

**PROPOSED DEFINITIONS OF SWAP DEALER
AND SECURITY-BASED SWAP DEALER**

The Securities and Exchange Commission and Commodity Futures Trading Commission jointly proposed rules¹ under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”)² to define, among other things, the terms “swap dealer” and “security-based swap dealer.” Comments on the proposed rules are due by February 22, 2011.

The proposed definitions have significant implications for participants in the financial markets. Entities that previously were not subject to registration with financial regulators may now be required to register with the CFTC, the SEC, or both, and comply with various rules promulgated by those regulators, because of the entities’ activities in swaps and security-based swaps. Moreover, otherwise-regulated entities that previously were not subject to regulation with respect to their swap or security-based swap activities may become subject to regulation governing those activities.

The Definitions

The CFTC proposes to define the term “swap dealer” in Rule 1.3(ppp) under the Commodity Exchange Act (“CEA”) and the SEC proposes to define the term “security-based swap dealer” (“SB swap dealer”) in Rule 3a71-1 under the Securities Exchange Act of 1934 (the “Exchange Act”). Whether a person is a swap dealer or an SB swap dealer within the meaning of the Dodd-Frank Act depends on the types of activities in which the person engages in swaps or security-based swaps.³ A person would be a swap dealer or an SB swap dealer, as applicable, under the proposed rules if that person engaged in one or more of the following activities:

1. holding oneself out as a swap dealer or SB swap dealer;
2. making markets in swaps or security-based swaps;

¹ Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant,” RIN 3038-AD06, Exchange Act Release No. 63452, 75 Fed. Reg. 80174 (Dec. 21, 2010) (the “Proposal”). For a discussion of the definitions of “Major Swap Participant” and “Major Security-Based Swap Participant,” please see our client memoranda “Proposed Definitions of Swap Participant and Major Security-Based Swap Participant” and “Commodity Pools as ECPs after the Dodd-Frank Act,” available at www.willkie.com/firm/pubs.aspx.

² Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

³ The term “swap” is defined in Section 1(a)(47) of the CEA and “security-based swap” is defined in Section 3(a)(68) of the Exchange Act.

3. regularly entering into swaps or security-based swaps with counterparties in the ordinary course of business for one's own account; or
4. engaging in activities that cause oneself to be commonly known in the trade as a dealer or market maker in swaps or security-based swaps.⁴

A person who meets either definition would need to register as a swap dealer with the CFTC and/or as an SB swap dealer with the SEC, as appropriate, and comply with certain capital, margin and business conduct requirements.

The proposed swap dealer and SB swap dealer definitions are disjunctive. Engaging in any one of the enumerated dealing activities would bring the person within one or both definitions, depending on whether the person's activities relate to swaps or security-based swaps, even if the person does not engage in any of the other enumerated activities. The definitions would not, however, encompass a person who engages in swap or security-based swap activities for the person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business. The definitions would also exempt persons who engage in a *de minimis* quantity of dealing in swaps or security-based swaps, as discussed more fully below.⁵

Analyzing Whether a Person Is a Swap Dealer or SB Swap Dealer

Dealer Generally

The SEC and the CFTC (collectively, the "Commissions") discuss a number of factors that indicate that a person is a "dealer,"⁶ rather than an investor, for purposes of determining if that person is a swap dealer or SB swap dealer. The Commissions note that:

- dealers tend to accommodate demand for swaps and security-based swaps from third parties;
- dealers are generally available to enter into swaps or security-based swaps to facilitate other parties' interests in entering into those instruments;

⁴ Proposal at 80175.

⁵ *Id.* An insured depository institution would not be a swap dealer if it offered to enter into a swap with a customer in connection with originating a loan for that customer.

⁶ The Commissions note that the Dodd-Frank Act did not amend the CEA or Exchange Act with respect to persons who act as brokers in swaps or security-based swaps. A security-based swap is a security within the meaning of the Exchange Act; therefore, a person who engages in the business of effecting transactions in security-based swaps for the accounts of others must, absent an exemption, register with the SEC under the Exchange Act and comply with the Exchange Act's requirements applicable to brokers. Proposal at 80175 n.10. Similarly, the Dodd-Frank Act amended the definitions of "Futures Commission Merchant" and "Introducing Broker" in the CEA to include persons who engage in soliciting or accepting orders in swaps. 7 U.S.C. 1a(28), (31) (2011).

- dealers tend not to request that other parties propose the terms of swaps or security-based swaps; rather, dealers tend to enter into those instruments on their own standard terms or on terms they arrange in response to other parties' interests; and
- dealers tend to be able to arrange customized terms for swaps or security-based swaps at the dealer's own initiative.⁷

Swap Dealer and SB Swap Dealer

The Commissions state that although the above factors are indicia relevant to determining whether a person is a swap dealer or SB swap dealer, certain of the principles relevant to identifying swap dealing differ from those relevant to identifying security-based swap dealing. According to the Commissions, swap dealers are identified by the functional role they play in the swaps markets. Swap dealers tend to accommodate demand and to be available to enter into swaps to facilitate other parties' interests in swaps, and tend to enter into swaps with more counterparties than do non-dealers. Non-dealers, by contrast, tend to enter into swaps with swap dealers more often than they do with other non-dealers.⁸ The Commissions do not explain why the preceding activities, identified as indicia of engaging in swap dealing, would not also be indicia of security-based swap dealing if such activities involved security-based swaps.

In addition to the general indicia of being a swap dealer or SB swap dealer, the SEC would look to the same factors that are relevant to determining if a person is a "dealer" in securities within the meaning of Section 3(a)(5) of the Exchange Act, as opposed to a "trader" who trades solely for its own account, in analyzing whether a person is an SB swap dealer. In considering the difference between a person who is a "dealer," rather than a "trader" who would not be required to register as a "dealer," the SEC:

Recognizes that dealers normally have a regular clientele, hold themselves out as buying or selling securities at a regular place of business, have regular turnover of inventory (or participate in the sale or distribution of new issues, such as by acting as an underwriter), and generally provide liquidity services in transactions with investors (or, in the case of dealers who are market makers, for other professionals).⁹

Other factors that indicate that a person is a dealer include receipt of customer property and provision of incidental advice in connection with transactions.

The Proposal notes that the security-based swap markets differ from the securities cash markets in certain respects, particularly with respect to the concepts of inventory and regular place of business. The absence of certain activities that might indicate that a person is not a dealer for purposes of cash market securities would not necessarily mean that such a person is not a dealer

⁷ Proposal at 80176.

⁸ *Id.* at 80177.

⁹ *Id.* at 16 *citing* Exchange Act Release No. 47364 (Feb. 13, 2003).

in security-based swaps. A person who is a dealer in securities cash markets typically has a regular turnover of inventory, *i.e.*, a turnover of proprietary securities positions. Security-based swaps, however, are bilateral contracts and not instruments likely to be maintained in inventory. The Proposal also suggests, without much elaboration, that an SB swap dealer might communicate its availability to enter into security-based swaps with market participants without maintaining a regular place of business.

According to the Proposal, a person who is a dealer in cash market securities who enters into a security-based swap transaction would appear to be engaged in security-based swap dealing activity with that customer.¹⁰ Persons who express a willingness to provide liquidity to counterparties that seek to enter into security-based swaps, regardless of the “direction” of the transaction or across a broad spectrum of risks, may be viewed as security-based swap dealers.¹¹

The Proposal notes that commenters have raised concerns that entities that enter into security-based swaps to hedge business risks could be viewed as SB swap dealers. As stated in the Proposal, however, entities that use security-based swaps to hedge business risks likely would not be SB swap dealers, absent other activity. Such entities, for example, presumably would not hold themselves out as SB swap dealers, an important factor in determining if an entity is an SB swap dealer.

Holding Out

The Proposal provides guidance on factors that may reasonably indicate that a person is holding itself out as, or is commonly known in the trade as, a dealer. Those factors include, among others, the following:

- soliciting interest in swaps or security-based swaps from potential counterparties;
- developing new types of swaps or security-based swaps and informing potential counterparties of the availability of, and the person’s willingness to enter into, such swaps or security-based swaps;
- membership in a swap association in a category reserved for dealers;
- providing marketing materials indicating the types of swaps or security-based swaps that a person is willing to enter into; or
- generally expressing a willingness to offer or provide a range of financial products that include swaps or security-based swaps.¹²

¹⁰ Proposal at 80178.

¹¹ *Id.*

¹² *Id.*

Market Making

The Commissions reject the notion that a person would be a market maker¹³ in swaps or security-based swaps, and thus a dealer, only if the person continuously provided two-sided quotations and stood ready to buy and sell a swap or a security-based swap. According to the Commissions, parties do not enter into many types of swaps or security-based swap transactions on a continuous basis. The Commissions are concerned that imputing a requirement of continuous activity could result in persons not being regulated as swap dealers or SB swap dealers even though they engage in dealing activities that are more than *de minimis*.¹⁴ The Commissions do not otherwise expand on what constitutes market making in swaps or security-based swaps.

Regularly Entering into Swaps or Security-Based Swaps in the Ordinary Course of Business

Under the Dodd-Frank Act, a person who regularly enters into swaps or security-based swaps with counterparties in the ordinary course of business or as a regular business for its own account is a swap dealer or SB swap dealer.¹⁵ Excluded from the definition of swap dealer/SB swap dealer is a person who enters into swaps or security-based swaps for the person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business. The Commissions state that a person enters into swap or security-based swap transactions as part of a regular business or in the ordinary course of business if it does so to accommodate demand for such transactions by third parties and in response to interest expressed from those third parties. By contrast, persons who do not provide such an accommodation should not be viewed as entering into swap/security-based swap transactions as part of a regular business or in the ordinary course of business.¹⁶

Commonly Known in the Trade as Dealing in Swaps or Security-Based Swaps

The Proposal states that if persons who have substantial experience with and knowledge of the swap and security-based swap markets view a person as a swap dealer or SB swap dealer, that view would tend to indicate that such a person is a swap dealer or SB swap dealer, even if the person is not known as a dealer by persons lacking such experience and knowledge.¹⁷ This position suggests that a person who does not appear to be actively holding itself out as a dealer could be deemed to be such if knowledgeable persons in the industry view the person as a dealer.

¹³ The proposed definition of swap dealer includes any person who makes a market in swaps (proposed Rule 1.3(ppp)(1)(ii)), and the proposed definition of SB swap dealer includes any person who makes a market in security-based swaps (proposed Rule 3a71-1(a)(ii)).

¹⁴ Proposal at 80178.

¹⁵ *Id.* at 80177.

¹⁶ *Id.*

¹⁷ *Id.* at 80178.

It is not clear how the Commissions would identify (a) “knowledgeable persons” in the industry, and (b) who such knowledgeable persons view as dealers in swaps or security-based swaps.

No Predominance

The definitions of swap dealer and SB swap dealer do not impose any predominance test, meaning that a person’s business does not need to be comprised solely or predominantly of swap or security-based swap activities in order for the person to fall within the definition of swap dealer or SB swap dealer. Persons may engage in businesses that are larger from a volume or other perspective than their swap or security-based swap businesses. If a person engages in swap or security-based swap dealing activity that is more than *de minimis*, the person nonetheless would be a swap dealer or SB swap dealer.¹⁸

De Minimis Exemption to the Definitions

The Dodd-Frank Act requires the Commissions to exempt persons who engage in a *de minimis* level of swap or security-based swap dealing from the definitions of swap dealer and SB swap dealer. In response, the Commissions have proposed Rule 1.3(ppp)(4) under the CEA and Rule 3a71-2 under the Exchange Act. Under the proposed rules, a person satisfying all of the following would not be deemed to be a swap dealer or SB swap dealer:

- The gross notional amount¹⁹ of swaps or security-based swaps that the person entered into over the prior 12 months in connection with its dealing activity²⁰ did not exceed \$100 million;
- The aggregate effective notional amount of swaps or security-based swaps with respect to which a person’s counterparty is a “special entity”²¹ did not exceed \$25 million over the prior 12 months;
- The person did not enter into swaps or security-based swaps as a dealer with more than 15 counterparties, other than swap dealers or SB swap dealers, over the prior 12 months;²² and

¹⁸ Proposal at 80178-80179.

¹⁹ A person’s quantity of dealing would be measured on a gross basis, without consideration of the market risk offsets associated with combining long and short positions. Proposal at 80180.

²⁰ The *de minimis* exception places limits on a person’s *dealing* activity in swaps or security-based swaps. Swap or security-based swap activity that constitutes hedging or mitigation of commercial risk would not count towards the limits.

²¹ “Special entity” is defined in Section 4s(h)(2)(C) of the CEA and Section 15F(h)(2)(C) of the Exchange Act. The term encompasses federal agencies; states; state agencies and political subdivisions (including cities, counties and municipalities); endowments; and “employee benefit plans” and “governmental plans,” as those terms are defined under the Employee Retirement Income Security Act of 1974.

²² Counterparties that are members of an affiliated group would generally count as one counterparty for purposes of this requirement. An affiliated group would be any group comprised of entities that are under common control, and that report information or prepare financial statements on a consolidated basis. Proposal at 80180 n.43.

- The person did not enter into more than 20 swaps or security-based swaps (as applicable)²³ as a dealer during the prior 12 months.²⁴

The proposed rules would not distinguish between the different types of swaps or security-based swaps into which the entities may enter.²⁵

Designations

Under the Dodd-Frank Act, a person may be designated as a dealer for one or more types, classes or categories of swaps or security-based swaps without being considered a swap dealer or SB swap dealer for other types, classes or categories of swaps or security-based swaps. The Commissions, however, propose that a person that falls within the definition of swap dealer or SB swap dealer would be a dealer for all types, classes or categories of swaps or security-based swaps or activities involving swaps or security-based swaps in which the person engages. The Proposal nevertheless allows the Commissions to provide for a person to be designated as a swap dealer or security-based swap dealer for only specified categories of swaps, security-based swaps, or activities without being classified as a dealer for all categories; essentially, the Commissions could permit limited-purpose swap/SB swap dealers.²⁶ The CFTC observes that certain non-financial entities, whose swap dealing activities are not a core part of their businesses, may conduct swap dealing activity through divisions, and not through separately incorporated affiliates. The CFTC anticipates that if these types of entities were to register as swap dealers, then certain of the swap dealer requirements would apply to the swap dealing activities of the relevant division, but not necessarily to the swap activities of other parts of the company.²⁷

Interpretive Issues

In addition to defining further the terms swap dealer and SB swap dealer, the Commissions also propose and seek comment on certain interpretations relating to the definitions of those terms.

²³ An amendment of an existing swap or security-based swap in which the counterparty remained the same and the underlying reference asset remained substantially the same would not count as a new swap or security-based swap. Proposal at 80180.

²⁴ Proposal at 80180.

²⁵ The definition of swap dealer excludes an insured depository to the extent that it offers to enter into a swap with a customer in connection with originating a loan with that customer. The swap must be linked to the financial terms of the loan, the loan cannot be a “sham loan,” and the loan cannot be a synthetic loan. There is no similar exclusion from the definition of SB swap dealer. Proposal at 80181-80182. It is not clear whether a loan and its corresponding swap must be entered into contemporaneously.

²⁶ Proposal at 80812. A person presumably could seek limited designation at the same time as, or at a time subsequent to, the person’s initial registration as a swap dealer or SB swap dealer.

²⁷ *Id.*

“Person”

The term “person” in the swap dealer and SB swap dealer definitions refers to a legal person, not to any business division within an organization that is not a separate legal person (*e.g.*, a trading desk of a broker-dealer is not a “person” for purposes of the swap dealer and SB swap dealer definitions).²⁸ For example, a broker-dealer that engages in security-based swap dealing activities or a futures commission merchant that engages in swap dealing activities, not a particular group or division within those entities, would register as an SB swap dealer or swap dealer, respectively.

Application to Certain Types of Swap/SB Swap Market Participants

The Commissions seek comment on the application of the definitions of swap dealer and SB swap dealer to aggregators, physical market participants and participants in electricity generation and transmission markets. Aggregators often enter into multiple swaps with other parties to aggregate those swap positions into a size that would make it more effective to enter into swaps in the larger swap market or would make entering into swaps more efficient in general.²⁹ Aggregation may, for example, improve negotiating strength with respect to counterparties or allow the parties using aggregators to obtain better pricing on the swaps. The Commissions request comment on whether the swap dealer definition should apply in this circumstance.

Physical Markets for Commodities

Certain participants in the physical markets for commodities, such as oil, natural gas, chemicals and metal, have developed highly customized transactions and market practices to accommodate their markets. Some of these transactions might constitute swaps. The Commissions ask if the swap dealer definition should apply to these participants and, if so, whether it should be tailored in some way.³⁰

The Electricity Markets

Similarly, the electricity markets are unique and complex. Certain participants engage in swap dealing activity with respect to the electricity markets. The Commissions ask if there are additional or different factors that should be considered in applying the dealer definition to participants in the electricity markets.³¹

²⁸ Proposal at 80183.

²⁹ *Id.*

³⁰ *Id.*

³¹ *Id.* at 80183-80184.

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February 14, 2011

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