

**SWAP DEALER  
AND SECURITY-BASED SWAP DEALER DEFINED**

The Securities and Exchange Commission and Commodity Futures Trading Commission jointly adopted final rules<sup>1</sup> under Title VII of the Dodd-Frank Act<sup>2</sup> defining, among other things, the terms “swap dealer” and “security-based swap dealer.”

The 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 additional regulations governing those activities.

The CFTC stated in the Release that the compliance date for the final rules and interpretive guidance further defining swap dealer and security-based swap dealer is subject to “separate registration and regulatory requirements that will be dealt with in separate rulemakings by the Commission.”<sup>3</sup> The SEC stated that registration as a security-based swap dealer will not be required until the dates provided in the SEC’s final rules regarding registration. Once registered, security-based swap dealers will need to comply with applicable requirements (such as business conduct, recording and reporting requirements) by the dates provided in those final rules.

The SEC and the CFTC (collectively, the “Commissions”) also proposed a phase-in period during which entities engaged in dealing activity above a *de minimis* threshold<sup>4</sup> could further postpone registration. That *de minimis* threshold (as discussed below) is substantially higher than the *de minimis* threshold that will apply after the phase-in period ends.

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<sup>1</sup> 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. 66868, [ ] Fed. Reg. [ ] ([Date ]) (the “Release”).

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

<sup>3</sup> Release at 398.

<sup>4</sup> *See infra* at 7.

## The Definitions

The CFTC defines the term “swap dealer” in Rule 1.3(ggg) under the Commodity Exchange Act (“CEA”) and the SEC defines 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 a security-based swap dealer within the meaning of the Dodd-Frank Act depends on the types of swap or security-based swap activities in which the person engages.<sup>5</sup> A person is a swap dealer or a security-based swap dealer, as applicable, if that person engages in one or more of the following activities:

1. holding oneself out as a swap dealer or security-based swap dealer;
2. making markets in swaps or security-based swaps;
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.<sup>6</sup>

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 recordkeeping, reporting, capital, margin and business conduct requirements.

The swap dealer and SB swap dealer definitions are disjunctive. Engaging in any one of the enumerated dealing activities will 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 will 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 will also exempt persons who engage in a *de minimis* quantity of dealing in swaps or security-based swaps, as discussed more fully below.<sup>7</sup>

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<sup>5</sup> 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.

<sup>6</sup> Release at 12.

<sup>7</sup> *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.

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

### *Dealer Generally*

The CFTC discusses a number of activities that indicate that a person is a “dealer,”<sup>8</sup> rather than an investor, for purposes of determining if that person is a swap dealer. The following activities are indicative of acting as a swap dealer:

- providing liquidity by accommodating demand for or facilitating interest in the instrument (swaps, in this case), holding oneself out as willing to enter into swaps (independent of whether another party has already expressed interest), or being known in the industry as being available to accommodate demand for swaps;
- advising a counterparty as to how to use swaps to meet the counterparty’s hedging goals, or structuring swaps on behalf of a counterparty;
- having a regular clientele and actively advertising or soliciting clients in connection with swaps;
- acting in a market maker capacity on an organized exchange or trading system for swaps; and
- helping to set the prices offered in the market (such as by acting as a market maker) rather than taking those prices, although the fact that a person regularly takes the market price for its swaps does not foreclose the possibility that the person may be a swap dealer.<sup>9</sup>

The SEC noted that the factors below are relevant for identifying security-based swap dealers:

- providing liquidity to market professionals or other persons in connection with security-based swaps;

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<sup>8</sup> 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. Release at 11 n.9. In mid-2011, the SEC issued temporary exemptions under the Exchange Act in connection with the revision of the “security” definition to encompass security-based swaps. Among other aspects, these temporary exemptions extended to certain broker activities involving security-based swaps. *Id.* 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).

<sup>9</sup> Release at 54-55.

- seeking to profit by providing liquidity in connection with security-based swaps;
- providing advice in connection with security-based swaps or structuring security-based swaps;
- presence of regular clientele and actively soliciting clients;
- use of inter-dealer brokers; and
- acting as a market maker on an organized security-based swap exchange or trading system.<sup>10</sup>

*Swap Dealer and SB Swap Dealer*

Because the definitions of the terms “swap dealer” in the CEA and “security-based swap dealer” in the Exchange Act are substantially similar, the rules further defining those terms and the accompanying interpretations in the Release reflect common underlying principles. At the same time, the Release notes that interpretations regarding the application of the definitions differ in certain respects, given the differences in the uses of and markets for swaps and security-based swaps. Relevant differences include: level of activity; no separate issuer; predominance of over-the-counter and non-standardized instruments; and mutuality of obligations and significance to “customer” relationship.<sup>11</sup>

The Commissions further note that the following elements of the interpretive approach to the swap dealer definition are also generally consistent with the dealer-trader distinction as it will be applied to determine if a person is a security-based swap dealer: (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 sole or 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. Finally, under the interpretive approach to the definition of both the terms “swap dealer” and “security-based swap dealer,” whether a person is acting as a dealer will turn upon the relevant facts and circumstances, as informed by the interpretive guidance set forth in the Release.<sup>12</sup>

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<sup>10</sup> *Id.* at 89-93.

<sup>11</sup> *Id.* at 85-86.

<sup>12</sup> *Id.* at 55.

### *Hedging Business Risks*

The CFTC is adopting CFTC Regulation § 1.3(ggg)(6)(iii) as an interim final rule to address the treatment of swaps used to hedge or mitigate commercial risks and their exclusion from the swap dealer analysis. The CFTC is not incorporating the bona fide hedging provisions of the CFTC's position limits rule, but the exclusion from the swap dealer analysis draws upon language in the CFTC's definition of bona fide hedging. The exclusion of certain swaps depends not on the effect or consequence of the swap, but on whether the purpose of the person entering into the swap is to hedge a physical position as defined in the rule or is in the nature of swap dealing activity. The hedging exclusion that the CFTC has adopted is in the nature of a safe harbor (*i.e.*, it describes activity that will not be considered swap dealing activity), and includes in the safe harbor the following types of swaps:

- swaps entered into 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;
- swaps that represent 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;
- swaps that are economically appropriate to the reduction of the person's risks in the conduct and management of a commercial enterprise;
- swaps that are entered into in accordance with sound commercial practices; and
- swaps that the person does not enter into in connection with activity structured to evade designation as a swap dealer.<sup>13</sup>

The CFTC is implementing this exclusion on an interim rule basis and is seeking comments on all aspects of the interim rule. The comment period for the interim final rule will close 60 days after the date of publication in the Federal Register.

### *Holding Out*

The Release 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:

- soliciting interest in swaps or security-based swaps from potential counterparties;

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<sup>13</sup> CFTC Regulation § 1.3(ggg)(6)(iii).

- 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.<sup>14</sup>

### *Market Making*

The Commissions reject the notion that a person would be a market maker<sup>15</sup> 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 provided guidance regarding activities that constitute making a market, such as:

- quoting bid or offer prices, rates or other financial terms for swaps on an exchange;
- responding to requests made directly, or indirectly through an interdealer broker, by potential counterparties for bid or offer prices, rates or other similar terms for bilaterally negotiated swaps;
- placing limit orders for swaps; or
- receiving compensation for acting in a market maker capacity on an organized exchange or trading system for swaps.

The Commissions also noted that when analyzing the above four factors, the dealer-trader interpretative framework may be applied.<sup>16</sup>

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<sup>14</sup> Release at 56, 96.

<sup>15</sup> The definition of swap dealer includes any person who makes a market in swaps (Rule 1.3(ggg)(1)(ii)), and the definition of SB swap dealer includes any person who makes a market in security-based swaps (Rule 3a71-1(a)(ii)).

<sup>16</sup> Release at 59-60.

*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. 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.<sup>17</sup>

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

The Release 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.<sup>18</sup> This position suggests that a person that 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. 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 considered a swap dealer or SB swap dealer.<sup>19</sup>

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<sup>17</sup> *Id.* at 62-66.

<sup>18</sup> *Id.* at 56.

<sup>19</sup> *Id.* at 96.

### ***De Minimis Exemption to the Definitions***

The Dodd-Frank Act requires the Commissions to exempt from the definitions of swap dealer and SB swap dealer persons who engage in a *de minimis* level of swap or security-based swap dealing. In response, the CFTC has adopted Rule 1.3(ggg)(4) under the CEA. Under the adopted rules, a person satisfying all of the following conditions will not be deemed to be a swap dealer:

- The aggregate gross notional amount of swaps that the person entered into over the prior 12 months in connection with its dealing activity<sup>20</sup> did not exceed \$3 billion; and
- The aggregate effective notional amount (the notional amount taking into account any leverage) of swaps with respect to which a person's counterparty is a "special entity"<sup>21</sup> did not exceed \$25 million over the prior 12 months.<sup>22</sup>

The SEC has adopted Rule 3a71-2 under the Exchange Act. A person will not be deemed to be a security-based swap dealer if the security-based swap positions connected with the dealing activity in which the person engages over the course of the immediately preceding 12 months have:

- An aggregate gross notional amount of no more than \$3 billion with regard to credit default swaps that constitute security-based swaps;
- An aggregate gross notional amount of no more than \$150 million with regard to security-based swaps other than credit default swaps; and
- An aggregate gross notional amount of no more than \$25 million with regard to all security-based swaps in which the counterparty is a special entity.<sup>23</sup>

The rules do not distinguish between the different types of swaps or security-based swaps into which the entities may enter.<sup>24</sup>

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<sup>20</sup> 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.

<sup>21</sup> "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.

<sup>22</sup> Release at 566.

<sup>23</sup> *Id.* at 610-11.

<sup>24</sup> 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.



The *de minimis* thresholds as adopted are substantially higher than those that the Commissions proposed. The proposed thresholds were \$100 million in gross notional amount of swaps or security-based swaps that the person entered into over the prior 12 months in connection with its dealing activity. As a result, far fewer persons will be required to register as swap dealers or SB swap dealers under the rules as adopted, as compared to the rules as proposed.

The Commissions, however, also proposed a phase-in period during which entities engaged in dealing activity above a certain threshold could further postpone registration. Swap dealers whose gross notional amount of swap dealing activity is less than \$8 billion<sup>25</sup> (or \$25 million with respect to swaps with special entities) and security-based swap dealers whose gross notional amount of security-based swap dealing activity in credit default swaps is less than \$8 billion<sup>26</sup> (or \$400 million in connection with security-based swaps other than credit default swaps or \$25 million with respect to swaps with special entities) could postpone registration until the end of the phase-in period. The phase-in period will expire roughly three years after the date that a data repository first receives swap or security-based swap data, as applicable.<sup>27</sup>

## 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, note 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 Release 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.<sup>28</sup> 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.<sup>29</sup>

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<sup>25</sup> Release at 149.

<sup>26</sup> *Id.* at 172.

<sup>27</sup> During the three year period the Commissions will gather data to publish a report regarding swap and security-based dealing activity and will determine whether to extend the phase-in period or modify the adopted *de minimis* threshold in the Release.

<sup>28</sup> Release at 191, 565. 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.

<sup>29</sup> *Id.*

### Interpretive Guidance re Application of Dealer Definitions

In addition to defining further the terms “swap dealer” and “SB swap dealer”, the Commissions also provided interpretive guidance:

- 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.<sup>30</sup>
- The dealer analysis does not apply to swaps and security-based swaps between majority-owned affiliates.<sup>31</sup> The Commissions noted that market participants enter into inter-affiliate swaps or security-based swaps for a variety of purposes, such as to allocate risk within a corporate group or to transfer risks within a corporate group to a central hedging or treasury entity.
- The final rules provide that the dealer analysis excludes swaps between a cooperative and its members (such as to allocate risk between the members and the cooperative as opposed to move those risks from the group to an unaffiliated third party), as long as the swaps in question are reported to the relevant data repository by the cooperative and are subject to policies and procedures of the cooperative which ensure that it monitors and manages the risk of such swaps.<sup>32</sup>
- The Commissions did not include any exclusions for aggregators of swaps or other persons that use swaps in connection with the physical commodity markets, including swaps in connection with the generation, transmission and distribution of electricity. The Commissions noted, however, that it is likely that a significant portion of the financial instruments used for risk management by such persons are the type of forward contracts that are not relevant in determining whether a person is a swap dealer.<sup>33</sup>

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<sup>30</sup> *Id.* at 115.

<sup>31</sup> *Id.* at 116.

<sup>32</sup> *Id.* at 118-19.

<sup>33</sup> *Id.* at 98.

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