

**PROPOSED DEFINITIONS OF MAJOR SWAP PARTICIPANT
AND MAJOR SECURITY-BASED SWAP PARTICIPANT**

The Commodity Futures Trading Commission and the Securities and Exchange Commission have jointly proposed rules¹ under Title VII of the Dodd-Frank Act² to define, among other things, the terms “major swap participant” under the Commodity Exchange Act³ and “major security-based swap participant” under the Securities Exchange Act of 1934.⁴ Comments on the proposed rules are due by February 22, 2011.

The proposed definitions may have significant implications for certain participants in the financial markets. Certain entities that previously were not subject to registration with financial regulators may now, as a result of their activities in swaps and/or security-based swaps (“SBS”), be required to register with, and comply with certain rules promulgated by, the CFTC, the SEC, or both, as applicable. Moreover, certain otherwise-regulated entities that previously were not subject to regulation with respect to their swap or SBS activities may become subject to additional regulation if they continue to engage in those activities.

I. Definitions of Major Swap Participant and Major Security-Based Swap Participant

Whether a person is required to register as a major swap participant (“MSP”) or a major SBS participant (“MSBSP”) depends on the person’s level of activity in swaps⁵ or SBS,⁶ respectively.

¹ Joint Proposed Rule; Proposed Interpretations: Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant”, 75 Fed. Reg. 80174 (Dec. 21, 2010) (the “Proposal”).

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

³ 7 U.S.C. § 1 *et seq.* (the “CEA”).

⁴ 15 U.S.C. § 78a *et seq.* (the “Exchange Act”).

⁵ Generally, a “swap” under the CEA could be any transaction that is not settled by delivery of the underlying commodity, including, but not limited to: (i) options, such as puts, calls, caps, and floors on most reference assets, (ii) swaps, such as those on interest rates, broad-based securities indices and other reference assets, (iii) credit default swaps, (iv) any other instrument “that is or becomes commonly known as a swap,” (v) foreign exchange swaps and foreign exchange forward contracts, and (vi) any instrument that combines any of the above. The definition of swap excludes futures and most forward contracts. CEA § 1a(47); 7 U.S.C. § 1a(47).

⁶ Generally, a “security-based swap” under the Exchange Act could be any transaction that is a swap and is based on: (i) a narrow-based security index (including any interest therein or value thereof), (ii) a single security or loan (including any interest therein or value thereof), or (iii) the occurrence or nonoccurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index provided that such event directly affects the financial statements, financial obligations, or financial condition of the issuer. Exchange Act § 3(a)(68); 15 U.S.C. § 78c(a)(68).

The CEA and the Exchange Act define MSP and MSBSP, respectively, as any person that is not a “swap dealer” or “security-based swap dealer,”⁷ and:

1. that maintains a “substantial position” in swaps or SBS for any of the major swap categories or major SBS categories as determined by the CFTC or SEC, as applicable (excluding positions held for “hedging or mitigating commercial risk” and positions maintained by or contracts held by any employee benefit plan for the primary purpose of hedging or mitigating risks directly associated with the operation of the plan) (the “Substantial Position Test”);
2. whose outstanding swaps or SBS create “substantial counterparty exposure” that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets (the “Counterparty Exposure Test”); or
3. that is a “financial entity” that:
 - (a) maintains a “substantial position” in outstanding swaps or SBS in any major swap category or any major SBS category as determined by the CFTC or SEC, respectively;
 - (b) is “highly leveraged” relative to the amount of capital it holds; and
 - (c) is not subject to capital requirements established by an appropriate federal banking agency (the “Financial Entity Test”).⁸

In addition to the above, the definition of MSP, but not the definition of MSBSP, includes an exception for any entity whose primary business is providing financing and that uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, at least 81% of which arise from financing that facilitates the purchase or lease of products that are manufactured by the parent company or another subsidiary of the parent company.⁹

A person that meets the Substantial Position Test, the Counterparty Exposure Test or the Financial Entity Test (collectively, the “Major Participant Tests”) generally would be required to register as an MSP with the CFTC, and/or as an MSBSP with the SEC, as appropriate, and comply with certain capital, margin and business conduct requirements. The Proposal further defines certain key terms used in each of the Major Participant Tests, which are discussed below.

⁷ Generally, a swap dealer or SBS dealer is any person that: (i) holds itself out as a dealer in swaps or SBS, (ii) makes a market in swaps or SBS, (iii) regularly enters into swaps or SBS for its own account, or (iv) is commonly known in the trade as a dealer or market-maker in swaps or SBS. For a discussion of the definitions of swap dealer and SBS dealer, please see our memorandum “Proposed Definitions of Swap Dealer and Security-Based Swap Dealer.”

⁸ CEA § 1a(33)(A); 7 U.S.C. § 1a(33)(A) and Exchange Act § 3(a)(67)(A); 15 U.S.C. § 78c(a)(67)(A).

⁹ CEA § 1a(33)(D); 7 U.S.C. § 1a(33)(D).

II. Contours of the MSP and MSBSP Definitions

A. The Substantial Position Test

1. Major Categories of Swaps and Security-Based Swaps

The CFTC proposes four major categories of swaps:

1. “rate swaps” (any swap based on reference rates such as fixed or floating interest rates, currency exchange, inflation or other monetary rates);
2. “credit swaps” (any swap primarily based on instruments of indebtedness or related broad-based indices);
3. “equity swaps” (any swap based on equities or equity indices); and
4. “other commodity swaps” (any swap not included in the first three categories, including any swap based on physical commodities).¹⁰

The SEC proposes two categories of SBS:

1. “security-based credit derivatives” (any SBS 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 SBS that is a credit swap, total return swap on one or more debt instruments, debt swap, debt index swap, or credit spread); and
2. “other security-based swaps” (any other SBS not included in the first category, including, for example, equity swaps).¹¹

The Proposal states that a person that meets the definition of either MSP or MSBSP will be considered as such with regard to all categories of swaps or SBS, as applicable. Nonetheless, a major participant that engages in activity in only one category of swaps or SBS may apply for relief from certain requirements that are applicable to major participants with regard to other categories of swaps or SBS. A person may, therefore, be designated as an MSP or MSBSP for one or more categories of swaps or SBS without being classified as a major participant for all categories of swaps or SBS.¹²

¹⁰ Proposal at 80186-80187.

¹¹ *Id.* at 80187.

¹² *Id.* at 80200.

2. Substantial Position

The CFTC and SEC (collectively, the “Commissions”) have articulated two tests that use objective, numerical criteria¹³ to determine whether a person holds a “substantial position” in any of the major swap categories or major SBS categories. The first test would account for current uncollateralized exposure,¹⁴ while the second test would account for both current uncollateralized exposure and potential future exposure.¹⁵ A position that satisfies either of these two tests at any time would be deemed a “substantial position.”

Under the first test, a person with a daily average current uncollateralized exposure would be: (a) an MSP if such exposure equaled or exceeded \$1 billion in credit, equity or other commodity swaps, or \$3 billion in rate swaps, or (b) an MSBSP if such exposure equaled or exceeded \$1 billion in either major category of SBS.

Under the second test, a person with a combined daily average current uncollateralized exposure and potential future exposure would be: (a) an MSP if such combined exposure equaled or exceeded \$2 billion in credit, equity or other commodity swaps, or \$6 billion in rate swaps, or (b) an MSBSP if such combined exposure equaled or exceeded \$2 billion in either major category of SBS.

In calculating a person’s swap and SBS exposure under these tests, the Commissions would take into account the person’s activities in both cleared and uncleared swaps and SBS.

¹³ The Commissions suggested that the use of such objective criteria should promote predictability. This definition borrows concepts from bank capital standards.

¹⁴ Current uncollateralized outward exposure would be calculated through the last business day of the calendar quarter by:

- marking to market swap or SBS positions with a negative value using industry standard practices;
- deducting the value of collateral posted with respect to the swap or SBS positions; and
- giving effect to the terms of any applicable master netting agreement.

Id. at 80189-80190.

¹⁵ Potential future exposure associated with a person’s swap or SBS positions would be calculated by:

- multiplying a specified risk factor by the total notional principal amount of a person’s swap or SBS positions (the risk factor would range from: (i) 0.5% to 15%, depending on the type of swap and the duration of the position, or (ii) 6% to 15%, depending on the type of SBS and the duration of the position);
- discounting positions subject to master netting agreements by a factor ranging between zero and 60%; and
- further discounting by 80% the notional principal amount of swaps or SBS that are cleared or subject to daily mark-to-market margining.

Id. at 80191-80193; 80213-80214; 80216-80217.

3. Hedging or Mitigating Commercial Risk

As directed by the Dodd-Frank Act, the Commissions propose to exclude swap or SBS positions held for the purpose of “hedging or mitigating commercial risk” from the calculation of the “substantial position” thresholds. The CFTC and the SEC, however, propose different definitions of the term “hedging or mitigating commercial risk.”¹⁶

The CFTC proposes to define “hedging or mitigating commercial risk” to include positions in swaps that qualify as bona fide hedges under the CEA and the CFTC rules, swaps that qualify for hedging treatment under Financial Accounting Standards Board Statement No. 133, and swaps that are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where risks arise in the ordinary course of business from one of several events.¹⁷ The CFTC would determine if a swap meets the definition by analyzing the facts and circumstances at the time the swap is entered into and would take into consideration the person’s overall hedging and risk mitigation strategies.

Like the CFTC, the SEC proposes to define “hedging or mitigating commercial risk” to include positions in SBS that are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where risks arise in the ordinary course of business from one of several events; the list of such events, however, is a subset of those under the CFTC’s proposed definition.¹⁸ A person’s ability to exclude these SBS positions from its “substantial position” calculation would be conditioned on the person: (i) identifying and documenting the risks that are being reduced by the SBS position, (ii) establishing and documenting a method of assessing the effectiveness of the SBS as a hedge, and (iii) regularly assessing the effectiveness of the SBS as a hedge.¹⁹

¹⁶ Nonetheless, the Commissions believe that whether an activity is commercial should not be determined solely by the person’s organizational status as a for-profit company, a nonprofit organization or a governmental entity. Rather, the determinative factor should be whether the underlying activity to which the swap relates is commercial in nature. *Id.* at 80194.

¹⁷ Such events include: (i) a potential change in the value of (a) assets that a person owns, produces, manufactures, processes, or merchandises, (b) liabilities that a person incurs, or (c) services that a person provides or purchases, (ii) a potential change in the value relating to any of the foregoing arising from foreign exchange rate movements, and (iii) a fluctuation in interest, currency or foreign exchange rate exposures arising from a person’s assets or liabilities. *Id.* at 80214-80215.

¹⁸ Such events include a potential change in the value of (a) assets that a person owns, produces, manufactures, processes, or merchandises, (b) liabilities that a person incurs, or (c) services that a person provides or purchases. *Id.* at 80217.

¹⁹ *Id.* at 80195.

B. The Counterparty Exposure Test

1. Substantial Counterparty Exposure

The Commissions propose that “substantial counterparty exposure” be determined using largely the same formula proposed for determining if a swap or SBS position constitutes a “substantial position,” with several key differences:

1. the calculation would not exclude hedging or employee benefit plan positions;
2. the calculation aggregates all of the person’s swap or SBS positions without regard to the major categories;
3. a person with a daily average current uncollateralized exposure would be: (a) an MSP if such exposure equaled or exceeded \$5 billion across the entirety of the person’s swaps, or (b) an MSBSP if such exposure equaled or exceeded \$2 billion across the entirety of the person’s SBS; and
4. a person with a combined daily average current uncollateralized exposure and potential future exposure would be: (a) an MSP if such combined exposure equaled or exceeded \$8 billion across the entirety of the person’s swaps, or (b) an MSBSP if such combined exposure equaled or exceeded \$4 billion across the entirety of the person’s SBS.²⁰

C. The Financial Entity Test

1. Financial Entity

For the purpose of the MSP and MSBSP definitions, the Commissions propose to use the same definition of “financial entity” as found in CEA § 2(h)(7), which generally includes swap dealers, SBS dealers, commodity pools, certain private funds (issuers that would be investment companies, as defined in the Investment Company Act of 1940, but for § 3(c)(1) or § 3(c)(7) of that act), certain ERISA employee benefit plans, and persons predominately engaged in certain banking or financial activities.²¹

2. Major Categories of Swaps and Security-Based Swaps and “Substantial Position”

The major categories of swaps and SBS and the definition of “substantial position,” for purposes of the Financial Entity Test, are the same as those laid out in the discussion of the Substantial Position Test above. Unlike the Substantial Position Test, however, the Financial Entity Test does not permit an exclusion from the substantial position calculation for positions held for hedging.

²⁰ *Id.* at 80197-80198.

²¹ *Id.* at 80198.

3. Highly Leveraged

The Proposal defines “highly leveraged” as a ratio of total liabilities to equity of either 8:1 or 15:1 (the Commissions are accepting comments as to which standard they should adopt), generally as determined in accordance with U.S. generally accepted accounting principles.²² Whether a person is highly leveraged would be determined on the last business day of the person’s fiscal quarter.²³

III. Time Frames for Determining Major Participant Status

The Commissions have proposed that a person not registered as an MSP or MSBSP but that meets the relevant registration criteria will not be deemed to be an MSP or MSBSP until the earlier of:

1. the date on which the person submits a complete application for registration with the CFTC or SEC, as applicable; or
2. two months after the end of the fiscal quarter in which the person’s swap or SBS activities reached the relevant MSP or MSBSP thresholds.

The Commissions have also proposed a registration grace period for would-be MSPs and MSBSPs. A person whose swap or SBS activity exceeds the applicable thresholds by 20% or less during a fiscal quarter would be permitted to wait until the end of its next fiscal quarter before having to determine whether registration with the CFTC or SEC is necessary. If the person’s swap or SBS activities did not exceed any of the applicable thresholds during its next fiscal quarter, the person would not be required to register.

Finally, the Commissions have proposed that once deemed an MSP or MSBSP, a person would continue to be so deemed until such time as its swap or SBS activities have remained below all of the applicable thresholds for four consecutive fiscal quarters after the date the person becomes registered as an MSP or MSBSP.²⁴

²² The Commissions observed that financial entities that are subject to capital requirements set by the federal banking agencies generally have leverage ratios of approximately 10:1, which suggests that the “highly leveraged” threshold of the Financial Entity Test generally would have to be lower than 10:1 to capture similarly leveraged financial institutions that are not subject to such capital requirements. *Id.* at 80199.

²³ *Id.* at 80198-80199.

²⁴ *Id.* at 80200.

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