A Closer Look

The Dodd-Frank Wall Street Reform and Consumer Protection Act

To view our other *A Closer Look* pieces on Dodd-Frank, please visit www.pwcregulatory.com

Part of an ongoing series

Impact On

Swap Dealers and Major Swap Participants

How they will be defined and regulated

January 2011

Under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank, or “the Act”), a person who engages in significant swap activities may be regulated as a “swap dealer” or “major swap participant” (MSP). Swap dealers and MSPs must register and comply with numerous regulatory requirements that include reporting, recordkeeping, business conduct, collateral management, capital, liquidity, and margin standards. Newly issued proposed joint rules by the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) define these key terms and establish a regulatory framework.[1]

[1] Published on December 21, 2010, the proposed joint rules define the terms "swap dealer," "security-based swap dealer," "major swap participant," and "major security-based swap participant" contained in Dodd-Frank. References to swap dealer and MSPs in this document include security-based swap dealers and major security-based swap participants, unless noted otherwise. The public comment period for the proposed joint rules ends on February 22, 2011.

pwc

The proposed swap dealer definition looks to an entity's interaction with its counterparties, and considers traditional dealing and market-making activities. The MSP definition uses numerical thresholds to identify entities that are not swap dealers but hold large swaps positions that may pose systemic risks to the US financial system. Each definition contains several exemptions and exclusions. The CFTC and SEC issued the proposed joint rules defining these terms to provide uniformity where possible. Differences arise when deemed necessary to address the unique characteristics of swaps and security-based swaps (SB swaps).[2]

Initial outlook and possible impact

The proposed rules will significantly affect the current swaps markets. The CFTC and SEC asked many specific questions in the draft release that accompanied the proposed rules, reflecting a willingness (and need) to be further educated on the nature and extent of market participants' profiles and derivatives activities.

The proposed rules may result in a considerable number of market participants qualifying as swap dealers or MSPs. For the financial services industry, entities may qualify as dealers and major swap participants in both swaps and SB swaps, requiring dual registration and regulation. An entity with swaps and SB swaps must grapple with the lack of complete uniformity in the proposed CFTC and SEC rules. This is most evident in the different characterization and application of hedging for MSP definition purposes.

The proposed rules, when final, will add significant new compliance risks and burdens. A swap market participant with actual or potentially material activities or exposures in swaps should consider its infrastructure for supporting continuous regulatory analysis of swap activities. Qualifying today for exclusion or exemption does not necessarily mean qualifying tomorrow, and a regulatory filter may be needed.

An entity whose qualification as a swap dealer or MSP is not crystal-clear faces special challenges. It must monitor its status in a new regulatory regime where precedent is important but does not yet exist. Many of the standards and tests require judgments on the totality of the circumstances across a complex, fast-paced business. Understanding industry practices will be important.

This *A Closer Look* summarizes the proposed definitions and describes the registration and core regulatory requirements applicable to swap dealers and MSPs.

Swap dealer definition

Under Dodd-Frank and the proposed rules, a swap dealer is any person that, absent an exemption or exclusion, engages in any of the following activities:

- Holds itself out as a dealer in swaps
- Makes a market in swaps
- Regularly enters into swaps with counterparties as an ordinary course of business for its own account

[2] Derivatives regulation in the United States follows a bifurcated approach that depends on whether the contract is a swap or an SB swap. The CFTC regulates "swaps," "swap dealers," and "major swap participants." The SEC regulates "security-based swaps," "security-based swap dealers," and "major security-based swap participants." The terms "swap" and "security-based swap" are defined in Dodd-Frank, but regulatory implementation of these terms is pending. In the proposed CFTC/SEC joint rules, swaps generally are "notional contracts requiring the performance of agreed terms by each party." SB swaps generally are swap contracts based on a narrow-based security index, a single security or loan, or an event related thereto. The regulators note, for example, that SB swaps may be used to hedge or gain economic exposure to underlying securities, a use that merits regulation that tracks existing securities law principles. Swaps do not transfer ownership interests, however, and activities that trigger dealer treatment in swaps would not necessarily be the same as for SB swaps.

- Engages in any activity causing it to be commonly known in the trade as a dealer or market maker in swaps

The CFTC and SEC view these as functional or conduct-based tests for dealer status, and list joint and separate indicia of dealer activity. Persons who "hold themselves out" or are "commonly known in the trade" as a dealer in swaps would engage in one or more of the following activities:

- Solicit interest in or market swaps to potential counterparties
- Develop and market new swap instruments and offer to enter into the same
- Belong to a swap association in a category reserved for dealers
- Generally be willing to offer a range of financial products, including swaps

With respect to market-making in swaps, an entity does not have to continuously offer to buy or sell swaps, unlike for market-makers in securities.

The CFTC and SEC would consider other "distinguishing characteristics" of swap dealers, including:

- A tendency to accommodate demand for swaps from other parties
- General availability to enter into swaps to facilitate other parties' interest in entering into swaps
- A tendency not to request that other parties propose the terms of swaps, but instead enter into swaps on their own standard terms or on terms they arrange in response to other parties' interests
- A tendency to be able to arrange customized terms for swaps upon request, or to create new types of swaps at their own initiative

The perception of the market may be important too. Swap dealer designation may be triggered if experienced and knowledgeable swap market participants view an entity as a swap dealer, even if less knowledgeable participants do not share this view.

Separate CFTC and SEC factors for dealer recognition

The CFTC proposes to focus on an entity's relationships with its counterparties and the volume of its trades when identifying a swap dealer. It noted that swap dealers tend to enter into swaps with more counterparties that are not swap dealers, whereas non–swap dealers enter into swaps with dealers more often than non-dealers. Swap dealers tend to accommodate demand for swaps from other parties and propose terms for swaps.

The SEC intends to interpret the SB swap dealer definition "in a manner that builds on the dealer-trader distinction," already used for securities. This distinction considers factors such as:

- Holding itself out as buying or selling securities at a regular place of business
- Regular turnover of inventory or engaging in underwriting
- Providing liquidity services in transactions with investors

The SEC would take into consideration the ways that SB swap markets differ from securities markets when applying its preexisting dealer-trader distinction. For example, SB swap dealers do not keep an inventory of SB swaps because they are contracts between parties that expire or terminate. SB swap dealers do not necessarily operate from a "regular place of business." Other indicia of SB swap dealer status considered by the SEC would include:

- Receiving customer property and furnishing incidental advice in connection with transactions
- While acting as dealer in a security, entering into a SB swap with a customer
- Expressing the ability to provide liquidity to counterparties seeking to enter into SB swaps, regardless of the direction of the transaction or across a broad spectrum of risks (e.g., credit default swaps related to a variety of issuers)

De minimis exemption from swap dealer status

An entity that engages in *de minimis* or limited swap dealing activities would not be regulated as a swap dealer. A four-part test would determine whether the *de minimis* exemption is available. To be eligible, the person must not, over the prior twelve months:

- Have entered into swap *or* SB swap positions in connection with swap dealing that exceeded $100 million in aggregate gross notional amount in connection with dealing activities
- Have entered into swap *or* SB swap positions in connection with swap dealing that exceeded $25 million in aggregate gross notional amount with "special entities" (including government agencies) that are counterparties[3]
- Have entered as a dealer with more than 15 counterparties[4]
- Have entered into more than 20 swaps (or SB swaps) in total as dealer[5]

Certain calculation and measurement rules would apply. For example, each transaction entered under a master agreement for swaps would count as a single swap for the 20-swap threshold.

An entity that qualifies for the *de minimis* swap dealer exemption would need to evaluate its status at the end of each month for the prior twelve months. If it meets the exemption, it would be exempt for the next month.

Proprietary and fiduciary swap dealing exemption

An entity that enters into swaps for its "own account, either individually or in a fiduciary capacity, but not as a part of a regular business" will not be regulated as a swap dealer, absent other swap dealer activities. The "own account" language would cover acting as principal, not agent.[6] A person who regularly enters into swaps as principal would not qualify as a swap dealer, unless it does so "as part of, or as an ordinary course of, a 'regular business.'" The regulators would interpret "regular business" or "ordinary course" to mean a person "whose function is to accommodate demand for swaps from other parties and enter into swaps in response to interest expressed by other parties."

---

[3] A "special entity" includes federal agencies; states; state agencies; political subdivisions including cities, counties, and municipalities; employee benefit plans and governmental plans under the Employee Retirement Income Security Act (ERISA); and endowments.
[4] The swap dealer definitions do not count swaps with other swap dealers.
[5] This is based on the current standard swap notional amount of $5 million per transaction.
[6] A person who enters swaps as agent for customers (i.e., for customer accounts) must register as either a futures commission merchant, an introducing broker, a commodity pool operator, or a commodity trading adviser.

Insured depository institution exclusion from swap dealer status only

The proposed rules provide an exemption from dealer status for insured depository institutions (IDIs) that enter into a swap with customers in connection with originating a loan, and do not engage in other dealer activities. This exclusion would apply only if the rate, associated asset/liability, or notional item underlying the swap is, or is directly related to, an originated loan. It is unclear whether swaps associated with an acquired loan would be accorded similar treatment.

Major swap participant definition

Under Dodd-Frank, an MSP is any person who is not a swap dealer and meets any of the following three tests: [7]

- Maintains a "substantial position" in any "major swap category," excluding positions held for hedging or mitigating commercial risk, and positions or contracts held by an ERISA employee benefit plan for the primary purpose of hedging or mitigating risks directly associated with operating the plan
- Has outstanding swaps that create "substantial counterparty exposure that could have serious adverse effects on the financial stability of the US banking system or financial markets"
- Is a "financial entity" that is (i) "highly leveraged relative to the amount of capital such entity holds," (ii) not subject to federal bank regulatory capital requirements, and (iii) maintains a "substantial position" in any of the major swap categories.[8]

These three tests focus on the market impact and risks presented by an entity's swap positions. The first test applies numerical thresholds to the net, uncollateralized portion of current and future swap exposures that are not used for hedging purposes in six major swap categories. A "substantial position" in any major swap category would trigger MSP treatment. The second test ignores the major swap categories and hedging activity exclusion and applies larger numerical thresholds to an entity's total swap book to identify a "substantial counterparty exposure." The third test targets financial entities that are highly leveraged, not subject to bank regulatory capital rules, and have a "substantial position" in a major swap category.

MSP test 1: substantial position in a major swap category

The first test for MSP status requires calculating a "substantial position" in a major swap category, then deducting hedging for commercial risk or by ERISA plans. Under the proposed rules, two alternative calculations would identify a "substantial position" by measuring (i) an entity's current uncollateralized exposure and (ii) its current uncollateralized exposure and potential future exposure. These calculations would not necessarily identify all entities with large swaps positions.

A person holds a substantial position in a major swap category if that person meets either of the following thresholds:

- Daily average ***current uncollateralized exposure***, on a mark-to-market basis, of $1 billion in credit swaps, equity swaps, other commodity swaps, credit derivatives, or other SB

[7] This discussion includes major security-based swap participants as MSPs, unless otherwise noted. An entity may be an MSP and a major SB swap participant.
[8] A "financial entity" would include any commodity pool, private fund, ERISA plan, or person predominantly engaged in the business of banking or activities that are financial in nature, as defined under the Bank Holding Company Act. For MSP analysis, it includes SB dealers and major SB swap participants. For major SB swap participant analysis, it includes swap dealers and MSPs.

swaps, or $3 billion in rate swaps, after giving effect to master netting agreements and adjusting for collateral

- Daily average ***current uncollateralized exposure plus potential future exposure*** of $2 billion for credit swaps, equity swaps, other commodity swaps, credit derivatives, or other SB swaps, or $6 billion in rate swaps after giving effect to master netting agreements.[9]

The agencies offer detailed guidelines for how and when to calculate compliance with these thresholds.

Major swap categories. The proposed rules defining MSPs under this test would divide all swap instruments into six major swap categories, four regulated by the CFTC and two regulated by the SEC:

- **Rate swaps.** Any swap based primarily on one or more reference rates (e.g., fixed to floating, foreign exchange rates, inflation rates, or other monetary rates).
- **Credit swaps.** Any swap primarily based on debt instruments (including swaps based primarily on one or more broad-based indices related to debt instruments), and any swap that is an index credit default swap or total return swap on one or more indices of debt instruments.
- **Equity swaps.** Any swap based primarily on equity securities, including on broad-based equity securities indices or any total return swap on one or more equity indices.
- **Other commodity swaps.** Any swap that is not a rate swap, credit swap, or an equity swap (e.g., any swap with a physical commodity or its price or other aspect as the underlying).
- **Credit derivatives.** Any SB swap that is based, in whole or in part, on one or more instrument of indebtedness (including loans) or a credit event relating to one or more issuers or securities, including any SB swap that is a credit default swap, total return swap on debt instruments, debt swap, debt index swap, or credit spread.
- **Other SB swaps.** Any SB swap that is not a credit derivative (e.g., an equity SB swap).

Deducting hedging and risk mitigation positions

The first test for MSP status identifies a substantial position in a major swap category and is the only MSP test that would exclude positions held for "hedging or mitigating commercial risk." The CFTC/SEC interpretation of hedging seeks to exclude from the substantial position test any swap that is "necessary to the conduct or management of a person's commercial activities."[10] The agencies consider hedging generally to mean that a swap generates gains or losses that offset losses or gains in an entity's commercial activities. A swap position would hedge commercial risk if it met the following two criteria:

- It is "economically appropriate to the reduction of risks associated with the conduct and management of a commercial enterprise" that arise from the potential change in value of its assets, liabilities, or services "in the ordinary course of business of the enterprise."
- It is not held for "a purpose that is in the nature of speculation, investing or trading."

The CFTC and SEC offer different interpretations of hedging to address the particular uses of swaps versus SB swaps. This may also reflect differing views between the agencies regarding

[9] The adjustment for netting is to be consistent with the approach employed for bank capital standards.
[10] The regulators note that the interpretation of hedging commercial risk for the MSP test sheds light on the end-user exemption from clearing, which relies on identical hedging language. The end-user clearing exemption is the subject of a separate rulemaking.

the purposes of the hedging exclusion. Accordingly, market participants need to ensure that they have the capacity to monitor and assess hedging transactions based on whether they are hedging with swaps or SB swaps.

- **CFTC view of hedging commercial risk with swaps.** The CFTC's view considers the hedging exception to include "swaps hedging or mitigating any of a person's business risks, regardless of their status under accounting guidelines or the bona fide hedging exemption." It plans to evaluate a swap for hedging by evaluating the "facts and circumstances" when the swap is entered into in light of a person's overall hedging and risk mitigation strategies. The CFTC also would include as hedging swaps that:
  - Reduce risks from the potential change in value of assets, services, inputs, products, or commodities that the person owns, produces, manufactures, processes, merchandises, leases, or sells (or reasonably expects to) in the ordinary course of business
  - Reduce risks from any potential change in value of a listed risk arising from associated foreign exchange rate movements
  - Reduce risks from any fluctuation in interest, currency, or foreign exchange rate exposures arising from a person's current or anticipated assets or liabilities
  - Qualify as bona fide hedge under the position limit exemption in the Commodity Exchange Act
  - Qualify for hedging treatment under ASC 815 (FAS 133)[11]
- **SEC view of hedging commercial risk with SB swaps.** The wording of the SEC's hedging rule differs in some respects from that of the CFTC. Unlike the CFTC, the SEC would expressly exclude hedging for risks associated with the "present" conduct of a commercial enterprise, and future risks that are "reasonably expected to arise." It also does not expressly include hedging items listed by the CFTC above. The SEC has not proposed a concept of bona fide hedging, but seeks to include a broad range of economic hedges. It would interpret the term "economically appropriate" based on whether "a reasonably prudent person would consider the security-based swap to be appropriate for managing the identified commercial risk." It states preliminarily that such a security should not introduce "any new material quantum of risks (i.e., it cannot reflect over-hedging that could reasonably have a speculative effect) and it should not introduce any basis risk or other new types of risk . . . more than reasonably necessary to manage the identified risk." Doing so would trigger treatment as a non-hedging, speculative SB swap.

Market participants may wish to comment on the operational feasibility of the proposed hedging exemption.

MSP test 2: substantial counterparty exposure

The second test for MSP status targets an entity whose overall counterparty exposure could pose systemic risks. Although it gives effect to netting agreements, the second test ignores hedging and major swap categories when identifying an entity whose "outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets."

The CFTC and SEC proposed using the same terms and calculation rules as those for identifying a substantial position in a major swap category. For this second test, however, the

[11] The conditions for qualifying for ASC 815 (FASB 133) hedge accounting currently are stringent. FASB issued an exposure draft in 2010 that may relax hedge accounting rules in the future.

calculations apply "across the entirety" of an entity's swap or SB swap positions, using the following thresholds:

	Current uncollateralized exposure	Current uncollateralized exposure plus future exposure
Swap	$5 billion	$8 billion
SB swap	$2 billion	$4 billion

MSP test 3: highly leveraged financial entity

The proposed rules take the unusual step of proposing two ratios for defining "highly leveraged" in the financial entity test, and seek comment on which one is most appropriate. The alternatives are ratios of 8:1 or 15:1, total liabilities to equity calculated under US GAAP.

This third MSP test also uses the same terms and calculation rules for identifying a substantial position as provided in the first MSP test. It does not deduct hedging or employee benefit plan positions, but would exclude cleared swaps as they are collateralized. Calculations would be done quarterly.

Exclusion for captive financing subsidiaries

The Act excludes from treatment as an MSP (but not from treatment as a major SB swap participant) a financing subsidiary that predominantly uses derivatives to hedge commercial risk related to interest rate and foreign currency exposures within its organization. To use this exclusion, 90% or more of the subsidiary's hedging must arise from financing that "facilitates the purchase or lease of products, 90% or more of which are" made by the parent company or its subsidiary. This provision was included for major nonfinancial corporations that have captive financing affiliates.

Other open issues identified by regulators

The proposed release contains many specific questions about the proposed rules and alternative regulatory approaches. This suggests that certain aspects of the proposed rules may change. Notable issues raised in the discussion of the swap dealer definitions include how to treat:

- Swaps between affiliates
- Swap aggregators and dealers in agricultural commodities
- Swaps in the physical commodity market and to the electricity industry
- Entities that must limit their swaps to particular counterparties, such as federal home loan banks

For the MSP definitions, the CFTC and SEC ask questions regarding numerous issues, such as:

- Aggregating swap positions of affiliates[12]
- Using bank Tier 1 capital to indicate MSP ability to absorb loss
- Application to managed accounts invested by asset managers and investment advisers[13]

[12] The agencies propose applying the MSP test to aggregate swap positions held by parent companies and their majority-owned subsidiaries.
[13] The agencies propose applying the MSP tests to entities that actually maintain substantial positions in swaps, and not the investment advisers or asset managers that invest client funds. The MSP test would aggregate and apply to all accounts with

- Exclusion of registered investment companies, ERISA plans, registered broker-dealers, registered futures commission merchants, sovereign wealth funds, banks, and other classes of regulated entities

Registering as a swap dealer or MSP

The CFTC and SEC will have separate processes for registering the swap dealers and MSPs they regulate. The CFTC proposed rules regarding registration on November 23, 2010. The SEC indicated that it will release its rules during the first quarter of 2011.

Registration is significant because, at least under CFTC rules, entities must able to comply with all the requirements applicable to swap dealers and MSPs on the effective date of registration. The CFTC permits swap dealers and MSPs to begin registering voluntarily as of April 15, 2011, with mandatory registration planned to start on July 21, 2011. Registration in either case would be deemed provisional until all final interrelated regulations regarding definitions, duties, and regulation of swap dealers and MSPs become effective.[14] Thereafter, swap dealers and MSPs would be deemed fully registered if they "demonstrate compliance with all applicable regulations." Failure to demonstrate such compliance leads to withdrawal of registration and prohibits the entity from engaging in "any subsequent new activities" within the swap dealer or MSP definition.

Limited swap dealer or MSP designation

The proposed rules permit limited designations as swap dealers and MSPs. Swap dealers may request limited dealer designation for certain types, classes, or categories of swaps. An MSP may request limited designation for a major swap category. Entities must apply for this status and would need to comply with the swap dealer or MSP requirements only for the designated activities or swap categories.

Regulation of registered swap dealers and MSPs

The Act provides that registered swap dealers and MSPs may be subject to various limits and duties, including with respect to:

- Capital and margin
- Reporting and recordkeeping, including daily trading records
- Business conduct standards and conflict-of-interest policies
- Documentation standards
- Trading duties
- Mandatory chief compliance officer designation and duties
- Segregation of collateral for uncleared swaps

These requirements are the subject of separate rulemakings, some of which have not yet been issued and others of which depend on multiple regulators. For example, the applicable capital and margin rules may be imposed by the CFTC, the SEC, or a banking regulator, depending on the type of dealer or MSP. The swap dealer and MSP margin requirements would stem from clearinghouses for cleared swaps and from CFTC and SEC regulations for uncleared swaps. Once an entity has determined that it is a swap dealer or MSP, it must undertake an extensive review of its compliance function to plan for fulfilling these requirements.

---

the same beneficial owner, potentially requiring investment advisers to perform or facilitate MSP analysis for clients with large swap portfolios.

[14] Provisional registration is no longer allowed after all applicable Dodd-Frank implementing regulations are effective.

While Dodd-Frank will have a significant impact on participants in derivatives markets, many implementation issues are currently unclear and are subject to the rulemaking processes of the CFTC, SEC, and other agencies, and various statutorily directed studies. PwC will continue to monitor those developments and provide you with updates, which will be available at www.pwcregulatory.com.

Additional information

If you would like additional information on Dodd-Frank or about PwC's Financial Services Regulatory Practice, please contact:

Dan Ryan
FS Regulatory Practice Chairman
646 471 8488
daniel.ryan@us.pwc.com

Gary Meltzer
FS Regulatory Practice Leader
646 471 8763
gary.c.meltzer@us.pwc.com

John Garvey
FS Advisory Practice Leader
646 471 2422
john.garvey@us.pwc.com

Kenneth Albertazzi
617 530 6237
kenneth.albertazzi@us.pwc.com

David Albright
703 918 1364
david.albright@us.pwc.com

Thomas Biolsi
646 471 2056
thomas.biolsi@us.pwc.com

John Campbell
646 471 7120
john.w.campbell@us.pwc.com

Jeff Lavine
703 918 1379
jeff.lavine@us.pwc.com

Robert Nisi
415 498 7169
robert.nisi@us.pwc.com

Ric Pace
703 918 1385
ric.pace@us.pwc.com

Richard Paulson
646 471 2519
richard.paulson@us.pwc.com

Lori Richards
703 610 7513
lori.richards@us.pwc.com

Frederick Elmy
646 471 2830
frederick.j.elmy@us.pwc.com

David Sapin
646 471 8481
david.sapin@us.pwc.com

Ellen Walsh
646 471 7274
ellen.walsh@us.pwc.com

Dan Weiss
703 918 1431
dan.weiss@us.pwc.com

Gary Welsh
703 918 1432
gary.welsh@us.pwc.com

Douglas Summa
646 471 8596
douglas.summa@us.pwc.com

www.pwcregulatory.com