentation standards for transactions;

- Major participants and dealers will be obligated to implement robust and professional risk management systems and comply with position limits;

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[1] The text of the Dodd-Frank Act can be accessed at http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/hr4173_enrolledbill.pdf.

[2] See Joint Proposed Rule Entitled "Further Definition of 'Swap Dealer,' 'Security-Based Swap Dealer,' 'Major Swap Participant,' 'Major Security-Based Swap Participant,' and 'Eligible Contract Participant,'" available at http://www.sec.gov/rules/proposed/2010/34-63452.pdf (the "Joint Proposed Rule").

- Each will be subject to business conduct requirements and conflict of interest requirements; and
- Each will have to hire a chief compliance officer who will implement standards to ensure compliance with the Dodd-Frank Act, among other obligations.

Definition of Dealer

Some market participants have expressed concern about the statutory definition of “dealer” because the definition could be broad enough to include private investment funds or their managers. The Dodd-Frank Act defines a dealer as (i) an entity that holds itself out as a dealer in swaps or SBSs; (ii) makes a market in swaps or SBSs; (iii) regularly enters into swaps or SBSs with counterparties as an ordinary course of business for one’s own account; or (iv) engages in activity causing itself to be commonly known in the trade as a dealer or market maker in swaps. Clause (iii) in particular could be broadly construed.

In the release proposing the definition of “dealer,” the Commissions state that there “does not appear to be a single set of criteria that can be determinative in all markets,” and also state that “rigid standards would not provide the necessary flexibility” for the Commissions.[3]

The Commissions do note that there may be certain distinguishing characteristics of dealers, including:

- Dealers tend to accommodate demand from other parties;
- Dealers generally are available to enter into swaps or SBSs to facilitate other parties’ interests in entering into those instruments;
- Dealers tend not to request that other parties propose terms of swaps or SBSs; rather, dealers tend to enter into instruments on their own standard terms or on terms they arrange in response to other parties’ interest; and
- Dealers tend to be able to arrange customized terms for swaps upon request.

These criteria generally do not describe private investment funds or their managers. Further, the Commissions address the concern of market participants in the statutory language of clause (iii) above by stating that clause (iii) should be read in conjunction with an express exception, which excludes from clause (iii) “[any] person that enters into swaps for such person’s own account, either individually or in a fiduciary capacity, but not as part of a regular business.” The “regular business” concept is described as covering persons whose function is to accommodate demand for swaps from other parties and enter into swaps in response to interest expressed by other parties. According to the Commissions, “persons who do not fulfill this function should not be deemed to enter into swaps as a part of a ‘regular business’ and are not likely to be swap dealers.”[4]

Definition of Major Participant

The definition of “major participant” may be more likely than the definition of dealer to capture private investment funds. According to the proposing release, the major participant definitions apply to the entities that maintain substantial positions in swaps and SBSs or that have swaps or SBSs that create substantial exposure, and not to the asset managers or investment advisers of those entities.[5] Therefore, it is unlikely that the definition would apply to the manager of a private investment fund.

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[3] Joint Proposed Rule, p.11.

[4] Joint Proposed Rule, p.15.

[5] Some commenters to the Commissions' proposed rules stated that the MSP definitions should not apply to entities such as investment companies and ERISA plans because they are already subject to regulation. The Commissions stated that they are not currently proposing excluding these entities.

There are three parts to the Dodd-Frank Act definition of MSP. A person that satisfies any one of them is a major participant:

- A person that maintains a "substantial position" in any of the "major categories" of swaps or SBSs, 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.

- A person whose outstanding swaps or SBSs create "substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets."

- Any 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 categories of swaps or SBSs.

The Dodd-Frank Act left the "major" categories of swaps to be determined by the applicable Commission. In addition, the statute directs the Commissions to define "substantial position," "substantial counterparty exposure" and "highly leveraged," among other provisions.

Definitions of Major Categories of Swaps, SBSs and Substantial Position

Major Categories

The SEC set forth two "major categories" of SBSs for the purposes of the major participant definition. The first category would encompass "any security-based swap that is based, in whole or in part, on one or more instruments of indebtedness (including loans), or a credit event relating to one or more issuers or securities, including but not limited to any security-based swap that is a credit default swap, total return swap on one or more debt instruments, debt swap, debt index swap or credit spread." The second category would encompass any other SBS that is not included in the first category (such as equity swaps).[6]

The CFTC has set forth four "major categories" of swaps for the purposes of the major participant definition. The four categories are rate swaps, credit swaps, equity swaps and commodity swaps. The four categories are intended to cover all swaps and each swap would be in the category that most closely describes the primary item underlying the swap or, if there are multiple items underlying the swap, the swap would be in the category that describes the item that is likely to have the most significant effect on the economic return of the swap.

If the proposed rules were adopted in their current form, managers of private investment funds would have to carefully examine their trades in order to determine which category a transaction would fall into for purposes of the definition.

Substantial Position

There are two tests to define "substantial position" and if a private investment fund were to satisfy either test, it would have to register as a major participant. The first test includes a numeric threshold in any major category of "uncollateralized exposure" and the second test includes a numeric threshold of uncollateralized exposure plus "potential future exposure," as determined by a formula. The Commissions rejected alternative methods to determine "substantial position," such as considering the financial strength of counterparties, notional amounts only and the number of counterparties.

Test One

The first test is "uncollateralized exposure," which is the exposure in each of the swap categories. Uncollateralized exposure is "the theoretical amount of potential risk that an entity would pose to its

[6] Joint Proposed Rule, p.54.

counterparties if the entity currently were to default."[7] This is the marking of swaps to market using industry standards, deducting collateral, and netting out exposure using a master netting agreement. For this test, the exposure threshold is $1 billion for either swaps or SBSs (other than rate swaps, for which it is $3 billion). Uncollateralized exposure would be measured at the close of each business day, beginning on the first business day of each calendar quarter and continuing through the last business day of that quarter.

Test Two

The second test considers "uncollateralized exposure" plus "potential future exposure." The Commissions stated that focusing solely on current uncollateralized exposure would be overly narrow because exposure can change significantly over short periods of time. Therefore, the second test would consider both current uncollateralized exposure and "potential future exposure," which accounts for how the value of the swap may move over time. For this test, the threshold exposure is $2 billion for either swaps or SBSs (other than rate swaps, for which it is $6 billion). The second test would determine potential future exposure by:

- Multiplying the total notional principal amount of the person's swap positions by specified risk factor percentages (ranging from 0.5 percent to 15 percent) based on the type of transaction and the duration of the position;

- Discounting the amount of positions subject to master netting agreements by a factor ranging between zero and 60 percent, depending on the effects of the agreement; and

- If the swaps are cleared or subject to daily mark-to-market margining, further discounting the amount of the positions by 80 percent.[8]

The statutory definition of "substantial position" excludes positions held for "hedging or mitigating commercial risk." Although their tests are slightly different, both the SEC and the CFTC provide that positions that hedge or mitigate commercial risk will not include any position used to speculate, trade or invest. *Swaps or SBSs that hedge other positions that themselves are held for speculating, trading or investing would not be considered swaps or SBSs that hedge or mitigate commercial risk.* It is not expected, therefore, that private funds would be able to exclude most of their swaps or SBS because they would qualify as speculating, trading or investing.

In addition, the statutory definition of "substantial position" excludes positions maintained by certain employee benefit plans for hedging or mitigating risks in the operation of the plan. Specifically, it excludes "positions maintained by any employee benefit plan (or any contract held by such a plan) as defined in paragraphs (3) and (32) of section 1 of ERISA (29 U.S.C. 1002) for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan."

Substantial Counterparty Exposure

There are also two tests to define "substantial counterparty exposure" and if a person were to satisfy either test, it would have to register as a major participant. Like the substantial position tests, the first test is a numeric threshold of "uncollateralized exposure" and the second test is a numeric threshold of "uncollateralized exposure" plus "potential future exposure." However, unlike the position tests which test only exposure in a "major category," the counterparty exposure test includes all swaps or SBSs across all major categories. For this test, with respect to swaps (not SBSs), the current uncollateralized exposure threshold would be $5 billion, or a combined current uncollateralized exposure and potential future exposure of $8 billion. For SBSs, the current uncollateralized exposure threshold would be $2 billion, or a combined current uncollateralized exposure and potential future exposure of $4 billion. Unlike the test for

[7] Joint Proposed Rule, p.58.

[8] Joint Proposed Rule, p.172 and the CFTC Fact Sheet, available at http://cftc.gov/ucm/groups/public/@newsroom/documents/file/defs_factsheet.pdf.

substantial position, the substantial counterparty exposure test does not exclude hedging positions or certain employee benefit plan positions.

Financial Entity and Highly Leveraged

The definition of "financial entity" includes private investment funds relying on section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940. For qualification as major participant, the definition of "highly leveraged" would be either a 15:1 debt-to-equity ratio or an 8:1 total liabilities-to-equity ratio. In addition, the person would have to have a "substantial position" in any of the "major swap categories." However, unlike the calculation for determining whether there is a "substantial position" under the first part of the definition of major participant, for purposes of the third part of the Dodd-Frank Act definition of major participant, the calculation does not exclude hedging positions or certain employee benefit plan positions.

Other Key Provisions From the Proposed Rules

1. A person can be a major participant based upon transactions that occurred prior to the enactment of the Dodd-Frank Act.

2. If an entity satisfies any threshold, but does not exceed it by 20 percent, it would become subject to requirements only if it exceeds any of the applicable daily average thresholds in the next fiscal quarter.

3. Any entity that is deemed to be an MSP would retain the status until such time that it does not exceed any of the applicable thresholds for four consecutive quarters after registration.

4. If a person satisfies the definition of MSP, it will be considered an MSP with respect to all categories of swaps and SBSs. However, a party may apply for relief with respect to other types of swaps or SBSs.

Application of Major Participant Definition to Managed Accounts

The proposing releases provide specific guidance with respect to the application of the major participant definition to managed accounts. The proposing release explains that "since the major participant definitions focus on the entity that enters into swaps and security-based swaps, all of the managed positions of which a person is the beneficial owner are to be aggregated (along with such beneficial owner's other positions) for purposes of determining whether such beneficial owner is a major participant."[9]

Conclusion

The current proposed definition of "dealer" seems unlikely to encompass private investment funds. Regarding the definition of "major participant," the CFTC's general counsel stated at the open meeting where the rules were proposed that there will likely not be more than "two handfuls" of entities that will qualify for this definition.[10]

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

[9] Joint Proposed Rule, p.109.

[10] See webcast on Dec. 1, 2010, available at http://capitolconnection.net/capcon/cftc/webcastarchive.htm.

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