

SECURITIES AND EXCHANGE COMMISSION

This file is maintained pursuant to the Freedom of Information Act (5 U.S.C. 552). It contains a copy of each decision, order, rule or similar action of the Commission, for April 2012, with respect to which the final votes of individual Members of the Commission are required to be made available for public inspection pursuant to the provisions of that Act.

Unless otherwise noted, each of the following individual Members of the Commission voted affirmatively upon each action of the Commission shown in the file:

MARY L. SCHAPIRO, CHAIRMAN

ELISSE B. WALTER, COMMISSIONER

LUIS A. AGUILAR, COMMISSIONER

TROY A. PAREDES, COMMISSIONER

DANIEL M. GALLAGHER, COMMISSIONER

(44 Documents)

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

February 23, 2012

IN THE MATTER OF :

PGI Energy, Inc. :

File No. 500-1 :

ORDER OF SUSPENSION
OF TRADING

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of PGI Energy, Inc. f/k/a Tensas, Inc. ("PGI Energy") because of questions regarding the accuracy and adequacy of representations by PGI Energy in press releases and other public statements concerning the company's business activities and contracts, and the nature and timing of a dividend the company announced to shareholders. PGI Energy is quoted on OTC Link operated by OTC Markets Group, Inc. under the ticker symbol "PGIE."

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed company.

THEREFORE, IT IS ORDERED, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed company is suspended for the period from 9:30 a.m. EST, on February 23, 2012 through 11:59 p.m. EST, on March 7, 2012.

By the Commission.

Elizabeth M. Murphy
Elizabeth M. Murphy
Secretary

1 of 44

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 66712 / April 2, 2012

INVESTMENT ADVISERS ACT OF 1940
Release No. 3390 / April 2, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14830

In the Matter of

Alex Martinez,

Respondent.

**ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS
PURSUANT TO SECTION 15(b) OF THE
SECURITIES EXCHANGE ACT OF 1934
AND SECTION 203(f) OF THE
INVESTMENT ADVISERS ACT OF 1940,
MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Alex Martinez ("Martinez" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934 and Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. Martinez, 52 years old, is a resident of Studio City, California. Martinez was the owner, CEO, and chief compliance officer of MAM Wealth Management, LLC (dba MAM Securities, LLC) ("MAM"), a California limited liability company formed in 2003, with its principal place of business in Sherman Oaks, California. From January 28, 2003 to August 16, 2011, MAM was a Commission registered broker-dealer and a California registered investment adviser.

2. On January 30, 2012, a judgment was entered by consent against Martinez, permanently enjoining him from future violations of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1) and 206(2) of the Advisers Act, in the civil action entitled Securities and Exchange Commission v. MAM Wealth Management, LLC, et al., Civil Action Number CV 11-2934 SJO (JCx), in the United States District Court for the Central District of California, Western Division.

3. The Commission's complaint alleged that from July 2007 through March 2009, Martinez and his codefendant, Rafael Sanchez, invested approximately \$10.3 million of their advisory clients' funds in MAM Wealth Management Real Estate Fund, LLC ("Fund"), a speculative and risky investment suitable only for sophisticated investors. Despite his knowledge of these risks, Martinez knowingly and recklessly misrepresented to clients that the Fund was a safe and relatively liquid investment. In addition, Martinez and Sanchez used their discretionary authority over the funds of MAM clients to invest substantial client assets into the Fund, in breach of their fiduciary duty because the Fund was an unsuitable investment for their clients who were unaccredited investors, retirees with limited means, or the Fund was contrary to the clients' stated conservative investment goals.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Martinez's Offer.

Accordingly, it is hereby ORDERED pursuant to Section 15(b) of the Exchange Act and Section 203(f) of the Advisers Act that Respondent Martinez be, and hereby is barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; and barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of

factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

*Chairman Schapiro
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

April 2, 2012

In the Matter of

eMax Worldwide, Inc.

File No. 500-1

ORDER OF SUSPENSION OF
TRADING

It appears to the Securities and Exchange Commission that the public interest and the protection of investors require a suspension of trading in the securities of eMax Worldwide, Inc. (CIK: 0000830519) because there is a lack of current and accurate information concerning its securities. eMax Worldwide, Inc. has failed to make periodic filings with the Commission and has more than 300 shareholders of record. eMax Worldwide, Inc. is quoted on OTC Markets Group Inc. under the ticker EMXC.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of eMax Worldwide, Inc. Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of eMax Worldwide, Inc. is suspended for the period from 9:30 a.m. EDT on April 2, 2012, through 11:59 p.m. EDT on April 16, 2012.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: **Jill M. Peterson**
Assistant Secretary

3 of 44

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 230 and 270

[Release Nos. 33-9309; 34-66720; IC-30026; File No. S7-12-10]

RIN 3235-AK50

**INVESTMENT COMPANY ADVERTISING: TARGET DATE RETIREMENT FUND
NAMES AND MARKETING**

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule; reopening of comment period.

SUMMARY: The Securities and Exchange Commission is reopening the period for public comment on amendments it originally proposed in Securities Act Release No. 9126 (June 16, 2010) [75 FR 35920 (June 23, 2010)] to allow interested persons to submit comments on the results of investor testing regarding target date retirement funds. The rule proposal would, if adopted, require a target date retirement fund that includes the target date in its name to disclose the fund's asset allocation at the target date immediately adjacent to the first use of the fund's name in marketing materials; require marketing materials for target date retirement funds to include a table, chart, or graph depicting the fund's asset allocation over time, together with a statement that would highlight the fund's final asset allocation; require a statement in marketing materials to the effect that a target date retirement fund should not be selected based solely on age or retirement date, is not a guaranteed investment, and the stated asset allocations may be subject to change; and provide additional guidance regarding statements in marketing materials for target date retirement funds and other investment companies that could be misleading.

DATES: Comments should be received on or before [insert date 45 days after publication in the Federal Register].

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/proposed.shtml>);
- Send an e-mail to rule-comments@sec.gov. Please include File No. S7-12-10 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-12-10. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: J. Matthew DeLesDernier, Attorney-Adviser, at (202) 551-6792, Office of Regulatory Policy, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-8549.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission ("Commission") is reopening the period for public comment on proposed rule amendments that are intended to provide enhanced information to investors concerning target date retirement funds and reduce the potential for investors to be confused or misled regarding these and other investment companies. These amendments were proposed on June 16, 2010,¹ and the comment period initially closed on August 23, 2010. The Commission's proposal would, if adopted, amend rule 482 under the Securities Act of 1933 and rule 34b-1 under the Investment Company Act of 1940 to require a target date retirement fund that includes the target date in its name to disclose the fund's asset allocation at the target date immediately adjacent to the first use of the fund's name in marketing materials. The proposal also would amend rule 482 and rule 34b-1 to require marketing materials for target date retirement funds to include a table, chart, or graph depicting the fund's asset allocation over time, together with a statement that would highlight the fund's final asset allocation. In addition, the proposal would amend rule 482 and rule 34b-1 to require a statement in marketing materials to the effect that a target date retirement fund should not be selected based solely on age or retirement date, is not a guaranteed investment, and the stated asset allocations may be subject to change. Finally, the proposal would amend rule 156 under the Securities Act to provide additional guidance regarding statements in marketing materials for target date retirement funds and other investment companies that could be misleading.

The Commission recently engaged a consultant to conduct empirical research on individual investors' understanding of target date retirement funds and marketing materials related to those funds. Investors participating in an online survey were asked questions about,

¹ Investment Company Advertising: Target Date Retirement Fund Names and Marketing, Securities Act Release No. 9126 (June 16, 2010) [75 FR 35920 (June 23, 2010)].

among other things, documents containing information about a hypothetical target date retirement fund, including information that would be required by the proposed amendments, if adopted. We have placed in the comment file for the proposed rule amendments the consultant's report concerning the online survey.² In order to provide all persons who are interested in this matter an opportunity to comment on this additional material, we believe that it is appropriate to reopen the comment period before we take action on the proposal.

We invite additional comment on the proposal in light of this material, and on any other matters that may have an effect on the proposal.

Accordingly, we will extend the comment period until **[insert date 45 days after publication in the Federal Register]**.

By the Commission.



Elizabeth M. Murphy
Secretary

Date: April 3, 2012

² See Comment File No. S7-12-10, available at <http://www.sec.gov/comments/s7-12-10/s71210.shtml>.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 66726 / April 3, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14831

In the Matter of

JERRY L. AUBREY,

Respondent.

**ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS
PURSUANT TO SECTION 15(b) OF THE
SECURITIES EXCHANGE ACT OF 1934,
MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") against Jerry L. Aubrey ("Aubrey" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

5 of 44

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. Respondent, of Moreno Valley, California, was the founder of, managing member of, and a salesperson for Progressive Energy Partners, LLC ("PEP"). Respondent operated PEP from about May 2005 to April 2010. Respondent holds no securities licenses and has never been registered with the Commission in any capacity. Respondent, 50 years old, is currently incarcerated in Tomoka Correctional Institution in Daytona Beach, Florida.

2. On December 20, 2011, a final judgment was entered against Respondent, permanently enjoining Respondent from future violations of Sections 5 and 17(a) of the Securities Act of 1933 ("Securities Act"), and Sections 10(b) and 15(a) of the Exchange Act and Rule 10b-5 thereunder, and permanently enjoining Respondent and any entity he owns or controls from offering unregistered securities, in the civil action entitled Securities and Exchange Commission v. Jerry L. Aubrey, et al., Civil Action Number SACV 11-1564 JVS (RNBx), in the United States District Court for the Central District of California.

3. The Commission's complaint alleged that PEP conducted an \$11 million boiler room fraud that victimized more than 200 investors. From approximately September 2005 to December 2009, PEP fraudulently offered and sold securities to investors nationwide and in Canada through unregistered offerings. Respondent claimed the investors' money would be used to develop and support oil and gas wells. In fact, the bulk of the money was used to line the Respondent's pockets, fund a lavish lifestyle, and make Ponzi-like payments intended to perpetuate the fraud. Respondent used PEP to run a Ponzi scheme by paying alleged investor returns with money raised from new investors. Respondent also misappropriated investor funds for his personal use. In addition, Respondent: 1) misrepresented to investors they could expect a greater than 50% annual return on their investment; 2) failed to disclose to investors that up to 35% of their investment would be used to pay sales commissions; and 3) falsely represented to investors that PEP used an accounting firm to assist with investor distributions. Furthermore, Respondent solicited potential investors in PEP and received a 2% sales commission on all PEP investments sold. Respondent was not registered as a broker-dealer or associated with a registered broker-dealer at the time Respondent operated PEP.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent's Offer.

Accordingly, it is hereby ORDERED pursuant to Section 15(b)(6) of the Exchange Act that Respondent be, and hereby is:

barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; and

barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 66736 / April 4, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14209

In the Matter of

Delilah A. Proctor,

Respondent.

**ORDER MAKING FINDINGS AND
IMPOSING REMEDIAL SANCTIONS
PURSUANT TO SECTION 15(b) OF THE
SECURITIES EXCHANGE ACT OF 1934**

I.

On January 28, 2011, the Securities and Exchange Commission ("Commission") instituted public administrative proceedings pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") against Delilah A. Proctor ("Proctor" or "Respondent Proctor").

II.

Respondent Proctor, pursuant to Rule 240(a) of the Commission Rules of Practice, 17 C.F.R. § 201.240(a), has now submitted an Offer of Settlement ("Offer") in connection with these public administrative proceedings which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over her and the subject matter of these proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent Proctor consents to the entry of this Order Making Findings and Imposing Remedial Sanctions Pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Order"), as set forth below.

6 of 44

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. From at least January 2008 to April 2009, Proctor was the manager of Sun Empire, LLC ("Sun Empire") and Empire Capital Asset Management ("ECAM") investment clubs. During this time, Proctor solicited investors on behalf of Sun Empire and ECAM. Proctor was associated with two registered broker-dealers between April 2003 and June 2006. She holds licenses as an Investment Company Products/Variable Contracts Limited Principal. In connection with the events set forth below, Proctor acted as an unregistered broker or dealer. Proctor, 57 years old, is a resident of Bakersfield, California.

2. On January 12, 2011, a final judgment was entered against Respondent Proctor, permanently enjoining her from future violations of Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933, and Sections 10(b) and 15(a) of the Exchange Act and Rule 10b-5 thereunder in the civil action entitled Securities and Exchange Commission v. Sun Empire, LLC, et al., Civil Action Number SACV09-399 DOC (RNBx), in the United States District Court for the Central District of California.

3. The Commission's complaint alleged that from at least September 2008 through April 2009, Proctor participated in unregistered offers and sales of securities in Sun Empire and ECAM. Proctor solicited investors from California and Nevada through a multi-level marketing scheme operated from an Anaheim, California hotel. The complaint further alleged that Proctor offered investors several types of investments that purportedly generated high-yield returns. Proctor made false and misleading statements in the unregistered offer and sale of Sun Empire and ECAM securities, and otherwise engaged in a variety of conduct which operated as a fraud and deceit on investors.

IV.

In view of the foregoing, the Commission deems it necessary and appropriate in the public interest to impose the sanctions agreed to in Respondent Proctor's Offer.

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act, that Respondent Proctor be, and hereby is barred from association with any broker, dealer, transfer agent, investment adviser, municipal securities dealer, municipal advisor, or nationally recognized statistical ratings organization. In addition, Respondent Proctor be, and hereby is barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent, or other person who engages in activities with a broker, dealer, or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of

factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: **Jill M. Peterson**
Assistant Secretary

*Commissioner Paredes
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 66739 / April 4, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14836

In the Matter of

GRANT M. CARROLL,

Respondent.

ORDER INSTITUTING ADMINISTRATIVE
PROCEEDINGS PURSUANT TO SECTION
15(b) OF THE SECURITIES EXCHANGE
ACT OF 1934, MAKING FINDINGS, AND
IMPOSING REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") against Grant M. Carroll ("Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. Grant M. Carroll, age 32, of Midland, Texas, was the "Director of Securities" for Quantum Funding Strategies, LLC.

2. On December 6, 2011, an agreed permanent injunction was entered against Respondent, permanently enjoining him from future violations of Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933, and Sections 10(b) and 15(a) of the Exchange Act and Rule 10b-5 thereunder, in the civil action styled *Securities and Exchange Commission v. Grant M. Carroll, et al.*, Civ. Action No. 1:10-cv-913 (United States District Court for the Western District of Texas, Austin Division).

3. The Commission's complaint alleged that from April 2007 to May 2008, Respondent, along with other defendants, raised approximately \$9 million from 20 investors by selling unregistered, high-yield interests in a Prime Bank scheme through the now-defunct company, Quantum Funding Strategies, LLC. The complaint also alleged that, while offering and selling the investments, Respondent claimed to be a licensed securities broker, and claimed that he had verified the bona fides of the high-yield investment, when, in fact, according to the complaint, Respondent had taken no steps to determine the legitimacy of the investment, or whether the investment had generated the purported profits. Respondent does not admit or deny these allegations.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Grant M. Carroll's Offer.

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act, Respondent Carroll be, and hereby is:

barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; and

barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a

customer, whether or not related to the conduct that served as the basis for the Commission order;
and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct
that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: **Jill M. Peterson**
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 66735 / April 4, 2012

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3376 / April 4, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14834

In the Matter of

BRYAN N. POLOZOLA, CPA,

Respondent.

**ORDER OF SUSPENSION PURSUANT
TO RULE 102(e)(2) OF THE
COMMISSION'S RULES OF PRACTICE**

I.

The Securities and Exchange Commission deems it appropriate to issue an order of forthwith suspension of Bryan N. Polozola ("Polozola") pursuant to Rule 102(e)(2) of the Commission's Rules of Practice [17 C.F.R. § 201.102(e)(2)].¹

II.

The Commission finds that:

1. Polozola is a certified public accountant licensed in Texas and New York.

2. On March 26, 2012, a judgment of conviction was entered against Polozola in United States v. Bryan N. Polozola, 1:11-cr-00374-RLW, in the United States District Court for the District of Columbia, finding him guilty of one count of making false statements to Commission staff during investigative testimony in violation of 18 U.S.C. § 1001.

¹ Rule 102(e)(2) provides in pertinent part: "Any . . . person who has been convicted of a felony or a misdemeanor involving moral turpitude shall be forthwith suspended from appearing or practicing before the Commission."

3. As a result of his conviction, Polozola was sentenced to a 24 month term of probation and ordered to serve 200 hours of community service and to pay an assessment in the amount of \$100.

III.

In view of the foregoing, the Commission finds that Polozola has been convicted of a felony within the meaning of Rule 102(e)(2) of the Commission's Rules of Practice.

Accordingly, it is ORDERED, that Bryan N. Polozola is forthwith suspended from appearing or practicing before the Commission pursuant to Rule 102(e)(2) of the Commission's Rules of Practice.

By the Commission.

Elizabeth M. Murphy
Secretary


By: **Jill M. Peterson**
Assistant Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Release No. 66737 / April 4, 2012

ACCOUNTING AND AUDITING ENFORCEMENT

Release No. 3377 / April 4, 2012

ADMINISTRATIVE PROCEEDING

File No. 3-14835

In the Matter of

JOHN M. WILLIAMS,

Respondent.

**ORDER INSTITUTING ADMINISTRATIVE
PROCEEDINGS PURSUANT TO RULE
102(e) OF THE COMMISSION'S RULES OF
PRACTICE, MAKING FINDINGS, AND
IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted against John M. Williams ("Respondent" or "Williams") pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice.¹

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the

¹ Rule 102(e)(3)(i) provides, in relevant part, that:

The Commission, with due regard to the public interest and without preliminary hearing, may, by order, . . . suspend from appearing or practicing before it any . . . accountant . . . who has been by name . . . permanently enjoined by any court of competent jurisdiction, by reason of his or her misconduct in an action brought by the Commission, from violating or aiding and abetting the violation of any provision of the Federal securities laws or of the rules and regulations thereunder.

Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III.3 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. Williams, age 38, worked for Deloitte Tax LLP ("Deloitte") in Philadelphia, Pennsylvania as a tax manager until January 2010. Williams has passed the CPA exam but does not hold a CPA license.

2. Hi-Shear Technology Corp. ("Hi-Shear") was, at all relevant times, an issuer with its principal place of business in Torrance, California. Until its acquisition by Chemring Group PLC ("Chemring") on November 24, 2009, Hi-Shear common stock was listed on the NYSE Amex under the ticker symbol "HSR." Hi-Shear designs and manufactures pyrotechnic, mechanical and electronic products for the defense and aerospace industries.

3. On March 2, 2012, the Commission filed a complaint against Williams in SEC v. John M. Williams (Civil Action No. 12-1126). On March 26, 2012, the court entered an order permanently enjoining Williams, by consent, from future violations of Sections 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Williams was also ordered to pay \$6,803.18 in disgorgement of ill-gotten gains from his sales of stock, and \$620.05 in prejudgment interest; and a \$6,803.18 civil penalty.

4. The Commission's complaint alleged, among other things, that Williams acquired nonpublic information concerning the acquisition of Hi-Shear by Chemring while providing tax services to Deloitte's client Chemring. The Complaint also alleged that in violation of Deloitte's policies and his employment agreement, Williams traded in the shares of Hi-Shear shortly before the September 16, 2009 announcement that Chemring would acquire Hi-Shear. The Complaint further alleged that although Deloitte required Williams to self-report his securities transactions, Williams did not report these trades, and was terminated for cause in January 2010.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanction agreed to in Respondent Williams' Offer.

Accordingly, it is hereby ORDERED, effective immediately, that:

A. Williams is suspended from appearing or practicing before the Commission as an accountant.

B. After five years from the date of this order, Respondent may request that the Commission consider his reinstatement by submitting an application (attention: Office of the Chief Accountant) to resume appearing or practicing before the Commission as:

1. a preparer or reviewer, or a person responsible for the preparation or review, of any public company's financial statements that are filed with the Commission. Such an application must satisfy the Commission that Respondent's work in his practice before the Commission will be reviewed either by the independent audit committee of the public company for which he works or in some other acceptable manner, as long as he practices before the Commission in this capacity; and/or

2. an independent accountant. Such an application must satisfy the Commission that:

(a) Respondent, or the public accounting firm with which he is associated, is registered with the Public Company Accounting Oversight Board ("Board") in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

(b) Respondent, or the registered public accounting firm with which he is associated, has been inspected by the Board and that inspection did not identify any criticisms of or potential defects in the respondent's or the firm's quality control system that would indicate that the respondent will not receive appropriate supervision;

(c) Respondent has resolved all disciplinary issues with the Board, and has complied with all terms and conditions of any sanctions imposed by the Board (other than reinstatement by the Commission); and

(d) Respondent acknowledges his responsibility, as long as Respondent appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards.

B. The Commission will consider an application by Respondent to resume appearing or practicing before the Commission provided that his state CPA license is current and he has resolved all other disciplinary issues with the applicable state boards of accountancy. However, if state licensure is dependent on reinstatement by the Commission, the Commission will consider an application on its other merits. The Commission's review may include consideration

of, in addition to the matters referenced above, any other matters relating to Respondent's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: **Jill M. Peterson**
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 66744 / April 5, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14434

In the Matter of

Alvin C. Ramsey,

Respondent.

**ORDER MAKING FINDINGS AND
IMPOSING REMEDIAL SANCTIONS
PURSUANT TO SECTION 15(b) OF THE
SECURITIES EXCHANGE ACT OF 1934**

On June 21, 2011, the Securities and Exchange Commission ("Commission") initiated proceedings pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") against Alvin C. Ramsey ("Ramsey" or "Respondent").

II.

Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings and Section III, 2 below, which are admitted, Respondent consents to the entry of this Order Making Findings and Imposing Remedial Sanctions Pursuant to Section 15(b) of the Securities Exchange Act of 1934.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. Respondent Ramsey, 44 years old, is a previously registered representative who, for the period of time in which he engaged in the conduct underlying the criminal information

described below, was associated with a broker-dealer and investment adviser dually registered with the Commission and located in Birmingham, Alabama and Martinez, Georgia.

2. On November 3, 2010, the U.S. District Court for the Southern District of Georgia entered a judgment against Ramsey after Ramsey pleaded guilty to one count of mail fraud in violation of Title 18 United States Code, Section 1341, in United States of America v. Alvin Charles Ramsey, Case No. 1:10-cr-00132.

3. Ramsey was sentenced to 50 months in custody with three years of supervised release after incarceration and ordered to make restitution in the amount of \$494,000.05.

4. The count of the criminal information to which Ramsey pleaded guilty alleged, inter alia, that from June 2005 to January 2008, Ramsey knowingly and willfully devised and intended to devise a scheme and artifice to defraud and misappropriate more than \$400,000 from a customer by means of false and fraudulent pretenses, representations, promises, and omissions, by use of a commercial interstate carrier.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Ramsey's Offer.

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act, Respondent shall be, and hereby is barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization.

Respondent shall be, and hereby is, barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By **Jill M. Peterson**
Assistant Secretary

*Commissioner Gallagher
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 66745 / April 5, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14837

In the Matter of

Scott A. Wolf,

Respondent.

ORDER INSTITUTING ADMINISTRATIVE
PROCEEDINGS PURSUANT TO SECTION
15(b) OF THE SECURITIES EXCHANGE
ACT OF 1934, MAKING FINDINGS, AND
IMPOSING REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") against Scott A. Wolf ("Wolf").

II.

In anticipation of the institution of these proceedings, Respondent Wolf has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent Wolf consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent Wolf's Offer, the Commission finds that:

1. Wolf is the founder and sole proprietor of Stone Lion Management, Inc., ("Stone Lion") a consulting company that purports to be in the business of helping start-up companies penetrate new markets by utilizing its network of clients. Between July 2008 and June 2010, Wolf and Stone Lion raised funds for Central Sleep Diagnostics, LLC ("Central Sleep"), Central Sleep Diagnostics of Florida, LLC ("Central Sleep Florida") and Advanced Sleep Devices, LLC ("Advanced Sleep"). At no point in time was a registration statement filed with the Commission in connection with these offerings.

Wolf also acted as Central Sleep and Advanced Sleep's director of investor relations. Wolf, 51 years old, is currently a resident of Dubai, United Arab Emirates.

2. On February 10, 2012, a final judgment was entered by consent against Respondent Wolf permanently enjoining him from future violations of Sections 5(a) and 5(c) of the Securities Act of 1933 and Section 15(a)(1) of the Exchange Act in a civil action entitled U.S. Securities and Exchange Commission v. Kenneth A. Dachman, et al., Civil Action Number 1:12-cv-00821 in the United States District Court for the Northern District of Illinois, Eastern Division.

3. The Commission's complaint, filed on February 6, 2012, alleged that, between July 2008 and June 2010, Wolf and Stone Lion raised over \$3.5 million from investors in Central Sleep and over \$567,000 from investors in Central Sleep Florida and Advanced Sleep. Among other things, Wolf and Stone Lion prepared the initial drafts of offering materials based on information provided by Kenneth A. Dachman, the founder and chairman of all three companies, and distributed the offering materials and stock certificates to investors in exchange for a 6% commission. Wolf and Stone Lion were not registered as brokers at any time during the offerings. In addition, the complaint further alleged that no registration statement was filed with the Commission in connection with the Central Sleep securities offering and that Wolf and Stone Lion failed to provide Central Sleep investors with any disclosure documents similar to those used in registered offerings or inquire or obtain information from investors as to whether they qualified as accredited investors. Many of the investors, including friends of Wolf's, were unsophisticated and did not qualify as accredited investors based on their net worth or income.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Wolf's Offer.

Accordingly, it is hereby ORDERED pursuant to Section 15(b)(6) of the Exchange Act that Respondent Wolf be, and hereby is:

barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent or nationally recognized statistical rating organization with the right to apply for reentry after one year to the appropriate self-regulatory organization, or if there is none, to the Commission.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy
Secretary

Kevin M. O'Neill
By: Kevin M. O'Neill
Deputy Secretary

*Commissioner Walter
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 66748 / April 5, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14509

In the Matter of

PETER EMRICH, ALBERTO
FERREIRAS, JAMES FRANKFURTH,
FRANK ROSSI, and DANA VALENSKY,

Respondents.

ORDER MAKING FINDINGS AND
IMPOSING REMEDIAL SANCTIONS
PURSUANT TO SECTION 15(b)(6) OF
THE SECURITIES EXCHANGE ACT OF
1934 AS TO PETER EMRICH

I.

On August 18, 2011, the Securities and Exchange Commission ("Commission") initiated proceedings pursuant to Section 15(b)(6) of the Securities Exchange Act of 1934 ("Exchange Act") against Peter Emrich ("Emrich" or "Respondent").

II.

Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him, the subject matter of these proceedings, and the findings in section III, paragraph 3 of this Order, which are admitted, Respondent consents to the entry of this Order Making Findings and Imposing Remedial Sanctions Pursuant to Section 15(b)(6) of the Securities Exchange Act of 1934 as to Peter Emrich, as set forth below.

12 of 44

III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

1. From approximately April 1999 through May 2001, Out of the Black Partners LLC ("Out of the Black"), a California limited liability company, sold securities in unregistered private offerings (the "Out of the Black Offering").

2. Emrich acted as unregistered broker-dealer by selling securities through the Out of the Black Offering. Emrich held Series 7, 24, 39, and 63 licenses. Emrich, age 70, is a resident of San Rafael, California.

3. On June 18, 2003, Emrich pleaded guilty to one count of conspiracy to commit securities fraud in violation of 18 U.S.C. § 371 before the United States District Court for the Eastern District of New York in United States v. Kozak, et al., 02-CR-879 (the "Kozak Case"), a criminal case arising from the Out of the Black Offering. On May 10, 2010, a criminal judgment was entered against Emrich. He was sentenced to two years probation and ordered to pay restitution of \$178,775.

4. The count of the indictment in the Kozak Case to which Emrich pleaded guilty, alleged, among other things, that between approximately April 1999 and May 2001, Emrich, and Respondents James Frankfurth, Alberto Ferreiras and others conspired to defraud investors by concealing the actual amount of sales commissions that would be paid from the proceeds of the Out of the Black Offering.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Emrich's Offer.

Accordingly, it is hereby ORDERED that:

Pursuant to Section 15(b)(6) of the Exchange Act, Emrich shall be, and hereby is barred from association with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent, and barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy
Secretary

Kevin M. O'Neill
By: Kevin M. O'Neill
Deputy Secretary

*Commissioner Walter
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 66749 / April 5, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14509

In the Matter of

PETER EMRICH, ALBERTO
FERREIRAS, JAMES FRANKFURTH,
FRANK ROSSI, and DANA VALENSKY,

Respondents.

ORDER MAKING FINDINGS AND
IMPOSING REMEDIAL SANCTIONS
PURSUANT TO SECTION 15(b)(6) OF
THE SECURITIES EXCHANGE ACT OF
1934 AS TO DANA VALENSKY

I.

On August 18, 2011, the Securities and Exchange Commission ("Commission") initiated proceedings pursuant to Section 15(b)(6) of the Securities Exchange Act of 1934 ("Exchange Act") against Dana Valensky ("Valensky" or "Respondent").

II.

Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him, the subject matter of these proceedings, and the findings in section III, paragraph 3 of this Order, which are admitted, Respondent consents to the entry of this Order Making Findings and Imposing Remedial Sanctions Pursuant to Section 15(b)(6) of the Securities Exchange Act of 1934 as to Dana Valensky, as set forth below.

13 of 44

III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

1. From approximately October 1998 through June 2000, Heritage Film Group LLC ("Heritage"), a California limited liability company, sold securities in an unregistered private offering (the "Heritage Offering").

2. Valensky controlled Vanguard Entertainment Productions, Inc., a California corporation that operated as an independent sales office that offered and sold securities in the Heritage Offering. Valensky acted as an unregistered broker-dealer in the Heritage Offering. Valensky held Series 22 and 63 licenses but was not associated with an entity registered with the Commission during the Heritage Offering. Valensky, age 62, is a resident of Laguna Niguel, California.

3. Valensky pleaded guilty before the United States District Court for the Eastern District of New York to one count of conspiracy to commit securities fraud in United States v. Leonard, et al., 02-CR-881 (the "Leonard Case"), a criminal case arising from securities offerings, including the Heritage Offering, and two counts of conspiracy to commit securities fraud in U.S. v. Noorai, et al., 02-CR-880 (the "Noorai Case"), a criminal case arising from a private offering of securities. On November 10, 2010, a criminal judgment was entered against Valensky in the Noorai and Leonard Cases. He was sentenced to concurrent terms of three years probation in the Noorai and Leonard Cases.

4. The count of the indictment to which Valensky pleaded guilty in the Leonard Case alleged, among other things, that Valensky and others conspired to defraud investors by concealing the actual amount of sales commissions that would be paid from the proceeds of the Heritage Offering.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Valensky's Offer.

Accordingly, it is hereby ORDERED that:

Pursuant to Section 15(b)(6) of the Exchange Act, Valensky shall be, and hereby is barred from association with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent, and barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy
Secretary

Kevin M. O'Neill

By: Kevin M. O'Neill
Deputy Secretary

*Commissioner Walter
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 66750 / April 5, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14509

In the Matter of

PETER EMRICH, ALBERTO
FERREIRAS, JAMES FRANKFURTH,
FRANK ROSSI, and DANA VALENSKY,

Respondents.

ORDER MAKING FINDINGS AND
IMPOSING REMEDIAL SANCTIONS
PURSUANT TO SECTION 15(b)(6) OF
THE SECURITIES EXCHANGE ACT OF
1934 AS TO FRANK ROSSI

I.

On August 18, 2011, the Securities and Exchange Commission ("Commission") initiated proceedings pursuant to Section 15(b)(6) of the Securities Exchange Act of 1934 ("Exchange Act") against Frank Rossi ("Rossi" or "Respondent").

II.

Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him, the subject matter of these proceedings, and the findings in section III, paragraph 4 of this Order, which are admitted, Respondent consents to the entry of this Order Making Findings and Imposing Remedial Sanctions Pursuant to Section 15(b)(6) of the Securities Exchange Act of 1934 as to Frank Rossi, as set forth below.

14 of 44

III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

1. From approximately December 1997 through December 1998, Little Giant LLC ("Little Giant"), a California limited liability company, sold securities in an unregistered private offering (the "Little Giant Offering").
2. From approximately October 1998 through June 2000, Heritage Film Group LLC ("Heritage"), a California limited liability company, sold securities in an unregistered private offering (the "Heritage Offering").
3. Rossi acted as an unregistered broker-dealer by selling securities through the Little Giant Offering and the Heritage Offering. Rossi held Series 6 and Series 63 licenses. Rossi, age 51, is a resident of Buffalo, New York.
4. On April 24, 2003, Rossi pleaded guilty before the United States District Court for the Eastern District of New York to two counts of conspiracy to commit securities fraud in violation of 18 U.S.C. § 371 in United States v. Leonard, et al. 02-CR-881 (the "Leonard Case"), a criminal case arising from the Little Giant Offering and the Heritage Offering. On March 21, 2011, a criminal judgment was entered against Rossi. He was sentenced to two years probation.
5. The counts of the indictment to which Rossi pleaded guilty in the Leonard Case alleged, among other things, that Rossi and others conspired to defraud investors by concealing the actual amount of sales commissions that would be paid from the proceeds of the Little Giant and Heritage Offerings.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Rossi's Offer.

Accordingly, it is hereby ORDERED that:

Pursuant to Section 15(b)(6) of the Exchange Act, Rossi shall be, and hereby is barred from association with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent, and barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy
Secretary

Kevin M. O'Neill
By: Kevin M. O'Neill
Deputy Secretary

*Commissioner Walter
not participating*

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Rel. No. 9311 / April 5, 2012

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 66752 / April 5, 2012

INVESTMENT ADVISERS ACT OF 1940
Rel. No. 3393 / April 5, 2012

Admin. Proc. File No. 3-13532

In the Matter of

ERIC J. BROWN, MATTHEW J. COLLINS, KEVIN J.
WALSH, and MARK W. WELLS

ORDER DENYING
COLLINS'S MOTION FOR
RECONSIDERATION OF
CIVIL PENALTIES

On February 27, 2012, we issued an opinion and order (the "Opinion") finding, in part, that Matthew J. Collins violated Section 17(a) of the Securities Exchange Act of 1934 and Exchange Act Rule 17a-3 (the "books and records provisions")¹ and failed to supervise within the meaning of Exchange Act Sections 15(b)(4)(E) and 15(b)(6).² We found that Collins failed to adequately supervise salesperson Eric J. Brown, whom we found in our Opinion to have violated Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Exchange Act Rule 10b-5 (collectively, the "antifraud provisions")³ in connection with the sale of variable annuities to elderly customers. Among other things, we found that Collins's failure to supervise Brown included Collins's "falsifying documents that misled his employer and the issuing insurance companies about what Brown was doing, [thus] creat[ing] an environment where Brown could defraud his clients with impunity."⁴ For these violations, we found it to be in the public interest to bar Collins from associating with any broker, dealer, or investment adviser, provided, however, that he may apply to become so associated in a non-supervisory capacity after two years; to impose a cease-and-desist order; to order disgorgement; and to impose a civil

¹ 15 U.S.C. § 78q(a); 17 C.F.R. § 240.17a-3.

² 15 U.S.C. § 78o(b)(4)(E), (b)(6).

³ *Id.* §§ 77q(a), 78j(b); 17 C.F.R. § 240.10b-5.

⁴ *Eric J. Brown*, Securities Exchange Act Rel. No. 66469, at 19 (Feb. 27, 2012), <http://www.sec.gov/litigation/opinions/2012/33-9299.pdf>.

penalty of \$310,000 (which represented a maximum second-tier civil monetary penalty for each of the five customers that Brown defrauded because of Collins's failure to supervise).

On March 9, 2012, Collins filed the present motion asking us to reconsider the imposition of \$310,000 in civil penalties. Collins submitted four arguments in support of his request: (1) that imposition of a \$310,000 sanction is "anomalous and inequitable"; (2) that the Commission erred in imposing a civil penalty for misconduct related to a customer who, Collins argues, never purchased or sold a security; (3) that the Commission did not adequately address his argument that "the large civil penalties . . . violate the Eighth Amendment's prohibitions against excessive fines"; and (4) that the Commission did not provide Collins an opportunity to demonstrate financial hardship or an inability to pay.

I.

We analyze Collins's request for reconsideration under Rule of Practice 470.⁵ That rule requires a motion for reconsideration to "briefly and specifically state the matters of record alleged to have been erroneously decided, the grounds relied upon, and the relief sought."⁶ Reconsideration is an extraordinary remedy "designed to correct manifest errors of law or fact, or to permit the presentation of newly discovered evidence."⁷ Applicants may not use motions for reconsideration to reiterate arguments previously made or to cite authority previously available; moreover, we will accept only such additional evidence that "the movant could not have known about or adduced before entry of the order subject to the motion for reconsideration."⁸ Motions for reconsideration, therefore, are granted only in exceptional cases.⁹ As explained below, Collins's motion does not establish such bases for reconsideration.

II.

A. Collins first argues that we should reconsider our imposition of a \$310,000 civil penalty because it was "contrary to basic equity" for the Commission to have "dramatically increase[d]" the \$130,000 sanction that the administrative law judge imposed in her initial decision (the "Initial Decision"). In making this argument, Collins interprets our Opinion as

⁵ 17 C.F.R. § 201.470.

⁶ *Id.*

⁷ *Perpetual Sec., Inc.*, Exchange Act Rel. No. 56962 (Dec. 13, 2007), 92 SEC Docket 472, 473; *see also Laminare Corp.*, Exchange Act Rel. No. 56789 (Nov. 15, 2007), 91 SEC Docket 3221, 3223; *Feeley & Wilcox Asset Mgmt. Corp.*, 56 S.E.C. 1264, 1265 (2003).

⁸ *Perpetual*, 92 SEC Docket at 473 n.4 (quoting *Feeley*, 56 S.E.C. at 1269 n.18).

⁹ *Feeley*, 56 S.E.C. at 1265.

finding that his misconduct was "less egregious than what was found in the Initial Decision." Collins points, in particular, to our conclusion that the record did not support a finding that Collins was a primary violator of the antifraud provisions and that Collins's misconduct did not support a third-tier civil penalty because the nominal amount of customer losses was not large. He concludes that, because of these findings, it is inequitable for the Opinion to impose a civil penalty that is "almost triple" the single \$130,000 third-tier civil penalty imposed in the Initial Decision. Collins adds that he "already paid a [\$5,000] civil penalty to the State of Florida's Department of Financial Services for the same conduct at issue here and that his license was placed on probation for one year." He further asserts that the "likelihood of future violation is slight" because "the conduct is old and occurred in isolated instances" and because Collins "has had no other regulatory issues other than the matters that occurred in this proceeding."

These arguments are essentially reiterations of claims Collins made during his appeal and are claims that we considered when determining that a \$310,000 civil penalty was in the public interest. These repackaged arguments, therefore, provide no basis for reconsideration. We nevertheless address several points below.

First, the civil penalty imposed in the Initial Decision is irrelevant. We have stated repeatedly that a law judge's opinion ceases to have any force or effect once the respondent files a petition for review.¹⁰ Moreover, our briefing order expressly stated that we had determined, on our own initiative, to review what sanctions were appropriate in this matter.¹¹ Second, and more important, failures to supervise are serious violations.¹² Supervisors are the first line of defense against wrongdoing by their subordinates. Collins not only abandoned this responsibility, but he also intentionally profited from his misconduct by retaining a portion of Brown's commissions from the underlying variable annuity sales. Nor was Collins's misconduct isolated, as he claims. Each defrauded customer, as we noted in our Opinion, presented Collins with "a unique

¹⁰ See, e.g., *Gregory M. Dearlove*, Exchange Act Rel. No. 57244 (Jan. 31, 2008), 92 SEC Docket 1867, 1884 n.42 ("The law judge's opinion ceased to have any force or effect once Dearlove filed his petition for review."), *petition denied*, 573 F.3d 801 (D.C. Cir. 2009); *Fundamental Portfolio Advisers, Inc.*, 56 S.E.C. 651, 679 n.44 (2003) (stating that, "because we granted the Division's petition for review, the initial decision ceased to have any force or effect"), *petition dismissed*, 167 F. App'x 836 (2d Cir. 2006).

¹¹ Order Granting Petition for Review and Scheduling Briefs, *Prime Capital Servs., Inc.*, Admin. Proc. File No. 3-13532 (Aug. 5, 2010) ("Pursuant to Rule of Practice 411(d), the Commission, on its own initiative, has determined to review what sanctions, if any, are appropriate in this matter.").

¹² See, e.g., *Clarence Z. Wurts*, 56 S.E.C. 430, 441 (2001) (noting "the seriousness with which we view failures to supervise").

opportunity to violate the securities laws."¹³ Collins repeatedly took advantage of these opportunities, thus benefitting himself at the expense of the firm's customers. This conduct, our Opinion explained, "displayed a blatant failure to deal fairly with elderly, unsophisticated customers and exhibited a clear disregard for their customers' interests."¹⁴ And, as we also concluded in our Opinion, we are concerned about Collins committing future violations and noted that the securities industry "presents continual opportunities for dishonesty and abuse."¹⁵ Collins's allegedly clean disciplinary history does not lessen that concern.¹⁶ In fact, Collins's continued assertion that his misconduct was not egregious adds yet more support to our concern, as expressed in our Opinion, that Collins's misconduct will continue in the future.¹⁷

Nor did the \$5,000 fee and one-year probation outweigh the reasons for imposing a \$310,000 civil penalty. The fee and probation concerned a settlement stipulation that Collins entered with Florida's Department of Financial Services. As Collins testified, that settlement involved the Florida regulator's investigation into his sales practices related to two customers, not all five customers at issue in our Opinion. Moreover, the settlement involved allegations by the Florida regulator that Collins "made misrepresentations on insurance applications." It did not allege that Collins failed to supervise, which was the primary basis for our imposition of civil penalties. The \$5,000 penalty and one-year probation to which Collins agreed, therefore, do not address the scope and egregiousness of Collins's misconduct as described in our Opinion.

B. Collins next contends that our imposition of the \$310,000 civil penalty improperly relied on misconduct related to customer Lenore Jaye. Collins alleges that Mrs. Jaye "never purchased or sold a variable annuity or any other security" and that "a purchase or sale of securities is one of the required elements of a violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder." Collins claims that, "[b]ecause there can be no underlying violation of the antifraud provisions of the federal securities laws relating to Lenore Jaye, Collins cannot be sanctioned for causing a violation by Brown or failing to reasonably supervise Brown with respect to Brown's conduct towards Lenore Jaye." We disagree. Even if, as Collins claims, Mrs. Jaye did not consummate a securities purchase, our

¹³ *Brown, supra* note 4, at 26.

¹⁴ *Id.* at 25.

¹⁵ *Id.* at 19 (quoting *Conrad P. Seghers*, Investors Advisers Act Release No. 2656 (Sept. 26, 2007), 91 SEC Docket 2293, 2304, *petition denied*, 548 F.3d 129 (D.C. Cir. 2008)).

¹⁶ *Cf., e.g., John A. Carley*, Exchange Act Rel. No. 57246 (Jan. 31, 2008), 92 SEC Docket 1693, 1740 (imposing a maximum second-tier penalty for respondent's failure to supervise despite respondent's lack of disciplinary history), *rev'd in part on other grounds sub nom. Zacharias v. SEC*, 569 F.3d 458 (D.C. Cir. 2009).

¹⁷ *See supra* note 13 and accompanying text.

Opinion held that Brown not only violated Exchange Act Section 10(b) and Rule 10b-5, but he also violated Securities Act Section 17(a). Liability under that provision requires only the "offer" of a security,¹⁸ and Brown clearly offered Mrs. Jaye a security. A violation of Securities Act Section 17(a) alone is thus sufficient to impose a civil penalty with respect to misconduct related to Mrs. Jaye.

C. Collins further contends that, in imposing a civil penalty, our Opinion did not adequately address his argument that a large civil penalty would violate the Eighth Amendment's prohibition against excessive fines.¹⁹ In making this argument, Collins suggests that our Opinion "essentially conclud[ed] that the civil penalties that it imposed on Collins complied with the Eighth Amendment because they were authorized by Congressional statute." To the contrary, our Opinion expressly rejected Collins's Eighth Amendment argument on grounds that went beyond just our statutory authority, noting that the imposition of a \$310,000 civil penalty was "consistent with the seriousness of . . . Collins's misconduct."²⁰

In his motion for reconsideration, Collins also cites to "new legal authority decided in February 2012 that found a violation of the Eighth Amendment's Excessive Fines Clause when a small civil penalty was imposed on a per-violation basis and added up to a disproportionately large civil penalty." That case – *Bunk v. Birkart Globistics GmbH & Co.*²¹ – is inapposite. *Bunk* involved wholly different statutory schemes, harms, misconduct, and fines than were present in the case before us.²² The U.S. District Court in *Bunk* expressly relied upon a crucial difference

¹⁸ 15 U.S.C. § 77q; see *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1467 (2d Cir. 1996) (noting that liability under Securities Act Section 17(a) involves fraud "in connection with the offer or sale of a security" (emphasis added)).

¹⁹ U.S. Const. amend. VIII.

²⁰ *Brown*, *supra* note 4, at 27; cf. *SEC v. Colonial Inv. Mgmt. LLC*, 381 F. App'x 27, 32 (2d Cir. 2010) (concluding that a district court did not abuse its discretion when imposing a \$25,000 second tier civil penalty per securities law violation (for a total civil penalty of \$450,000) where defendant was head trader "responsible for all of Colonial's trading and investment decisions" and "the evidence clearly established that [defendant] engaged in conduct that was, at the very least, in 'reckless disregard of [the] regulatory requirement'" (quoting 15 U.S.C. § 78u(d)(3)(B)(ii))).

²¹ No. 1:02cv1168 (AJT/TRJ), No. 1:07cv1198 (AJT/TRJ), 2012 WL 488256 (E.D. Va. Feb. 14, 2012).

²² *Bunk*, 2012 WL 488256, at *4-11 (concluding, in part, that imposition of approximately \$50,000,000 in fines pursuant to the False Claims Act was unconstitutionally

(continued...)

between that case and ours when reaching its decision. In concluding that an approximately \$50,000,000 fine under the False Claims Act²³ was unconstitutionally excessive, the U.S. District Court differentiated the False Claims Act (which states only that civil penalties shall be not less than \$5,500 and not more than \$11,000) from other federal statutes that expressly state that a civil penalty shall be assessed for each claim or violation. That same distinction is present here, as both of the statutes governing the civil penalty we imposed against Collins – Exchange Act Section 21B(b) and Section 203(i)(2) of the Investment Advisers of 1940 – specify that civil monetary penalties can be issued by the Commission "for each act or omission."²⁴

D. Collins concludes by arguing that the Commission never "provided him with any procedure to demonstrate an inability to pay the significantly higher penalty" that the we imposed against him. In support, Collins claims that "Rule 410(c) of the Commission's Rules of Practice is the only rule that addresses inability to pay arguments and that rule relates only to petitions to the Commission that challenge an initial decision's imposition of a civil penalty."²⁵ Collins, however, misreads Rule 410(c). That rule requires simply that, when a party files a petition for review in which the party asserts an "inability to pay disgorgement, interest, or a penalty," that party must then include a sworn financial disclosure form with the opening brief. Nothing in Rule 410(c), however, limits a party's ability to present evidence of an inability to pay to only those instances where the party specifically challenges the imposition of a civil penalty.

²² (...continued)

excessive where the defendant had submitted 9,136 invoices under a fraudulent government contract and where that misconduct involved no harm to the U.S. Government).

²³ 31 U.S.C. § 3729(a)(1)-(3) (2000).

²⁴ *Bunk*, 2012 WL 488256, at *10 ("Congress chose to say only that a person who violates the FCA is liable to the United States for a civil penalty of not less than \$5,500 and not more than \$11,000. Congress did not say, as it did in other federal statutes, that a civil penalty shall be assessed for each false claim or that a Court, in its discretion, may impose a civil penalty up to a certain amount."); *cf. also, e.g., Steven E. Muth*, 58 S.E.C. 770, 813 (2005) (imposing penalty for each customer that respondent defrauded (for a total penalty of \$770,000) in a matter where respondent's unjust enrichment of approximately \$14,000 was "relatively small and w[ould] be disgorged").

²⁵ 17 C.F.R. § 201.410(c).

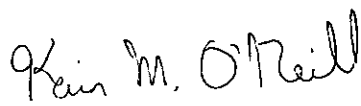
In fact, Rule 630(a) expressly allows a party to present evidence of an inability to pay in "any proceeding" in which a party "may" be ordered to pay disgorgement, interest, or penalties.²⁶ That avenue was available here. Collins knew that these proceedings could result in his having to pay higher sanctions, as the Division of Enforcement filed a cross-appeal seeking civil penalties of \$620,000 (an amount twice what we ultimately imposed against Collins and nearly five times what the law judge imposed), and we noted in our briefing order that we, on our own initiative, had also "determined to review what sanctions, if any, are appropriate in this matter."²⁷ Collins was thus well aware that we could impose a larger sanction than the law judge had imposed and had ample opportunity to present evidence of an inability to pay such a penalty during these proceedings.

* * *

For these reasons, it is ORDERED that the motion for reconsideration filed by Matthew J. Collins be, and it hereby is, denied.

By the Commission.

Elizabeth M. Murphy
Secretary


By: Kevin M. O'Neill
Deputy Secretary

²⁶ *Id.* § 201.630(a) ("In any proceeding in which an order requiring payment of disgorgement, interest or penalties may be entered, a respondent may present evidence of an inability to pay disgorgement, interest or a penalty.").

²⁷ *See supra* note 11 and accompanying text.

*Chairman Shapiro
Commissioner Gallagher
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 66771 / April 9, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14838

In the Matter of

HEREUARE, INC.,

Respondent.

ORDER INSTITUTING PROCEEDINGS
PURSUANT TO SECTION 12(j) OF THE
SECURITIES EXCHANGE ACT OF 1934, MAKING
FINDINGS, AND REVOKING REGISTRATION OF
SECURITIES

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act"), against hereUare, Inc. ("hereUare" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, Respondent consents to the entry of this Order Instituting Proceedings Pursuant to Section 12(j) of the Securities Exchange Act of 1934, Making Findings, and Revoking Registration of Securities ("Order"), as set forth below.

16 of 44

III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

A. hereUare is a Delaware corporation that was based in Santa Clara, California (and later Palo Alto, California) from at least 2007-2009. It purports to provide Internet telecommunications services, including a search engine, messaging, and classifieds. hereUare's predecessor, PeopleNet International Corporation ("PeopleNet"), registered its common stock pursuant to Section 12(g) of the Exchange Act in 2001 and changed its official name to "hereUare, Inc." in March 2007. Neither PeopleNet shares nor hereUare shares have ever traded on any exchange.

B. hereUare has failed to comply with Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder, while its common stock was registered with the Commission in that it has not filed an Annual Report on Form 10-K since April 2010, or periodic or quarterly reports on Form 10-Q for any fiscal period subsequent to its fiscal quarter ending September 30, 2009.

IV.

Section 12(j) of the Exchange Act provides as follows:

The Commission is authorized, by order, as it deems necessary or appropriate for the protection of investors to deny, to suspend the effective date of, to suspend for a period not exceeding twelve months, or to revoke the registration of a security, if the Commission finds, on the record after notice and opportunity for hearing, that the issuer of such security has failed to comply with any provision of this title or the rules and regulations thereunder. No member of a national securities exchange, broker, or dealer shall make use of the mails or any means of instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security the registration of which has been and is suspended or revoked pursuant to the preceding sentence.

In view of the foregoing, the Commission finds that it is necessary and appropriate for the protection of investors to impose the sanction specified in Respondent's Offer.

Accordingly, it is hereby ORDERED, pursuant to Section 12(j) of the Exchange Act, that registration of each class of Respondent's securities registered pursuant to Section 12 of the Exchange Act be, and hereby is, revoked.

By the Commission.

Elizabeth M. Murphy
Secretary

Kevin M. O'Neill
By: Kevin M. O'Neill
Deputy Secretary

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

*Commissioner Walter
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 66775 / April 10, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14839

In the Matter of

HQ Sustainable Maritime
Industries, Inc.,

Respondent.

ORDER INSTITUTING PROCEEDINGS,
MAKING FINDINGS, AND REVOKING
REGISTRATION OF SECURITIES PURSUANT TO
SECTION 12(j) OF THE SECURITIES EXCHANGE
ACT OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act"), against HQ Sustainable Maritime Industries, Inc. ("HQS" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Proceedings, Making Findings, and Revoking Registration of Securities Pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

A. HQS, a Delaware corporation with U.S. headquarters in Seattle, Washington and principal offices in the Hainan Province of the People's Republic of China, reports that it processes and sells tilapia, marine bio and healthcare products, and feed products. From May 2007 to July 2011, the securities of HQS were registered under Section 12(b) of the Exchange Act and traded on the NYSE Amex LLC ("NYSE Amex"). On July 13, 2011, the NYSE Amex filed a Form 25 with the Commission removing HQS's securities from listing on the NYSE Amex and from registration under Section 12(b) of the Exchange Act. Since the delisting and removal from registration under Section 12(b) of the Exchange Act, the securities of HQS have been registered under Section 12(g) of the Exchange Act and quoted on OTC Link under the symbol "HQSM.PK."

B. HQS has failed to comply with Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder, while its common stock was registered with the Commission, in that it has not filed an Annual Report on Form 10-K since March 15, 2010, or quarterly reports on Form 10-Q for any fiscal period subsequent to its fiscal quarter ending September 30, 2010.

IV.

Section 12(j) of the Exchange Act provides as follows:

The Commission is authorized, by order, as it deems necessary or appropriate for the protection of investors to deny, to suspend the effective date of, to suspend for a period not exceeding twelve months, or to revoke the registration of a security, if the Commission finds, on the record after notice and opportunity for hearing, that the issuer of such security has failed to comply with any provision of this title or the rules and regulations thereunder. No member of a national securities exchange, broker, or dealer shall make use of the mails or any means of instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security the registration of which has been and is suspended or revoked pursuant to the preceding sentence.

In view of the foregoing, the Commission finds that it is necessary and appropriate for the protection of investors to impose the sanction specified in Respondent's Offer.

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

Accordingly, it is hereby ORDERED, pursuant to Section 12(j) of the Exchange Act, that registration of each class of Repondent's securities registered pursuant to Section 12 of the Exchange Act be, and hereby is, revoked.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

*Chairman Shapiro
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3395 / April 11, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14842

In the Matter of

MARK YAGALLA,

Respondent.

ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS
PURSUANT TO SECTION 203(f) OF
THE INVESTMENT ADVISERS ACT
OF 1940, MAKING FINDINGS, AND
IMPOSING REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Mark Yagalla ("Yagalla" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, Respondent consents to the Commission's jurisdiction over him and the subject matter of these proceedings and the entry of this Order Instituting Administrative Proceedings Pursuant to Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that

1. Yagalla was the principal of Ashbury Capital Management, L.L.C. ("Ashbury Management") and was president, chief executive officer and portfolio manager of Ashbury Capital Partners, L.P. ("Ashbury Fund"). According to Form D filings with the Commission by Ashbury Fund and Ashbury Management, Ashbury Fund was a "private hedge fund" and Ashbury Management provided investment management and advisory services to Ashbury Fund. From at least July 1998 to October 2000, Yagalla was an associated person of an investment adviser, Ashbury Management. Yagalla is 34 years old and a resident of Florida.

2. On November 12, 2001, Yagalla pled guilty to committing securities fraud in violation of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") [15 U.S.C. §78j(b)], and Rule 10b-5 [17 C.F.R. §240.10b-5], and of committing or causing the commission of an offense against the United States punishable as a principal under 18 U.S.C. §2 before the United States District Court for the Southern District of New York, in *United States of America v. Mark Yagalla*, Case no. 01 Cr. 511 (SHS). Pursuant to the criminal judgment docketed on March 5, 2002, Yagalla was sentenced to 65 months imprisonment, three years of supervised release and ordered to make restitution of \$32,089,463.

3. Yagalla consented to the entry of a final judgment in *SEC v. Ashbury Capital Partners, L.P., et al.*, 00-7898 (PAC) permanently enjoining him from violations of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and from aiding and abetting the violation of Sections 206(1) and (2) of the Advisers Act. That final judgment was entered on April 4, 2012.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Yagalla's Offer.

Accordingly, it is hereby ORDERED pursuant to Section 203(f) of the Advisers Act that Respondent Yagalla be, and hereby is:

barred from association with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent;

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution

order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy
Secretary


By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 66782 / April 11, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14840

In the Matter of

National Stock Transfer, Inc.,

Respondent.

**ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS
PURSUANT TO SECTION 17A OF THE
SECURITIES EXCHANGE ACT OF 1934,
MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 17A of the Securities Exchange Act of 1934 ("Exchange Act") against National Stock Transfer, Inc. ("National" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 17A of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

19 of 44

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. National is a suspended Utah corporation, owned by Roger Greer and Kay Berensen-Galster ("Galster") and operated by Galster, with its principal place of business in Salt Lake City, Utah. National's corporate standing with the State of Utah lapsed in 2010. National has been registered as a transfer agent with the Commission since March 29, 1983.

2. On November 9, 2011, a final judgment was entered by consent against National, permanently enjoining it from future violations of Sections 17(a)(3) and 17A(d) of the Exchange Act and Rules 17Ad-2, 17f-1, 17f-2(a), 17Ac2-1(c), 17Ac-2-2, 17Ad-6, 17Ad-7, 17Ad-10, 17Ad-13, 17Ad-15(c), 17Ad-17 and 17Ad-19 thereunder, in the civil action entitled Securities and Exchange Commission v. National Stock Transfer, et al., Civil Action Number 2:11-cv-798, in the United States District Court for the District of Utah.

3. The Commission's Complaint alleged that, for at least five years, National violated many of the transfer agent provisions of the federal securities laws, including, among other things, that National failed to report lost or stolen securities in a timely manner, failed to maintain certain records, failed to maintain control books for all of its issuers and failed to file its annual report with the Commission. During the time period covered by the Complaint, National acted as the transfer agent for at least 58 issues of common and preferred stock with a shareholder base of approximately 28,046 accounts.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent's Offer.

Accordingly, it is hereby ORDERED pursuant to Section 17A(c)(3) of the Exchange Act, Respondent's registration as a transfer agent is hereby revoked.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

April 12, 2012

In the Matter of

**AP Henderson Group,
BPO Management Services, Inc.,
Capital Mineral Investors, Inc.,
CardioVascular BioTherapeutics, Inc., and
1st Centennial Bancorp,**

File No. 500-1

**ORDER OF SUSPENSION OF
TRADING**

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of AP Henderson Group because it has not filed any periodic reports since the period ended September 30, 2005.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of BPO Management Services, Inc. because it has not filed any periodic reports since the period ended September 30, 2009.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Capital Mineral Investors, Inc. because it has not filed any periodic reports since the period ended September 30, 2008.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of CardioVascular BioTherapeutics, Inc. because it has not filed any periodic reports since the period ended September 30, 2008.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of 1st Centennial Bancorp because it has not filed any periodic reports since the period ended September 30, 2008.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed companies. Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed companies is suspended for the period from 9:30 a.m. EDT on April 12, 2012, through 11:59 p.m. EDT on April 25, 2012.

By the Commission.

Elizabeth M. Murphy
Secretary


By: Jill M. Peterson
Assistant Secretary

*Commissioner Aguilar
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Release No. 66796 / April 12, 2012

ACCOUNTING AND AUDITING ENFORCEMENT

Release No. 3380 / April 12, 2012

ADMINISTRATIVE PROCEEDING

File No. 3-14846

In the Matter of

JORGE L. CASTILLO, CPA,

Respondent

ORDER INSTITUTING ADMINISTRATIVE
PROCEEDINGS PURSUANT TO RULE
102(e) OF THE COMMISSION'S RULES OF
PRACTICE, MAKING FINDINGS, AND
IMPOSING REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted against Jorge L. Castillo ("Castillo" or "Respondent") pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice.¹

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these

¹ Rule 102(e)(3)(i) provides, in relevant part, that:

The Commission, with due regard to the public interest and without preliminary hearing, may, by order, . . . suspend from appearing or practicing before it any . . . accountant . . . who has been by name . . . permanently enjoined by any court of competent jurisdiction, by reason of his or her misconduct in an action brought by the Commission, from violating or aiding and abetting the violation of any provision of the Federal securities laws or of the rules and regulations thereunder.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. National is a suspended Utah corporation, owned by Roger Greer and Kay Berensen-Galster ("Galster") and operated by Galster, with its principal place of business in Salt Lake City, Utah. National's corporate standing with the State of Utah lapsed in 2010. National has been registered as a transfer agent with the Commission since March 29, 1983.

2. On November 9, 2011, a final judgment was entered by consent against National, permanently enjoining it from future violations of Sections 17(a)(3) and 17A(d) of the Exchange Act and Rules 17Ad-2, 17f-1, 17f-2(a), 17Ac2-1(c), 17Ac-2-2, 17Ad-6, 17Ad-7, 17Ad-10, 17Ad-13, 17Ad-15(c), 17Ad-17 and 17Ad-19 thereunder, in the civil action entitled Securities and Exchange Commission v. National Stock Transfer, et al., Civil Action Number 2:11-cv-798, in the United States District Court for the District of Utah.

3. The Commission's Complaint alleged that, for at least five years, National violated many of the transfer agent provisions of the federal securities laws, including, among other things, that National failed to report lost or stolen securities in a timely manner, failed to maintain certain records, failed to maintain control books for all of its issuers and failed to file its annual report with the Commission. During the time period covered by the Complaint, National acted as the transfer agent for at least 58 issues of common and preferred stock with a shareholder base of approximately 28,046 accounts.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent's Offer.

Accordingly, it is hereby ORDERED pursuant to Section 17A(c)(3) of the Exchange Act, Respondent's registration as a transfer agent is hereby revoked.

proceedings, and the findings contained in Section III. 2. below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. Castillo, age 56, is and has been a certified public accountant licensed to practice in the State of New Jersey. From at least 2003 through 2010, Castillo served, and publicly presented himself, as the independent, outside auditor for Provident Capital Indemnity Ltd. ("PCI"), a purported insurance and reinsurance company based in Costa Rica.

2. On April 6, 2012, a final judgment was entered against Castillo by consent, permanently enjoining him from future violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and Section 17(a) of the Securities Act of 1933, in the civil action entitled SEC v. Provident Capital Indemnity, Ltd., Minor Vargas Calvo, and Jorge L. Castillo, Civil Action No. 3:11-CV-045 (REP), in the United States District Court for the Eastern District of Virginia.

3. The Commission's Complaint alleged, among other things, that Castillo falsely represented that he had audited PCI's financial statements from at least 2003 through 2009, when, in fact, he never conducted an audit of PCI's financial statements for those years; rather than conduct proper audits, he instead issued clean audit opinions at the bidding of PCI's president, which falsely stated that PCI's financial statements for those years "present fairly, in all material respects, the financial position of [PCI] in conformity with generally accepted accounting principles." The Complaint alleged that Castillo's actions, in turn, supported the illusion that PCI had materially larger assets – including a Long-Term Asset that purportedly comprised 70% to 80% of PCI's total assets – and a greater financial wherewithal to support its obligation on financial guarantee bonds issued in connection with life settlement investments. Castillo allegedly knew or was reckless in not knowing that the Long-Term Asset did not exist and assisted PCI's president in manufacturing false backup for the Long-Term Asset. The Complaint also alleged that Castillo knew, or was reckless in not knowing that PCI was providing his false audit reports to a rating agency that, in partial reliance on those reports, gave PCI a high rating. The Complaint also alleged that, on occasion, Castillo assisted PCI's president in formulating responses to the rating agency's questions. The Complaint also alleged that PCI's president asked Castillo to issue certificates to life settlement issuers that falsely stated PCI had made payments to purchase reinsurance, which Castillo did; such actions supported the illusion that PCI's obligations on financial guarantee bonds were backed by reinsurance.

4. The Commission's Complaint further alleged that in 2010, after learning of a regulatory inquiry into his conduct, Castillo asked the president of PCI to manufacture backup material to support Castillo's purported audit procedures and told the PCI president that he had

destroyed or was in the process of destroying all of his e-mails. Castillo also urged PCI's president to destroy documents.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanction agreed to in Respondent Castillo's Offer.

Accordingly, it is hereby ORDERED, effective immediately, that:

Castillo is suspended from appearing or practicing before the Commission as an accountant.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: **Jill M. Peterson**
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

*Chairman Schapiro
Commissioner Gallagher
not participating
Commissioner Paredes
Disapproved*

SECURITIES ACT OF 1933
Release No. 9312 / April 12, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14845

In the Matter of

GOLDMAN, SACHS & CO.

Respondent.

ORDER UNDER RULE 602(e) OF THE
SECURITIES ACT OF 1933 GRANTING A
WAIVER OF THE RULE 602(c)(3)
DISQUALIFICATION PROVISION

I.

Goldman, Sachs & Co. ("Goldman" or "Respondent") has submitted a letter, dated March 15, 2012, requesting a waiver of the Rule 602(c)(3) disqualification from the exemption from registration under Regulation E arising from Goldman's settlement of an administrative proceeding commenced by the Commission.

II.

On April 12, 2012, pursuant to Goldman's Offer of Settlement, the Commission issued an Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order against Goldman. Under the Order, the Commission found that Goldman failed to establish, maintain and enforce written policies and policies reasonably designed, given the nature of its business, to prevent the misuse of material, nonpublic information concerning its analysts' published research, in willful violation of Section 15(g) of the Securities Exchange Act of 1934 ("Exchange Act"). In the Order, the Commission ordered Goldman to cease and desist from committing or causing any violations and any future violations of Section 15(g) of the Exchange Act, ordered Goldman be censured, ordered Goldman to pay a civil penalty in the amount of \$22 million, with \$11 million of this amount to be deemed satisfied by payment of \$11 million to the Financial Industry Regulatory Authority in a related proceeding, and ordered Goldman to comply with specified undertakings.

22 of 44

III.

The Regulation E exemption is unavailable for the securities of small business investment company issuers or business development company issuers if, among other things, any investment adviser or underwriter for the securities to be offered is subject to an order of the Commission entered pursuant to section 15(b) or 15A(1) of the Securities Exchange Act of 1934. 17 C.F.R. § 230.602(c)(3). Rule 602(e) of the Securities Act of 1933 ("Securities Act") provides, however, that the disqualification "... shall not apply ... if the Commission determines, upon a showing of good cause, that it is not necessary under the circumstances that the exemption be denied." 17 C.F.R. § 230.602(e).

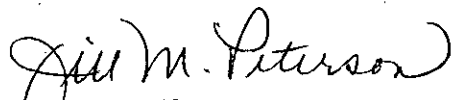
IV.

Based upon the representations set forth in Goldman's request, the Commission has determined that pursuant to Rule 602(e) under the Securities Act a showing of good cause has been made that it is not necessary under the circumstances that the exemption be denied as a result of the Order.

Accordingly, **IT IS ORDERED**, pursuant to Rule 602(e) under the Securities Act, that a waiver from the application of the disqualification provision of Rule 602(c)(3) under the Securities Act resulting from the entry of the Order is hereby granted.

By the Commission.

Elizabeth M. Murphy
Secretary


By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

*Chairman Schapiro
Commissioner Gallagher
not participating
Commissioner Paredes
Disapproved*

SECURITIES EXCHANGE ACT OF 1934
Release No. 66791 / April 12, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14845

In the Matter of

GOLDMAN, SACHS & CO.

Respondent.

ORDER INSTITUTING ADMINISTRATIVE
AND CEASE-AND-DESIST PROCEEDINGS,
PURSUANT TO SECTIONS 15(b) AND 21C
OF THE SECURITIES EXCHANGE ACT OF
1934, MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS AND A CEASE-
AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Goldman, Sachs & Co. ("Respondent" or "Goldman").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings as well as those fact findings herein to the extent also contained in Section V of the Consent Order with the Commonwealth of Massachusetts Securities Division, Docket No. 2009-079, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

RESPONDENT

Goldman, a New York limited partnership with its principal offices in New York, New York, is a broker-dealer and investment adviser registered with the Commission pursuant to Section 15 of the Exchange Act and Section 203 of the Investment Advisers Act of 1940.

Goldman is an affiliate of The Goldman Sachs Group, Inc., whose common stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act and trades on the New York Stock Exchange. Goldman engages in a nationwide securities business. In 2003, Goldman, without admitting or denying the findings, consented to the issuance of a Commission order finding, among other violations, that Goldman violated Section 15(f) of the Exchange Act by failing to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material, nonpublic information obtained from outside consultants concerning U.S. Treasury 30-year bonds. In re Goldman Sachs & Co., Exchange Act Rel. No. 48436 (Sept. 4, 2003). Goldman paid a \$5 million civil penalty and disgorgement and interest totaling more than \$4.3 million.

SUMMARY

This matter concerns Goldman's failure to establish, maintain, and enforce adequate policies and procedures concerning its trading "huddle" program – a practice where Goldman's equity research analysts provided their best trading ideas to firm traders and a select group of Goldman's top clients. From 2006 to 2011, Goldman typically held weekly huddle meetings in each of the firm's research sectors, during which the firm's equity research analysts met with traders and sometimes sales persons to discuss the analysts' "high-conviction" short-term trading ideas and other "market color" concerning stocks they covered, as well as traders' views on the market. Beginning in 2007, Goldman began a program known as the Asymmetric Service Initiative ("ASI"), pursuant to which research analysts called a select group of priority clients to share information and trading ideas from the huddles. The huddles and ASI were an extensive undertaking created by Goldman with the goals of improving the performance of the firm's traders and generating increased commission revenues from ASI clients.

At the same time, Goldman analysts were told that the performance of their trading ideas would be monitored by both Research and Trading. Analysts' contributions to huddles and ASI, such as increased commissions generated from ASI clients, were discussed in analysts' written performance reviews and in other documents used in connection with analyst evaluations.

Goldman's huddle program created a serious and substantial risk that analysts would share material, nonpublic information concerning their published research with ASI clients and firm traders. Many of these clients and traders were frequent, high-volume traders, and the potential for misuse of material, nonpublic information concerning Goldman's published research in connection with the huddles was high. However, Goldman did not establish, maintain, and enforce adequate policies and procedures to prevent such misuse in light of the risks arising from the huddles and ASI. In addition, its surveillance of trading ahead of research changes, both in connection with huddles and otherwise, was deficient. As a result, Goldman willfully violated Section 15(g) of the Exchange Act.

FACTS

A. Goldman's Equity Research Division

Goldman's Global Investment Research division ("GIR") includes the Americas Equity Research group ("Americas Research Group"), comprised of research professionals responsible for covering equity securities issued in the United States, Canada, and Latin America. The Americas Research Group is divided into six, formerly seven, subject-matter sectors.

Goldman's equity research analysts provide the firm's clients with investment recommendations and analysis on public companies and their stocks through published research reports. For each stock they cover, Goldman analysts publish an investment rating, an estimate of the target price they expect the stock to reach in six or twelve months, and an estimate of expected earnings per share. They also publish a coverage view concerning the investment outlook for all the stocks within their specific subsector or coverage group (e.g., Asset Managers or Oil Refiners). Since June 2006, Goldman has utilized a rating system of Buy, Neutral, and Sell relative to each coverage group. These ratings are based on a stock's expected return over a defined time period, typically six or twelve months. The Americas Research Group generally maintains a distribution of stocks limiting the number of Buys to 25-35% and Sells to 10-15% within each coverage group.

In addition to its relative rating system, Goldman also publishes an Americas Conviction List ("Conviction List"), which represents a "focused list of [Goldman's] best ideas" from its Americas Research Group analysts. Stocks on the Conviction List could have an underlying investment rating of either Buy or Sell, but a Neutral-rated stock could not be added to the Conviction List.¹ Each sector business unit within the Americas Research Group generally contributes at least one stock to the Conviction List. An addition to, or removal from, the Conviction List is considered by Goldman's written policies to be material information, as is a change to a stock's investment rating. Changes to ratings and the Conviction List require approval from Goldman's GIR Americas Investment Review Committee ("IRC").

Since at least 2006, Goldman has employed a performance evaluation and compensation system that includes measuring an analyst's commercial impact. Goldman evaluates research analysts using an Analyst Scorecard ("Scorecard"), which plays an integral role in determining the bonus portion of an analyst's compensation. The Scorecard allocates points for, among other things, the accuracy and quality of research and evaluations from internal Goldman personnel, including sales persons and traders. The Scorecard also includes feedback received directly from Goldman clients through a process known as "broker votes." Many institutional investors use broker votes to rate research analysts and other personnel across the industry, and then allocate their trading — and resulting commissions — to the firms whose personnel they rate most highly.

B. "Huddles" and Asymmetric Service Initiative

Beginning in 2006, Goldman began holding weekly huddle meetings in each of its seven equity research sectors. Huddles were internal meetings in which Goldman's equity research analysts and traders, and sometimes sales persons, discussed, among other things, recent developments, market color and short-term trade ideas.² A primary purpose of the huddle meetings was to allow Goldman's equity research analysts and traders to engage in "a focused dialogue of the highest conviction ideas in that sector" and to spotlight "commercially oriented trading ideas." For example, a manager in the Financials sector emailed her team that they had a responsibility to generate trade ideas for huddles "based on your view of the stocks that will move short term . . . and make the [trading] desk money."

The Goldman traders who participated in huddles were primarily those who dealt directly with the firm's customers, including market-making and client-facilitation traders from Goldman's

¹ As of January 2011, stocks with an investment rating of Sell were no longer added to the Conviction List.

² Generally, there were seven different huddle meetings held each week, and each meeting could include discussions of as many as 15-20 different stocks.

Securities Division. However, until 2009, members of Goldman's Franchise Risk Management ("FRM") group, who also were authorized to establish large, long-term positions on behalf of the firm, attended huddles, as well. FRM advised market-makers, client-facilitation traders, and salespeople, but did not interact with clients.

In January 2007, Goldman launched its Asymmetric Service Initiative, which was an effort to generate additional revenue for the firm by providing market commentary and trading ideas in a structured format to a select group of approximately 180 hedge fund and investment management clients ("ASI clients"). As part of ASI, research analysts prepared scripts regarding the ideas discussed at huddles, and then used those scripts to call ASI clients concerning their ideas. Analysts were instructed to use the script as a guideline when making ASI calls, and to "lead with trading color . . . and with the most interesting and actionable ideas." Analysts were also permitted to discuss the ideas from huddles, including short-term trading ideas, with non-ASI clients.

In return for sharing trading ideas and market color through the ASI service, Goldman hoped to generate increased trading commissions from ASI clients. Goldman selected clients that would be offered the ASI service based on the actual amount of trading commissions received from the client, or the potential for Goldman to earn greater trading commissions from the client in the future. Revenues received by Goldman's Securities Division from certain ASI clients significantly increased after Goldman began conducting ASI in 2007. For example, a July 2007 document prepared by GIR identified "\$2M incremental new revenue associated with the accounts under [the Communications, Media, and Entertainment sector's] Asymmetric Service Initiative . . . YTD is \$14 million."

Research analysts were acutely aware of the importance of huddles and ASI to Goldman and to their own evaluations and potentially their compensation. Beginning in late 2006, Goldman began tracking the performance of a small subset of trade ideas raised by research analysts during huddles, using a spreadsheet known internally as the "Record of Ideas." Research analysts decided which of their specific trade ideas would be tracked on these spreadsheets, and typically selected their best or highest conviction ideas for inclusion on the tracking spreadsheets.

Moreover, GIR management informed research analysts that the performance of ideas from huddles would be tracked. For example, an internal memorandum concerning huddles described the Record of Ideas and stated that, "Research would monitor the quality of ideas, accuracy of the call/return generated." The memorandum further stated, "Employing the Research record of ideas, trading will evaluate how research recommendations contributed to their performance. Aggregated impact on trading may be shared with research management."

Goldman's huddle program affected research analyst evaluations and potentially their compensation in numerous ways. First, the huddle and ASI program was part of a concerted effort within GIR to improve or maintain the broker votes of Goldman's highest priority clients, including ASI clients, and accordingly, generate greater trading commissions. In furtherance of this goal, analysts received more credit on Scorecards – and therefore their evaluations – for the broker votes of Goldman's priority clients, including those who received ASI, than those of other Goldman clients. Second, Goldman sales and trading personnel, including staff who attended huddles and/or serviced ASI clients, provided feedback on research analysts through Scorecards and written annual evaluations. Finally, analysts themselves commented on huddles in their own written annual evaluations. For example, one analyst specifically noted how huddle performance

would “add value to traders’ P&Ls,” and another analyst touted that his huddle ideas had generated the “highest total return of all analysts contributing to the huddle list.”

During 2011, Goldman discontinued both the huddles and ASI.

C. Goldman Failed to Establish, Maintain, and Enforce Adequate Policies and Procedures to Prevent the Misuse of Material, Nonpublic Information Regarding Equity Research in Connection with the Huddles and ASI

Having created the huddles and ASI, Goldman failed to establish adequate policies, or adequately enforce and maintain its existing policies, to prevent the misuse of material, nonpublic information concerning upcoming changes to its research in connection with these programs. In the first instance, Goldman did not establish adequate written policies and procedures to address the issues arising from the new huddle program that it created. In addition, Goldman did not maintain and enforce adequate controls to monitor huddles and ensure that research analysts were not using the huddle program to prematurely disclose material, nonpublic information concerning their published research. Finally, Goldman’s surveillance of trading ahead of research changes – both in connection with huddles and otherwise – was materially deficient in numerous ways.

1. Deficiencies in Goldman’s Written Policies and Procedures

During the relevant period, huddles were subject to Goldman’s existing written policies and procedures. These policies generally prohibited equity research analysts from discussing unpublished research with clients or anyone outside of GIR other than members of the firm’s Legal or Compliance departments. Moreover, analysts were prohibited from selectively disclosing any new “material statements” regarding companies under their coverage before those statements were broadly disseminated to all of the firm’s clients. Goldman did not establish a specific written policy or procedure concerning huddles.³ However, in January 2008 research management issued an internal memorandum concerning huddles which stated that huddles were subject to the firm’s existing policies and procedures and that during huddles, “analysts must not engage in selective disclosure of unpublished research or indicate pending changes in ratings, conviction list designations, price targets or earnings estimates, or in any way disavow their published views.” Analysts were also instructed not to “save” for the huddle any information concerning short-term events that the analyst believed might be of interest to clients.

Prior to November 2006, Goldman’s written policies and procedures required that “any new, material statements” by an analyst about a covered company must be disseminated broadly to all clients of the firm. Broad dissemination was required for all research reports, as well as statements prepared by the analyst for circulation to sales and trading, unless the statement fell into one of two exceptions: a purely factual announcement, or a reiteration, elaboration, or review of previously-published research without any new analysis.

In November 2006, as Goldman was placing more emphasis on the huddles program, Goldman revised its dissemination policy. The revised policy still required broad dissemination of any “new material statements” and defined these to include changes to “key quantum data” – *i.e.*, changes to ratings, price targets, earnings forecasts, and coverage views – as well as reaffirmations of price targets or ratings in light of major news, when that news would call the analyst’s prior

³ During 2007, members of Goldman’s Compliance Division drafted a proposed insert concerning huddles for the GIR Global Policies and Procedures Manual, but no such policy was ever implemented.

rating into question. However, the November 2006 policy also provided that “[a]ll other statements, including internal messages commenting on short-term trading issues or market color, shall not require broad dissemination unless they would call into question published price targets or recommendations.” Goldman’s policies and procedures did not define the terms “short-term trading issues” or “market color.” Nor did the policies and procedures provide any guidance concerning what statements would call into question an analyst’s published price targets or ratings.

Shortly after the new dissemination policy was formally adopted, a December 2006 internal training presentation concerning information exchanges between research analysts and other personnel in Goldman’s Securities Division stated that analysts were free to share short-term trading ideas, even if those ideas were “not necessarily in the same direction as the investment rating” (e.g., a short-term idea to sell a stock with a published Buy rating), but did not define the limits of when that was acceptable without broad dissemination. This concept was reiterated in the January 2008 memorandum concerning huddles, which stated that, “[a]s with any client, dialogue as to events that may have a near-term or short-term impact on stocks is permissible.”

Although Goldman’s policies specifically permitted analysts to discuss “short term” trading ideas without broad dissemination – and analysts were encouraged to share their short-term trading ideas with clients and firm traders through huddles and the ASI program – Goldman did not define or provide adequate guidance or training to research analysts concerning the limits of what constituted a “short-term” or “near term” trading idea. Goldman employees’ understanding of the meaning of this term varied, with some analysts stating that they understood a “short-term” idea potentially could be as long as eleven months, provided that the time horizon for their published rating or price target was twelve months. Accordingly, Goldman’s written policies and procedures failed to adequately define the difference between “material statements” that required broad dissemination and “short-term” trading ideas that did not.

Furthermore, although huddles and ASI increased the risk of misuse of material, nonpublic information concerning upcoming changes to analysts’ published research, Goldman’s written policies and procedures did not restrict an analyst from proposing a trade idea for a specific stock during a huddle when the analyst had already contacted the IRC or begun drafting a report to change the rating on that stock. For example:

- Company A – In April 2009, the Goldman equity research analyst covering Company A discussed the stock during a huddle, even though four days earlier he had recommended the stock to the IRC as a potential addition to Goldman’s Conviction List. The script for the huddle noted that, while investor sentiment was negative on Company A, the analyst covering the stock expected that interest in stocks in that industry would increase before an upcoming industry conference. Five days later, the analyst’s rating on Company A was upgraded from Neutral to Buy, and the stock was added to the Conviction List. There is no record of anyone from Goldman’s compliance group having attended this huddle.
- Company B – In April 2008, the Goldman equity research analyst covering Company B discussed the stock during a huddle, after he had already drafted a report upgrading Company B from Neutral to Buy. The script for the huddle noted that the analyst looked to turn more positive on his group, and highlighted Company B. Company B was also added to the Financials sector Record of Ideas that day. Within hours after the huddle, the analyst recommended an upgrade of Company B at an internal meeting.

Four business days later, Goldman upgraded Company B from Neutral to Buy. The following day, the analyst removed Company B from the Record of Ideas. A representative from Goldman's compliance group did not attend the huddle.

- Company C – In July 2008, the analyst covering Company C discussed the stock during a huddle, even though he had already proposed a potential downgrade of the stock and scheduled an IRC meeting to discuss the downgrade. The script for the huddle stated that the analyst expected certain companies to be “under pressure,” including Company C. The next day, the analyst downgraded Company C from a Neutral to Sell. Compliance did not attend the huddle.

2. Deficiencies in Goldman's Controls over the Huddles

Goldman's policies explicitly required that analysts broadly disseminate any new material statements or changes to key quantum data, such as a rating change. However, Goldman lacked adequate controls to ensure that analysts were not using huddles or ASI as a forum to preview rating changes to firm traders and ASI clients.

Goldman's Global Compliance Division had a specific group that attended to research-related compliance issues (“Research Compliance Group”). Representatives of Goldman's Research Compliance Group attended some, but not all, huddles between 2006 and sometime in 2008, when attendance by Compliance became less frequent. More frequent Compliance monitoring of the huddles recommenced in August 2009, after publication of a media report concerning huddles and the initiation of the SEC's and other regulatory investigations. Thus, hundreds of huddles were not monitored by representatives of the firm's Compliance Division.

Goldman did not conduct any regular review or comprehensive audit to identify or review the circumstances when ratings changes occurred shortly after a stock was discussed in a huddle. In fact, between January 2007 and August 2009, there were hundreds of instances when a ratings change occurred within five business days after the stock was discussed at a huddle, referenced in a huddle script, or included on the Record of Ideas. However, with few exceptions, there are no records of any investigation or inquiry by Goldman concerning whether analysts had disclosed an upcoming rating change to ASI clients and firm traders through the huddles process.⁴ Whether or not any information regarding the impending ratings changes was communicated during those huddles, the sheer volume of those instances, had they been adequately identified and investigated by Goldman, should have alerted Goldman to the risk that material, nonpublic information concerning its analysts' published research could be improperly disclosed and misused.

The circumstances concerning these huddles were red flags that should have alerted Goldman to the need for both adequate review of the instances and stronger controls surrounding the huddles and ASI in order to prevent the potential misuse of material, nonpublic information concerning its analysts' published research. Analysts' communications at huddles and with ASI

⁴ In October 2007, Goldman's Compliance Testing Group conducted a limited review of the huddles program after an analyst made comments during a huddle indicating that his price target on a stock might be revised downward. The review was based only on the subset of trade ideas tracked on the Record of Ideas, and did not include thousands of stocks referenced in the scripts from that time period. Consequently, the review encompassed only a portion of all stocks discussed in huddles or huddle scripts during the relevant period. Ultimately, Goldman took no action or implemented any changes as a result of this review.

clients shortly before rating changes presented a serious risk and opportunity for the misuse of material, nonpublic information concerning analysts' published research. However, Goldman did not have adequate controls and procedures in place to even identify, much less review, any of these incidents to determine whether analysts had previewed upcoming rating changes in the huddles.

In addition, Goldman did not respond adequately to a red flag concerning the potential misuse of material, nonpublic information concerning published research by a Goldman analyst. The 2007 written evaluation for one Goldman analyst included a comment from a junior analyst stating that the analyst "needs to be more careful with the substance of his conversations with clients as some are aware of upgrades/downgrades ahead of the event." However, the analyst was never questioned about this allegation, and there is no record of any follow-up or inquiry conducted by GIR management or the Research Compliance Group concerning this issue.

Goldman's monitoring of huddles and ASI was further undermined by the fact that Goldman did not maintain complete documentation concerning those programs. Huddle scripts, Records of Ideas, or other records were not prepared for every huddle, and those records that exist do not reliably reflect all stocks discussed during a huddle or the comments made about each stock. Similarly, Goldman maintained very few records concerning which ASI clients were called with ideas discussed during any particular huddle, when they were called, and what was said. Although there was no specific regulatory requirement to create and maintain such records, the absence of documentation concerning the huddles and ASI compromised Goldman's ability to effectively monitor the potential misuse of material, nonpublic information concerning analysts' published research in connection with the programs. For example, when the Compliance Testing Group conducted its October 2007 review, they noted that "huddle sheets" – a document reflecting trading ideas that some sectors created for use in huddles – were not available for 15 of the 20 instances it sought to review.

Moreover, Goldman's Research Compliance Group did not keep complete records of all compliance questions arising from huddles. Goldman only kept records of instances when it determined there was an *actual* violation of Goldman policies and procedures by research employees. Goldman did not track compliance issues concerning research employees that ultimately were deemed not to have violated firm policies. Although there was no specific regulatory requirement to create and maintain records concerning potential violations of firm policy, the lack of such records also undermined Goldman's ability to monitor huddles and ASI for the misuse of material, nonpublic information concerning analysts' published research – including the ability of Goldman to assess how frequently issues relating to huddles or particular analysts were raised, as well as the adequacy of the review of any such incident.

3. Deficiencies in Goldman's Surveillance of Trading Ahead of Research Changes

During the relevant period, Goldman conducted limited surveillance of trading ahead of research changes, but it did not perform any surveillance specifically relating to huddles. Furthermore, Goldman's surveillance of trading ahead of research changes was not reasonably designed to ensure that analysts were not prematurely disclosing material research changes to firm traders and clients, either through the huddles, ASI or otherwise.

Goldman's surveillance of trading in advance of research changes was flawed in several material aspects. First, prior to September 2008, Goldman did not conduct surveillance of trading ahead of all changes to Goldman's Conviction List, even though Goldman's internal policies

required broad dissemination of changes to the Conviction List. For example, Goldman did not conduct surveillance of trading when a stock previously rated Buy or Sell was added to or removed from the Conviction List without any change to its Buy or Sell rating. Similarly, Goldman did not conduct surveillance of institutional client trading ahead of *any* rating changes until March 2009. Further, although market-making and customer-facilitation traders participated in huddles, Goldman did not conduct any surveillance of trading in those accounts.

Additionally, the surveillance group analysts reviewing trading ahead of ratings changes did not know that a stock was discussed in a huddle before the rating change. Without this key information, the surveillance group could not adequately investigate whether research analysts were improperly conveying material, nonpublic information to firm traders and ASI clients through the huddle program.

Since November 2008, Goldman has relied on its proprietary, algorithm-driven surveillance system called Global Surveillance Architecture to review trading ahead of rating changes. The system generates alerts based solely on the profitability of trading. Moreover, during the relevant period, Goldman's Surveillance Architecture system only generated an alert when an account's trading in a particular security was extremely profitable. For example, in order to trigger an alert for a rating or Conviction List change, a Goldman firm account had to reach a profitability threshold of \$650,000 and a "high activity" institutional account (defined as an account that trades \$46 million or more over a four-month period) had to reach a profitability threshold of at least \$3 million.⁵

LEGAL ANALYSIS

Section 15(g) of the Exchange Act requires broker-dealers to establish, maintain and enforce written policies and procedures, reasonably designed, taking into consideration the nature of the broker's or dealer's business, to prevent the misuse, in violation of the Exchange Act or the rules and regulations thereunder, of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer.⁶ The internal controls requirements imposed by Section 15(g) are essential to protect against the risk of misuse of material, nonpublic information, which can undermine investor confidence in the integrity of the markets. Section 15(g) is intended to guard against a broad range of potential market violations, including insider trading and trading in advance of material research changes.

Broker-dealers must be cognizant of their duties under Section 15(g) and the need to tailor their policies to the specific activities of the individual firm, particularly as their businesses evolve. The Commission has long held that the requirement that broker-dealers implement and maintain policies and procedures consistent with the nature of its business "is critical to effectively preventing the misuse of material, nonpublic information." *In re Gabelli & Co., Inc.*, Exchange Act Rel. No. 35057 (Dec. 8, 1994). The Commission also has consistently made clear that broker-dealers must take seriously their responsibilities to design and enforce sufficiently robust

⁵ Between the implementation of the Global Surveillance Architecture in November 2008 and May 2011, 740 alerts were triggered based on trading ahead of research rating and Conviction List changes. However, Goldman's surveillance analysts determined after only a limited review that all but one could be closed without any further action.

⁶ Section 15(g) of the Exchange Act was formerly Section 15(f). The provision was renumbered in 2010 by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

policies and procedures to prevent the misuse of material, nonpublic information. See, e.g., In re Goldman Sachs & Co., Exchange Act Rel. No. 48436 (Sept. 4, 2003) (finding Section 15(f) violation where Goldman Sachs failed to prevent the misuse of material, nonpublic information potentially obtained by its paid outside consultants); In re Merrill Lynch, Pierce, Fenner & Smith Inc., Exchange Act Rel. No. 63760 (Jan. 25, 2011) (finding Section 15(g) violation where Merrill Lynch failed to prevent the misuse of customer order information); In re Merrill Lynch, Pierce, Fenner & Smith, Inc., Exchange Act Rel. No. 59555 (March 11, 2009) (finding Section 15(f) violation where Merrill Lynch failed to limit or monitor traders' access to the equity squawk box which broadcast material, nonpublic information); In re Banc of America Securities LLC, Exchange Act Release No. 55466 (March 14, 2007) (finding Section 15(f) violation where Banc of America failed to establish and enforce policies and procedures to protect against the misuse of material, nonpublic research information). The mere establishment of policies and procedures alone is not sufficient to prevent the misuse of material, nonpublic information. It also is necessary to implement measures to monitor compliance with and enforcement of those policies and procedures. See, e.g., In re Morgan Stanley & Co. Inc., et al., Exchange Act Release No. 54047 (June 27, 2006) (finding Section 15(f) violation where Morgan Stanley failed to enforce existing policies and procedures concerning surveillance over a four-year period).

Goldman's policies and procedures were not reasonably designed, given the nature of its business, to prevent the misuse of material, nonpublic information concerning its analysts' published research. After creating the huddles and ASI programs, Goldman failed to adequately address the increased risk for the misuse of material, nonpublic information resulting from these programs. Goldman's policies and procedures did not define what constituted a "short term" idea that could be discussed at huddles without broad dissemination to all of the firm's clients. Goldman's policies and procedures also did not restrict analysts from proposing a trading idea for a specific stock during a huddle when the analyst had already contacted the IRC or begun drafting a report to change the rating on that stock. Goldman also failed to enforce its existing policies and lacked adequate controls to monitor the huddle program for the misuse of the firm's material, nonpublic research information. Compliance did not attend hundreds of huddles. Goldman had no process in place to identify the hundreds of instances when an analyst discussed a stock at a huddle and then changed the rating within days of the huddle. Moreover, Goldman did not review such incidents to determine whether the analyst had prematurely disclosed a rating change during the huddle. Goldman's surveillance of research changes also was deficient in several material aspects. For example, Goldman did not conduct surveillance of trading of all Conviction List changes until late 2008, and did not conduct surveillance of client trading ahead of *any* research changes until March 2009, approximately two years after it began the ASI program. In addition, Goldman surveillance analysts had no information concerning the matters that were discussed at huddles when they investigated suspicious trading. Even when alerts regarding trading ahead of research changes were triggered by Goldman's surveillance system, all but one were closed with no further action after only a limited review. Accordingly, Goldman willfully violated Section 15(g) of the Exchange Act.⁷

⁷ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

UNDERTAKINGS

Goldman has undertaken to, within ninety (90) days of the entry of this Order:

1. Goldman shall complete a comprehensive review, including recommendations, of the policies, procedures and practices maintained and implemented by the Respondent pursuant to Section 15(g) of the Exchange Act that relate to the findings of this Order;
2. Goldman shall adopt, implement and maintain practices and written policies and procedures pursuant to Section 15(g) of the Exchange Act that are consistent with the findings of this Order and the recommendations contained in the comprehensive review; and
3. Goldman shall submit a report, approved and signed by Goldman's Legal Department, to M. Alexander Koch, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 100 F Street, N.E., Washington, D.C. 20549-5041, which details the results of the review, the new policies, procedures and practices adopted pursuant to Section 15(g) of the Exchange Act, and the actions taken to implement the new policies and procedures.

Goldman shall certify, in writing, compliance with the undertakings set forth above. The certification shall identify the undertakings, provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and Respondent agrees to provide such evidence. The certification and supporting material shall be submitted to M. Alexander Koch, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 100 F Street N.E., Washington, D.C. 20549-5041, with a copy to the Office of Chief Counsel of the Enforcement Division, Securities and Exchange Commission, no later than thirty (30) days from the date of the completion of the undertakings.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent's Offer.

Accordingly, pursuant to Sections 15(b) and 21C of the Exchange Act, it is hereby ORDERED that:

- A. Respondent shall cease and desist from committing or causing any violations and any future violations of Section 15(g) of the Exchange Act;
- B. Respondent is censured;
- C. Pursuant to Section 15(b)(4) of the Exchange Act, Respondent shall, within ten (10) days of the entry of this Order, pay a total civil money penalty in the amount of \$22 million, \$11 million of which shall be deemed satisfied upon payment by Respondent of a \$11 million civil penalty to the Financial Industry Regulatory Authority in a related proceeding, and \$11 million of which shall be paid to the Securities and Exchange Commission for remittance to the United States Treasury. Payment to the Securities and Exchange Commission shall be: (1) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (2) made payable to the Securities and Exchange Commission; (3) hand-delivered or mailed to the Securities and Exchange Commission, Office of

Financial Management, Accounts Receivable, 100 F Street, N.E., Mail Stop 6042, Washington, D.C. 20549; and (4) submitted with a cover letter that identifies Goldman, Sachs & Co. as the Respondent in this proceeding and includes the file number of this proceeding, a copy of which cover letter and money order or check shall be sent to Antonia Chion, Associate Director, Division of Enforcement, Securities and Exchange Commission, 100 F Street N.E., Washington, D.C. 20549-5041; and,

D. Respondent shall comply with the undertakings enumerated in Section III above.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 66787 / April 12, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14843

In the Matter of

**AP Henderson Group,
BPO Management Services, Inc.,
Capital Mineral Investors, Inc.,
CardioVascular BioTherapeutics, Inc., and
1st Centennial Bancorp,**

Respondents.

**ORDER INSTITUTING
ADMINISTRATIVE
PROCEEDINGS AND NOTICE
OF HEARING PURSUANT TO
SECTION 12(j) OF THE
SECURITIES EXCHANGE ACT
OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against the Respondents named in the caption.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. AP Henderson Group ("APHG")¹ (CIK No. 1096653) is a revoked Nevada corporation located in Las Vegas, Nevada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). APHG is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2005, which reported a net loss of \$8,038,612 for the prior nine months. As of April 5, 2012, the common stock of APHG was quoted on OTC Link (formerly "Pink Sheets") operated by OTC Markets Group Inc. ("OTC Link"), had seven market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

¹The short form of each issuer's name is also its stock symbol.

2. BPO Management Services, Inc. ("HAXS") (CIK No. 768892) is a Pennsylvania corporation located in Anaheim, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). HAXS is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2009, which reported a net loss of \$10,730,010 for the prior nine months. As of April 5, 2012, the common stock of HAXS was quoted on OTC Link, had nine market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

3. Capital Mineral Investors, Inc. ("CMIV") (CIK No. 1221678) is a revoked Nevada corporation located in Las Vegas, Nevada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CMIV is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2008, which reported a net loss of \$194,306 for the prior nine months. As of April 5, 2012, the common stock of CMIV was quoted on OTC Link, had four market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

4. CardioVascular BioTherapeutics, Inc. ("CVBT") (CIK No. 1303497) is a Delaware corporation located in Las Vegas, Nevada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CVBT is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2008, which reported a net loss of \$4,683,000 for the prior nine months. As of April 5, 2012, the common stock of CVBT was quoted on OTC Link, had sixteen market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

5. 1st Centennial Bancorp ("FCEN") (CIK No. 1097081) is a California corporation located in Redlands, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). FCEN is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2008, which reported a net loss of \$19,767,000 for the prior nine months. On March 25, 2009, FCEN filed a Chapter 7 petition in the U.S. Bankruptcy Court for the Central District of California, which was still pending as of April 5, 2012. As of April 5, 2012, the common stock of FCEN was quoted on OTC Link, had nine market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

6. As discussed in more detail above, all of the Respondents are delinquent in their periodic filings with the Commission, have repeatedly failed to meet their obligations to file timely periodic reports, and failed to heed delinquency letters sent to them by the Division of Corporation Finance requesting compliance with their periodic filing obligations or, through their failure to maintain a valid address on file with the Commission as required by Commission rules, did not receive such letters.

7. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports, and Rule 13a-13 requires domestic issuers to file quarterly reports.

8. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate for the protection of investors that public administrative proceedings be instituted to determine:

A. Whether the allegations contained in Section II hereof are true and, in connection therewith, to afford the Respondents an opportunity to establish any defenses to such allegations; and,

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of each class of securities registered pursuant to Section 12 of the Exchange Act of the Respondents identified in Section II hereof, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents.

IV.

IT IS HEREBY ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice [17 C.F.R. § 201.110].

IT IS HEREBY FURTHER ORDERED that Respondents shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If Respondents fail to file the directed Answers, or fail to appear at a hearing after being duly notified, the Respondents, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents, may be deemed in default and the proceedings may be determined against it upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means permitted by the Commission Rules of Practice.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 120 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice [17 C.F.R. § 201.360(a)(2)].

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Elizabeth M. Murphy
Secretary


By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

April 13, 2012

IN THE MATTER OF
CITY CAPITAL CORPORATION

File No. 500-1

ORDER OF SUSPENSION
OF TRADING

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of City Capital Corporation ("City Capital"). Questions have also arisen regarding the accuracy and adequacy of publicly available information about City Capital because it has not filed any periodic reports since its delinquent 2009 Form 10-K, filed June 15, 2010.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed company.

THEREFORE, IT IS ORDERED, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed company is suspended for the period from 9:30 a.m. EDT on April 13, 2012 and terminating at 11:59 p.m. EDT on April 26, 2012.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: **Jill M. Peterson**
Assistant Secretary

*Commissioner Aguilar
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 66814 / April 16, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14847

In the Matter of

Peter J. Bottini,
Phillip J. Hoeh, and
Kevin E. Strine,

Respondents.

ORDER INSTITUTING CEASE-AND-
DESIST PROCEEDINGS PURSUANT TO
SECTION 21C OF THE SECURITIES
EXCHANGE ACT OF 1934, MAKING
FINDINGS, AND IMPOSING A CEASE-
AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Peter J. Bottini ("Bottini"), Phillip J. Hoeh ("Hoeh"), and Kevin E. Strine ("Strine") (collectively, "Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the "Offers") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), as set forth below:

26 of 44

III.

On the basis of this Order and Respondents' Offers, the Commission finds¹ that:

Summary

These proceedings arise out of optionsXpress, Inc.'s ("optionsXpress") violation of the delivery and close-out requirements of Regulation SHO of the Exchange Act ("Reg. SHO"). From at least October 2008 to March 18, 2010, optionsXpress failed to satisfy its close-out obligations under Rules 204 and 204T of Reg. SHO by repeatedly engaging in a series of transactions, known as "resets," which gave the appearance of having purchased shares to close-out an open failure-to-deliver position while in fact not doing so.

The resets were accomplished by optionsXpress facilitating its customers buying shares and simultaneously selling deep in-the-money call options that were essentially the economic equivalent of selling shares short. The purchase of shares created the illusion that the firm had satisfied the close-out obligation; however, the shares that were ostensibly purchased in the reset transactions were never actually delivered to the purchasers because on the same day the shares were "purchased," the deep in-the-money calls were exercised, thereby effectively reselling the shares. These paired reset transactions were not bona fide purchases because their purpose was to perpetuate an open short position while giving the illusion of satisfying the delivery and close-out requirements of Reg. SHO.

During the relevant period, optionsXpress and several customers routinely engaged in these paired reset transactions in a number of securities, including Sears Holding Corporation, American International Group, Chipotle Mexican Grill, Inc., Joseph A. Bank Clothiers, Inc. and Mead Johnson Nutrition Company. As a result, optionsXpress and its customers had continuous failures to deliver in these and other securities that persisted for months, thereby undermining the purpose of Rules 204 and 204T of Reg. SHO.

From at least October 2008 to March 18, 2010, Respondents Bottini, Hoeh, and Strine were a cause of optionsXpress' violations of Rules 204 and 204T of Reg. SHO as they knew or should have known that their acts or omissions as described below would contribute to these violations.

Respondents

1. Peter Bottini, age 42, is a resident of Chicago, IL and is in charge of trading and customer service for optionsXpress. He holds Series 3, 4, 7, 24, 55, and 63 licenses.

2. Phillip Hoeh, age 43, is a resident of Glen Ellyn, IL and joined optionsXpress as its Chief Compliance Officer on March 19, 2009. He holds Series 4, 7, 8, 14, 24, 27, 55, and 63 licenses.

¹ The findings herein are made pursuant to Respondents' Offers of Settlement and are not binding on any other person or entity in this or any other proceeding.

3. Kevin Strine, age 48, is a resident of Round Lake, IL and is the Vice President of Compliance at optionsXpress. He reported directly to Hoeh and is a lawyer licensed in Wisconsin and holds Series 4, 7, 24, and 63 licenses.

Other Relevant Entity

4. optionsXpress is a Delaware corporation with a principal place of business in Chicago, IL. optionsXpress is a self-clearing, retail, on-line broker specializing in options and futures. It is a broker-dealer registered with the Commission and with 53 states and territories. It is also a member of the Financial Industry Regulatory Authority ("FINRA"), the Chicago Board Options Exchange ("CBOE"), and various stock exchanges. optionsXpress was a wholly-owned subsidiary of optionsXpress Holdings, Inc. until September 1, 2011, when it became a wholly-owned subsidiary of The Charles Schwab Corporation.

The Regulatory Framework of Regulation SHO

5. Reg. SHO Rules 204 and 204T deal with the requirement to close-out failures to deliver. Rule 204T became effective on September 18, 2008 and Rule 204 became effective on July 31, 2009. Rules 204 and 204T require participants of a registered clearing agency to deliver equity securities to a registered clearing agency when delivery is due; that is, by settlement date. Settlement date is generally three days after the trade date ("T+3").² optionsXpress is a participant of a registered clearing agency.

6. Rules 204 and 204T were adopted, among other things, to address abusive "naked" short selling and failures to deliver. Abusive "naked" short selling generally refers to selling short without having stock available for delivery and failing to deliver stock within the standard three-day settlement cycle. For short sales, if the participant does not deliver securities by T+3 and has a failure-to-deliver position at the clearing agency, it must take affirmative action to close-out the failure-to-deliver position by purchasing or borrowing securities of like kind and quantity by no later than the beginning of regular trading hours on the settlement day following the settlement date ("T+4").

7. A participant of a clearing agency does not fulfill its close-out requirements under Rules 204 and 204T if it enters into an arrangement with another person to purchase or borrow securities as required, and the participant knows or has reason to know that the other person will not deliver securities in settlement of the purchase or borrow. Moreover, where a participant of a clearing agency subject to the close-out requirement purchases or borrows securities on the applicable close-out date and on that same date engages in sale transactions that can be used to re-establish or otherwise extend the participant's fail position, and for which the participant is unable to demonstrate a legitimate economic purpose, the participant will not be deemed to have satisfied the close-out requirement.

² The three-day settlement period generally applies to most exchange-traded security transactions, including stocks, bonds, municipal securities, electronically-traded funds, and limited partnerships. Government securities and stock options settle on the next settlement day following the trade (or T+1).

The Violative Trading Activity

8. There were six self-directed customer accounts at optionsXpress (the "Customers") engaged in reverse conversions and similar options trading strategies starting no later than October 2008. In these transactions, the Customers simultaneously entered into the sale of a put and purchase of call with identical strike prices and expiration dates creating a synthetic long position. The Customers would also hedge their synthetic long position by creating a short position, generally, by selling deep-in-the-money calls.³ The synthetic long and short positions were for an equal number of shares/contracts and thus, through this set of transactions, the Customers eliminated directional risk in the stock price.

9. The deep-in-the-money calls sold to create the short position referenced hard-to-borrow securities and were frequently exercised. After the options were exercised and assigned to the Customers, the Customers had a synthetic long position and a short stock position for which they (and optionsXpress) were required to deliver shares by T+3. However, neither optionsXpress nor the Customers delivered the shares by T+3 thus creating a failure-to-deliver position.

10. Instead of closing out the failure-to-deliver position and delivering the shares, optionsXpress and the Customers would give the appearance of closing out their fails by entering into a "buy-write", *i.e.*, they would simultaneously buy the shares they needed to cover the failure-to-deliver position and write (sell) standard deep-in-the-money calls for an equivalent number of shares.⁴ The newly written deep-in-the-money calls were generally exercised the same day they were sold (and thus were assigned to the Customers later that same day) putting the Customers back in their original short position, continuing the failure-to-deliver position, and causing them to enter into another buy-write the following day. As a result, optionsXpress maintained a net short position at the end of each day.

11. optionsXpress and the Customers knew, or should have known, that most, if not all, the calls that were sold as part of the buy-writes would be exercised and assigned on the same day they were sold, resulting in shares not being delivered on settlement. Thus, optionsXpress and the Customers knew, or should have known, that these transactions would result in failures-to-deliver.

12. The buy-writes continued on a daily basis until the original synthetic long position was unwound or expired. As a result, optionsXpress had a continuous negative (or failure-to-deliver) position in a number of securities in the National Securities Clearing Corporation's Continuous Net Settlement system for extended periods of time.

³ An option that is "deep in-the-money" has a strike price that is far below (in the case of a call option) or far above (in the case of a put) the market price for the given security. Selling deep-in-the-money calls is essentially the economic equivalent of selling shares unless the stock price drops precipitously and therefore approaches the strike price.

⁴ To enter into the buy-write, the Customers paid a certain amount, generally between 1 and 2 pennies per share.

The Regulatory Guidance of Regulation SHO

13. In 2003, the SEC issued guidance to “disabuse traders of any notion” that a married stock/option trade designed to give the appearance of a long position could be used to circumvent regulatory requirements. SEC Interpretive Rel. 34-48795 (Nov. 21, 2003). In July 2007, the American Stock Exchange (“AMEX”) fined several entities and individuals for violating Reg. SHO Rule 203 based on trading activity similar to what the Customers were doing. *In the Matter of Scott H. Arenstein and SBA Trading, LLC* (July 20, 2007); *In the Matter of Brian A. Arenstein and ALA Trading, LLC* (July 20, 2007). In the *Arenstein* cases, the respondents engaged in a series of reset transactions, mostly married puts, but also some buy-writes, that employed short-term options to circumvent the close-out obligation of Rule 203.

14. Following the release of the *Arenstein* cases, CBOE sent a regulatory circular to its members, including optionsXpress, “strongly cautioning” its members that transactions “pairing the close-out with one or more short-term options positions that are utilized to reverse that close-out are deemed improper reset arrangements that do not satisfy the Regulation SHO close-out requirement.” CBOE Regulatory Circular RG07-87 (Aug. 9, 2007). “Short sales of threshold securities (that result in fails to deliver) paired with one or more short-term option transactions, for example, including, but not limited to, reverse conversions and deep in-the-money long call/short stock, are highly indicative of transactions that may be assisting a contra-party faced with a close-out obligation in creating the appearance of a bona-fide stock purchase.” *Id.* (emphasis added). CBOE then noted that while its examples involved market-makers, “the same analysis would apply to similar arrangements between any market participants.” *Id.* CBOE closed by recognizing “that transactions matching options with stock may be used as part of a legitimate trading strategy, and we do not want to discourage their use for that purpose.” *Id.*

15. In August 2009, the SEC brought settled enforcement actions against several entities and individuals regarding similar options trading and violations of Rule 203. *In the Matter of Hazan Capital Management, LLC and Steven M. Hazan*, Exchange Act Release No. 34-60441 (Aug. 5, 2009); *In the Matter of TJM Proprietary Trading, LLC, Michael R. Benson, and John T. Burke*, Exchange Act Release No. 34-60440 (Aug. 5, 2009). In the *Hazan* and *TJM* cases, the respondents engaged in a series of sham reset transactions that employed short-term paired stock and options positions (married puts and/or buy-writes using both FLEX options and standard exchange-traded options) to circumvent the close-out obligations of Rule 203. Three months later, the SEC brought settled enforcement actions against several other entities regarding similar trading and violations of Reg. SHO. *In the Matter of Rhino Trading, Fat Squirrel Trading Group, Damon Rein, and Steven Peter*, Exchange Act Release No. 34-60941 (Nov. 4, 2009).

Bottini, Hoeh, and Strine Knew or Should Have Known that the Trading was Problematic

16. On October 15, 2008, less than a month after the Commission issued its emergency order putting Rule 204T into effect, one of optionsXpress’ traders sent an internal email which described the trading: “the customer has short positions on hard to borrow stocks where the customer has to buy in every day. Our customer is buying back the short and writing in the money calls which are assigned on a daily basis.” Two weeks later, the firm’s Clearing Department raised concerns that the stock was not being bought in at market open. Strine replied back to the Clearing

Department and the traders telling them: "According to the rules, they need to be closed out at the opening. The industry is pushing back on this, and requesting the [whole] day, but as it is now, we need to cover at the open."

17. The following month, the Clearing Department informed Bottini of the "vicious cycle" that the buy-writes were causing: "Since we have an open CNS fail and as soon as we buy to cover, the customer shorts a call which gets assigned immediately, we are in a vicious cycle."

18. In mid-November 2008, Bottini sent an email to the Clearing Department about an article in *The Wall Street Journal* describing the trading activity in the *Arenstein* cases and noting that FINRA had several cases involving this activity. Bottini wrote: "There is an article in the WSJ about how short sellers in [Sears] are using options to circumvent the SEC cover rule. I think we need to review this." The Clearing Department emailed back: "[The Customers are] definitely doing this."

19. In July 2009, Bottini asked one of the exchanges for a fee modification for the buy-writes. As part of the request, Bottini noted that "[w]e do have some larger retail clients that have developed some 'predictable' strategies/behavior." According to Bottini, the market makers using the exchange had begun to anticipate the buy-writes – meaning that the counterparties to the buy-writes were anticipating that the buy-writes would occur each day. Due to the fees, Bottini and optionsXpress worked to find another market for the buy-writes.

20. On August 5, 2009, the SEC instituted the *Hazan* and *TJM* settled actions, which were reviewed by Hoch and Strine. Strine immediately recognized the similarities between the conduct in those actions and the Customers' trading, but advised that there were distinguishing factors and the trading continued.

21. The following day, a trader at optionsXpress notified the Customers that "[u]nfortunately we will need to change how buy ins are covered. . . . This means once we get the buy in lists, the shares will need to be covered immediately in the morning. I apologize for this unfortunate change, but the SEC won't budge on these rules." In response to a question from one of the Customers, a trader at optionsXpress elaborated: "Compliance has also notified me that this could change further by having us place the covers in your account at the market, and have the customer place any option orders." Nonetheless, and despite Strine's advice in October 2008, optionsXpress was still not placing the buy-in orders at market open. In fact, optionsXpress did not consistently execute the buy-writes at or near market open.

"Perpetual" Buy-In Procedures

22. On August 10, 2009, one of optionsXpress' traders emailed Strine with concerns about the short sale process: "Not sure what Phil [Hoch] brought up on Friday, but we're still getting the buy in report pretty late in the morning." He then raised concerns about optionsXpress' stock borrowing process noting that the "SEC is really cracking down on this." Later the same day the trader noted that buy-ins were another issue: "I know we're the traders over here, but it seems we're giving them too much leeway with these buy writes instead of covering them on the short shares first." Strine responded: "I agree that we need to tighten up our procedures on the buy-ins."

To do this, we will no longer allow customers to conduct their own buys. We will process the buy-in for each account at the open." The decision to no longer allow customers to conduct their own buy-ins was made by a group of people that included Hoeh and Bottini.

23. On August 19, 2009, the optionsXpress Compliance Department instituted new buy-in procedures. Strine wrote the new procedures at the direction of Hoeh. The decision to implement the new procedures was made by a group including Hoeh and Bottini. The new procedures called for two buy-in lists instead of one: a regular list and a list of failure-to-deliver positions where "the fail is continuously open due to customers being assigned in the money short calls," also known internally as the "perpetual," "chronic," or "rolling fails" list. There were different procedures for the two lists.

24. According to Hoeh, a "perpetual fail" was "a fail where the issue, specific issue or security is failing a number of days . . . to me it would be if firms didn't close out the fail and left it alone and it would be a perpetual fail if they didn't meet their close-out obligations and let that fail continue." He also noted that "the rule requires us to reduce that fail to deliver, so you would violate Rule, you know, 203 and 204 if you had a fail and you didn't close it out within the required time frames."

25. After the new procedures were issued, Bottini followed up with the trading desk saying: "Did we contact our largest clients?" An optionsXpress trader responded: "Definitely, spent a lot of time on the phone with [the Customers] yesterday." The traders communicated to the Customers that: "Basically they have told us our practices our [sic] not consistent with the rules, and that changes must be made."

26. On August 20, 2009, one of the optionsXpress traders asked Strine and Hoeh if they could continue to place the buy-writes. Hoeh responded citing Reg. SHO and the Rule 204 issuing release: "we . . . must execute the buy-in on the open for the specified amount to cover the fail. The customer then can do whatever other transaction they want but it is a separate transaction." Hoeh also reminded the trader that "[i]t is expected that buy-ins are occurring at or close to the open, within the first 30 minutes of trading has been accepted to be the 'beginning' of trading hours." Strine also responded: "the answer is absolutely not. We do not want to be an active party in the call transactions. We are fulfilling our obligation to issue the buy-in. If we process the buy-write, regulators could consider the buy-ins as sham transactions." Strine forwarded his response to Hoeh adding: "I believe that if we do the buy-write for them, auditors will consider them sham transactions as the SEC did with the two fined prop trading institutions [*Hazan* and *TJM*]."

27. After receiving the guidance from Hoeh and Strine, the optionsXpress trader told the other traders: "Compliance is telling us that buy-writes can no longer be used to cover a buy-in. We must place the orders separately. Since this will ultimately shut down these orders, we can place them another way. . . . Execution will put in market orders to cover the shares at the open. All we require the customer to do is call in and place a not held option order with execution. The outcome will basically be the same, but two separate orders will be in customers [sic] account, which the SEC wants to see."

28. Following the issuance of the new procedures, the traders generally entered the buy-in order at or before market open, but marked the order as "do not send to exchange"—meaning that the order was not automatically routed to an exchange for execution. Instead, the traders paired the stock order with the option order and called a floor broker to manually place the buy-write later in the day. This change did not substantively alter the buy-write procedures except the Customers contacted optionsXpress earlier in the day. According to Bottini, the buy-writes would not be executed at market open because they were being sent to a floor broker on a best efforts basis.

29. Sometime between August 20, 2009 and September 23, 2009, Bottini suggested, and Hoeh agreed, that the firm's best execution obligation required optionsXpress to combine the buy-in order with the sale of calls as a buy-write. According to Hoeh, the final decision to allow the Customers' buy-writes to continue was made by himself, Bottini, and optionsXpress' Chief Financial Officer ("CFO"). According to Hoeh and Strine, the best-execution obligation was the primary reason that optionsXpress determined that the buy-writes were permissible under Reg. SHO.

Communications with the Regulators

30. On September 23, 2009, optionsXpress received a letter of caution from CBOE. CBOE noted that optionsXpress conducted buy-ins on the morning of T+4, but found that the firm called certain customers prior to the execution of those buy-ins, which was a deviation from optionsXpress' procedures. That deviation allowed the Customers to buy themselves in with a buy-write. In response to CBOE's concerns, optionsXpress began emailing the Customers, instead of calling them. Otherwise, there were no changes to the procedures and optionsXpress continued to execute the Customers' buy-writes.

31. On that same day, an optionsXpress trader forwarded a copy of the *Hazan* order to Bottini, citing the language about sham transactions. The trader then stated: "I am not placing any orders today." Bottini responded minutes later: "Please execute the buy ins and customer orders today. Compliance has reviewed and is not convinced this applies. They have asked our regulator for an opinion and have not received it." Later that day, Strine emailed Hoeh, Bottini, the CFO, and other senior executives regarding *Hazan*: "We addressed this issue back in August when the SEC issued its findings in these cases. Although I see issues with what our customers are doing, I pointed out distinguishing factors in my response back in August. . . . Additionally, we have responded to four inquiries regarding this issue: one from CBOE and three from FINRA. While the FINRA issues are still ongoing, CBOE didn't seem to have any issues with our response." The Clearing Department also contacted Strine noting that Strine and Hoeh had previously addressed the issue by saying buy-writes were not allowed: "Don't want to get anyone in trouble, but somewhere down the road this is going to bite us."

32. On September 24, 2009, Hoeh, Strine, the CFO, and optionsXpress' in-house counsel called FINRA to ask questions about the Customers' trading. FINRA said it would not discuss the issue because of its ongoing inquiry. The same day, the same four individuals (including Hoeh and Strine) called the SEC's Division of Trading and Markets ("Trading & Markets"). According to optionsXpress, Trading & Markets told optionsXpress to "keep doing

what you're doing—keep closing out” and that Trading & Markets would get back to optionsXpress on the best execution question.

33. After the call, upon further investigation, Trading & Markets learned additional facts that optionsXpress did not disclose on the call, including that FINRA had an open inquiry and that the customers were using deep-in the-money calls to circumvent Reg. SHO. As a result, on October 2, 2009, Trading & Markets called optionsXpress and spoke to its in-house counsel and the CFO, telling them that the SEC declined to get involved and that it could provide optionsXpress with “no comfort.” optionsXpress’ in-house counsel informed Bottini, Hoeh, and Strine of the call.

34. After the October 2, 2009 call with Trading & Markets, Hoeh, Strine, the CFO, and in-house counsel called FINRA. optionsXpress told FINRA that it had received a call from the SEC, and that the SEC had declined to be involved. optionsXpress also said that it was at a loss about what to do and was seeking guidance on the activity. FINRA told optionsXpress that if it wanted guidance, it should send a request in writing to FINRA’s general counsel or the SEC. optionsXpress did not submit a written request for guidance to either the SEC or FINRA’s general counsel. Instead, optionsXpress continued executing the Customers’ buy-writes.

35. Two weeks after the October 2, 2009 call, Strine emailed several optionsXpress employees, including Hoeh, about another Reg. SHO issue and noted that “[w]e are already under heavy scrutiny from regulators on our short sale practices, and this problem could push us over the edge.”

36. On December 30, 2009, the SEC Division of Enforcement made its first request for information to optionsXpress. On January 14, 2010, Hoeh, Strine, the CFO, and in-house counsel had a call with FINRA staff. During the call, FINRA staff expressed concern that the buy-ins did not result in a net flat or long position at the end of the day. Despite the expression of concern from an employee of FINRA, optionsXpress continued to allow the buy-writes.

37. On February 17, 2010, optionsXpress and all of the Customers received subpoenas from the SEC. On February 23, 2010 and March 4, 2010, SEC staff told optionsXpress that they had “grave concerns” about the trading. The buy-writes continued.

The Trading Finally Ceases

38. On March 9, 2010, Bottini, Hoeh, and the CFO called CBOE, asking it to advocate on optionsXpress’ behalf in connection with the SEC investigation. CBOE instead referred optionsXpress to the CBOE’s regulatory circulars which discussed sham transactions and the *Arenstein* cases. The same day, optionsXpress decided to halt the trading, but allowed it to continue until the March options expiration. The decision to halt the trading was made by Bottini and Hoeh.

39. As a result of the conduct described above, from at least October 2008 to March 2010, optionsXpress violated Rules 204 and 204T of Exchange Act Reg. SHO by failing to satisfy its close-out obligations.

Violations

Bottini Caused optionsXpress' Violations of Reg. SHO

40. As a result of the conduct described above, Bottini was a cause of optionsXpress' violations of Rules 204 and 204T of Exchange Act Reg. SHO. Bottini knew or should have known that his acts or omissions as described above would contribute to these violations.

Hoeh Caused optionsXpress' Violations of Reg. SHO

41. As a result of the conduct described above, Hoeh was a cause of optionsXpress' violations of Rules 204 and 204T of Exchange Act Reg. SHO. Hoeh knew or should have known that his acts or omissions as described above would contribute to these violations.

Strine Caused optionsXpress' Violations of Reg. SHO

42. As a result of the conduct described above, Strine was a cause of optionsXpress' violations of Rules 204 and 204T of Exchange Act Reg. SHO. Strine knew or should have known that his acts or omissions as described above would contribute to these violations.

Undertakings

43. Respondents Bottini, Hoeh, and Strine shall cooperate fully with the Commission in any and all investigations, litigations or other proceedings relating to or arising from the matters described in the Order.

44. In connection with such cooperation, Respondents Bottini, Hoeh, and Strine shall (a) produce, without service of a notice or subpoena, any and all non-privileged documents and other information requested by the Commission's staff; (b) be interviewed by the Commission's staff at such times as the staff reasonably may request and to appear and testify without service of a notice or subpoena in such investigations, litigations, hearings or trials as may be requested by the Commission's staff; and (c) in connection with any testimony of the Respondents to be conducted at deposition, hearing or trial pursuant to a notice or subpoena, agree that any such notice or subpoena for Respondents' appearance and testimony may be served by regular mail on their respective counsel.

45. In determining whether to accept the Respondents' Offers, the Commission has considered these undertakings.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in the Respondents' Offers.

Accordingly, it is hereby ORDERED that:

Pursuant to Section 21C of the Exchange Act, Respondents Bottini, Hoeh, and Strine cease and desist from committing or causing any violations and any future violations of Rule 204 of Exchange Act Regulation SHO.

By the Commission.

Elizabeth M. Murphy
Secretary

Kevin M. O'Neill
By: Kevin M. O'Neill
Deputy Secretary

*Commissioner Aguilar
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9313 / April 16, 2012

SECURITIES EXCHANGE ACT OF 1934
Release No. 66815 / April 16, 2012

INVESTMENT COMPANY ACT OF 1940
Release No. 30034 / April 16, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14848

In the Matter of

optionsXpress, Inc.,
Thomas E. Stern, and
Jonathan I. Feldman,

Respondents.

ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-
AND-DESIST PROCEEDINGS
PURSUANT TO SECTION 8A OF THE
SECURITIES ACT OF 1933,
SECTIONS 15(b) AND 21C OF THE
SECURITIES EXCHANGE ACT OF
1934, AND SECTION 9(b) OF THE
INVESTMENT COMPANY ACT OF
1940 AND NOTICE OF HEARING

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against optionsXpress, Inc. ("optionsXpress") and Thomas E. Stern ("Stern"). Further, the Commission also deems it appropriate and in the public interest that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act against Jonathan I. Feldman ("Feldman").

27 of 44

II.

After an investigation, the Division of Enforcement alleges that:

A. SUMMARY

1. This case involves a complex short selling scheme to profit by circumventing the delivery requirements of Regulation SHO of the Exchange Act ("Reg. SHO"). From at least October 2008 to March 18, 2010, optionsXpress, Inc. ("optionsXpress"), a wholly-owned subsidiary of The Charles Schwab Corporation ("Schwab"), failed to satisfy its close-out obligations under Rules 204 and 204T of Reg. SHO by repeatedly engaging in a series of sham transactions, known as "resets," designed to give the appearance of having purchased shares to close-out an open failure-to-deliver position while in fact not doing so.

2. Further, one of optionsXpress' customers, Jonathan I. Feldman ("Feldman"), committed fraud in violation of Section 10(b) of the Exchange Act and Rules 10b-21 and 10b-5 thereunder and Section 17(a) of the Securities Act when he sold options knowing that he had no intention of fulfilling his obligations under those contracts. optionsXpress and its Chief Financial Officer ("CFO") aided and abetted Feldman in this fraud.

3. The sham resets were accomplished by optionsXpress facilitating its customers buying shares and simultaneously selling deep in-the-money call options that were essentially the economic equivalent of selling shares short. The purchase of shares created the illusion that the firm had satisfied the close-out obligation; however, the shares that were ostensibly purchased in the reset transactions were never actually delivered to the purchasers because on the same day the shares were "purchased," the deep in-the-money calls were exercised, thereby effectively reselling the shares.

4. These paired reset transactions were not bona fide purchases because their purpose was to perpetuate an open short position while giving the illusion of satisfying the delivery and close-out requirements of Reg. SHO. These sham transactions thus allowed optionsXpress and its customers to engage in what amounts to a stock-kiting scheme that deprived true stock purchasers of the benefits of ownership.

5. During the relevant period, optionsXpress and several customers, including Feldman, routinely engaged in these paired sham transactions in a number of securities, including Sears Holding Corporation, American International Group, Chipotle Mexican Grill, Inc., Joseph A. Bank Clothiers, Inc. and Mead Johnson Nutrition Company. As a result, optionsXpress and its customers had continuous failures to deliver in these and other securities that persisted for months, thereby undermining the purpose of Rules 204 and 204T of Reg. SHO.

6. These sham reset transactions also impacted the market for the issuers. For example, from January 1, 2010 to January 31, 2010, the customers who engaged in the above-described activity, including Feldman, accounted for on average 47.9% of the

daily trading volume in Sears.

7. In 2009 alone, the six optionsXpress customer accounts in total purchased approximately \$5.7 billion worth of securities and sold short approximately \$4 billion of options. In 2009, Feldman himself purchased at least \$2.9 billion of securities and sold short at least \$1.7 billion of options through his account at optionsXpress.

B. RESPONDENTS

8. optionsXpress is a Delaware corporation with a principal place of business in Chicago, IL. optionsXpress is a self-clearing, retail, on-line broker specializing in options and futures. It is a broker-dealer registered with the Commission. It is also a member of the Financial Industry Regulatory Authority ("FINRA"), the Chicago Board Options Exchange ("CBOE"), various stock exchanges, and is registered with 53 states and territories. optionsXpress was a wholly-owned subsidiary of optionsXpress Holdings, Inc. ("Holdings") until September 1, 2011, when it became a wholly-owned subsidiary of Schwab.

9. Stern, 66, of Chicago, IL, was the Chief Financial Officer of optionsXpress; the Chief Administrative Officer of Holdings; the President and Chief Executive Officer, Chief Compliance Officer and Director of optionsXpress International, Inc.; the Chief Financial Officer and Director of brokersXpress, LLC; and the Chief Financial Officer, Secretary, Director, and Chief Compliance Officer of OX Trading, LLC. He is a board member of the Options Clearing Corporation ("OCC"). Stern holds himself out as an options industry expert. He holds Series 3, 4, 7, 24, 27, and 63 licenses.

10. Feldman, 55, of Baltimore, MD, was a retail customer of optionsXpress. In June 2010, the Office of Thrift Supervision fined Feldman for making material misrepresentations and/or concealing material facts as part of a scheme to defraud a federally-insured financial institution. He is a Senior Vice President at a regional savings bank.

C. REGULATION SHO

11. Rules 203, 204, and 204T of Reg. SHO deal with the requirement to close-out failures to deliver. Rule 204T became effective on September 18, 2008 and Rule 204 became effective on July 31, 2009. 17 C.F.R. § 242.204.

12. Rules 204 and 204T require participants of a registered clearing agency to deliver equity securities to a registered clearing agency when delivery is due; that is, by settlement date. Settlement date is generally three days after the trade date ("T+3"). optionsXpress is a participant of a registered clearing agency.

13. For short sales, if the participant does not deliver securities by T+3 and it has a failure-to-deliver position at the clearing agency, it must purchase or borrow securities of

like kind and quantity to close out the failure-to-deliver position by no later than the beginning of regular trading hours on the settlement day following the settlement date ("T+4").

14. A participant of a clearing agency does not fulfill its requirements under Rules 204 and 204T if it enters into an arrangement with another person to purchase or borrow securities as required, and the participant knows or has reason to know that the other person will not deliver securities in settlement of the purchase or borrow. 17 C.F.R. § 242.204(f); 73 FR 61706, 61714-61715 n.78 (Oct. 17, 2008).

15. Where a participant of a clearing agency subject to the close-out requirement purchases or borrows securities on the applicable close-out date and on that same date engages in sale transactions that can be used to re-establish or otherwise extend the participant's fail position, and for which the participant is unable to demonstrate a legitimate economic purpose, the participant will not be deemed to have satisfied the close-out requirement. 74 Fed. Reg. 38266, 38272 n.82 (July 31, 2009).

16. To satisfy the close-out requirements under Rules 204 and 204T, a clearing broker must take affirmative action to close out the failure-to-deliver position by purchasing or borrowing securities. 73 Fed. Reg. at 61710-11.

17. In narrowly limited instances, Rules 204 and 204T provide credit for certain activity conducted by a broker-dealer prior to the occurrence of the fail. Under Rule 204's pre-fail credit provision, a broker-dealer can meet its close-out obligation by purchasing or borrowing securities after the trade date but no later than the end of regular trading hours on the settlement date of the transaction if (1) the purchase or borrow is bona fide; (2) the purchase or borrow is of a quantity of securities sufficient to cover the entire amount of the broker-dealer's failure to deliver; and (3) the broker-dealer can demonstrate that it has a net flat or net long position on its books and records on the day of the purchase or borrow. 17 C.F.R. § 242.204(e). Rule 204T contained a similar provision, however, the broker-dealer could not meet the requirements of the provision unless it purchased the shares. 17 C.F.R. § 242.204T(e).

18. Under Rule 10b-21 of the Exchange Act, it is a manipulative or deceptive device or contrivance for any person to submit an order to sell an equity security if such person deceives a broker or dealer, a participant of a registered clearing agency, or a purchaser about its intention or ability to deliver the security on or before the settlement date, and such person fails to deliver the security on or before settlement date.

19. Rule 10b-21 and Rules 204 and 204T were adopted, among other things, to address abusive "naked" short selling and failures to deliver. Abusive "naked" short selling generally refers to selling short without having stock available for delivery and failing to deliver stock within the standard three-day settlement cycle.

20. Sellers sometimes intentionally fail to deliver securities as part of a scheme to manipulate the price of a security, or possibly to avoid borrowing costs associated with

short sales, especially when the costs of borrowing stock are high. Failures to deliver, however, can negatively affect purchasers of stock by depriving them of the benefits of ownership, such as voting and lending, and create a misleading impression of the market for an issuer's stock.

D. ALLEGATIONS

The Violative Trading

21. Six customer accounts at optionsXpress, including Feldman ("the Customers"), engaged in reverse conversions and similar options trading strategies starting no later than October 2008.

22. To execute these strategies, the Customers simultaneously entered into the sale of a put and purchase of call with identical strike prices and expiration dates creating a synthetic long position. The Customers would also create a short position to hedge their synthetic long position. They generally did this by selling deep-in-the-money calls. The synthetic long position and the short position were for an equal number of shares/contracts. Through this set of transactions, the Customers eliminated directional risk in the stock price.

23. An option that is "deep in-the-money" has a strike price that is far below (in the case of a call option) or far above (in the case of a put) the market price for the given security.

24. The deep-in-the-money calls sold to create the short position referenced hard-to-borrow securities and were frequently exercised. After the options were exercised and assigned to the Customers, the Customers had a synthetic long position and a short stock position for which they (and optionsXpress) were required to deliver shares by T+3.

25. However, neither optionsXpress nor the Customers delivered the shares by T+3 thus creating a failure-to-deliver position.

26. Instead of delivering the shares, optionsXpress and the Customers would give the appearance of closing out their fails by entering into a "buy-write," *i.e.*, they would simultaneously buy the shares they needed to cover the failure-to-deliver position and write (sell) deep-in-the-money calls representing an equivalent number of shares.

27. optionsXpress, Stern, and the Customers knew, or were reckless in not knowing, that most, if not all, the calls that were sold as part of the buy-writes would be exercised and assigned on the same day they were sold, resulting in shares not being delivered on settlement. Thus, optionsXpress, Stern, and the Customers knew, or were reckless in not knowing, that these transactions would result in failures-to-deliver.

28. Selling deep-in-the-money calls is essentially the economic equivalent of

selling shares unless the stock price drops precipitously and therefore approaches the strike price.

29. To enter into the buy-write, the Customers paid a certain amount, generally between 1 and 2 pennies per share.

30. The newly written deep-in-the-money calls were generally exercised the same day they were sold (and thus were assigned to the Customers later the same day) putting the Customers back in their original short position, continuing the fails, and causing them to enter into another buy-write the following day. As a result, optionsXpress maintained a net short position at the end of each day.

31. The buy-writes continued on a daily basis until the original synthetic long position was unwound or expired. As a result, optionsXpress had a negative position in the National Securities Clearing Corporation's ("NSCC") continuous net settlement ("CNS") system for extended periods of time.

32. While the daily use of buy-writes gave the impression that optionsXpress was closing out the failures to deliver as required, optionsXpress and the Customers were simply kiting stock to maintain the naked short position.

33. Put another way, the buy-write was a matched order entered for the improper purpose of appearing to close out delivery fails without actually delivering the shares.

34. The transactions were profitable for the Customers because they: (i) sold the initial position "for a credit"; (ii) took no risk with respect to the change in the price of the stock and options that occurred over the life of the position; and (iii) did not incur the costs associated with borrowing or purchasing sufficient shares to make delivery on the short sale. optionsXpress received Commissions on the transactions.

35. The Customers received a net credit for their initial position because of a difference in the relative value of the put and the call. Normally, the price of the put and the call will be in parity; however, the stock associated with the options traded by the Customers was generally hard-to-borrow and therefore expensive to borrow. Because of this, the cost of borrowing the stock was incorporated into the price of the put. Thus, the value of the put was higher relative to the value of the call.

36. Due to the cost of borrowing such hard-to-borrow stocks, the increased price the Customers received for selling the put would have been completely offset by the cost of instituting and maintaining the stock position, had optionsXpress and the Customers complied with their delivery obligations. In order to comply with those obligations, they would have had to borrow or purchase shares of the underlying stock in order to close-out the failure-to-deliver position.

37. By engaging in the buy-writes and thus having a constant unsettled stock

position, optionsXpress and the Customers were able to evade the requirements of Reg. SHO at a relatively minimal cost, thereby maintaining the profitability of the trade.

38. By not delivering shares, optionsXpress and its Customers were extracting a profit at the expense of the true purchasers of the shares. There was no legitimate economic purpose to the buy-write transactions.

39. Indeed, the buy-writes standing alone were economically nonsensical because they cost the Customers money. Their purpose was to perpetuate a failure to deliver. This is not a legitimate economic purpose.

40. optionsXpress' website notes that under normal circumstances the chance to execute profitable reverse conversions is extremely limited: "Individual investors and most other off-the-floor traders don't have an opportunity to do conversions and reversals because price discrepancies typically only exist for a matter of moments. Professional option traders, on the other hand, are constantly on the lookout for these opportunities. As a result, the market quickly returns to equilibrium."

41. From at least October 7, 2008 to March 18, 2010, the Customers conducted the trading strategy described above in the following securities and time periods.

Security	Ticker	1st Buy-Write	Last Buy-Write
American International Group, Inc.	AIG	11/23/2009	1/6/2010
American International Group, Inc.	AIG	7/23/2009	10/7/2009
AMEDISYS Inc.	AMED	12/30/2009	2/17/2010
AMEDISYS Inc.	AMED	2/22/2010	3/18/2010
A-Power Energy Generation Systems, Ltd.	APWR	11/5/2009	11/10/2009
A-Power Energy Generation Systems, Ltd.	APWR	11/20/2009	11/30/2009
A-Power Energy Generation Systems, Ltd.	APWR	3/4/2010	3/10/2010
BioCryst Pharmaceuticals, Inc.	BCRX	11/16/2009	12/17/2009
Citigroup, Inc.	C	6/19/2009	7/24/2009
Chipotle Mexican Grill, Inc.	CMG	7/29/2009	8/12/2009
Chipotle Mexican Grill, Inc.	CMG	11/23/2009	12/17/2009
Chipotle Mexican Grill, Inc.	CMG	9/11/2009	11/12/2009
Chipotle Mexican Grill, Inc.	CMG	1/2/2009	1/21/2009
Chipotle Mexican Grill, Inc.	CMG	6/26/2009	7/21/2009
China Sky One Medical, inc.	CSKI	1/12/2010	2/17/2010
Direxion Daily Financial Bull 3X Shares	FAS	10/8/2009	11/23/2009
FUQI International, Inc.	FUQI	12/7/2009	1/11/2010
Greenhill & Co., Inc.	GHL	12/29/2008	2/23/2009
Greenhill & Co., Inc.	GHL	12/9/2008	12/17/2008
Interoil Corporation	IOC	4/3/2009	5/12/2009
Interoil Corporation	IOC	5/15/2009	5/22/2009

Jos. A. Bank Clothiers Inc.	JOSB	10/7/2008	10/21/2008
Jos. A. Bank Clothiers Inc.	JOSB	11/11/2008	11/20/2008
Jos. A. Bank Clothiers Inc.	JOSB	10/29/2008	11/5/2008
Jos. A. Bank Clothiers Inc.	JOSB	12/9/2008	12/12/2008
Jos. A. Bank Clothiers Inc.	JOSB	1/23/2009	2/24/2009
Life Partners Holdings, Inc.	LPHI	2/22/2010	3/18/2010
Life Partners Holdings, Inc.	LPHI	2/2/2010	2/12/2010
Mead Johnston Nutritional Company	MJN	11/27/2009	12/8/2009
Mead Johnston Nutritional Company	MJN	12/10/2009	12/18/2009
MannKind Corp.	MNKD	12/29/2009	2/17/2010
M&T Bank Corp.	MTB	7/2/2009	9/17/2009
M&T Bank Corp.	MTB	3/24/2009	4/14/2009
OSIRIS Therapeutics, Inc.	OSIR	10/5/2009	10/13/2009
RINO International Corporation	RINO	3/11/2010	3/17/2010
Origin Agritech Limited	SEED	12/1/2009	12/23/2009
Sears Holding Corporation	SHLD	10/7/2008	3/24/2009
Sears Holding Corporation	SHLD	4/8/2009	3/18/2010
Shanda Interactive Entertainment Ltd.	SNDA	7/21/2009	9/17/2009
Synaptics Inc.	SYNA	1/5/2010	2/17/2010
The Talbots Inc.	TLB	2/5/2010	3/18/2010
Texas Industries Inc.	TXI	8/17/2009	10/13/2009
Under Armour, Inc.	UA	7/10/2009	7/20/2009
Under Armour, Inc.	UA	7/30/2009	8/10/2009

42. As a result of the trading, optionsXpress had a continuous failure-to-deliver position in these securities for extended periods of time. For instance, optionsXpress had a failure-to-deliver position in Sears for at least 236 continuous settlement days during the 2009-2010 period. In total during the relevant period, optionsXpress had failures to deliver in at least 25 issuers at least 1,317 times.

43. During this period, the NSCC sent optionsXpress numerous notices of intention to buy-in for many of the securities listed above. NSCC sends these notices to the clearing broker with the oldest failure-to-deliver position when requested to do so by clearing brokers with failures to receive.

44. From at least June 2009 to March 18, 2010, Feldman conducted the trading strategy described above in at least the following securities and time periods:

Security	Ticker	1st Buy-Write	Last Buy-Write
American International Group, Inc.	AIG	7/29/2009	10/2/2009
AMEDISYS Inc.	AMED	1/7/2010	2/12/2010
AMEDISYS Inc.	AMED	2/23/2010	3/17/2009
A-Power Energy Generation Systems, Ltd.	APWR	11/5/2009	11/10/2009
A-Power Energy Generation Systems, Ltd.	APWR	11/20/2009	11/30/2009

A-Power Energy Generation Systems, Ltd.	APWR	3/4/2010	3/10/2010
Citigroup, Inc.	C	6/19/2009	7/24/2009
China Sky One Medical, inc.	CSKI	1/12/2010	2/17/2010
Mead Johnston Nutritional Company	MJN	11/27/2009	12/8/2009
Mead Johnston Nutritional Company	MJN	12/10/2009	12/18/2009
Life Partners Holdings, Inc.	LPHI	2/2/2010	2/12/2010
Life Partners Holdings, Inc.	LPHI	2/22/2010	3/18/2010
OSIRIS Therapeutics, Inc.	OSIR	10/5/2009	10/13/2009
Origin Agritech Limited	SEED	12/4/2009	12/17/2009
Sears Holding Corporation	SHLD	9/22/2009	11/12/2009
Sears Holding Corporation	SHLD	12/2/2009	3/9/2010
The Talbots Inc.	TLB	2/16/2010	3/18/2010
Texas Industries Inc.	TXI	8/20/2009	10/13/2009
Under Armour, Inc.	UA	7/10/2009	7/20/2009
Under Armour, Inc.	UA	7/30/2009	8/10/2009

45. The daily volume of the Customers' trades in some of these issuers was a significant portion of the securities' total daily trading volume. For example, between January 1, 2010 and January 31, 2010, the Customers traded between 832,100 shares and 1,603,000 shares of Sears Holding Corporation ("Sears") stock a day which accounted for between 15.6% and 62.2% of Sears' daily trading volume. On average in the month of January 2010, the Customers accounted for 47.9% of the daily trading volume in Sears.

46. In 2009, the Customers combined purchased a total of approximately \$5.7 billion worth of securities and sold short a total of approximately \$4 billion of options through their accounts at optionsXpress. In 2009, Feldman purchased at least \$2.9 billion of securities and sold short at least \$1.7 billion of options through his account at optionsXpress.

The Law Was Clear: The Reset Transactions Were Violations of Reg. SHO

47. In 2003, the SEC issued guidance to "disabuse traders of any notion" that a married stock/option trade designed to give the appearance of a long position could be used to circumvent regulatory requirements. SEC Interpretive Rel. 34-48795 (Nov. 21, 2003). "Even viewed in the most favorable light, these married put transactions appear to be nothing more than temporary stock lending agreements designed to give the appearance of a 'long' position in order to effect sales of stock in a manner that would otherwise be prohibited." *Id.* "The Commission has previously indicated that where transactions involve no market risk and serve no purpose other than rendering a person an owner of a security in order to accomplish indirectly what was prohibited directly, the activity may violate the federal securities laws." *Id.*

48. In July 2007, the American Stock Exchange ("AMEX") fined several entities and individuals for violating Reg. SHO Rule 203 based on trading activity similar to what the Customers were doing. *In the Matter of Scott H. Arenstein and SBA Trading,*

LLC (July 20, 2007); *In the Matter of Brian A. Arenstein and ALA Trading, LLC* (July 20, 2007). In the *Arenstein* cases, the respondents engaged in a series of reset transactions, mostly married puts, but also some buy-writes, that employed short-term options to circumvent the close-out obligation of Rule 203.

49. Following the release of the *Arenstein* cases, CBOE sent a regulatory circular to its members, including optionsXpress, "strongly cautioning" its members that transactions "pairing the close-out with one or more short-term options positions that are utilized to reverse that close-out are deemed improper reset arrangements that do not satisfy the Regulation SHO close-out requirement." CBOE Regulatory Circular RG07-87 (Aug. 9, 2007). "Short sales of threshold securities (that result in fails to deliver) paired with one or more short-term option transactions, for example, including, but not limited to, *reverse conversions and deep in-the-money long call/short stock*, are highly indicative of transactions that may be assisting a contra-party faced with a close-out obligation in creating the appearance of a bona-fide stock purchase." *Id.* (emphasis added). CBOE then noted that while its examples involved market-makers, "the same analysis would apply to similar arrangements between any market participants." *Id.*

50. The following year, CBOE reiterated its caution: "When accompanied by certain option transactions, stock purchases that are intended to effect close-outs of fail to deliver positions may bring into question whether a bona-fide purchase has occurred." The Circular also noted that while it was permissible to re-establish a short stock position the business day following a close-out, "if the underlying stock purchase was not bona-fide or did not completely satisfy any close-out requirement, a pre-borrow of stock is required for the subsequent establishment of the new short stock position on the following business day until the close-out is satisfied." CBOE Regulatory Circular RG08-63.

51. The CBOE regulatory circulars were reviewed by optionsXpress' compliance officers in connection with the trading.

52. On October 14, 2008, the SEC adopted Rule 204T noting that "the purchase of paired positions of stock and options that are designed to create the appearance of a bona fide purchase of securities but that are nothing more than a temporary stock lending arrangement would not satisfy Regulation SHO's close-out requirement." 73 Fed. Reg. at 61715 n.78.

53. In July 2009, when the SEC adopted Rule 204 it reiterated its guidance: "where a participant subject to the close-out requirement purchases or borrows securities on the applicable close-out date and on that same date engages in sale transactions that can be used to re-establish or otherwise extend the participant's fail position, and for which the participant is unable to demonstrate a legitimate economic purpose, the participant will not be deemed to have satisfied the close-out requirement." 74 Fed. Reg. at 38272 n.82.

54. Less than a month later, the SEC brought settled enforcement actions

against several entities and individuals regarding similar options trading and violations of Rule 203. *In the Matter of Hazan Capital Management, LLC and Steven M. Hazan*, Exchange Act Release No. 34-60441 (Aug. 5, 2009); *In the Matter of TJM Proprietary Trading, LLC, Michael R. Benson, and John T. Burke*, Exchange Act Release No. 34-60440 (Aug. 5, 2009). In the *Hazan* and *TJM* cases, the respondents engaged in a series of sham reset transactions that employed short-term paired stock and options positions (married puts and/or buy-writes using both FLEX options and standard exchange-traded options) to circumvent the close-out obligations of Rule 203.

55. Three months later, the SEC brought settled enforcement actions against several other entities regarding similar trading and violations of Reg. SHO. *In the Matter of Rhino Trading, Fat Squirrel Trading Group, Damon Rein, and Steven Peter*, Exchange Act Release No. 34-60941 (Nov. 4, 2009).

Red Flags

56. optionsXpress knew early on that the trading was problematic. On October 15, 2008, less than one month after the Commission issued its emergency order putting Rule 204T into effect, one of optionsXpress' traders sent an internal email which described the trading: "the customer has short positions on hard to borrow stocks where the customer has to buy in every day. Our customer is buying back the short and writing in the money calls which are assigned on a daily basis."

57. In late October 2008, the Clearing Department raised concerns that the stock was not being bought in at market open. The Compliance Department replied back to the Clearing Department and the traders telling them: "According to the rules, they need to be closed out at the opening. The industry is pushing back on this, and requesting the [whole] day, but as it is now, we need to cover at the open." Nonetheless, the Compliance Department did not subsequently follow up with the Clearing Department to ensure that failures to deliver were in fact bought in at market open.

58. The following month, the optionsXpress Clearing Department informed an optionsXpress senior officer of the "vicious cycle" that the buy-writes were causing: "Since we have an open CNS fail and as soon as we buy to cover, the customer shorts a call which gets assigned immediately, we are in a vicious cycle."

59. In mid-November 2008, the optionsXpress senior officer sent an email to the Clearing Department about a *Wall Street Journal* article describing the trading activity in the *Arenstein* case and noting that the FINRA had several cases involving this activity: "There is an article in the WSJ about how short sellers in [Sears] are using options to circumvent the SEC cover rule. I think we need to review this." The Clearing Department emailed back: "[The Customers are] definitely doing this."

60. The Clearing Department also raised its concerns to the Compliance Department noting that the trading was "suspicious." The Compliance Department reached out to the trader who executed the buy-writes and he explained the process again:

"What he's doing is short covering on hard to borrow stock. It's cheaper for him to do the deep in the money buy write and get assigned the next day than to put on a married put."

61. Despite this and other indications that optionsXpress was aware of the Customers' trading strategy, optionsXpress told FINRA in an August 10, 2009 letter that "OXPS did not know—and could not know—the customers' motive for selling calls. . . . We do not know, and cannot speculate, as to the motive for the strategy employed by our customers. Therefore, although maintenance of a short position in GHL may have been a result of the customers' actions, OXPS does not know the customers' motives during the review period."

62. Starting in November 2008, CBOE began asking optionsXpress for information related to its Reg. SHO compliance. On February 26, 2009, CBOE notified optionsXpress that it was investigating the trading to determine whether SEC Rule 204T had been violated. Stern, who functioned as optionsXpress' primary regulatory liaison, was also involved in the response to CBOE's investigation and reviewed the Customers' trading.

63. In May 2009, FINRA initiated its first investigation related to the activity described above.

64. In July 2009, optionsXpress asked an exchange for a fee modification for the buy-writes. As part of the request, an optionsXpress' senior officer noted that "[w]e do have some larger retail clients that have developed some 'predictable' strategies/behavior."

65. According to the optionsXpress' senior officer, the market makers using the exchange had begun to anticipate the buy-writes – meaning that the counterparties to the buy-writes were anticipating that the buy-writes would occur each day. Because of the fees at the exchange, optionsXpress worked to find another market for the buy-writes.

optionsXpress Institutes a Policy for "Perpetual" Buy-Ins

66. On August 5, 2009, the SEC instituted the *Hazan* and *TJM* actions. The following day, a trader at optionsXpress notified the Customers that "[u]nfortunately we will need to change how buy ins are covered. . . . This means once we get the buy in lists, the shares will need to be covered immediately in the morning. I apologize for this unfortunate change, but the SEC won't budge on these rules."

67. In response to a question from Feldman, a trader at optionsXpress elaborated: "Compliance has also notified me that this could change further by having us place the covers in your account at the market, and have the customer place any option orders."

68. Despite the Compliance Department's advice in 2008 discussed above in

paragraph 57, optionsXpress was still not placing the buy-in orders at market open. In fact, optionsXpress never consistently executed the buy-writes at or near market open.

69. On August 10, 2009, one of optionsXpress' traders emailed the Compliance Department with concerns about the short sale process: "[W]e're still getting the buy in report pretty late in the morning." He then raised concerns about optionsXpress' stock borrowing process noting that the "SEC is really cracking down on this."

70. Later the same day the trader noted that buy-ins were another issue: "I know we're the traders over here, but it seems we're giving them too much leeway with these buy writes instead of covering them on the short shares first." The Compliance Department responded: "I agree that we need to tighten up our procedures on the buy-ins. To do this, we will no longer allow customers to conduct their own buys. We will process the buy-in for each account at the open."

71. The decision to no longer allow customers to conduct their own buy-ins was made by a group of people that included Stern.

72. On August 19, 2009, optionsXpress' Compliance Department instituted new buy-in procedures. The decision to implement the new procedures was made by a group, including Stern. In addition, Stern oversaw the implementation of the new procedures and in the process, became intimately familiar with the Customers' trading activity.

73. The new procedures called for two buy-in lists instead of one: a regular list and a list of failure-to-deliver positions where "the fail is continuously open due to customers being assigned in the money short calls," also known internally as the "perpetual," "chronic," or "rolling fails" list. There were different procedures for the two lists.

74. After the new procedures were instituted, one of optionsXpress' traders asked the Clearing Department what qualifies as a "perpetual buy in." The Clearing Department replied: "Always short, covers your buys by buying [sic] short options deep in the money, so they get assigned. More or less, their trade date position stays constant, settled position never closes or goes long."

75. According to an optionsXpress compliance officer, a "perpetual fail" was "a fail where the issue, specific issue or security is failing a number of days...to me it would be if firms didn't close out the fail and left it alone and it would be a perpetual fail if they didn't meet their close-out obligations and let that fail continue." He also noted that "the rule requires us to reduce that fail to deliver, so you would violate Rule, you know, 203 and 204 if you had a fail and you didn't close it out within the required time frames."

76. After the new procedures were issued, an optionsXpress senior officer

followed up with the trading desk saying: "Did we contact our largest clients?" An optionsXpress trader responded: "Definitely, spent a lot of time on the phone with Feldman [and the other Customers] yesterday." The traders communicated to the Customers that: "Basically they have told us our practices our [sic] not consistent with the rules, and that changes must be made."

77. The buy-ins for these "largest clients," the Customers, were treated differently than the buy-ins for optionsXpress' other customers. Those other customers were treated less favorably by optionsXpress. As explained by one of the traders: "For list #1, [a trader] will take care of contacting the big names: [including Feldman and the other Customers]. If any other names are on list #1 that are not above, go ahead and place market orders to cover at 8:25 a.m. and send the normal email notification to the customers."

78. When optionsXpress received complaints from other customers who received buy-ins without prior notice, optionsXpress responded that it was complying with Reg. SHO ("I again apologize for this inconvenience, but we are following the SEC regulations regarding short selling."); ("The rule clearly states on page 6, section B, that any short position that cannot be delivered, must be closed out 'immediately.'"); ("I understand your frustration over this buy in, but even though you held the security for six months, we couldn't continuously locate the shares to hold against your position. I will be happy to credit back your commission, but the loss will not be reinstated by optionsXpress. This is a risk of shorting stocks.").

79. An optionsXpress trader forwarded Feldman a copy of Rule 204 as part of the implementation of the new procedures. optionsXpress' Clearing Department had previously sent Feldman a copy of Rule 204 on August 3, 2009.

80. On August 21, 2009, Feldman asked if he could "roll the AUG 5 short calls to SEP 5 calls during the day Friday? If I did, they wouldn't be assigned over the weekend . . . then whatever I end up with is like a new position to be dealt with Monday morning, isn't it?" An optionsXpress trader replied: "It all comes down to end of the day, what are we net. If you did roll the Aug 5 calls, then we have shares of AIG that we failed to cover. We can use the exercises/assignments to cover the short shares on expiration, but we can't turn around and say exercises/assignments don't apply to short positions at the end of the day, this is a huge red flag to the SEC."

Compliance Says "Absolutely Not" to the Buy-Writes

81. On August 20, 2009, one of the optionsXpress traders asked the Compliance Department if they could continue to place the buy-writes. A compliance officer responded citing Reg. SHO and the Rule 204 issuing release: "we . . . must execute the buy-in on the open for the specified amount to cover the fail. The customer then can do whatever other transaction they want but it is a separate transaction." He also reminded the trader that "[i]t is expected that buy-ins are occurring at or close to the open, within the first 30 minutes of trading has been accepted to be the 'beginning' of

trading hours.”

82. A second compliance officer also responded: “the answer is absolutely not. We do not want to be an active party in the call transactions. We are fulfilling our obligation to issue the buy-in. If we process the buy-write, regulators could consider the buy-ins as sham transactions.” That compliance officer forwarded his response to another compliance officer adding: “I believe that if we do the buy-write for them, auditors will consider them sham transactions as the SEC did with the two fined prop trading institutions [Hazan and TJM].”

83. After receiving the guidance from the compliance officers, the optionsXpress trader told the other traders: “Compliance is telling us that buy-writes can no longer be used to cover a buy-in. We must place the orders separately. Since this will ultimately shut down these orders, we can place them another way. . . . Execution will put in market orders to cover the shares at the open. All we require the customer to do is call in and place a not held option order with execution. The outcome will basically be the same, but two separate orders will be in customers [sic] account, which the SEC wants to see.”

84. Despite the guidance that the Customers needed to call in an order for the sale of the options, this did not necessarily occur. As Feldman told an optionsXpress senior officer in a November 2009 email: “I usually give ‘standing orders’ to [the optionsXpress trader] and don’t even talk to him each day.”

85. Following the issuance of the new procedures, the traders generally entered the buy-in order at or before market open, but marked the order as “do not send to exchange”—meaning that the order was not automatically routed to an exchange for execution.

86. Instead, the traders paired the stock order with the option order and called a floor broker to manually place the buy-write later in the day. This change did not substantively alter the buy-write procedures except the Customers contacted optionsXpress earlier in the day.

87. According to an optionsXpress senior officer, the buy-writes would not be executed at market open because they were being sent to a floor broker on a best efforts basis.

88. Nonetheless, Stern allowed the Customers’ buy-writes to continue.

**optionsXpress Limits the Number of Buy-Writes Due to Regulatory Risk
But Allows Them to Continue**

89. On September 8, 2009, optionsXpress limited Feldman to no more than 8,000 short contracts in AIG. An optionsXpress senior officer explained to Feldman that there was a risk that the regulators could say that the buy-write activity was prohibited.

90. According to the optionsXpress senior officer: "I spoke several times [with Feldman] about my concerns about being involved in an investigation into the trading behavior that they were engaged in. I indicated that I was concerned about market risk and one of the market risks would be an interpretation by a regulator that the action of selling calls and buying stock in a hard-to-borrow security might be scrutinized and that the actions might be deemed not appropriate."

91. The senior officer also told one of the other Customers that the trading "may attract attention."

optionsXpress Receives a Letter of Caution from CBOE

92. On September 23, 2009, optionsXpress received a letter of caution from CBOE. CBOE noted that optionsXpress' procedures called for a buy-in on the morning of T+4, but found that the firm called certain customers prior to the execution of those buy-ins, which was a deviation from optionsXpress' procedures. That deviation allowed the Customers to buy themselves in with a buy-write.

93. In response, to CBOE's concerns, optionsXpress claims they began emailing the Customers, instead of calling them. Otherwise, there were no changes and optionsXpress continued to execute the Customers' buy-writes.

**An optionsXpress Trader Refuses to Execute the Buy-Writes
But Is Told to Continue**

94. On September 23, 2009, the same day that optionsXpress received the CBOE letter of caution, an optionsXpress trader forwarded a copy of the *Hazan* order to an optionsXpress senior officer at 8:16 a.m., citing the language about sham transactions. The trader then stated: "I am not placing any orders today." The senior officer responded minutes later: "Please execute the buy ins and customer orders today. Compliance has reviewed and is not convinced this applies. They have asked our regulator for an opinion and have not received it."

95. At 9:02 a.m., an optionsXpress compliance officer sent an email to a group of senior executives, including Stern: "We addressed this issue back in August when the SEC issued its findings in these cases. Although I see issues with what our customers are doing, I pointed out distinguishing factors in my response back in August. . . Additionally, we have responded to four inquiries regarding this issue: one from CBOE and three from FINRA. While the FINRA issues are still ongoing, CBOE didn't

seem to have any issues with our response.”

96. On the same day, the Clearing Department sent an email to the Compliance Department noting that the Compliance Department had previously addressed the issue by saying buy-writes were not allowed: “Don’t want to get anyone in trouble, but somewhere down the road this is going to bite us.”

97. Also, on the same day, optionsXpress emailed the *Hazan* order to Feldman.

optionsXpress Calls FINRA and the SEC

98. On September 24, 2009, optionsXpress’ in-house counsel, Stern, and two compliance officers called FINRA to ask questions about the trading. FINRA said it would not discuss the issue because of its ongoing investigation.

99. The same day, optionsXpress’ in-house counsel, Stern, and the two compliance officers called the SEC’s Division of Trading and Markets (“Trading & Markets”). According to optionsXpress, Trading & Markets told optionsXpress to “keep doing what you’re doing—keep closing out” and that Trading & Markets would get back to the firm on whether it had a best execution obligation requiring it to combine the Customers’ buy-in orders with the sale of calls as buy-writes.

100. However, the trading example that optionsXpress gave to Trading & Markets, as well as other information optionsXpress provided on the call, were inaccurate and incomplete.

101. Upon further investigation, Trading & Markets learned additional facts that optionsXpress did not disclose on the call, including that FINRA had an open investigation and that the customers were using deep-in the-money calls to circumvent Reg. SHO. As a result, on October 2, 2009, Trading & Markets called optionsXpress and spoke to its in-house counsel and Stern telling them that the SEC declined to get involved and that it could provide optionsXpress with “no comfort.”

102. After the October 2, 2009 call with Trading & Markets, optionsXpress’ in-house counsel, Stern, and two compliance officers called FINRA. optionsXpress told FINRA that it had received a call from the SEC, and that the SEC had declined to be involved. optionsXpress also said that it was at a loss about what to do and was seeking guidance on the activity.

103. FINRA told optionsXpress that if it wanted guidance, it should send a request in writing to FINRA’s general counsel or the SEC.

104. optionsXpress did not submit a written request for guidance to either the SEC or FINRA’s general counsel. Instead, optionsXpress continued executing the Customers’ buy-writes.

105. Two weeks after the call, the Compliance Department sent an email about another Reg. SHO issue and noted that "[w]e are already under heavy scrutiny from regulators on our short sale practices, and this problem could push us over the edge."

Feldman Transfers Part of His Account to Another Broker-Dealer

106. In early November 2009, Feldman transferred part of his holdings from optionsXpress to another broker-dealer based on a recommendation from a floor broker through whom some of the buy-writes were being traded. Feldman had negotiated a deal with the floor broker for lower costs based on the volume of the daily buy-writes.

107. Less than a month later, Feldman transferred his positions back to optionsXpress because the new broker-dealer's clearing broker did not want the business.

108. In an internal email the clearing broker noted that because Feldman was getting assigned every day on the buy-write calls "the position is continuously on the books. In other words his 'cover' never removes the position because a new assignment recreates it and in the CNS world it is the same position continuously open on the books."

109. While at the other broker-dealer, Feldman had a series of conversations with one of its registered representatives regarding the fact that Feldman's shares were not settling. For example, Feldman explained: "I don't settle the stock@all so what diff wld t+2 be?"

110. Upon being told that the clearing broker planned to settle the stock before transferring the position back to optionsXpress, Feldman stated: "They are going to settle the stock? [The clearing broker] is going to settle that, actually settle the stock?"

111. After receiving an assignment notice on Sears, Feldman emailed: "So how many SHLD do I have to buy-in today (to avoid settlement)?"

112. Similarly, in a phone conversation discussing how Feldman would cover shares of Sears that were going to settle on a certain date, Feldman stated: "So I could do a buy-write and then I wouldn't settle," to which the registered representative replied, "Exactly. You do a buy-write so you don't"

113. Feldman and the registered representative also discussed the fact that there were daily assignments. For example, the registered representative explained to Feldman: "See the problem is if I roll today it doesn't really solve anything because you're just going to get assigned again and again and again." He also explained to Feldman that optionsXpress could not transfer his deep-in-the-money calls because "they wouldn't have the DEC 30 calls to deliver until they settle but they settle and are assigned same day so nothing to move."

114. The registered representative also told Feldman that there was no reason

the counterparty would not exercise the options and that "market-makers are always going to assign what you're short." Feldman had a similar conversation with a trader at optionsXpress who explained: "the market maker is usually always going to assign whatever call [it purchases] . . . normally you'll always going to get assigned," to which Feldman replied, "Yeah that's what I'm saying."

115. When Feldman was asked to leave the new broker-dealer, he and the registered representative also discussed which brokers would allow Feldman to continue the trading and concluded that it would be difficult to find one. As Feldman summarized: "Right, so they [another clearing firm] might let you get away with certain things because they don't notice but if it doesn't fit their rules, they're not going to make any exceptions."

116. The registered representative also told Feldman that no other major broker-dealer was doing this type of activity. In early January 2010, Feldman also discussed with one of the optionsXpress traders that no one else on the "street" was doing the buy-writes on Sears.

117. The registered representative also explained to Feldman why the activity would violate Reg. SHO: "[The clearing broker] finally had a CNS fail, not net flat outside of Reg. SHO where they said their compliance told them that they had to go out and buy this stock no matter what, whether you have a net flat position in your account or not they have to go out and borrow them."

118. The registered representative also told Feldman that the regulators were concerned about this type of activity. "I don't think [optionsXpress is] going to take you because the CBOE regulators are starting to get heavy on this activity, that's why [the clearing broker] is getting more than likely skittish."

119. Nonetheless, optionsXpress allowed Feldman to return, but raised his rate for buy-ins by \$.005 per share.

120. When another Customer threatened to leave optionsXpress shortly after Feldman's return, an optionsXpress senior officer told others within optionsXpress that the Customer would not be able to leave: "We had another customer [Feldman] move to [the other broker-dealer] and they were kicked back to us []. They do not want this business."

Feldman Asks about "Restarting the Clock"

121. On December 4, 2009, an optionsXpress compliance officer explained Reg. SHO to Feldman again: "when an assignment results in a short sale in a security we are already failing to deliver, we have to take action to clean up the entire fail immediately."

122. Feldman responded: "Wow, that's a wonderfully thorough explanation. . .

. This gives me some food for thought. I'm wondering if there might not be some different strategies I could use to avoid buyins, or 'restart the clock' sometimes. Is there a time we can talk?"

123. optionsXpress took no action regarding Feldman's desire to "restart" the settlement clock.

optionsXpress Is Contacted by Multiple Regulators

124. On December 15, 2009, optionsXpress received a letter of caution from FINRA for violating Rule 204T by failing to timely close out a failure-to-deliver position in October 2008.

125. FINRA noted in the letter that it had decided to provide a Cautionary Action Letter as a "compliance aid to assist the Firm in ensuring that it is in compliance with SEC Rule 204T;" however, "any subsequent violations of SEC Rule 204T may result in disciplinary action."

126. optionsXpress did not change its procedures following the receipt of this letter and the buy-writes continued.

127. On December 30, 2009, the SEC Division of Enforcement made its first request for information to optionsXpress.

128. On January 14, 2010, Stern, optionsXpress' in-house counsel, and two compliance officers had a call with FINRA staff. During the call, FINRA staff expressed concern that the buy-ins did not result in a net flat or long position at the end of the day.

129. Despite the expression of concern from an employee of FINRA, optionsXpress continued to allow the buy-writes.

130. On February 12, 2010, optionsXpress sent a letter to FINRA falsely stating that "[i]nitially the customers may have been notified before the buy-in purchase was executed, but after late December 2008, they would have been notified after the buy-in purchase was executed." The letter also contained other inaccuracies.

131. On February 17, 2010, optionsXpress and all of the Customers received subpoenas from the SEC.

132. On February 23, 2010 and March 4, 2010, SEC staff told optionsXpress that they had "grave concerns" about the trading. The buy-writes continued.

optionsXpress Increases Commissions

133. In January 2010, after the Division of Enforcement made its first request for information, optionsXpress told Feldman that it was going to keep in place the commission increase that it imposed following Feldman's return from the other broker-dealer.

134. optionsXpress told Feldman that the reasons for the increase included regulatory concerns and increased compliance costs. "We have had discussions with the regulators about these strategies. It seems several market-makers have been complaining to the regulators about them. We continue to ask the regulators for guidance on these trades. . . . it continues to be a drain on our compliance staff."

135. Several days later, optionsXpress told Feldman that "[r]egulators continue to ask questions, we provide answers and ask for guidance."

136. optionsXpress was not seeking guidance from regulators during this period.

137. In February 2010, optionsXpress began charging the other Customers an increased commission as well. In explaining the increased commissions, a trader at optionsXpress explained that the trades were so large the regulators might start to notice.

138. After optionsXpress increased the commission, Feldman complained: "Millions of \$\$ inc [sic] commissions[sic],,,,yet treat me/us like criminals. . . . But, in the big picture..it's still quite the gig..where can you get such mkt-bating [sic] retuens [sic] consistently? So, as disgusting as [optionsXpress] are [sic], have to bend over and get raped, and take the punishment,,,,,"

The Trading Finally Ceases

139. On March 9, 2010, Stern and two other optionsXpress officers called CBOE, asking it to advocate on optionsXpress' behalf in connection with the SEC investigation. CBOE instead referred optionsXpress to the CBOE's regulatory circulars which discussed sham transactions.

140. The same day, optionsXpress decided to halt the trading, but allowed it to continue until the March options expiration. The decision to halt the trading was made by Stern and two other optionsXpress officers.

**optionsXpress, Stern, and Feldman Knew or Were Reckless in Not Knowing
That the Calls Would Be Exercised**

141. optionsXpress, Stern, and Feldman knew or were reckless in not knowing that the buy-write calls would be exercised and assigned.

142. optionsXpress' buy-in procedures – authorized by Stern – reference the “perpetual” list and acknowledge that the list is based on the premise that the calls were being exercised and assigned on a daily basis.

143. optionsXpress employees referenced the “daily,” “chronic,” “perpetual,” and “rolling” buy-ins on numerous occasions, expressed the expectation that the options would be assigned, and explained to the customers that “the market maker is usually always going to assign whatever call [it purchases] . . . normally you’ll [sic] always going to get assigned.”

144. Feldman acknowledged on numerous occasions that the options were being exercised the same day that they were sold. For example, Feldman sent an instant message to a friend: “it slmost [sic] doesn’t matter, JUL or SEP, as u get assigned that night anyway, so what’s the diff?”; emailed an optionsXpress senior officer: “a buy-write of 2500 SHLD, incurs a commission of \$1,250 each and every day”; and emailed optionsXpress’ Risk Department: “it’s part of my daily routine. Brush teeth, get coffee, rest [sic] C [Citigroup, Inc.], cover buyin on C [Citigroup, Inc.].”

145. According to Feldman: “[Y]ou’d be stupid to say, oh, I’m going to write these and none them are going to get exercised.”

146. A registered representative at Feldman’s other broker-dealer also told Feldman: “You know your counterparty is dropping on almost every one.” Dropping on almost everyone signifies that the counterparty would almost always choose to exercise the deep-in-the-money calls written by Feldman as part of the buy-write.

147. Feldman and the traders at optionsXpress followed the open interest and daily volume of the options.

148. Open interest is the number of contracts in existence at the beginning of trading. The daily volume is the number of contracts that traded during the day.

149. Feldman admitted that he used the open interest to determine which options he would use and that he paid “a lot of attention to” the volume.

150. An examination of the open interest and volume would have shown that the call options were being exercised the same day. For example, the following is the open interest and volume on SHLD January 5 calls:

Date	OptionsXpress Buy-Write	Volume Traded	Open Interest
Nov. 27, 2009	1359	1359	2
Nov. 30, 2009	1383	1383	2
Dec. 1, 2009	1407	1407	2
Dec. 2, 2009	1525	1525	2

151. When asked by a registered representative what the open interest was on a particular option strike, Feldman replied: "probably not very high because they exercise." Similarly when a registered representative told Feldman "you should of got assigned on 1914 according to open interest." Feldman replied: "Yup, since 214 of [] stayed open and OI [open interest] was 300. Good use of math!"

152. Further, it generally made no economic sense for the counterparty not to exercise the options (and, therefore, maintain a short stock position). The counterparty faced the same carrying costs as the Customers (*i.e.*, it would have to pay the hard to borrow rate on shares sold short). Also, every day that the options were exercised the Customers needed to do more buy-writes. The counterparty was making a penny or more a share each day that the Customers did the buy-writes. If the options were not exercised, then the counterparty would have not only been exposed to the borrow rate, but would have lost out on a guaranteed return of one penny a share the following day.

Feldman and OptionsXpress Knew the Effect of the Trading

153. In late 2009 and early 2010, Feldman discussed with a friend an electronic message board where there was speculation regarding the buy-write activity. In late December, the friend told Feldman that the participants in the message boards "think Sears is buying back shares. . . . they have no idea."

154. In late January, when the message board posts were discussing daily "mystery trades," "illusory trades," and "faux trades" in Sears, including possible manipulation of its daily trading volume and violations of Reg. SHO, Feldman told his friend: "I read the latest thread on the SHLD 'volume spikes'. Very entertaining. (Until someone notifies the SEC and they shut down the strategy!!)."

155. Feldman also admitted that he was aware that "everybody was out there just like getting worked up in a tizzy." In fact, he bragged about his effect on the market to the floor broker who executed the buy-writes.

156. Feldman also reviewed a website which discussed the "manipulative" activity noting that it was "consistent with the illegal 'reset' transaction" described in *Hazan*.

157. Feldman sold options knowing that the calls would be exercised and assigned, and that he did not intend to deliver the shares by settlement date, and in fact on numerous occasions he did not deliver the shares as required. In doing this "stock kiting," he deceived clearing brokers and the ultimate purchasers (or recipients) of the stock about his intention to deliver the shares.

158. Feldman's use of buy-writes was the equivalent of doing matched orders. Feldman used the buy-writes (and optionsXpress allowed him to use the buy-writes) for the improper purpose of appearing to close out delivery fails without actually delivering the shares. Feldman's use of buy-writes was a manipulative device and deceived the market.

159. When optionsXpress and Feldman failed to deliver shares, the unsettled position was assigned via lottery to clearing brokers who had a net purchase of shares on that day and thus to the ultimate purchasers of those shares. These ultimate purchasers and clearing brokers reasonably presumed that they would receive the shares they bought in the open market (within the standard three-day settlement period), when in fact they did not.

160. Indeed, many of the clearing brokers submitted notices to CNS (who in turn sent them to optionsXpress) requesting immediate delivery of the shares that were not delivered by settlement date.

161. When a seller of securities fails to deliver securities on settlement date, the seller effectively unilaterally converts a securities contract (which is expected to settle within the standard three-day settlement period) into an undated futures-type contract, to which the buyer might not have agreed, or that might have been priced differently.

E. VIOLATIONS

162. As a result of the conduct described above, optionsXpress willfully violated Rules 204 and 204T of Reg. SHO which require participants of a registered clearing agency to deliver securities by settlement date. If the participants do not deliver securities by settlement date in connection with a short sale, they must purchase or borrow securities of like kind and quantity to close out the failure-to-deliver position by no later than the beginning of regular trading hours on the settlement day following the settlement date.

163. As a result of the conduct described above, Feldman willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rules 10b-5 and 10b-21 thereunder which prohibit fraudulent conduct in the offer or sale of securities and in connection with the purchase or sale of securities.

164. As a result of the conduct described above, Stern caused and willfully aided and abetted optionsXpress' violations of Rules 204 and 204T and Feldman's

violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rules 10b-5 and 10b-21 thereunder.

165. As a result of the conduct described above, optionsXpress caused and willfully aided and abetted Feldman's violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rules 10b-5 and 10b-21 thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate in the public interest that public administrative and cease-and-desist proceedings be instituted to determine:

A. Whether the allegations set forth in Section II hereof are true and, in connection therewith, to afford Respondents an opportunity to establish any defenses to such allegations;

B. What, if any, remedial action is appropriate in the public interest against Respondents optionsXpress and Stern pursuant to Section 15(b) of the Exchange Act including, but not limited to, disgorgement and civil penalties pursuant to Section 21B of the Exchange Act;

C. What, if any, remedial action is appropriate in the public interest against Respondents optionsXpress and Stern pursuant to Section 9(b) of the Investment Company Act; and

D. Whether, pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, all Respondents should be ordered to cease and desist from committing or causing violations of and any future violations of Reg. SHO Rule 204, Section 17(a) of the Securities Act, and Section 10(b) of the Exchange Act and Rules 10b-5 and 10b-21 thereunder, and whether all Respondents should be ordered to pay a civil penalty pursuant to Section 8A(g) of the Securities Act and Section 21B(a) of the Exchange Act, and whether all Respondents should be ordered to pay disgorgement pursuant to Section 8A(e) of the Securities Act, and Sections 21B(e) and 21C(e) of the Exchange Act.

IV.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened not earlier than 30 days and not later than 60 days from service of this Order at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice, 17 C.F.R. § 201.110.

IT IS FURTHER ORDERED that Respondents shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice, 17 C.F.R. § 201.220.

If Respondents fail to file the directed answer, or fail to appear at a hearing after being duly notified, the Respondents may be deemed in default and the proceedings may be determined against them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f) and 310 of the Commission's Rules of Practice, 17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f) and 201.310.

This Order shall be served forthwith upon Respondents personally or by certified mail.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 300 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice.

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Elizabeth M. Murphy
Secretary

Kevin M. O'Neill
By: Kevin M. O'Neill
Deputy Secretary

*Commissioner Aguilar
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940

Release No. 3397 / April 18, 2012

ADMINISTRATIVE PROCEEDING

File No. 3-14851

In the Matter of

BRIAN J. SMART,

Respondent.

ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS
PURSUANT TO SECTION 203(f) OF THE
INVESTMENT ADVISERS ACT OF 1940
AND NOTICE OF HEARING

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Brian J. Smart ("Smart" or "Respondent").

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT

1. Smart, 35 years old, is a resident of Lehi, Utah.
2. From 2003 until 2009, Smart owned and operated an unregistered investment adviser, Smart Assets, LLC ("Smart Assets").

B. ENTRY OF THE INJUNCTION

3. On June 8, 2011, a final judgment was entered against Smart and Smart Assets, permanently enjoining defendants from future violations of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Exchange Act Rule 10b-5, and ordering defendants to pay \$2,059,077 in disgorgement, prejudgment interest of \$597,426, and a civil penalty of \$2,059,077, in the civil action titled SEC v. Brian J.

Smart, et al., Civil Action Number 2:09-CV-00224, in the United States District Court for the District of Utah.

4. The Court found that Smart and Smart Assets, inter alia, misappropriated over \$2.05 million from investors through a "systematic program of deception and fraud." The Court found that Smart falsely represented that he would place investor funds in safe, principal guaranteed investments. Instead, the Court found, Smart used investor money to pay personal expenses, to invest in risky real estate ventures and hard money loans, and to pay purported "dividends" to other investors.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate in the public interest that public administrative proceedings be instituted to determine:

A. Whether the allegations set forth in Section II hereof are true and, in connection therewith, to afford Respondent an opportunity to establish any defenses to such allegations; and

B. What, if any, remedial action is appropriate in the public interest against Respondent pursuant to Section 203(f) of the Advisers Act.

IV.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice, 17 C.F.R. § 201.110.

IT IS FURTHER ORDERED that Respondent shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice, 17 C.F.R. § 201.220.

If Respondent fails to file the directed answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default and the proceedings may be determined against him upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f) and 310 of the Commission's Rules of Practice, 17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f) and 201.310.

This Order shall be served forthwith upon Respondent personally or by certified mail.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 210 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice.

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

*Commissioner Aguilar
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 66828 / April 18, 2012

INVESTMENT ADVISERS ACT OF 1940
Release No. 3398 / April 18, 2012

INVESTMENT COMPANY ACT OF 1940
Release No. 30038 / April 18, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14852

In the Matter of

**MidSouth Capital, Inc. and
Mark D. Hill,**

Respondents.

**ORDER INSTITUTING ADMINISTRATIVE AND
CEASE-AND-DESIST PROCEEDINGS PURSUANT
TO SECTIONS 15(b) AND 21C OF THE SECURITIES
EXCHANGE ACT OF 1934, SECTION 203(f) OF THE
INVESTMENT ADVISERS ACT OF 1940 AND
SECTION 9(b) OF THE INVESTMENT COMPANY
ACT OF 1940, MAKING FINDINGS AND IMPOSING
REMEDIAL SANCTIONS AND A CEASE-AND-
DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents MidSouth Capital, Inc. ("MidSouth") and Mark D. Hill ("Hill") and pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against Hill.

II.

In anticipation of the institution of these proceedings, Respondents have submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are

admitted, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings pursuant to Sections 15(b) and 21C of the Exchange Act, Section 203(f) of the Advisers Act and Section 9(b) of the Investment Company Act, Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order.

III.

On the basis of this Order and Respondents' Offer, the Commission finds that:¹

SUMMARY

1. These proceedings arise out of MidSouth's failures to comply with its net capital obligations under Section 15(c)(3) of the Exchange Act and Rule 15c3-1 thereunder. Beginning in 2008 and continuing through August 2011, MidSouth, a registered broker-dealer, continued to effect transactions in securities on multiple occasions when it did not have the required net capital. In October 2011, despite being notified by both Financial Industry Regulatory Authority ("FINRA") and Commission staff that it should cease effecting transactions while not in net capital compliance, MidSouth continued to do so in violation of Commission rules, while also not timely providing the required notifications of its violations. Throughout this time period, Respondent Hill was MidSouth's Chairman, largest shareholder and CEO. During a part of 2011, including time periods when MidSouth was in violation of its net capital obligations yet continued to effect transactions in securities, Hill also served as MidSouth's Financial and Operations Principal ("FinOp").

2. By effecting transactions in securities without sufficient net capital, MidSouth willfully violated Section 15(c)(3) of the Exchange Act and Rule 15c3-1 thereunder. In addition, by failing to provide notifications to the Commission of its net capital deficiencies and failing to create and maintain accurate books and records, MidSouth violated Section 17(a)(1) of the Exchange Act and Rules 17a-11 and 17a-3 thereunder. Hill, as MidSouth's principal owner, chief executive and FinOp, willfully aided and abetted and caused the foregoing violations.

RESPONDENTS

3. MidSouth is a registered introducing broker-dealer based in Atlanta, Georgia. MidSouth was also a registered investment adviser in several states. MidSouth filed a Form BDW on January 25, 2012, which is not yet effective, seeking to withdraw its registration as a broker-dealer. On June 15, 2010, MidSouth settled a regulatory action with FINRA in which it consented, without admitting or denying the allegations, to findings that it had failed to maintain sufficient net capital as of December 31, 2008 while engaging in securities business. Pursuant to that settlement, MidSouth agreed to a censure and a \$5,000 fine.

¹ The findings herein are made pursuant to Respondents' Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

4. Hill has been, for all relevant time periods, the Chairman and largest shareholder of MidSouth. For all relevant time periods until November 9, 2011, Hill was the CEO of MidSouth. Between April 2011 and November 9, 2011, Hill also served as MidSouth's FinOp.

MIDSOUTH REPEATEDLY VIOLATED THE NET CAPITAL, NOTIFICATION AND
BOOKS AND RECORDS REQUIREMENTS

5. The Exchange Act and rules thereunder require a broker-dealer, among other things, to maintain a certain minimum net capital at all times while effecting transactions in securities. As an introducing broker that does not clear or carry customer accounts, and does not engage in other activities that require higher minimum net capital requirements, MidSouth was required at all relevant times to maintain a minimum net capital of the greater of 6 2/3 percent of its aggregate indebtedness or \$5,000.

6. On seven occasions between December 2008 and October 2011, MidSouth violated its net capital requirements by effecting transactions in securities while failing to maintain the minimum required net capital. The majority of these violations were discovered by FINRA or Commission staff during examinations of MidSouth.

7. During certain of these times, FINRA and/or the Commission specifically notified MidSouth that continuing to effect transactions in securities while non-compliant with Rule 15c3-1 would violate Section 15(c)(3) of the Exchange Act and Rule 15c3-1 thereunder. Despite these notices, MidSouth failed to cease its broker-dealer operations during the time periods when it was not in compliance with Rule 15c3-1.

8. MidSouth also repeatedly failed to file on a timely basis the requisite notifications with the Commission and FINRA of its net capital deficiencies.

9. The seventh and most recent violation was discovered after Commission staff commenced an on-site examination of MidSouth on September 14, 2011. Based on the information provided during the exam, the Commission staff advised MidSouth that, contrary to MidSouth's conclusion, the firm's net capital and net capital deficiency as of September 30, 2011 were (\$24,262) and (\$49,036), respectively.

10. This deficiency arose because MidSouth had improperly included an aged unsecured receivable from an affiliated entity as an allowable asset for net capital purposes. MidSouth included this asset in its net capital based on the advice of Hill and because the receivable was from a broker-dealer. The receivable should not have been included in computing MidSouth's net capital.

11. By letter dated and sent by fax and mail on Monday, October 24, 2011, FINRA notified MidSouth and Hill that, given the improper inclusion of the receivable in the firm's net capital, MidSouth was non-compliant with its minimum net capital requirement. That letter also advised MidSouth that, pursuant to FINRA's rules, "a member shall suspend all business operations during any period in which it is not in compliance with the Net Capital Rule" and

further advised MidSouth of its obligations to file a Rule 17a-11 notification with FINRA and the Commission.

12. On October 26, 2011, after MidSouth failed to file its own Rule 17a-11 notification with FINRA and the Commission, FINRA made such notification on MidSouth's behalf. In that notification, FINRA stated:

FINRA staff left messages with FINOP Mark Hill on 10/24, 10/25 and 10/26 advising him that we need to discuss the firm's treatment of this receivable. He was advised that this was not an allowable asset and he should file a 17a-11 notification. On October 24, 2011, Hill was advised by FINRA staff via written notification that pursuant to FINRA Rule 4110(b)(1) the member should suspend all business operations during any period in which the firm is not in compliance with the net capital rule. As of the time of this filing [October 26, 2011], there has been no response from Hill regarding this matter.

13. On October 24, 2011, Commission staff orally advised MidSouth that it appeared not to be in compliance with its minimum net capital requirements as of September 30, 2011 and that continuing its broker-dealer operations while out of compliance would violate Rule 15c3-1 of the Exchange Act. On October 26, 2011, Commission staff called and sent by fax, email and regular mail a letter to MidSouth and Hill advising MidSouth of its net capital deficiency. That letter further advised that MidSouth should provide the required Rule 17a-11 notification and reminded MidSouth and Hill that "conducting a securities business and securities transactions without the minimum required net capital under Rule 15c3-1 is considered a violation of the rule."

14. Notwithstanding these warnings, MidSouth continued its broker-dealer securities business by effecting transactions in securities between September 30, 2011 and October 28, 2011.

HILL WILLFULLY AIDED AND ABETTED
AND CAUSED MIDSOUTH'S VIOLATIONS

15. Hill was aware of and had primary responsibility to address MidSouth's net capital obligations, remedy past deficiencies and ensure future compliance. Indeed, MidSouth's website stated that Hill oversaw "all areas of the firm" and three of the deficiency notifications from FINRA were sent directly to Hill, who had become MidSouth's FinOp as of in or about April 2011.

16. Hill acted intentionally, or, at a minimum, with severe recklessness in aiding and abetting and causing MidSouth to violate its net capital obligations. As a result of MidSouth's multiple past failures, Hill was fully aware of MidSouth's net capital problems. However, notwithstanding this knowledge, as well as being specifically advised by FINRA and the Commission of MidSouth's obligations, Hill intentionally, or with severe recklessness, permitted and caused MidSouth to fail in keeping accurate books and records, in providing appropriate Rule 17a-11 notifications, and in ceasing to effect transactions while not in net capital compliance. By such conduct, Hill willfully aided and abetted and caused MidSouth's net capital violations.

17. As a result of the conduct described above, MidSouth willfully violated Section 15(c)(3) of the Exchange Act and Rule 15c3-1 thereunder that require a broker-dealer to maintain a certain minimum net capital at all times while effecting transactions in securities and prohibit a broker-dealer from effecting such transactions while not in compliance with this net capital obligation.

18. As a result of the conduct above, Hill willfully aided and abetted and caused MidSouth's violations of Section 15(c)(3) of the Exchange Act and Rule 15c3-1 thereunder.

19. As a result of the conduct described above, MidSouth willfully violated Section 17(a)(1) of the Exchange Act and Rule 17a-11 thereunder that require that a broker-dealer notify FINRA and the SEC, via a Rule 17a-11 notification, of its net capital deficiency the "same day" of the occurrence of such deficiency, which obligation applies even if the broker or dealer "does not agree that it is, or has been, in violation of" its net capital obligations.

20. As a result of the conduct described above, Hill willfully aided and abetted and caused MidSouth's violations of Section 17(a)(1) of the Exchange Act and Rule 17a-11 thereunder.

21. As a result of the conduct described above, MidSouth willfully violated Section 17(a)(1) of the Exchange Act and Rule 17a-3 thereunder that require registered brokers and dealers to make and keep current accurate books and records relating to their brokerage business, including, under Rule 17a-3(a)(11), an accurate computation of net capital.

22. As a result of the conduct described above, Hill willfully aided and abetted and caused MidSouth's violations of Section 17(a)(1) of the Exchange Act and Rule 17a-3 thereunder.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondents' Offer.

Accordingly, pursuant to Sections 15(b) and 21C of the Exchange Act, Section 203(f) of the Advisers Act and Section 9(b) of the Investment Company Act, it is hereby ORDERED that:

A. MidSouth is censured;

B. MidSouth cease and desist from committing or causing any violations and any future violations of Sections 15(c)(3) and 17(a)(1) of the Exchange Act and Rules 15c3-1, 17a-11 and 17a-3 thereunder;

C. Hill cease and desist from willfully aiding and abetting and causing any violations and any future violations of Sections 15(c)(3) and 17(a)(1) of the Exchange Act and Rules 15c3-1, 17a-11 and 17a-3 thereunder;

D. Hill be, and hereby is, suspended from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization for a period of six (6) months, effective on the second Monday following the entry of this Order;

E. Hill is prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter for a period of six (6) months, effective on the second Monday following the entry of this Order.

F. Hill shall, within one hundred and eighty (180) days of the entry of this Order, pay a civil money penalty in the amount of \$15,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (a) made by United States postal money order, certified check, bank cashier's check or bank money order; (b) made payable to the Securities and Exchange Commission; (c) hand-delivered or mailed to the Securities and Exchange Commission, Office of Financial Management, 100 F St., NE, Stop 6042, Washington, DC 20549; and (d) submitted under cover letter that identifies Mark D. Hill as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to William P. Hicks, Securities and Exchange Commission, 950 East Paces Ferry Road, N.E., Suite 900 Atlanta, Georgia 30326-1382

By the Commission.

Elizabeth M. Murphy
Secretary


By: **Jill M. Peterson**
Assistant Secretary

COMMODITY FUTURES TRADING COMMISSION

17 CFR PART 1

RIN 3038-AD06

SECURITIES AND EXCHANGE COMMISSION

17 CFR PART 240

[Release No. 34-66868; File No. S7-39-10]

RIN 3235-AK65

FURTHER DEFINITION OF "SWAP DEALER," "SECURITY-BASED SWAP DEALER," "MAJOR SWAP PARTICIPANT," "MAJOR SECURITY-BASED SWAP PARTICIPANT" AND "ELIGIBLE CONTRACT PARTICIPANT."

AGENCIES: Commodity Futures Trading Commission; Securities and Exchange Commission.

ACTION: Joint final rule; joint interim final rule; interpretations.

SUMMARY: In accordance with Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"), the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") (collectively, the "Commissions"), in consultation with the Board of Governors of the Federal Reserve System ("Board"), are adopting new rules and interpretive guidance under the Commodity Exchange Act ("CEA"), and the Securities Exchange Act of 1934 ("Exchange Act"), to further define the terms "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant," and "eligible contract participant."

DATES: Effective date for this joint final rule and joint interim final rule: [[INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]]; provided, however, that the effective date of CFTC Regulations §§ 1.3(m)(5) and 1.3(m)(6) is December 31, 2012. The comment period for the interim final rule (CFTC Regulation § 1.3(ggg)(6)(iii)) will close [[INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL

REGISTER]]. Compliance with the element of CFTC Regulation § 1.3(m)(8)(iii) requiring that a commodity pool be formed by a registered CPO shall be required with respect to a commodity pool formed on or after December 31, 2012 for any person seeking to rely on such regulation; compliance with such element shall not be required with respect to a commodity pool formed prior to December 31, 2012.

FOR FURTHER INFORMATION CONTACT: CFTC: Jeffrey P. Burns, Assistant General Counsel, at 202- 418-5101, jburns@cftc.gov, Mark Fajfar, Assistant General Counsel, at 202-418-6636, mfajfar@cftc.gov, Julian E. Hammar, Assistant General Counsel, at 202-418-5118, jhammar@cftc.gov, or David E. Aron, Counsel, at 202-418-6621, daron@cftc.gov, Office of General Counsel; Gary Barnett, Director, at 202-418-5977, gbarnett@cftc.gov, or Frank Fisanich, Deputy Director, at 202-418-5949, ffisanich@cftc.gov, Division of Swap Dealer and Intermediary Oversight, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, N.W., Washington, DC 20581;

SEC: Joshua Kans, Senior Special Counsel, Richard Grant, Special Counsel, or Richard Gabbert, Attorney Advisor, at 202-551-5550, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-7010.

SUPPLEMENTARY INFORMATION:

I. Background

On July 21, 2010, President Obama signed the Dodd-Frank Act into law.¹ Title VII of the Dodd-Frank Act established a statutory framework to reduce risk, increase transparency, and

¹ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010). The text of the Dodd-Frank Act may be accessed at <http://www.cftc.gov/LawRegulation/OTCDERIVATIVES/index.htm>.

promote market integrity within the financial system by, among other things: (i) providing for the registration and regulation of swap dealers and major swap participants; (ii) imposing clearing and trade execution requirements on standardized derivative products; (iii) creating recordkeeping and real-time reporting regimes; and (iv) enhancing the Commissions' rulemaking and enforcement authorities with respect to all registered entities and intermediaries subject to the Commissions' oversight.

The Dodd-Frank Act particularly provides that the CFTC will regulate "swaps," and that the SEC will regulate "security-based swaps." The Dodd-Frank Act also adds definitions of the terms "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant" and "eligible contract participant" to the CEA and Exchange Act.² Section 712(d)(1) of the Dodd-Frank Act further directs the CFTC and the SEC, in consultation with the Board, jointly to further define those terms, among others.³

² See Dodd-Frank Act sections 721 and 761. Sections 721(b)(2) and 761(b)(2) also provide that the CFTC and SEC may by rule further define any other term included in an amendment made by Title VII to the CEA or the Exchange Act, respectively.

³ In addition, section 712(d)(1) directs the CFTC and SEC, in consultation with the Board, jointly to further define the terms "swap," "security-based swap," and "security-based swap agreement." These further definitions are the subject of a separate rulemaking by the Commissions. See CFTC and SEC, Notice of Proposed Joint Rulemaking, Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 FR 29818 (May 23, 2011) ("Product Definitions Proposal"). Section 712(d)(2)(A), in turn, provides that the Commissions shall jointly adopt such other rules regarding the definitions set forth in section 712(d)(1) as they "determine are necessary and appropriate, in the public interest, and for the protection of investors."

In addition, section 721(c) of the Dodd-Frank Act requires the CFTC to adopt a rule to further define the terms "swap dealer," "major swap participant," and "eligible contract participant" for the purpose of including transactions and entities that have been structured to evade Title VII. Also, section 761(b) of the Dodd-Frank Act permits the SEC to adopt a rule to further define the terms "security-based swap dealer," "major security-based swap participant," and "eligible contract participant," with regard to security-based swaps, for the purpose of including transactions and entities that have been structured to evade Title VII.

In December 2010, the Commissions proposed rules and interpretations to further define the meaning of the terms “swap dealer,” “security-based swap dealer,” “major swap participant,” “major security-based swap participant,” and “eligible contract participant.”⁴ The Commissions received approximately 968 written comments in response to the Proposing Release.⁵ In addition, the Staffs of the Commissions participated in approximately 114 meetings with market participants and other members of the public about the Proposing Release,⁶ and the Commissions held a Joint Public Roundtable on the proposed dealer and major participant definitions.⁷ After considering the comments received, the Commissions are adopting final rules and interpretations to further define these terms.

⁴ See CFTC and SEC, Notice of Proposed Joint Rulemaking: Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant,” Securities Exchange Act Release No. 63452, 75 FR 80174 (Dec. 21, 2010) (“Proposing Release”).

Prior to issuing the Proposing Release, the Commissions issued a joint Advance Notice of Proposed Rulemaking (“ANPRM”) requesting public comment regarding the definitions of the terms “swap,” “security-based swap,” “security-based swap agreement,” “swap dealer,” “security-based swap dealer,” “major swap participant,” “major security-based swap participant,” and “eligible contract participant.” See CFTC and SEC, Advance Notice of Proposed Joint Rulemaking: Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act, Securities Exchange Act Release No. 62717, 75 FR 51429 (Aug. 20, 2010). The Proposing Release and these final rules both reflect comments received in response to the ANPRM.

⁵ Comment letters received in response to the Proposing Release may be found on the Commissions’ websites at <http://comments.cftc.gov/PublicComments/CommentList.aspx?id=933> and at <http://www.sec.gov/comments/s7-39-10/s73910.shtml>.

⁶ Summaries of these staff meetings may be found on the Commissions’ websites at http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF_2_Definitions/index.htm and <http://www.sec.gov/comments/s7-39-10/s73910.shtml#meetings>.

⁷ A transcript of the roundtable discussion and public comments received with respect to the roundtable may be found on the CFTC’s website at http://www.cftc.gov/PressRoom/Events/opaevent_cftcsecstaff061611.

II. Definitions of “Swap Dealer” and “Security-Based Swap Dealer”

The Dodd-Frank Act definitions of the terms “swap dealer” and “security-based swap dealer” focus on whether a person engages in particular types of activities involving swaps or security-based swaps.⁸ Persons that meet either of those definitions are subject to statutory requirements related to, among other things, registration, margin, capital and business conduct.⁹

The CEA and Exchange Act definitions in general encompass persons that engage in any of the following types of activity:

- (i) holding oneself out as a dealer in swaps or security-based swaps,
- (ii) making a market in swaps or security-based swaps,
- (iii) regularly entering into swaps or security-based swaps with counterparties as an ordinary course of business for one’s own account, or

⁸ See section 721 of the Dodd-Frank Act (adding Section 1a(49) of the CEA, 7 U.S.C. 1a(49), to define “swap dealer”) and section 761 of the Dodd-Frank Act (adding Section 3(a)(71) of the Exchange Act, 15 U.S.C. 78c(a)(71), to define “security-based swap dealer”).

⁹ The Dodd-Frank Act excludes from the Exchange Act definition of “dealer” persons who engage in security-based swaps with eligible contract participants. See section 3(a)(5) of the Exchange Act, 15 U.S.C. 78c(a)(5), as amended by section 761(a)(1) of the Dodd-Frank Act.

The Dodd-Frank Act does not include comparable amendments for persons who act as brokers in swaps and security-based swaps. Because security-based swaps, as defined in section 3(a)(68) of the Exchange Act, are included in the Exchange Act section 3(a)(10) definition of “security,” persons who act as brokers in connection with security-based swaps must, absent an exception or exemption, register with the SEC as a broker pursuant to Exchange Act section 15(a), and comply with the Exchange Act’s requirements applicable to brokers.

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. See “Order Granting Temporary Exemptions under the Securities Exchange Act of 1934 in Connection with the Pending Revision of the Definition of “Security” to Encompass Security-Based Swaps, and Request for Comment,” Securities Exchange Act Release No. 64795 (Jul. 1, 2011), 76 FR 39927, 39939 (Jul. 7, 2011) (addressing availability of exemption to registration requirement for securities brokers).

- (iv) engaging in any activity causing oneself to be commonly known in the trade as a dealer or market maker in swaps or security-based swaps.¹⁰

These dealer activities are enumerated in the CEA and Exchange Act in the disjunctive, in that a person that engages in any one of these activities is a swap dealer under the CEA or security-based swap dealer under the Exchange Act, even if such person does not engage in one or more of the other identified activities.

At the same time, the statutory dealer definitions provide exceptions for a person that 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."¹¹ The Dodd-Frank Act also instructs the Commissions to exempt from designation as a dealer a person that "engages in a de minimis quantity of [swap or security-based swap] dealing in connection with transactions with or on behalf of its customers."¹² Moreover, the definition of "swap dealer" (but not the definition of "security-based swap dealer") provides that an insured depository institution is not to be considered a swap dealer "to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer."¹³ The statutory definitions further provide that a person may be designated as a dealer for one or more types, classes or categories

¹⁰ See CEA section 1a(49)(A), 7 U.S.C. 1a(49)(A); Exchange Act section 3(a)(71)(A), 15 U.S.C. 78c(a)(71)(A).

¹¹ See CEA section 1a(49)(C), 7 U.S.C. 1a(49)(C); Exchange Act section 3(a)(71)(C), 15 U.S.C. 78c(a)(71)(C).

¹² See CEA section 1a(49)(D), 7 U.S.C. 1a(49)(D); Exchange Act section 3(a)(71)(D), 15 U.S.C. 78c(a)(71)(D).

¹³ See CEA section 1a(49)(A), 7 U.S.C. 1a(49)(A).

of swaps or security-based swaps, or activities without being designated a dealer for other types, classes or categories or activities.¹⁴

In the Proposing Release, the Commissions proposed rules to identify the activity that would cause a person to be a dealer,¹⁵ to implement the exception for de minimis dealing activity,¹⁶ to implement the exception from the swap dealer definition in connection with the origination of loans by insured depository institutions,¹⁷ and to provide for the limited purpose designation of dealers.¹⁸ The release also set forth proposed interpretive guidance related to the definitions.

After considering the comments received, the Commissions are adopting final rules and interpretations to further define the terms “swap dealer” and “security-based swap dealer.” In this Adopting Release, we particularly address: (i) the general analysis for identifying dealing activity involving swaps and security-based swaps; (ii) the exclusion from the “swap dealer” definition in connection with the origination of loans by insured depository institutions; (iii) the application of the dealer analysis to inter-affiliate swaps and security-based swaps; (iv) the application of the de minimis exception from the dealer definitions; and (v) the limited designation of swap dealers and security-based swap dealers.

¹⁴ See CEA section 1a(49)(B), 7 U.S.C. 1a(49)(B); Exchange Act section 3(a)(71)(B), 15 U.S.C. 78c(a)(71)(B).

¹⁵ See proposed CFTC Regulation § 1.3(ggg)(1); proposed Exchange Act rule 3a71-1(a), (b).

¹⁶ See proposed CFTC Regulation § 1.3(ggg)(4); proposed Exchange Act rule 3a71-2.

¹⁷ See proposed CFTC Regulation § 1.3(ggg)(5).

¹⁸ See proposed CFTC Regulation § 1.3(ggg)(3); proposed Exchange Act rule 3a71-1(c).

A. General Considerations for the Dealer Analysis

1. Proposed approach

The proposed rules to define the activities that would lead a person to be a “swap dealer” and “security-based swap dealer” were based closely on the corresponding language of the statutory definitions.¹⁹ The Proposing Release further noted that the Dodd-Frank Act defined the terms “swap dealer” and “security-based swap dealer” in a functional manner, and stated that those statutory definitions should not be interpreted in a constrained, overly technical or rigid manner, particularly given the diversity of the swap and security-based swap markets. The Proposing Release also identified potential distinguishing characteristics of swap dealers and security-based swap dealers based on the functional role that dealers fulfill in the swap and security-based swap markets, such as: dealers tend to accommodate demand from other parties; dealers generally are available to enter into swaps or security-based swaps to facilitate other parties’ interest; dealers tend not to request that other parties propose the terms of swaps or security-based swaps, but instead tend to enter into those instruments on their own standard terms or on terms they arrange in response to other parties’ interest; and dealers tend to be able to arrange customized terms for swaps or security-based swaps upon request, or to create new types of swaps or security-based swaps at the dealer’s own initiative.²⁰

The proposal recognized that the principles for identifying dealing activity involving swaps can differ from principles for identifying dealing activity involving security-based swaps, in part due to differences in how those instruments are used.²¹

¹⁹ See CFTC Regulation § 1.3(ggg); Exchange Act rule 3a71-1(a), (b).

²⁰ Proposing Release, 75 FR at 80176.

²¹ Id.

a. "Swap dealer" activity

Consistent with the statutory definition, the proposed rule stated that the term "swap dealer" includes a person that "regularly enters into swaps with counterparties as an ordinary course of business for its own account," but also that "the term swap dealer does not include a person that enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business." The Proposing Release stated that these two provisions should be read in combination with each other, and explained that the difference between the two provisions is whether or not the person enters into swaps as a part of, or as an ordinary course of, a "regular business." Thus, the Proposing Release equated the phrases "ordinary course of business" and "regular business." The Proposing Release also stated that persons who enter into swaps as a part of a "regular business" are those persons whose function is to accommodate demand for swaps from other parties and enter into swaps in response to interest expressed by other parties. Such persons would be swap dealers.²² Conversely, the Proposing Release said that persons who do not fulfill this function in connection with swaps should not be deemed to enter into swaps as part of a "regular business," and thus would not likely be swap dealers.²³

In addition, the Proposing Release noted that the nature of swaps precludes importing concepts used to identify dealers in other areas. The Proposing Release explained that because swaps are typically not bought and sold, concepts such as whether a person buys and sells swaps,

²² In addition, the Proposing Release explained that (in general, and not specifically limited to the provisions relating to entering into swaps as part of a "regular business") the proposed swap dealer definition does not depend on whether a person's activity as a swap dealer is the person's sole or predominant business (other than through the de minimis exception discussed below).

²³ See Proposing Release, 75 FR at 80177.

makes a two-sided market in swaps, or trades within a bid/offer spread cannot necessarily be used to determine if the person is a swap dealer, even if such concepts are useful in determining whether a person is a dealer in other financial instruments.²⁴

The Proposing Release further stated that swap dealers can be identified through their relationships with counterparties, explaining that swap dealers tend to enter into swaps with more counterparties than do non-dealers, and in some markets, non-dealers tend to constitute a large portion of swap dealers' counterparties. In contrast, the Proposing Release said, non-dealers tend to enter into swaps with swap dealers more often than with other non-dealers. The Proposing Release noted that it is likely that swap dealers are involved in most or all significant parts of the swap markets.²⁵

The Proposing Release concluded that this functional approach would identify as swap dealers those persons whose function is to serve as the points of connection in the swap markets. Thus, requiring registration and compliance with the requirements of the Dodd-Frank Act by such persons would thereby reduce risk and enhance operational standards and fair dealing in those markets.²⁶

The Proposing Release also noted that the swap markets are diverse and encompass a wide variety of situations in which parties enter into swaps with each other, and invited comment as to what aspects of the parties' activities in particular situations should, or should not, be considered swap dealing activities. Specifically, the Proposing Release invited comment

²⁴ See id. at 80176-77.

²⁵ See id. at 80177.

²⁶ See id.

regarding persons who enter into swaps: (i) as aggregators; (ii) as part of their participation in physical markets; or (iii) in connection with the generation and transmission of electricity.²⁷

First, regarding aggregators, the Proposing Release noted that some persons, including certain cooperatives, enter into swaps with other parties in order to aggregate the swap positions of the other parties into a size that would be more amenable to entering into swaps in the larger swap market. The Proposing Release explained that, for example, certain cooperatives enter into swaps with smaller businesses because the smaller business cannot establish a commodity position large enough to be traded on a swap or futures market, or large enough to be of interest to larger financial institutions. The Proposing Release said that while such persons engage in activities that are similar in many respects to those of a swap dealer, it may be that the swap dealing activities of these aggregators would not exceed the de minimis threshold, and therefore they would not be swap dealers. The CFTC requested comment as to how the de minimis threshold would apply to such persons, and in general on the application of the swap dealer definition to this activity. The Proposing Release also noted that the CFTC was engaged in a separate rulemaking pursuant to section 723(c)(3)(B) of the Dodd-Frank Act regarding swaps in agricultural commodities, and requested comment on the application of the swap dealer definition to dealers, including potentially agricultural cooperatives, that limit their dealing activity primarily to swaps in agricultural commodities.²⁸

Second, the Proposing Release noted that the markets in physical commodities such as oil, natural gas, chemicals and metals have developed highly customized transactions, some of

²⁷ See id. at 80183-84.

²⁸ After publication of the Proposing Release, the CFTC adopted a final rule on agricultural swaps under which swaps in agricultural commodities will be permitted to transact subject to the same rules as all other swaps. See Agricultural Swaps; Final Rule, 76 FR 49291 (Aug. 10, 2011).

which would be encompassed by the statutory definition of the term "swap," and that some participants in these markets engage in swap dealing activities that are above the proposed de minimis threshold. The CFTC invited comment as to any different or additional factors that should be considered in applying the swap dealer definition to participants in these markets.

Third, the Proposing Release noted a number of complexities that arise when applying the swap dealer definition in connection with the generation and transmission of electricity. In particular, the Proposing Release noted that additional complexity results because electricity is generated, transmitted and used on a continuous, real-time basis, and because the number and variety of participants in the electricity market is very large, and some electricity services are provided as a public good rather than for profit. The CFTC invited comment as to any different or additional factors that should be considered in applying the swap dealer definition to participants in the generation and transmission of electricity. Specifically, the CFTC invited comment on whether there are special considerations, including without limitation special considerations arising from section 201(f) of the Federal Power Act,²⁹ related to not-for-profit power systems such as rural electric cooperatives and entities operating as political subdivisions of a state and on the applicability of the exemptive authority in section 722(f) of the Dodd-Frank Act to address those considerations.

²⁹

16 U.S.C. 824(f).

b. “Security-based swap dealer” activity

The Proposing Release noted the parallels between the definition of “security-based swap dealer” and the definition of “dealer” under the Exchange Act,³⁰ as well as the fact that security-based swaps may be used to hedge risks associated with owning certain types of securities or to gain economic exposure akin to ownership of certain types of securities. As a result, the Proposing Release took the view that the same factors that are relevant to determining whether a person is a “dealer” under the Exchange Act also are generally relevant to the analysis of whether a person is a security-based swap dealer. The Proposing Release also addressed the relevance of the “dealer-trader” distinction for identifying dealing activity involving security-based swaps,³¹ while recognizing that certain concepts associated with the dealer-trader distinction – particularly concepts involving “turnover of inventory” and “regular place of business” – appeared potentially less applicable to the security-based swap dealer definition. In addition, the Proposing Release noted that under the dealer-trader distinction, we would expect that entities that use security-based swaps to hedge business risks, absent other activities, likely would not be dealers.³²

³⁰ See Exchange Act sections 3(a)(5)(A), (B), 15 U.S.C. 78c(a)(5)(A), (B), as amended by Section 761(a)(1) of the Dodd-Frank Act.

³¹ The Proposing Release referred to the fact that the SEC previously has noted that the dealer-trader distinction: “recognizes that dealers normally have a regular clientele, hold themselves out as buying or selling securities at a regular place of business, have a 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).” Proposing Release, 75 FR at 80177 (citing Securities Exchange Act Release No. 47364 (Feb. 13, 2003) (footnotes omitted)). The Proposing Release further noted that other non-exclusive factors that are relevant for distinguishing between dealers and non-dealers can include receipt of customer property and the furnishing of incidental advice in connection with transactions. See *id.*

³² See Proposing Release, 75 FR at 80177-78.

- c. Additional principles common to both definitions
- i. “Hold themselves out” and “commonly known in the trade” tests

The Proposing Release identified the following non-exclusive list of factors as potentially indicating that a person meets the “hold themselves out” and “commonly known in the trade” tests of the statutory dealer definitions:

- contacting potential counterparties to solicit interest in swaps or security-based swaps;
- developing new types of swaps or security-based swaps (which may include financial products that contain swaps or security-based swaps) and informing potential counterparties of the availability of such swaps or security-based swaps and a willingness to enter into such swaps or security-based swaps with the potential counterparties;
- membership in a swap association in a category reserved for dealers;
- providing marketing materials (such as a website) that describe the types of swaps or security-based swaps that one is willing to enter into with other parties; or
- generally expressing a willingness to offer or provide a range of financial products that would include swaps or security-based swaps.³³

The Proposing Release further stated that the test for being “commonly known in the trade” as a swap dealer or security-based swap dealer may appropriately reflect, among other factors, the perspective of persons with substantial experience with and knowledge of the swap and security-based swap markets (regardless of whether a particular entity is known as a dealer by persons without that experience or knowledge). The Proposing Release also stated that holding oneself out as a security-based swap dealer likely would encompass a person who is a

³³ See id. at 80178.

dealer in another type of security entering into a security-based swap with a customer, as well as a person expressing its availability to enter into security-based swaps, regardless of the direction of the transaction or across a broad spectrum of risks.³⁴

ii. Market making

In addressing the statutory definitions' "making a market" test, the Proposing Release noted that while continuous two-sided quotations and a willingness to buy and sell a security are important indicators of market making in the equities market, these indicia may not be appropriate in the swap and security-based swap markets. The proposal also noted that nothing in the statutory text or legislative history suggested the intent to impute a "continuous" activity requirement to the dealer definitions.³⁵

iii. No predominance test

The Proposing Release further addressed whether a person should be a dealer only if that activity is the person's sole or predominant business, and took the view that such an approach was not consistent with the statutory definition. The Proposing Release rejected this as an unworkable test of dealer status because many parties that commonly are acknowledged as dealers also engage in other businesses that outweigh their swap or security-based swap dealing business in terms of transaction volume or other measures.³⁶

³⁴ See id.

³⁵ See id.

³⁶ See id. at 80178-79.

iv. Application to new types of swaps and new activities

The Proposing Release noted that the Commissions intended to apply the dealer definitions flexibly when the development of innovative business models is accompanied by new types of dealer activity, following a facts-and-circumstances approach.³⁷

2. Commenters' views

Numerous commenters addressed the proposed rules and interpretations in connection with the "swap dealer" and "security-based swap dealer" definitions. Several commenters addressed principles that are common to the two dealer definitions, while a number of commenters also addressed interpretations in the Proposing Release that were specific to the "swap dealer" definition.

a. "Hold themselves out" and "commonly known in the trade" tests

Some commenters expressed the view that the persons that hold themselves out as or are commonly known as dealers are easy to identify.³⁸ In addressing the "hold themselves out" and "commonly known" criteria of the dealer definitions, commenters placed particular focus on whether only dealers engage in the activities cited by the Proposing Release, or whether those activities are common both to dealers and to other users of swaps and security-based swaps. Commenters particularly stated that end users contact potential counterparties,³⁹ develop new

³⁷ See *id.* at 80179.

³⁸ See transcript of Joint CFTC-SEC Staff Roundtable Discussion on Proposed Dealer and Major Participant Definitions Under Dodd-Frank Act, June 16, 2011 ("Roundtable Transcript") at 22-23 (remarks of Ron Filler, New York Law School), 50-51 (remarks of Ron Oppenheimer, Working Group of Commercial Energy Firms), 215 (remarks of Bella Sanevich, NISA Investment Advisors LLC).

³⁹ See letters from the Financial Services Roundtable ("FSR") dated February 22, 2011 ("FSR I"), the International Swap Dealers Association ("ISDA") dated February 22, 2011 ("ISDA I") and the Midsize Bank Coalition of America ("Midsize Banks").

types of swaps or security-based swaps,⁴⁰ and propose terms or language for swap or security-based swap agreements.⁴¹ One commenter further stated that identifying dealing activity based on whether a person develops new types of swaps or proposes swap terms would discourage innovation and the free negotiation of swaps.⁴² Some commenters stated that merely responding to a request for proposals or quotations should not, in itself, constitute dealing.⁴³ Commenters also criticized the Proposing Release's suggestion that criteria for identifying dealing activity include membership in a dealer category of a trade association,⁴⁴ as well as providing marketing materials and offering a range of financial products.⁴⁵ Commenters also argued for more objective criteria for identifying persons "commonly known" as dealers.⁴⁶

Conversely, one commenter said that three particular activities cited in the Proposing Release – membership in a swap association category reserved for dealers, providing marketing materials and expressing a willingness to offer a range of financial products – are indicative of holding oneself out as a dealer or being commonly known in the trade as a dealer, and should be

⁴⁰ See letters from the Committee on Capital Markets Regulation ("CCMR") dated February 22, 2011 ("CCMR I"), FSR I, ISDA I and Midsize Banks.

⁴¹ See letters from the BG Americas & Global LNG ("BG LNG") dated February 22, 2011 ("BG LNG I"), CCMR I, EDF Trading North America, LLC ("EDF Trading") and The Gavilon Group, LLC ("Gavilon") dated February 21, 2011 ("Gavilon II").

⁴² See letter from EDF Trading.

⁴³ See meeting with American Electric Power, Calpine Corporation ("Calpine"), Constellation, DC Energy LLC ("DC Energy"), Edison International ("Edison Int'l"), Exelon Corp., GenOn, Southern Company, Edison Electric Institute ("EEI") and Electric Power Supply Association ("ESPA") (collectively "Electric Companies") on April 13, 2011.

⁴⁴ See letter from ISDA I and joint letter from National Corn Growers Association ("NCGA") and Natural Gas Supply Association ("NGSA") ("NCGA/NGSA") dated February 22, 2011 ("NCGA/NGSA I").

⁴⁵ See letter from ISDA I.

⁴⁶ See letters from ISDA I and Peabody Energy Corporation ("Peabody").

codified in the final rule.⁴⁷ Another commenter suggested other factors, such as having a derivatives sales team, that should be treated as indicators of dealer activity.⁴⁸ Commenters also expressed the view that this aspect of the dealer definition should focus on whether a person solicits expressions of interest in swaps from a range of market participants,⁴⁹ and that end users of swaps can actively seek out and negotiate swaps without necessarily being swap dealers.⁵⁰

b. Market making

Several commenters generally requested that the Commissions provide more guidance as to which activities constitute making a market in swaps or security-based swaps.⁵¹ Commenters also described various activities as indicating, or not indicating, market making activity. For example, two commenters expressed the view that market making is characterized by entering into swaps on one side of the market and then establishing offsetting positions on the other side of the market.⁵² Other commenters equated market making to providing liquidity by regularly quoting bid and offer prices for swaps, and standing ready to enter into swaps.⁵³ One commenter stated that market making activity is indicated by a person consistently presenting itself as willing to take either side of a trade.⁵⁴ Two commenters said that market makers receive tangible

⁴⁷ See letter from FSR I.

⁴⁸ See meeting with Vitol, Inc. ("Vitol") on February 16, 2011.

⁴⁹ See letter from Midsize Banks.

⁵⁰ See letter from EDF Trading.

⁵¹ See joint letter from American Benefits Council and the Committee on Investment of Employee Benefits Assets ("ABC/CIEBA") and letters from FSR I.

⁵² See letters from DC Energy and FSR I.

⁵³ See letters from Edison Int'l, NextEra Energy Resources, LLC ("NextEra") dated February 22, 2011 ("NextEra I") and Vitol, and joint letter from American Electric Power, Edison Int'l, Exelon Corp., and Southern Company ("Utility Group").

⁵⁴ See letter from ISDA I.

benefits (such as reduced trading fees) in return for the obligation to transact when liquidity is required.⁵⁵

In contrast, one commenter said the proposal correctly did not limit market making to consistently quoting a two-sided market, because to do so would insert a loophole into the definition.⁵⁶ Some commenters expressed the view that mere active participation in a market or entering into swaps on both sides of a market does not necessarily constitute market making.⁵⁷ Others said that occasionally quoting prices on both sides of the market is not market making when done to obtain information about the market or to mask one's view of the market.⁵⁸ One commenter stated that futures commission merchants ("FCMs") and broker-dealers that facilitate customers' entering into swaps are not necessarily market makers.⁵⁹ Other commenters urged the Commissions to reject the view that market making requires continuous activity.⁶⁰

A number of commenters addressed the issue of how the dealer definitions should treat swaps or security-based swaps entered into on a trading platform such as a designated contract market ("DCM"), national securities exchange, swap execution facility ("SEF"), or security-

⁵⁵ See joint letter from EEI and EPSA ("EEI/EP SA") and letter from Vitol.

⁵⁶ See letter from Americans for Financial Reform ("AFR").

⁵⁷ See letters from ABC/CIEBA, Managed Funds Association ("MFA") dated February 22, 2011 ("MFA I"), and Vitol.

⁵⁸ See letters from NextEra and Vitol.

⁵⁹ See letter from Newedge USA LLC ("Newedge"); see also Roundtable Transcript at 39 (remarks of Eric Chern, Chicago Trading Company).

⁶⁰ See letters from American Federation of State, County and Municipal Employees ("AFSCME"), and FSR I.

based SEF (collectively referred to herein as “exchanges”).⁶¹ Several stated that entering into swaps or security-based swaps on exchanges should not be considered in determining if a person is a dealer.⁶² Some of these commenters emphasized the fact that parties would not know the identity of the counterparty to the swap executed on an exchange (i.e., such swaps are “anonymous”),⁶³ while other commenters said that such swaps do not constitute “accommodating demand” for swaps or “facilitating interest” in swaps.⁶⁴ Another commenter said that future means of executing swaps on exchanges are likely to be diverse, and it is premature to draw conclusions about how they should be treated in the dealer definitions.⁶⁵

Two commenters asserted that firms that provide liquidity in cleared and exchange-executed swaps by actively participating in the market provide heterogeneity among liquidity providers and thereby disperse risk, and further stated that to regulate such persons as swap

⁶¹ While some of these commenters specially addressed this issue in the context of whether a person is a market maker in swaps, others more generally addressed the issue in terms of whether a person is a dealer. For clarity, all of those comments are being addressed in the market maker context.

⁶² See letters from EEI/EPISA, International Energy Credit Association (“IECA-Credit”) dated February 22, 2011 (“IECA-Credit I”), and NextEra I, joint letter from Shell Trading (US) Company and Shell Energy North America (US), L.P. (“Shell Trading”) dated February 22, 2011 (“Shell Trading I”), and joint letter from Allston Trading, LLC, Atlantic Trading USA LLC, Bluefin Trading LLC, Chopper Trading LLC, DRW Holdings, LLC, Eagle Seven, LLC, Endeavor Trading, LLC, Geneva Trading USA, LLC, GETCO, Hard Eight Futures, LLC, HTG Capital Partners, IMC Financial Markets, Infinium Capital Management LLC, Kottke Associates, LLC, Liger Investments Limited, Marquette Partners, LP, Nico Holdings LLC, Optiver US, Quantlab Financial, LLC, RGM Advisors, LLC, Tibra Trading America LLC, Traditum Group LLC, WH Trading and XR Trading LLC (“Traders Coalition”).

⁶³ See letters from Shell Trading I and Traders Coalition.

⁶⁴ See letters from EEI/EPISA, IECA-Credit I, and NextEra I. For further discussion of this issue, see parts II.A.4 and II.A.5 below.

⁶⁵ See letter from Metropolitan Life Insurance Company (“MetLife”).

dealers subject to increased capital requirements would discourage their participation in the market and increase risk.⁶⁶

One commenter expressed the view that the statutory definition uses dealing and market making interchangeably, and suggested that the analysis of whether a person acts as a dealer should be subsumed within the analysis of whether it acts as a market maker.⁶⁷

c. Exception for activities not part of a “regular business”

Several commenters addressed the exception from the dealer definitions for swap or security-based swap activities that are not part of a “regular business.” Some commenters supported the Commissions’ proposed interpretation in the context of the “swap dealer” definition and stated that this interpretation should be codified in the text of the final rule.⁶⁸

Many commenters said that the activity of entering into swaps or security-based swaps should not be deemed to be a “regular business,” and thus not indicative of dealing activity, when the person’s use of swaps or security-based swaps are ancillary to, or in connection with, a separate non-swap business that is the person’s primary business.⁶⁹ Some commenters making this point said that when the person’s primary business relates to physical commodities, the person’s use of swaps relating to those commodities does not constitute a “regular business.”⁷⁰

⁶⁶ See letters from Newedge and Traders Coalition; Roundtable Transcript at 39 (remarks of Eric Chern, Chicago Trading Company).

⁶⁷ See letter from ISDA I.

⁶⁸ See letters from FSR I, MFA I and Midsize Banks.

⁶⁹ See Roundtable Transcript at 88 (remarks of Steve Walton, Bank of Oklahoma).

⁷⁰ See letters from Atmos Energy Corporation (“Atmos Energy”), Dominion Resources, Inc. (“Dominion Resources”), EDF Trading, Edison Int’l, EEI/EPSCo, Gavilon II, Hess Corporation and its affiliates (“Hess”), Mississippi Public Utility Staff, NextEra I, National Milk Producers Federation (“NMPF”), Shell Trading I, Utility Group and Working Group of Commercial Energy Firms (“WGCEF”)

Other commenters stated that where a person enters into swaps to serve its own business needs, as opposed to serving the business needs of the counterparty, the person's use of swaps does not constitute a "regular business."⁷¹ Other commenters said that the use of swaps to hedge the commercial risks of a business does not constitute a "regular business" of entering into swaps.⁷² Some commenters also suggested that the "regular business" exclusion should be interpreted to mean "regular swap dealing business" or "regular security-based swap dealing business" to prevent the dealer definitions from capturing hedgers.⁷³

On the other hand, two commenters said that the proposed interpretation was correct in the view that the test of whether a person has a "regular business" of entering into swaps does not necessarily depend on whether a person's swap activities are a predominant activity, because such an approach would allow a person to engage in a significant level of swap dealing activity without registering as a swap dealer simply because the person also has substantial activities in a non-swap business or businesses.⁷⁴

on the swap dealer definition dated February 22, 2011 ("WGCEF I"), and meeting with Bunge on February 23, 2011.

⁷¹ See letters from BT Pension Scheme Management Limited ("BTPS"), EDF Trading, EEI/EPISA and Vitol.

⁷² See letters from American Petroleum Institute ("API") dated February 22, 2011 ("API I"), Calpine, Coalition of Physical Energy Companies ("COPE") dated February 22, 2011 ("COPE I"), Dominion Resources, EDF Trading, Edison Int'l and Peabody; see also Roundtable Transcript at 45 (remarks of Ed Prosser, Gavilon) and letter from Church Alliance. In addition, three commenters said that the interpretation of the provisions relating to a "regular business" in the Proposing Release is correct, because it will exclude from the definition of swap dealer those persons using swaps to hedge commercial risk. See letters from Air Transport Association of America, Inc. ("ATAA"), IECA-Credit I and joint letter from Petroleum Marketers Association of America and New England Fuel Institute.

⁷³ See letters from Church Alliance and Peabody.

⁷⁴ See letters from AFR and Better Markets, Inc. ("Better Markets") dated February 22, 2011 ("Better Markets I").

Other commenters suggested that the types of swap activities that a person engages in are relevant to determining whether the person has a “regular business” of entering into swaps. One commenter stated that a person has a “regular business” of entering into swaps when the person has a primary business of accommodating demand or facilitating interest in swaps,⁷⁵ while others similarly emphasized that a “regular business” of entering into swaps is characterized by financial intermediation activities.⁷⁶ One commenter took the view that a person that enters into swaps primarily with financial intermediaries does not have a “regular business” of entering into swaps.⁷⁷

Some commenters said that the final rule should clarify the point at which a person’s episodic or occasional swap activities become a “regular business” of entering into swaps.⁷⁸ Others stated that the fact that a person enters into swaps frequently or with a large number of counterparties does not necessarily mean that the person has a “regular business” of entering into swaps.⁷⁹

Commenters proposed specific tests for determining if a person has a “regular business” of entering into swaps. One commenter said the determination should look to whether a person

⁷⁵ See letter from IECA-Credit I.

⁷⁶ See letter from NextEra I and Shell Trading I. Another commenter disagreed with this approach, however, saying that a person who enters into swaps as an intermediary between smaller customers and larger financial institutions is not entering into swaps for its “own account” and therefore is not a swap dealer, but rather would be an FCM or introducing broker. See letter from MFX Solutions, Inc. (“MFX”) dated February 22, 2011 (“MFX I”).

⁷⁷ See letter from Traders Coalition.

⁷⁸ See letters from BG LNG I and WGCEF I.

⁷⁹ See letters from NCGA/NGSA I and Vitol. One of these commenters asked that the final rule clarify that simply because a person engages in swap activity exceeding the thresholds for the de minimis exception from the swap dealer definition does not necessarily mean that the person is engaged in a “regular business” of swap dealing. See letter from Vitol.

enters into swaps to accommodate demand from other parties and to profit from a bid/ask spread on swaps (as opposed to swaps that are substitutes for physical transactions or positions and used by at least one party to hedge commercial risk), and consider specifically the volume, revenues and profits of such activities, the person's value at risk (VaR) and exposure from such activities, and its resources devoted to such activities.⁸⁰ Another commenter said that the determination should be based on the nature of the person's business, the person's business purpose for using swaps, and the person's method of executing swap transactions (e.g., a person whose business primarily relates to physical commodities, who uses swaps to hedge commercial risk, and who executes swaps on an exchange would be less likely to have a "regular business" of entering into swaps).⁸¹

One commenter argued that the "regular business" exception should apply to all four of the dealer tests – not only the test for persons that regularly enters into swaps or security-based swaps as an "ordinary course of business" – and further argued that the "regular business" exception should be linked to a "two-way market" base requirement to avoid commercial hedgers being encompassed by the dealer definitions.⁸²

d. Other dealer issues

Commenters also addressed other issues in the Proposing Release, including: (i) whether Congress intended that there be implicit preconditions to dealer status; (ii) whether the concepts of "accommodating demand" for swaps or security-based swaps or "facilitating interest" in swaps are useful in identifying dealers; and (iii) whether the interpretation of the dealer

⁸⁰ See letter from NextEra I; see also letter from Hess (proposing similar criteria).

⁸¹ See letter from Shell Trading I.

⁸² See letter from ISDA dated I.

definitions should depend on pre-defined, objective criteria:

i. Preconditions

Several commenters said that the proposal is overbroad and would encompass persons that Congress did not intend to regulate as dealers.⁸³ Comments in this vein said that the statutory definition should be interpreted to require that persons meet certain criteria or engage in certain activity, not explicitly stated in the statute, to be covered by the swap dealer definition. For instance, some commenters said that a dealer is a person who enters into swaps or security-based swaps on either side of the market and who profits from fees for doing so, or from the spread between the terms of swaps on either side of the market.⁸⁴ Other commenters made a similar point, saying that swap dealers are those persons that intermediate between swap users on either side of the market.⁸⁵

The commenters were not all in agreement on this, however. Several commenters (including some of those that said swap dealers enter into swaps on both sides of the market) also stated that there are a variety of situations in which a person's activity of contemporaneously

⁸³ See, e.g., letters from BG LNG I, EDF Trading, ISDA I, NCGA/NGSA dated February 17, 2012 ("NCGA/NGSA II") and WGCEF I, and joint letter from American Farm Bureau Federation, American Soybean Association, National Association of Wheat Growers, National Cattlemen's Beef Association, National Corn Growers Association, National Council of Farmer Cooperatives, National Grain and Feed Association, National Milk Producers Federation and National Pork Producers Council ("Farmers' Associations").

⁸⁴ See letters from COPE I, Edison Int'l, Hess, ISDA I, Shell Trading I, Utility Group, Vitol and WGCEF I; see also Roundtable Transcript at 43-45 (remarks of Ed Prosser, Gavilon). However, other commenters questioned whether profiting from a bid/ask spread is a relevant test of dealer status, and emphasized that dealers are those persons who take risk by entering into swaps or security-based swaps on both sides of the market. See Roundtable Transcript at 21, 56 (remarks of Richard Ostrander, Morgan Stanley) and 43 (remarks of Russ Wasson, National Rural Electric Cooperative Association ("NRECA")). Another commenter pointed out that it could be difficult to determine how a person is profiting from entering into swaps. See Roundtable Transcript at 42 (remarks of Michael Masters, Better Markets).

⁸⁵ See letters from API I, BG LNG I and NCGA/NGSA II.

entering into swaps on both sides of the market is not indicative of dealing activity.⁸⁶ One commenter said that it would not be appropriate to require that a person enter into swaps or security-based swaps on both sides of the market as a litmus test for dealer status, because to do so would create loopholes in the definition.⁸⁷ Two commenters also supported rejection of any interpretation that would limit the dealer definitions to encompass only those entities that solely or predominately act as dealers.⁸⁸

In addition, commenters were particularly divided as to whether acting as an intermediary always is indicative of swap dealing, as some commenters said that a person is not a swap dealer when it simply stands between two parties by entering into offsetting swaps with each party.⁸⁹

ii. “Accommodating demand” and “facilitating interest”

A number of commenters addressed the Proposing Release’s view that a tendency to accommodate demand for swaps and a general availability to enter into swaps to facilitate other parties’ interest in swaps (referred to here as “accommodating demand” and “facilitating

⁸⁶ The examples cited were: entering into swaps on either side of a market depending on a firm’s commercial purpose for entering each particular swap (see letters from the Industrial Energy Consumers of America (“IECA-Consumers”) and WGCEF I, and letter from the Not-For-Profit Electric End User Coalition (“NFPEEU”), consisting of NRECA, American Public Power Association (“APPA”) and Large Public Power Council (“LPPC”); see also Roundtable Transcript at 44 (remarks of Ed Prosser, Gavilon)); entering into swaps on both sides of an illiquid market for purposes of price discovery or to elicit bids and offers from other market participants (see letters from Hess, Vitol and WGCEF I); and entering into swaps on both sides of the market as part of an investment strategy (see letter from ABC/CIEBA).

⁸⁷ See letter from AFR.

⁸⁸ See letters from AFR and Better Markets I.

⁸⁹ See letters from BOKF, National Association (“BOK”) dated January 13, 2012 (“BOK V”), MFX I, Newedge and Northland Energy Trading LLC (“Northland Energy”); see also Roundtable Transcript at 48 (remarks of John Nicholas, Newedge). One commenter queried whether the final rule should clarify whether a customer relationship between the parties to a swap is necessary in order for the swap to be relevant in determining whether either of the parties is a swap dealer. See letter from Representative Scott Desjarlais (“Rep. Desjarlais”).

interest”) are characteristic of swap dealers. Some commenters stated that accommodating demand and facilitating interest would not be effective factors to identify swap dealers, particularly in bilateral negotiations where it is difficult to say which party is accommodating demand for swaps.⁹⁰ Other commenters said the activities of accommodating demand or facilitating interest are indicative of swap dealing only in certain circumstances, such as when they are not related to a person’s commodity business,⁹¹ or when done with the purpose of serving the needs of the other party to the swap.⁹² Some commenters argued that the statement in the Proposing Release that swap dealers are likely involved in most or all significant parts of the swap markets is incorrect in the market for energy swaps. There, the commenters said, persons can find counterparties for swaps without the intermediation of a swap dealer, and swaps entered into directly by two end users are more frequent.⁹³

Other commenters, though, said that the proposal’s focus on accommodating demand and facilitating interest strikes the right balance and that the proposed approach is generally correct.⁹⁴ Another commenter did not object to including accommodating demand and facilitating risk as factors in the definition, but said that those factors should be applied flexibly.⁹⁵

⁹⁰ See letters from NextEra I and Peabody and meeting with Vitol on February 15, 2011.

⁹¹ See letter from Shell Trading I.

⁹² See letters from IECA-Credit I, National Association of Insurance Commissioners (“NAIC”), Vitol and WGCEF I. One of these commenters also said that entering into a bespoke swap with a registered swap dealer, in which the swap dealer lays off risk, should not be viewed as accommodating demand or facilitating interest. See letter from Vitol.

⁹³ See letter from BG LNG I, NCGA/NGSA I, NFPPEU, NRG Energy, Inc. (“NRG Energy”) and WGCEF I and meeting with Vitol on February 16, 2011.

⁹⁴ See letters from AFR and MFX I.

⁹⁵ See letter from National Grain and Feed Association (“NGFA”) dated February 22, 2011 (“NGFA P”).

iii. Application of objective criteria, and additional factors

Some commenters, specifically addressing the CFTC's proposed interpretive approach to the "swap dealer" definition, said that the final rule should set out objective criteria that market participants could use to determine whether or not they are covered by the definition and therefore required to register as swap dealers.⁹⁶ Others focused especially on statements in the Proposing Release to the effect that swap dealers are those persons who "tend to" engage in certain activities, and that persons who engage in certain activities are "likely" to be swap dealers, as being overly subjective and difficult to interpret.⁹⁷

Certain commenters suggested specific objective criteria to use to identify swap dealers. One commenter said that swap dealing activity is characterized by more frequent use of swaps; having substantial staff and technological resources devoted to swaps; a larger portion of revenue and profit being derived from swap activity; and owning fewer physical assets related to the type of swaps entered into.⁹⁸ Another commenter said that to identify swap dealers, the CFTC should compare a person's revenue or profits generated by swap activity to its overall revenue or profits; compare a person's total business volume to the volume, VaR and exposure associated with the swap activity; compare a person's total business resources to the resources devoted to swap

⁹⁶ See letters from BG LNG I, EEI/EPISA, Peabody, Rep. Desjarlais and Utility Group. Some commenters said that the CFTC's interpretive approach to the swap dealer definition should be codified in the text of the final rule. See letters from Alternative Investment Management Association Limited ("AIMA") dated February 22, 2011 ("AIMA I") and COPE I.

⁹⁷ See letters from BG LNG I, Chesapeake Energy Corporation ("Chesapeake Energy"), COPE I, ISDA I, Vitol and WGCEF I. Some commenters focused on particular aspects of the swap dealer definition as requiring further detail, such as, for example, what it means to be "commonly known in the trade" as a swap dealer (see letter from Peabody) and the definition of market making (see letters from Midsized Banks and Peabody).

⁹⁸ See letter from Hess.

activity; and consider ownership or control of physical assets in the specific market or region to which the person's swap activity is tied.⁹⁹

More generally, some commenters supported codification of more concrete tests in connection with the dealer definitions.¹⁰⁰ However, other commenters said that the use of bright line rules to determine whether a person is a dealer would be inappropriate given the dynamic nature of the swap and security-based swap markets. These commenters supported a facts and circumstances approach to the dealer definition as a better approach.¹⁰¹ One commenter also raised issues about the sources of information that may be considered as part of a dealer determination.¹⁰²

e. Application of Exchange Act "dealer-trader" distinction

i. Security-based swap dealer definition

A number of commenters supported the proposed use of the dealer-trader distinction under the Exchange Act to interpret the "security-based swap dealer" definition.¹⁰³ Two commenters, however, specifically opposed use of the distinction in the context of security-based swaps, arguing that use of the distinction would create confusion or would be inconsistent with the goal of improved transparency.¹⁰⁴

⁹⁹ See letter from NextEra I.

¹⁰⁰ See, e.g., letters from EEI/EPSC, FSR I, ISDA I, NextEra I and WGCEF I.

¹⁰¹ See letters from Better Markets I, Chris Barnard ("Barnard") and Prof. Michael Greenberger, University of Maryland School of Law ("Greenberger").

¹⁰² See letter from ISDA I (stating that sources of information considered by the Commissions in determining dealer status should be revealed to the entity being evaluated).

¹⁰³ See, e.g., letters from Coalition for Derivatives End-Users ("CDEU"), CCMR I, ISDA I and MetLife.

¹⁰⁴ See letters from AFR and AFSCME.

ii. Swap dealer definition

Some commenters said that the CFTC should apply the dealer-trader distinction as it has been interpreted with respect to the definition of “dealer” under the Exchange Act to identify swap dealers.¹⁰⁵ Some commenters said that the applicable interpretations under the Exchange Act mean that swaps a person uses for proprietary trading (including for speculative purposes) should not be considered in determining if the person is a swap dealer because dealers enter into transactions in order to profit from spreads or fees regardless of their view of the market for the underlying item, whereas traders enter into transactions in order to take a view on the direction of the market or to obtain exposure to movements in the price of the underlying item.¹⁰⁶ Two commenters said that if the CFTC applied the distinction, traders should be subject to potential registration as major swap participants, and dealers should be subject to regulation as swap dealers.¹⁰⁷ Commenters acknowledged differences between the market for swaps and the market for securities, but said that the Exchange Act interpretations are still relevant.¹⁰⁸

¹⁰⁵ Some of these commenters said that, since some provisions in the statutory swap dealer definition are similar to the definition of a “dealer” under the Exchange Act, Congress intended that the two definitions would be applied in the same way. See letters from API I, BG LNG I, CDEU, IECA-Consumers and WGCEF I. Others said that the CFTC should apply these interpretations because they have been effectively applied for a long time in the context of securities. See letters from CCMR I and MFA I.

¹⁰⁶ See letters from Gavilon II, and Next Era I, and meetings with Electric Companies on April 13, 2011 and WGCEF on April 28, 2011. Another commenter said the interpretations mean that dealers and traders can be distinguished by their activities: dealers hold themselves out as buying and selling on a regular basis, derive income from providing services in the chain of distribution, and profit from price spreads, while traders do not provide services or extend credit but, rather, profit from changes in the market value of underlying items. See letter from API I.

¹⁰⁷ See letters from EDF Trading and IECA-Consumers.

¹⁰⁸ See letters from API I, Gavilon I and IECA-Consumers.

On the other hand, some commenters agreed with the CFTC's view not to apply Exchange Act interpretations to the definition of the term "swap dealer." These commenters said that it is appropriate not to apply the interpretations under the Exchange Act to identify persons that meet the swap dealer definition under the CEA.¹⁰⁹

e. Application to particular swap markets

i. Aggregators

Certain commenters addressed persons who enter into swaps as aggregators, with most of those commenters discussing agricultural cooperatives. Commenters said that agricultural cooperatives that hedge their own risks or the risks of their members regarding agricultural commodities should be excluded from the swap dealer definition because Congress did not intend to treat agricultural cooperatives as swap dealers and because agricultural cooperatives are in effect an extension of their members.¹¹⁰ Some commenters said that the agricultural cooperatives' use of swaps allows their members to hedge risks when the members' transactions are too small for (or otherwise not qualified for) the futures markets.¹¹¹

¹⁰⁹ See letters from AFR and AFSCME; see also joint meeting with AFR and Better Markets on March 17, 2011 (dealer-trader distinction not helpful in identifying swap dealers because the transparency and operational robustness of the swap market is much lower than in the securities market). One commenter said the precedents should be applied only by the SEC to identify security-based swap dealers. See letter from NAIC.

¹¹⁰ See letters from Dairy Farmers of America ("DFA"), Growmark, Land O'Lakes, Inc. ("Land O'Lakes") dated February 22, 2011 ("Land O'Lakes II"), National Council of Farmer Cooperatives ("NCFC") dated February 22, 2011 ("NCFC I") and NMPF. One commenter also said that a subsidiary of an agricultural cooperative that enters into swaps with its parent cooperative, and the members of the parent cooperative, should be excluded from the swap dealer definition for the same reason. See meeting with Agrivisor. Another commenter said that an agricultural cooperative's swaps with farmers and other persons for risk management should be disregarded in determining if the cooperative is a swap dealer so long as the swaps relate to the marketing function of the cooperative, even if the swaps are not with members of the cooperative. See letter from NMPF.

¹¹¹ See letters from DFA and Growmark.

Some commenters said that an exclusion from the swap dealer definition also should be available to private companies that serve as aggregators for swaps in agricultural commodities or otherwise offer swaps for agricultural risk management.¹¹² These commenters said that such an exclusion would reduce the costs and regulatory burdens imposed on such companies and therefore provide a broader choice of swap providers to farmers and other agricultural market participants, which they said would reduce risks.¹¹³

One commenter discussed a small energy firm that aggregates demand for swaps from small energy retailers and consumers. This commenter said that such aggregators should be excluded from the swap dealer definition because imposing the swap dealer regulations (which would be promulgated with large financial firms in mind) on such firms would increase costs for the aggregators, discourage the aggregators' offering of swaps, and thereby reduce choice and efficiency in the market.¹¹⁴ Another commenter said that a firm that enters into swaps with microfinance lenders and offsetting swaps with commercial banks is akin to an introducing broker or FCM, and should be excluded from the swap dealer definition on the grounds that it does not enter into swaps on its own initiative, but rather to provide access to the swap markets to smaller counterparties.¹¹⁵

¹¹² See letters from Farmers' Associations, NGFA I and NMPF.

¹¹³ See *id.*

¹¹⁴ See letter from Northland Energy. This commenter defined an "aggregator" as a person who: (i) enters into swaps predominantly in one direction with counterparties that are using swaps to establish bona fide hedges; and (ii) offsets risks associated with such swaps using regulated futures contracts or cleared swaps.

¹¹⁵ See letter from MFX dated June 3, 2011 ("MFX II"). This commenter said that the exclusion should be available to a person who operates primarily on a not-for-profit basis and limits its swap activities to offering swaps to persons in underserved markets and offsetting such swaps, and who meets other requirements to limit the scope of the exclusion.

Another commenter said that there is no need for any special treatment of aggregators in the swap dealer definition. According to this commenter, the CFTC's guidance regarding the definition and the de minimis exception from the definition address the relevant issues properly and completely.¹¹⁶

ii. Physical commodity swaps

Commenters that discussed physical commodity swaps primarily focused on swaps related to energy commodities such as oil, natural gas and electricity. The commenters said that the market for these swaps is different from the market for swaps on interest rates and other financial commodities because, among other things, the swaps are used to mitigate price and delivery risks directly linked to a commercial enterprise; less swap activity flows through intermediaries; the markets for the underlying physical commodities are separately regulated; and the failure of a commodity market participant is not likely to impact financial markets as a whole.¹¹⁷ Therefore, these commenters believe, the application of the swap dealer definition to participants in these physical commodity swap markets should be different from the application to participants in the financial commodity swap markets.¹¹⁸ Some commenters said that imposing the costs of swap dealer regulation on participants in the markets for physical

¹¹⁶ See letter from Better Markets I.

¹¹⁷ See letters from BG LNG I, Dominion Resources, National Energy Marketers Association ("NEM"), NFPEEU, Vitol and WGCEF I joint letter from Senator Debbie Stabenow and Representative Frank Lucas (many commercial end-users of swaps with inherent physical commodity price risk use swaps to hedge such risk and otherwise for their own trading objectives and not for the benefit of others) and meetings with Bunge on May 18, 2011 and Electric Companies on April 13, 2011.

¹¹⁸ See id.

commodity swaps would discourage participation in the market, thereby reducing liquidity and increasing market concentration.¹¹⁹

iii. Electricity swaps

Commenters on the use of swaps in connection with the generation and transmission of electricity addressed a variety of issues. First, commenters said that markets related to electricity are different from markets for other physical commodities in that electricity must be generated and transmitted at the time it is needed (it cannot be stored for future use); the overall demand for electricity is inelastic but demand at any particular time is subject to external variables, such as weather; the generation, transmission and use of electricity is widely dispersed and geographically specific; the markets are overseen by regulators such as state Public Utility Commissions, regional transmission organizations ("RTOs") and the Federal Energy Regulatory Commission ("FERC"); and government mandates require continuous supply of electricity and treat electricity as a "public good."¹²⁰ Commenters said that because of these differences, the use of swaps related to electricity is different from the use of swaps on other physical commodities in that electricity swaps: are more highly customized to a particular place and time; are more likely to relate to a short time period or be more frequently entered into; typically can be tied to a specific generation, transmission or use of electricity; are more likely to be entered into directly by end-users rather than through dealers; are likely to be entered into by electricity companies on

¹¹⁹ See letters from Dominion Resources, NEM and NFPEEU.

¹²⁰ See letters from Edison Int'l, the staff of the FERC ("FERC Staff"), National Association of Regulatory Utility Commissioners ("NARUC"), NEM, NextEra I, NFPEEU and National Rural Utilities Cooperative Finance Corporation ("NRU CFC") dated February 14, 2011 ("NRU CFC I"), joint letter from NRECA, APPA, LPPC, EEI and EPSA ("Electric Trade Associations") and meetings with Electric Companies on April 13, 2011 and NFPEEU on January 29, 2011.

both sides of the market; and in many cases were subject to regulatory oversight prior to the Dodd-Frank Act.¹²¹

Commenters made various points regarding how swaps related to electricity should be treated for purposes of the swap dealer definition. A coalition of not-for-profit power utilities and electric cooperatives said that electricity cooperatives should be excluded from the swap dealer definition because they are non-profit entities that enter into swaps for the benefit of their members, they do not hold themselves out as swap dealers, they do not make markets, and their swaps are not necessarily reflective of market rates.¹²² Other commenters said that swaps related to transactions on tariff schedules approved by FERC or the Electric Reliability Council of Texas should be disregarded in determining if a person is a swap dealer.¹²³ And, some commenters said that any special treatment of swaps related to electricity should apply not only to companies that generate, transmit or distribute electricity, but also to energy marketing companies that use swaps to benefit from price changes in the underlying energy commodities or to hedge related risks.¹²⁴

On the other hand, some commenters acknowledged that a person who makes a market in swaps related to electricity by standing ready to enter into such swaps in order to profit from a

¹²¹ See letters from Edison Int'l, EEI/EPSCA, Electric Trade Associations, FERC Staff, NextEra I and NFPPEU and meeting with Electric Companies on April 13, 2011.

¹²² See letter from NFPPEU. This commenter said the exclusion from the swap dealer definition should extend to persons acting as an operating or purchasing agent for other utilities in connection with energy infrastructure products, or otherwise entering into energy commodity swaps on behalf of other end users.

¹²³ See letters from EDF Trading, FERC Staff and NARUC.

¹²⁴ See letters from DC Energy, EDF Trading and EEI/EPSCA.

bid/ask spread would be a swap dealer, even if the person was in the business of generating, transmitting or distributing electricity and owned physical facilities for that purpose.¹²⁵

f. Suggested exclusions from the dealer definitions

Several commenters took the view that the swap dealer and security-based swap dealer definitions should categorically exclude, or should be interpreted in a way that would be expected to exclude, a variety of types of persons or transactions. Commenters particularly suggested that the following categories of persons should be excluded from the dealer definitions: agricultural cooperatives and electric cooperatives (as addressed above), employee benefit plans as defined in the Employee Retirement Income Security Act of 1974 (“ERISA”),¹²⁶ farm credit system institutions,¹²⁷ Federal Home Loan Banks,¹²⁸ insured depository institutions that limit their swap dealing activity to riskless principal transactions,¹²⁹ FCMs and broker-dealers that limit their swap dealing activity to riskless principal transactions,¹³⁰ financial guaranty insurers and their affiliates that do not enter into new swaps,¹³¹ asset managers,¹³² non-financial companies offering swaps related to their physical commodity business,¹³³ any person

¹²⁵ See letter from EEL/EPSC and meeting with Electric Companies on April 13, 2011.

¹²⁶ See letter from ABC/CIEBA.

¹²⁷ See letter from Farm Credit Council dated February 22, 2011 (“Farm Credit Council I”).

¹²⁸ See letters from Credit Union National Association (“CUNA”) and Federal Home Loan Banks (“FHLB”) dated February 22, 2011 (“FHLB I”).

¹²⁹ See letter from BOK dated January 31, 2011 (“BOK I”); but see letter from Vitol at 7 (riskless principal transactions are a “good model for true swap dealing activity”).

¹³⁰ See letter from Newedge.

¹³¹ See letter from Association of Financial Guaranty Insurers (“AFGI”).

¹³² See letter from BlackRock, Inc. (“BlackRock”) dated February 22, 2011 (“BlackRock I”).

¹³³ Commenters making this point varied in their phrasing of potential exclusions, and particularly suggested exclusions for: agricultural firms offering swaps as risk management tools related to physical

who enters into swaps or security-based swaps only with registered dealers and major participants,¹³⁴ persons that do not pose systemic risk,¹³⁵ hedge funds¹³⁶ and entities that enter into swaps or security-based swaps solely in a fiduciary capacity.¹³⁷

Commenters also suggested that the dealer definitions categorically exclude, or should be interpreted to exclude, the following types of swaps and security-based swaps: exchange-cleared swaps and security-based swaps,¹³⁸ options to make or receive delivery of physical commodities,¹³⁹ cash forward transactions with embedded swaps and book-out transactions,¹⁴⁰ swaps or security-based swaps that are used for hedging or mitigating commercial risk,¹⁴¹ swaps entered into to profit from future changes in the price of the underlying commodity,¹⁴² swaps or security-based swaps entered into as a fiduciary or agent for another person,¹⁴³ swaps or security-

commodities (see letter from NGFA I); all firms, other than financial entities whose primary business is swap dealing (see letter from NEM); any person that uses swaps only to reduce price volatility, enters into a volume of swaps relating to any physical commodity that is less than the volume of its trading in that commodity, and is not making a market (see letter from Chesapeake Energy); or any person that limit its use of swaps to hedging or speculating (see letters from API I).

¹³⁴ See letter from ISDA I.

¹³⁵ See letters from NARUC and NCGA/NGSA I.

¹³⁶ See letter from MFA I.

¹³⁷ See letters from FSR dated February 22, 2011 and Midsize Banks.

¹³⁸ See letters from Commodity Markets Council ("CMC"), EEI/EPSC, IECA-Credit I, NextEra I, Shell Trading I, Utility Group and Vitol.

¹³⁹ See letters from NextEra I and WGCEF I. The commenters acknowledged that such options may or may not be included in the definition of "swap."

¹⁴⁰ See letter from CMC.

¹⁴¹ See, e.g., letters from Edison Int'l and WGCEF I and joint letter from Senator Stabenow and Representative Lucas (also saying that definition of "hedging" should be consistent with respect to the dealer and major participant definitions and the end-user exception from clearing).

¹⁴² See letters from EEI/EPSC, NextEra I, Utility Group and WGCEF I.

¹⁴³ See letters from Midsize Banks, NFPEEU and FSR I.

based swaps entered into for purposes of price discovery,¹⁴⁴ and, as noted above, swaps related to items that are covered by a tariff approved by FERC or the Electric Reliability Council of Texas.¹⁴⁵

In contrast, some commenters opposed providing any categorical exclusions from the dealer definitions. One commenter stated that the definitions' focus on a person's activities – as opposed to whether that person falls within a particular category – is a better means of determining whether the person is a swap dealer.¹⁴⁶ Another commenter described the requested exclusions as attempts to achieve carve-outs that are not provided for in the statute.¹⁴⁷

Lastly, several commenters addressed the extraterritorial application of the definitions of the terms “swap dealer,” “security-based swap dealer,” “major swap participant,” “major security-based swap participant,” and “eligible contract participant.” In general, the commenters addressed when and how the definitions should be applied to persons based outside the U.S. and how the definitions should take account of non-U.S. requirements that may be applicable to such persons.¹⁴⁸ The Commissions intend to separately address issues related to the application of

¹⁴⁴ See letters from EEI/EPSC, Vitol and WGCEP I.

¹⁴⁵ See letters from EDF Trading, FERC Staff and NARUC.

¹⁴⁶ See letter from Better Markets I.

¹⁴⁷ See letter from AFSCME. Additional commenters emphasized the need for transparency about swaps and swap activities. See letters from Jason Cropping and BJ D'Milli.

¹⁴⁸ See, e.g., letters from FSR I, Institute of International Bankers, ISDA I, Investment Management Association, Japan Financial Services Agency, Securities Industry and Financial Markets Association (“SIFMA”) dated February 3, 2011 (“SIFMA I”), and the World Bank Group, joint letter from the Autorité de contrôle prudentiel and the Autorité des marchés financiers, joint letter from Bank Of America Merrill Lynch, Barclays Capital, BNP Paribas S.A. (“BNP Paribas”), Citi, Crédit Agricole Corporate and Investment Bank, Credit Suisse Securities (USA), Deutsche Bank AG (“Deutsche Bank”), HSBC, Morgan Stanley, Nomura Securities International, Inc. (“Nomura Securities”), Société Générale and UBS Securities LLC (“Twelve Firms”), joint letter from the Bank of Tokyo-Mitsubishi UFJ, Ltd., Mizuho Corporate Bank, Ltd. and Sumitomo Mitsui Banking Corporation, and joint letter from Barclays Bank PLC, BNP Paribas, Credit Suisse AG, Deutsche Bank, HSBC, Nomura Securities, Rabobank

these definitions to non-U.S. persons in the context of the application of Title VII to non-U.S. persons.

g. Cost-benefit issues and hedging deterrence

Several commenters emphasized the cost of being regulated as a dealer, and emphasized that an overbroad scope of the dealer definitions would impose significant unwarranted costs on entities contrary to the goals of the Dodd-Frank Act, and would deter the use of swaps and security-based swaps for hedging.¹⁴⁹ Some commenters also noted that impact of the provisions of section 716 of the Dodd-Frank Act on entities that are deemed to be swap dealers or security-based swap dealers.¹⁵⁰ Also, one commenter suggested that using a qualitative test for the dealer definition might increase costs due to regulatory uncertainty.¹⁵¹

Nederland, Royal Bank of Canada, the Royal Bank of Scotland Group pLc, Société Générale, the Toronto-Dominion Bank and UBS AG.

¹⁴⁹ See joint letter from Representatives Spencer Bachus and Frank Lucas at 2 (“Casting an overly-broad net in defining [dealer and major participant] could force some smaller participants to leave the marketplace as a result of increased costs, or eliminate certain types of contracts used for hedging. If either occurs, businesses will be left exposed to market volatility and the consequences will ultimately be felt by Americans in the form of increased consumer costs.”) and letters from ISDA Iat 7 (“The substantial additional burdens and costs of Dealer regulation must be reserved for those whose business it is to ‘make the market,’ that is, those who consistently both buy and sell. This is in accord with Dodd-Frank Act’s market regulatory goals, as well as the legislation’s obvious intent to preserve healthy growth and innovation in the U.S. swap markets.” (footnote omitted)), Peabody at 2-3 (“Legal uncertainty over the application to end users of the significant regulatory requirements for [swap dealers] could lead end users to minimize their use of swaps in order to avoid the risk of being deemed to be [a swap dealer].”), and Church Alliance (stating that the risk of incurring the costs of dealer regulation would harm employee benefit plans by reducing their use of swaps and security-based swaps for hedging and risk mitigation).

¹⁵⁰ See letters from American Bankers Association (“ABA”) dated November 3, 2011 (“ABA I”), BOK I, and ISDA I. Section 716 of the Dodd-Frank Act prohibits any “swaps entity” – a term that encompasses swap dealers and security-based swap dealers – from receiving Federal assistance with respect to any swap, security-based swap, or other activity of the swaps entity.

¹⁵¹ See letter from API I (stating that costs of regulatory uncertainty stem from the use of qualitative factors for identifying dealing, and from regulatory efforts to reach beyond “true” swap dealers); see also letter from Dominion Resources (the opportunity costs associated with regulatory uncertainty should be considered)

One commenter specifically suggested that in considering the final rules, the Commissions should consider empirical data regarding the costs and benefits flowing from the rules and issue a second analysis of the costs and benefits of the rules for public comment,¹⁵² while other commenters said that the consideration of cost and benefits should include the cumulative cost of interrelated regulatory burdens arising from all the rules proposed under the Dodd-Frank Act.¹⁵³ Other commenters said the Commissions should consider alternatives that would impose fewer costs.¹⁵⁴

Another commenter said that the cost-benefit analyses in the Proposing Release may have understated the benefits of the proposed rules, because focusing on individual aspects of all the rules proposed under the Dodd-Frank Act prevents consideration of the full range of benefits that arise from the rules as a whole, in terms of providing greater financial stability, reducing systemic risk and avoiding the expense of assistance to financial institutions in the future.¹⁵⁵ This commenter said the consideration of benefits of the proposed rules should include the mitigated risk of a financial crisis.¹⁵⁶

¹⁵² See letter from WGCEF I.

¹⁵³ See letters from ABA I, NFPEEU and WGCEF dated December 20, 2011, enclosing a report prepared by NERA Economic Consulting ("NERA") ("WGCEF VIII"); see also letter from NERA dated March 13, 2012.

¹⁵⁴ See letters from NextEra I (referring to alternative *de minimis* tests) and NFPEEU.

¹⁵⁵ See letter from Better Markets dated June 3, 2011 ("Better Markets II").

¹⁵⁶ Better Markets cited estimates that the worldwide cost of the 2008 financial crisis in terms of lost output was between \$60 trillion and \$200 trillion, depending primarily on the long term persistence of the effects. See letter from Better Markets II.

3. Final rules and interpretation – general principles

Consistent with the Proposing Release, the final rules that define the terms “swap dealer” and “security-based swap dealer” closely follow the statutory definitions’ four tests and exclusion for activities that are not part of a “regular business.”¹⁵⁷ In addition, this Adopting Release sets forth interpretive guidance regarding various elements of the final rules.

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 this Adopting Release reflect common underlying principles. At the same time, the 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.¹⁵⁸ For example, because security-based swaps may be used to hedge or gain economic exposure to underlying individual securities (while recognizing distinctions between security-based swaps and other types of securities, as discussed below), there is a basis to build upon the same principles that presently are used to identify dealers for other types of securities. These same principles, though instructive, may be inapplicable to swaps in certain circumstances or may be applied differently in the context of dealing activities involving commodity, interest rate, or other types of swaps.

For these reasons, we separately are addressing the interpretation of the “swap dealer” and “security-based swap dealer” definitions.

¹⁵⁷ See CFTC Regulation § 1.3(ggg)(1),(2); Exchange Act rule 3a71-1(a), (b).

¹⁵⁸ Section 712(a)(7)(A) of the Dodd-Frank Act provides that in adopting rules and orders implementing Title VII, the Commissions shall treat functionally or economically similar products or entities in a similar manner. Section 712(a)(7)(B), though, provides that the Commissions need not act in an identical manner.

Also, as discussed below, the Commissions are directing their respective staffs to report separately regarding the rules being adopted in connection with the definition and related interpretations. These staff reports will help the Commissions evaluate the “swap dealer” and “security-based swap dealer” definitions in all respects, including whether new or revised tests or approaches would be appropriate for identifying swap dealers and security-based swap dealers.¹⁵⁹

4. Final rules and interpretation – definition of “swap dealer”

The Dodd-Frank Act contains a comprehensive definition of the term “swap dealer,” based upon types of activities. As noted above, we are adopting a final rule under the CEA that, like the proposed rule, defines the term “swap dealer” using terms from the four statutory tests and the exclusion for swap activities that are not part of “a regular business.”¹⁶⁰ The final rule includes modifications from the proposed rule that are described below, including provisions stating that swaps entered into for hedging physical positions as defined in the rule, swaps between majority-owned affiliates, swaps entered into by a cooperative with its members, and certain swaps entered into by registered floor traders, are excluded from the swap dealer determination.¹⁶¹ The Commissions, in consideration of comments received, are also making certain modifications to the interpretive guidance set out in the Proposing Release with respect to various elements of the statutory definition of the term “swap dealer,” as described below.

The determination of whether a person is covered by the statutory definition of the term “swap dealer” requires application of various provisions of the rule further defining that term, as

¹⁵⁹ See part V, *infra*.

¹⁶⁰ See CFTC Regulation § 1.3(ggg)(1), (2).

¹⁶¹ See CFTC Regulation § 1.3(ggg)(6)(ii), (iii).

well as the interpretive guidance in this Adopting Release, depending on the person's particular circumstances. We intend that the determination with respect to a particular person would proceed as follows.

The person would begin by applying the statutory definition, and the provisions of the rule which implement the four statutory tests and the exclusion for swap activities that are not part of "a regular business,"¹⁶² in order to determine if the person is engaged in swap dealing activity. In that analysis, the person would apply the interpretive guidance described in this part II.A.4, which provides for consideration of the relevant facts and circumstances. As part of this consideration, the person would apply elements of the dealer-trader distinction, as appropriate, including as described in part II.A.4.a, below.

The rule provides that certain swaps are not considered in the determination of whether a person is a swap dealer.¹⁶³ In particular, swaps entered into by an insured depository institution with a customer in connection with originating a loan with that customer,¹⁶⁴ swaps between majority-owned affiliates,¹⁶⁵ swaps entered into by a cooperative with its members,¹⁶⁶ swaps entered into for hedging physical positions as defined in the rule,¹⁶⁷ and certain swaps entered into by registered floor traders¹⁶⁸ are excluded from the swap dealer determination.

¹⁶² See CFTC Regulation § 1.3(ggg)(1), (2).

¹⁶³ See CFTC Regulation § 1.3(ggg)(5), (6).

¹⁶⁴ See CFTC Regulation § 1.3(ggg)(5); see also part II.B, *infra*.

¹⁶⁵ See CFTC Regulation § 1.3(ggg)(6)(i); see also part II.C, *infra*.

¹⁶⁶ See CFTC Regulation § 1.3(ggg)(6)(ii); see also part II.C, *infra*.

¹⁶⁷ See CFTC Regulation § 1.3(ggg)(6)(iii); see also part II.B.4.e, *infra*.

¹⁶⁸ See CFTC Regulation § 1.3(ggg)(6)(iii); see also part II.B.4, *infra*.

If, after completing this review (taking into account the applicable interpretive guidance and excluding any swaps as noted above), the person determines that it is engaged in swap dealing activity, the next step is to determine if the person is engaged in more than a de minimis quantity of swap dealing.¹⁶⁹ If so, the person is a swap dealer. When the person registers, it may apply to limit its designation as a swap dealer to specified categories of swaps or specified activities of the person in connection with swaps.¹⁷⁰

In this part II.A.4., we provide interpretive guidance on the application of the “swap dealer” definition, modified from the Proposing Release as appropriate based on comments received. This guidance separately addresses the following: application of the dealer-trader framework; the “holding out” and “commonly known” criteria; market making; the not part of “a regular business” exception; the exclusion of swaps entered into for hedging physical positions as defined in the rule; and the overall interpretive approach to the definition.¹⁷¹

a. Use of the dealer-trader distinction

We believe that the dealer-trader distinction¹⁷² – which already forms a basis for identifying which persons fall within the longstanding Exchange Act definition of “dealer” – in general provides an appropriate framework for interpreting the statutory definition of the term

¹⁶⁹ See CFTC Regulation § 1.3(ggg)(4); see also part II.D, infra.

¹⁷⁰ See CFTC Regulation § 1.3(ggg)(3); see also part II.E, infra.

¹⁷¹ The Commissions note that interpretations of the applicability of the dealer-trader distinction to the “swap dealer” definition under the CEA do not affect existing, or future, interpretations of the dealer-trader distinction under the Exchange Act.

¹⁷² See note 31, supra. The principles embedded within the “dealer-trader distinction” are also applicable to distinguishing dealers from non-dealers such as hedgers or investors. See note 250, infra.

“swap dealer.”¹⁷³ While there are differences in the structure of those two statutory definitions,¹⁷⁴ we believe that their parallels – particularly their exclusions for activities that are “not part of a regular business” – warrant analogous interpretive approaches for distinguishing dealers from non-dealers.¹⁷⁵ Thus, the dealer-trader distinction forms the basis for a framework that appropriately distinguishes between persons who should be regulated as swap dealers and those who should not. We also believe that the distinction affords an appropriate degree of flexibility to the analysis, and that it would not be appropriate to seek to codify the distinction in rule text.

The Commissions recognize that the dealer-trader distinction needs to be adapted to apply to swap activities in light of the special characteristics of swaps and the differences

¹⁷³ The Commissions note that interpretations of the applicability of the dealer-trader distinction to the “swap dealer” definition under the CEA do not affect existing, or future, interpretations of the dealer-trader distinction under the Exchange Act.

¹⁷⁴ For example, while the “dealer” definition encompasses certain persons in the business of “buying and selling” securities, the “swap dealer” definition does not address either “buying” or “selling.” We also note that the “dealer” definition requires the conjunctive “buying and selling” – which connotes a degree of offsetting two-sided activity. In contrast, the swap dealer definition (particularly the “regularly enters into” swaps language of the definition’s third prong) lacks that conjunctive terminology.

¹⁷⁵ In the Proposing Release, the CFTC did not propose to use principles from the dealer-trader distinction to interpret the definition of the term “swap dealer,” instead proposing an interpretive approach that focused on, among other things, a person’s functional role in the swap markets and its relationships with swap counterparties. See Proposing Release, 75 FR at 80177. There was, however, some overlap in practice between the factors identified in the Proposing Release relating to a swap dealer’s functional role and relationships and the principles of the dealer-trader distinction that were proposed to be applied to identify security-based swap dealers. Moreover, the changes to the interpretive approach to the swap dealer definition that we are adopting here and discussed in this part II.A.4 are in many respects similar to the principles of the dealer-trader distinction. We also acknowledge the commenters who asked for additional guidance regarding the application of the definitions. See, e.g., letters from Gaviion II, Peabody and the Utility Group, and meeting with CDEU on April 7, 2011.

Thus, while the incorporation of the dealer-trader distinction in the interpretation of the term “swap dealer” constitutes a change from the Proposing Release, this is simply reflective of the other changes to the CFTC’s interpretive approach that we are adopting for the final rule and the overlap between the factors relating to a swap dealer’s functional role and counterparty relationships and the principles of the dealer-trader distinction.

between the “dealer” definition, on the one hand, and the “swap dealer” definition, on the other. Relevant differences between the swap market and the markets for securities (other than security-based swaps) include:

- Level of activity – Swap markets are marked by less activity than markets involving certain types of securities (while recognizing that some debt and equity securities are not actively traded). This suggests that in the swap context, concepts of “regularity” should account for a participant’s level of activity in the market relative to the total size of the market.
- No separate issuer – Each counterparty to a swap in essence is the “issuer” of that instrument; in contrast, dealers in cash market securities generally transact in securities issued by another party. This distinction suggests that the concept of maintaining an “inventory” of securities is inapposite in the context of swaps. Moreover, this distinction – along with the fact that the “swap dealer” definition lacks the conjunctive “buying and selling” language of the “dealer” definition – suggests that concepts of two-sided markets at times would be less relevant for identifying swap dealers than they would be for identifying dealers.¹⁷⁶
- Predominance of over-the-counter and non-standardized instruments – Swaps are thus far are not significantly traded on exchanges or other trading systems, in contrast to some cash market securities (while recognizing that many cash market securities also are not significantly traded on those systems).¹⁷⁷ These attributes – along with the lack of “buying and selling” language in the swap dealer definition, as noted above – suggest that concepts of

¹⁷⁶ The analysis also should account for the fact that a party to a swap can use other derivatives or cash market instruments to hedge the risks associated with the swap position, meaning that two-way trading is not necessary to maintain a flat risk book.

¹⁷⁷ Even though we expect trading of swaps on exchanges following the implementation of Title VII, we expect there to remain a significant amount of over-the-counter activity involving swaps.

what it means to make a market need to be construed flexibly in the contexts of the swap markets.

- Mutuality of obligations and significance to “customer” relationship – In contrast to a secondary market transaction involving equity or debt securities, in which the completion of a purchase or sale transaction can be expected to terminate the mutual obligations of the parties to the transaction, the parties to a swap often will have an ongoing obligation to exchange cash flows over the life of the agreement. In light of this attribute, some market participants have expressed the view that they have “counterparties” rather than “customers” in the context of their swap activities.

In applying the dealer-trader distinction, it also is necessary to apply the statutory provisions that will govern swap dealers in an effective and logical way. Those statutory provisions added by the Dodd-Frank Act advance financial responsibility (e.g., the ability to satisfy obligations, and the maintenance of counterparties’ funds and assets) associated with swap dealers’ activities,¹⁷⁸ other counterparty protections,¹⁷⁹ and the promotion of market efficiency and transparency.¹⁸⁰ As a whole, the relevant statutory provisions suggest that we should interpret the “swap dealer” definition to identify those persons for which regulation is

¹⁷⁸ E.g., capital and margin requirements (CEA section 4s(e)), and requirements for segregation of collateral (CEA sections 4d(f), 4s(l)).

¹⁷⁹ E.g., requirements with respect to business conduct when transacting with special entities (CEA sections 4s(h)(2), 4s(h)(4), 4s(h)(5)); disclosure requirements (CEA section 4s(h)(3)(B)); requirements for fair and balanced communications (CEA section 4s(h)(3)(D)); other requirements related to the public interest and investor protection (CEA section 4s(h)(3)(D)); and conflict of interest provisions (CEA section 4s(j)(5)).

¹⁸⁰ E.g., reporting and recordkeeping requirements (CEA section 4s(f)); daily trading records requirements (CEA section 4s(g)); regulatory standards related to the confirmation, processing, netting, documentation and valuation of security-based swaps (CEA section 4s(i)); position limit monitoring requirements (CEA section 4s(j)(1)); risk management procedure requirements (CEA section 4s(j)(2)); and requirements related to the disclosure of information to regulators (CEA section 4s(j)(3)).

warranted either: (i) due to the nature of their interactions with counterparties; or (ii) to promote market stability and transparency, in light of the role those persons occupy within the swap and security-based swap markets.

There are several aspects of our interpretive approach to the swap dealer definition that are particularly similar to the dealer-trader distinction as it will be applied to determine if a person is a security-based swap dealer. In particular, the following activities, which are indicative of dealing activity in the application of the dealer-trader distinction,¹⁸¹ similarly are indicative that a person is acting as a swap dealer:¹⁸² (i) 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; (ii) advising a counterparty as to how to use swaps to meet the counterparty's hedging goals, or structuring swaps on behalf of a counterparty; (iii) having a regular clientele and actively advertising or soliciting clients in connection with swaps;¹⁸³ (iv) acting in a market maker capacity on an organized exchange or trading system for swaps;¹⁸⁴ and (v) helping to set the

¹⁸¹ See generally part II.A.5, *infra*.

¹⁸² To clarify, the activities listed in the text are indicative of acting as a swap dealer. Engaging in one or more of these activities is not a prerequisite to a person being covered by the swap dealer definition.

¹⁸³ As with the interpretation of the dealer-trader distinction with respect to securities, a nomenclature distinction between "counterparties" and "customers" is not significant for purposes of applying the dealer-trader distinction to swap activities. Contractual provisions related to nomenclature, such as a provision stating that no "customer" relationship is present, would not be significant if the reality of the situation is different. See note 271, *infra*, and accompanying text.

¹⁸⁴ As with the dealer-trader distinction as it has been interpreted under the Exchange Act with respect to securities (and as noted below in the discussion of the "makes a market in swaps" prong of the swap dealer definition), the presence of an organized exchange or trading system is not a prerequisite to

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.

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. Last, 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 this Adopting Release.

At the same time, the Commissions recognize that the dealer-trader distinction is not static, but rather has evolved over time through interpretive materials. The Commissions expect the dealer-trader distinction to evolve over time with respect to swaps independently of its evolution over time with respect to securities or security-based swaps. Prior interpretations and future developments in the law regarding securities or security-based swaps may inform the

being a market maker for purposes of the swap dealer definition, nor is acting as a market maker a prerequisite to being a swap dealer.

interpretation of the swap dealer definition, but will not be dispositive in identifying dealers in the swap markets.¹⁸⁵

- b. Indicia of holding oneself out as a dealer in swaps or being commonly known in the trade as a dealer in swaps

The final rule further defining the term “swap dealer” includes the provisions in the proposed rule which incorporate the statutory requirements that the term includes a person that is holding itself out as a dealer in swaps or is engaging in any activity causing it to be commonly known in the trade as a dealer or market maker in swaps.¹⁸⁶

We continue to believe that the Proposing Release appropriately identifies a number of factors as indicia of “hold[ing] itself out as a dealer in swaps” and “engag[ing] in any activity causing [itself] to be commonly known in the trade as a dealer or market maker in swaps.”¹⁸⁷ In our view, those factors thus are relevant to determining if a person is a swap dealer. For example, regarding the proposed factor of “membership in a swap association in a category reserved for dealers,” we note that the bylaws of the International Swaps and Derivatives Association (“ISDA”) provide that any business organization that:

¹⁸⁵ In interpreting the term “swap dealer,” we intend to consider, but do not formally adopt, the body of court decisions, SEC releases, and SEC staff no-action letters that have interpreted the dealer-trader distinction

¹⁸⁶ See CFTC Regulation § 1.3(ggg)(1)(i) and (iv).

¹⁸⁷ These factors are as follows: contacting potential counterparties to solicit interest; developing new types of swaps or security-based swaps and informing potential counterparties of their availability and of the person’s willingness to enter into the swap or security-based swap; membership in a swap association in a category reserved for dealers; providing marketing materials describing the type of swaps or security-based swaps the party is willing to enter into; and generally expressing a willingness to offer or provide a range of products or services that include swaps or security-based swaps. See Proposing Release, 75 FR at 80178.

directly or through an affiliate, as part of its business (whether for its own account or as agent), deals in derivatives shall be eligible for election to membership in the Association as a Primary Member, provided that no person or entity shall be eligible for membership as a Primary Member if such person or entity participates in derivatives transactions solely for the purpose of risk hedging or asset or liability management.¹⁸⁸

We believe that in circumstances such as this, where a category of association membership requires that a person deal in derivatives and not limit its participation in derivative transactions to solely risk hedging, membership in the category is an indicator of swap dealer status.¹⁸⁹

We take note, however, of the comments that these activities may be insufficient to establish that a person is a swap dealer. In particular, we generally agree with commenters that many commercial end users of swaps do, from time to time, actively seek out and negotiate swaps. Yet, based on the applicable facts and circumstances, these end users do not necessarily fall within the definition of a swap dealer solely because they actively seek out and negotiate swaps from time to time.

The activities described in the Proposing Release as indicia of holding oneself out as a swap dealer or engaging in any activity causing oneself to be commonly known as a swap dealer should not be considered in a vacuum, but should instead be considered in the context of all the

¹⁸⁸ See By-laws of ISDA at 3, available at: <https://www.isdadocs.org/membership>. The Commissions note that the Primary Members of ISDA are not limited to only financial firms.

¹⁸⁹ However, while such membership is an indicator of swap dealer status, a person holding such membership could nonetheless be excluded by other provisions of the definition of the term "swap dealer." For example, an insured depository institution that limits its activity to offering swaps in connection with the origination of loans, as discussed below in part II.B, would not be covered by the definition simply because it holds such membership.

activities of the swap participant. While the activities listed in the Proposing Release are indicators that a person is holding itself out or is commonly known as a swap dealer, these are factors to be considered in the analysis. They are not per se conclusive, and could be countered by other factors indicating that the person is not a swap dealer.¹⁹⁰ Because of the flexibility—including the consideration of applicable facts and circumstances—needed for such an analysis, we do not believe that it is appropriate to codify this guidance in rule text, as suggested by some commenters.

c. Market making

The final rule defining “swap dealer” includes the provision from the proposed rule which incorporates the statutory requirement that this term include a person that “makes a market in swaps.”¹⁹¹

We have considered the comments suggesting various descriptions of activities that should and should not be deemed to be market making in swaps for purposes of this rule. In consideration of these comments, we clarify that making a market in swaps is appropriately described as routinely standing ready to enter into swaps at the request or demand of a

¹⁹⁰ The statutory definition of the term “swap dealer” contains four separate clauses, or “prongs,” joined by the disjunctive “or,” the ordinary meaning of which is that the prongs are stated as alternative types of swap dealer. Accordingly, where an assessment of all the activities of a swap participant demonstrates that the person is not holding itself out as a swap dealer or engaging in any activity that causes it to be commonly known as a swap dealer, that person may, nonetheless, be a swap dealer based on the market making or regular business prongs of the swap dealer definition, discussed below. The Commissions note, however, that as discussed below in part II.A.4.g, the CFTC’s overall interpretive guidance, including guidance regarding the dealer-trader framework, applies to identify swap dealers under all four prongs of the statutory “swap dealer” definition.

¹⁹¹ See CFTC Regulation § 1.3(ggg)(1)(ii). Because the statutory swap dealer definition contains four disjunctive prongs, the CFTC does not agree with a commenter (see letter from ISDA I) who asserted that status as a market maker in swaps is a prerequisite to a person being a swap dealer.

counterparty. In this regard, “routinely” means that the person must do so more frequently than occasionally, but there is no requirement that the person do so continuously.¹⁹²

It is appropriate, in response to comments asking for further guidance regarding what activities constitute making a market in swaps, to describe some of the activities indicative of whether a person is routinely standing ready to enter into swaps at the request or demand of a counterparty. Such activities include routinely: (i) quoting bid or offer prices, rates or other financial terms for swaps on an exchange; (ii) 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; (iii) placing limit orders for swaps; or (iv) receiving compensation for acting in a market maker capacity on an organized exchange or trading system for swaps.¹⁹³ These examples are not exhaustive, and other activities also may be

¹⁹² A person that occasionally, or less than routinely, enters into a swap at the request of a counterparty is not a maker of a market in swaps, and therefore is not a swap dealer on that basis. However, we reiterate, as stated in the Proposing Release, that since many types of swaps are not entered into on a continuous basis, it is not necessary that a person enter into swaps at the request or demand of counterparties on a continuous basis in order for the person to be a market maker in swaps and, therefore, a swap dealer.

¹⁹³ In addition, section 619 of the Dodd-Frank Act (the “Volcker Rule”) generally prohibits banking entities from engaging in proprietary trading, but contains an exception for certain market making-related activities. The Commissions have proposed an approach to the Volcker Rule under which a person could seek to avoid the Volcker Rule in connection with swap activities by asserting the availability of that market making exception. See SEC, Board, Office of the Comptroller of the Currency (“OCC”), and Federal Deposit Insurance Corporation (“FDIC”), Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Proposed Rule, 76 FR 68846 (Nov. 7, 2011); CFTC, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Proposed Rule, 77 FR 8332 (Feb. 14, 2012). Under this approach, such a person would likely also be required to register as a swap dealer (unless the person is excluded from the swap dealer definition, such as by the exclusion of certain swaps entered into in connection with the origination of a loan). The SEC has proposed to adopt the same approach with respect to the interplay of the Volcker Rule and the definition of the term “security-based swap dealer.” See note 272, *infra*.

indicative of making a market in swaps if the person engaging in them routinely stands ready to enter into swaps as principal at the request or demand of a counterparty.

In determining whether a person's routine presence in the market constitutes market making under these four factors, the dealer-trader interpretative framework may be usefully applied.¹⁹⁴ Under the dealer-trader distinction, seeking to profit by providing liquidity to the market is an indication of dealer activity.¹⁹⁵ Thus, in applying these four factors, it is useful to consider whether the person is seeking, through presence in the market, compensation for providing liquidity, compensation through spreads or fees, or other compensation not attributable to changes in the value of the swaps it enters into.¹⁹⁶ If not, such activity would not be indicative of market making.

Some commenters suggested that, in order to be a market maker in swaps, a person must make a two-way market in swaps.¹⁹⁷ Nonetheless, it is possible for a person making a one-way market in swaps to be a maker of a market in swaps and, therefore, within the swap dealer definition. This may be true, for example, where a person routinely stands ready to enter into swaps on a particular side of the market—say, routinely bidding for floating exposures on a swap

¹⁹⁴ We recognize that routine presence in the swap market is not necessarily indicative of making a market in swaps. For example, persons may be routinely present in the market in order to engage in swaps for purposes of hedging, to advance their investment objectives, or to engage in proprietary trading.

¹⁹⁵ See note 265, *infra*, and accompanying text.

¹⁹⁶ In this case, the spread from which a person profits may be between two or more swaps, or it may be between a swap and another position or financial instrument. In contrast, entering into swaps in order to obtain compensation attributable to changes in the value of the swaps is indicative of using swaps for a hedging, investment or trading purpose.

¹⁹⁷ See letters cited in notes 52 to 58, *supra*. Although swaps are notional contracts requiring the performance of agreed upon terms by each party, it is possible to describe swap users in practical terms as being on either "side" of a market. For example, for many swaps the party paying a fixed amount is on one "side" of the market and the party paying a floating amount is on the other "side."

trading platform—while entering into transactions on the other side of the market in other instruments (such as futures contracts). The relevant indicator of market maker status is the willingness of the person to routinely stand ready to enter into swaps at the request or demand of a counterparty (as opposed to entering into swaps to accommodate one's own demand or desire to participate in a particular market), be it on one or both sides of the market, and then to enter into offsetting positions, either in the swap market or in other markets.

The Commissions disagree with the commenters who said that swaps executed on an exchange should not be considered in determining if a person is a market maker in swaps and thus a swap dealer.¹⁹⁸ First, the statutory definition of the term "swap dealer" makes no distinction between swaps executed on an exchange and swaps that are not, suggesting that the same protections should apply regardless of the method of executing the swap. Second, from the perspective of an end user seeking to execute a swap on an exchange, the important consideration under our analysis is whether a market maker is ready to enter into swaps, not whether the market maker is aware of the counterparty's identity. A market maker in swaps routinely stands ready to enter into swaps at the request or demand of a counterparty, regardless of whether the counterparty and the market maker meet on a disclosed basis through bilateral negotiations or anonymously through an exchange.¹⁹⁹ Similarly, the issue of whether a person is

¹⁹⁸ See, e.g., letters cited in note 62, *supra*.

¹⁹⁹ As discussed above, in many cases routine presence in the swap market, without more, would not constitute market making activity. Nevertheless, the CFTC will, in connection with promulgation of final rules relating to capital requirements for swap dealers and major swap participants, consider institution of reduced capital requirements for entities or individuals that fall within the swap dealer definition and that execute swaps only on exchanges, using only proprietary funds. Similarly, the CFTC also will consider the applicability to such entities or individuals of the other requirements imposed on swap dealers (e.g., internal business conduct standards, external business conduct standards with counterparties), and may adjust those swap dealer requirements as appropriate.

a registered FCM or broker-dealer is not necessarily relevant to whether the person is a maker of a market in swaps, if the person is routinely standing ready to enter into swaps at the request or demand of a counterparty. Third, we believe it would be inappropriate to disregard swaps executed on exchanges in order, as some commenters suggested,²⁰⁰ to encourage market participants to use, or to provide liquidity to, exchanges. Finally, variety of exchanges, markets, and other facilities for the execution of swaps are likely to evolve in response to the requirements of the Dodd-Frank Act, and there is no basis for any bright-line rule excluding swaps executed on an exchange, given the impossibility of obtaining information about how market participants will interact and execute swaps in the future, after the requirements under the Dodd-Frank Act are fully in effect. For all these reasons, we have determined that it is inappropriate to restrict the “making a market in swaps” prong of the swap dealer definition (i.e., routinely standing ready to enter into swaps at the request or demand of a counterparty) to swaps that are not executed on an exchange.²⁰¹

d. Exception for activities not part of “a regular business”

The final rule includes the provisions in the proposed rule that incorporate the provisions of the statutory definition regarding activities that are not part of “a regular business” of entering into swaps. One provision states that the term “swap dealer” includes a person that “regularly

²⁰⁰ See, e.g., letters cited in note 66, supra. Since the structures of the markets on which swaps will be executed are still in development, and market obligations have not been established, there is little support for comments asserting that market makers should be defined as only those persons who receive benefits from the market (such as reduced trading fees) in return for the obligation to transact when the market requires liquidity.

²⁰¹ By contrast, it may be appropriate, over time, to tailor the specific requirements imposed on swap dealers depending on the facility on which the swap dealer executes swaps. For example, the application of certain business conduct requirements may vary depending on how the swap is executed, and it may be appropriate, as the swap markets evolve, to consider adjusting certain of those requirements for swaps that are executed on an exchange or through particular modes of execution.

enters into swaps with counterparties as an ordinary course of business for its own account"; the other provision states that the term "swap dealer" does not include a person that "enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business."²⁰²

The Commissions continue to believe, as stated in the Proposing Release, that the phrases "ordinary course of business" and "a regular business" are, for purposes of the definition of "swap dealer" essentially synonymous. In this context, we interpret these phrases to focus on activities of a person that are usual and normal in the person's course of business and identifiable as a swap dealing business. It is not necessarily relevant whether the person conducts its swap-related activities in a dedicated subsidiary, division, department or trading desk, or whether such activities are a person's "primary" business or an "ancillary" business, so long as the person's swap dealing business is identifiable.²⁰³

²⁰² Final CFTC Regulation § 1.3(ggg)(2) is modified from the proposal to include the word "a" before the words "regular business," to conform the text of the rule to the text of the statute. See CEA section 1a(49)(C), 7 U.S.C. 1a(49)(C).

As stated in the Proposing Release, we interpret the reference in the definition of the term "swap dealer" to a person entering into swaps "with counterparties . . . for its own account" to refer to a person who enters into a swap as a principal, and not as an agent. A person who enters into swaps as an agent for customers (i.e., for the customers' accounts) would be required to register as either an FCM, introducing broker, commodity pool operator or commodity trading advisor, depending on the nature of the person's activity.

²⁰³ We recognize, as noted by one commenter (see letter from ISDA I), that the "regular business" exclusion is not limited solely to the "ordinary course of business" test of the swap dealer definition. Our interpretations of the other three tests are, and should be read to be, consistent with the exclusion of activities that are not part of a regular business.

We have taken into consideration comments seeking additional guidance regarding the types and levels of activities that constitute having “a regular business” of entering into swaps.²⁰⁴ In this regard, any one of the following activities would generally constitute both entering into swaps “as an ordinary course of business” and “as a part of a regular business”.²⁰⁵ (i) entering into swaps with the purpose of satisfying the business or risk management needs of the counterparty (as opposed to entering into swaps to accommodate one’s own demand or desire to participate in a particular market); (ii) maintaining a separate profit and loss statement reflecting the results of swap activity or treating swap activity as a separate profit center; or (iii) having staff and resources allocated to dealer-type activities with counterparties, including activities relating to credit analysis, customer onboarding, document negotiation, confirmation generation, requests for novations and amendments, exposure monitoring and collateral calls, covenant monitoring, and reconciliation.²⁰⁶

The Commissions see merit in the comments saying that “a regular business” of entering into swaps can be characterized by entering into swaps to satisfy the business or risk management needs of the other party to the swap, and so incorporate this element into our interpretation of the rule.²⁰⁷ Also, an objective indicator of a person being engaged in “a regular

²⁰⁴ See, e.g., letters from BG LNG I, COPE I, IECA-Credit I, Shell Trading I, WGCEF I and Vitol (stating that the proposed approach was overly subjective and requesting guidance as to the specific activities that are covered by the statutory definition).

²⁰⁵ These activities are inconsistent with entering into a swap to hedge a physical position as defined in § 1.3(ggg)(6)(iii). As discussed below, such hedging is not dealing activity.

²⁰⁶ The three indicators of being engaged in “a regular business” of entering into swaps described here are set forth in the alternative. Any one of these indicators may be sufficient, based on a facts and circumstances analysis, to reach a conclusion that an entity is engaged in “a regular business” of entering into swaps.

²⁰⁷ This element of the interpretation reflects our agreement with those commenters who said that “a regular business” of entering into swaps is characterized by having a business of accommodating demand

business” of entering into swaps is when the person accounts for the results of its swap activities separately, by maintaining a separate profit and loss statement for those activities or treating them as a separate profit center. Our interpretation incorporates this indicator of activity that is “a regular business” of entering into swaps.

Other comments suggesting specific criteria to identify “a regular business” also were helpful. We agree with commenters²⁰⁸ that “a regular business” of entering into swaps can be characterized by having staff and resources allocated to the types of activities in which swap dealers must engage with their counterparties, such as those noted above (e.g., credit analysis, confirmation generation, collateral calls, and covenant monitoring). However, we understand that some end users of swaps engage in some of these activities and, in certain circumstances, may have staff and resources available for these activities. Therefore, this element of the definition should be applied in a reasonable manner, taking all appropriate circumstances into account. This element does not depend on whether a specific amount or percentage of expenses or employee time are related to these swap activities. Instead, it is appropriate to objectively examine a person’s use of staff and resources related to swap activities. Using staff and resources to a significant extent in conducting credit analysis, opening and monitoring accounts and the other activities noted above, is an indication that the person is engaged in “a regular business” of entering into swaps.

Regarding the commenters’ assertion that the activity of entering into swaps in connection with a person’s physical commodity business cannot constitute “a regular business”

or facilitating interest in swaps (see letter from IECA-Credit I), and those commenters who said that “a regular business” does not encompass the use of swaps to serve a person’s own business needs, as opposed to serving the business needs of the counterparty (see letters cited in note 71, *supra*).

²⁰⁸ See letters cited in note 80, *supra*.

of the person, we believe that while in most cases this is not dealing activity,²⁰⁹ a per se exclusion of this type is not appropriate because it is possible that in some circumstances a person might enter into swaps that are connected to a physical commodity business but also serve market functions characteristic of the functions served by swap dealers. Also, again, the statutory definition does not contain any such exclusion, but rather includes any person who “regularly enters into swaps with counterparties as an ordinary course of business for its own account,” without regard to the person’s particular type of business.

Consistent with the statutory definition, we interpret “a regular business” of entering into swaps in a manner that applies equally to all market participants that engage in the activities set forth in the statutory definition. This will ensure that all participants in the swap markets are regulated in a fair and consistent manner, regardless of whether their underlying business is primarily physical or financial in nature.²¹⁰

Finally, as noted above, the manner in which persons negotiate, execute and use swaps is likely to evolve in response to the requirements of the Dodd-Frank Act and the other forces that will shape the swap markets going forward. For this reason, it would be inappropriate to craft per se exclusions from the swap dealer definition at a time when the only available information about the use of swaps relates to the period prior to implementation of the Dodd-Frank Act.²¹¹

²⁰⁹ See CFTC Regulation § 1.3(ggg)(6)(iii) (swaps entered into for hedging physical positions as defined in the rule are not considered in the determination of whether a person is a swap dealer).

²¹⁰ Regulation of firms engaged in an underlying physical business is also consistent with regulatory practices outside the U.S. For example, non-financial entities register with the Financial Services Authority in the U.K. as “Oil Market Participants” and “Energy Market Participants.” See Financial Services Authority Handbook EMPS and OMPS, available at <http://fsahandbook.info/FSA/html/handbook>.

²¹¹ For the same reasons, we do not believe it would be appropriate, in determining whether a person has a “regular business” of entering into swaps, to consider whether a person engages in activities

e. Interim final rule excluding swaps entered into for hedging physical positions

We note that some commenters said that swaps used to hedge or mitigate commercial risks should not be considered in determining whether a person is a swap dealer.²¹² We understand that swaps are used to hedge risks in numerous and varied ways, and we expect that the number of persons covered by the definition will be very small in comparison to the thousands of persons that use swaps for hedging.

In terms of the statutory definition of the term “swap dealer,” the CFTC notes as an initial matter that there is no specific provision addressing hedging activity. Thus, the statutory definition leaves the treatment of hedging swaps to the CFTC’s discretion; it neither precludes consideration of a swap’s hedging purpose, nor does it require an absolute exclusion of all swaps used for hedging.²¹³

normally associated with financial institutions, as some commenters suggested. See letters cited in note 76, supra.

²¹² See, e.g., letters cited in note 72, supra.

²¹³ In this regard, the statutory definition of the term “swap dealer” stands in contrast to the statutory definition of the term “major swap participant” which, as discussed further below, explicitly provides that positions in swaps held for hedging or mitigating commercial risk are to be excluded in certain parts of that definition. See CEA section 1a(33)(A)(i)(1), 7 U.S.C. 1a(33)(A)(i)(1). The absence of any explicit requirement in the “swap dealer” definition to exclude swaps held for hedging or mitigating commercial risk does not support the view that Congress intended to categorically exclude all swaps that may serve as hedges in determining whether a person is covered by the definition.

Similarly, the absence of any limitation in the statutory definition of the term “swap dealer” to financial entities, when such limitation is included elsewhere in Title VII, indicates that no such limitation applies to the swap dealer definition. CEA section 2(h)(7), 7 U.S.C. 2(h)(7), specifically limits the application of the clearing mandate, in certain circumstances, to only “financial entities.” That section also provides a detailed definition of the term “financial entity.” See CEA section 2(h)(7)(C), 7 U.S.C. 2(h)(7)(C). That such a limitation is included in this section, but not in the swap dealer definition, does not support the view that the statutory definition of the term “swap dealer” should encompass only financial entities.

In general, entering into a swap for the purpose of hedging is inconsistent with swap dealing.²¹⁴ The practical difficulty lies in determining when a person has entered into a swap for the purpose of hedging, as opposed to other purposes for entering into swaps, such as accommodating demand for swaps or as part of making a market in swaps, and in distinguishing a swap with a hedging purpose from a swap with a hedging consequence. In view of these uncertainties, the CFTC believes it is appropriate to adopt an interim final rule that draws upon the principles of bona fide hedging that the CFTC has long applied to identify when a financial instrument is used for hedging purposes, and excludes from the swap dealer analysis swaps entered into for the purpose of hedging physical positions that meet the requirements of the rule.

Specifically, the CFTC is adopting as an interim final rule CFTC Regulation § 1.3(ggg)(6)(iii), which provides that the determination of whether a person is a swap dealer will not consider a swap that the person enters into, if:

(i) the person enters into the swap 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

²¹⁴ For example, under the dealer-trader distinction, the Commissions would expect persons that use security-based swaps to hedge their business risks, absent other activity, likely would not be dealers. See part II.A.5.b, *infra*. Under the CFTC's interpretive guidance, making a market in swaps is appropriately described as routinely standing ready to enter into swaps at the request or demand of a counterparty, and the indicia of swap dealing as a "regular business" include entering into swaps to satisfy the business or risk management needs of the counterparty. Entering into swaps for the purpose of hedging one's own risks generally would not be indicative of this form of swap activity. See also, e.g., joint letter from Senator Stabenow and Representative Lucas (the final rule should distinguish using swaps for hedging from swap dealing).

anticipates incurring; or (c) services that the person provides, purchases, or anticipates providing or purchasing;

(ii) the swap represents 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;

(iii) the swap is economically appropriate to the reduction of the person's risks in the conduct and management of a commercial enterprise;

(iv) the swap is entered into in accordance with sound commercial practices; and

(v) the person does not enter into the swap in connection with activity structured to evade designation as a swap dealer.²¹⁵

Thus, although the CFTC is not incorporating the bona fide hedging provisions of the CFTC's position limits rule here, the exclusion from the swap dealer analysis draws upon language in the CFTC's definition of bona fide hedging.²¹⁶ For example, the exclusion expressly includes swaps hedging price risks arising from the potential change in value of existing or anticipated assets, liabilities, or services, if the hedger has an exposure to physical price risk. And, as in the bona fide hedging rule, the exclusion utilizes the word "several" to reflect that there is no requirement that swaps hedge risk on a one-to-one transactional basis in order to be

²¹⁵ See CFTC Regulation § 1.3(ggg)(6)(iii). All five requirements set forth in the regulation must be met with respect to the swap, in order for the swap to be excluded from the swap dealer determination by the regulation.

²¹⁶ See CFTC Regulation § 151.5(a)(1). The definition of bona fide hedging in CFTC Regulation § 1.3(z), which applies for excluded commodities, is not relevant here, because it does not contain the requirement that the swap represents a substitute for a transaction made or to be made or a position taken or to be taken in a physical marketing channel, as required by CFTC Regulation § 1.3(ggg)(6)(iii)(B). We believe that this requirement is an important aspect of how principles from the bona fide hedging definition are useful in identifying swaps that are entered into for the purpose of hedging as opposed to other purposes.

excluded, but rather they may hedge on a portfolio basis.²¹⁷ For these reasons, swaps that qualify as enumerated hedging transactions and positions are examples of the types of physical commodity swaps that are excluded from the swap dealer analysis if the rule's requirements are met.²¹⁸

This provision in the final rule is consistent with our overall interpretive approach to the definition of the term "swap dealer." The interpretations of the statutory dealer definitions by both Commissions focus on a person's activities in relation to its counterparties and other market participants.²¹⁹ As noted above, for example, one indicator that a person enters into swaps as part of "a regular business" is that the person does so to satisfy the business or risk management needs of the counterparty. This aspect of the swap dealer analysis turns on the accommodation of a counterparty's needs or demands. If a person enters into swaps for the purpose of hedging a physical position as defined in CFTC Regulation § 1.3(ggg)(6)(iii), by contrast, then the swap can be identified as not having been entered into for the purpose of accommodating the

²¹⁷ See CFTC, Position Limits for Futures and Swaps; Final Rule, 76 FR 71626, 71649 (Nov. 18, 2011).

²¹⁸ The swaps that qualify as enumerated hedging transactions and positions are those listed in CFTC Regulation § 151.5(a)(2) and appendix B to part 151. These examples are illustrative of the types of "assets," "liabilities," and "services" contemplated in CFTC Regulation § 1.3(ggg)(6)(iii), because the price risk arising from changes in their value could be offset or mitigated with a swap that represents 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. To be clear, notwithstanding that a swap does not fit precisely within such examples, it may still satisfy CFTC Regulation § 1.3(ggg)(6)(iii).

Regarding commenters' queries about dynamic hedging, which one commenter described as the ability to modify the hedging structure related to physical assets or positions when relevant pricing relationships applicable to that asset change (see joint letter from WGCEF and CMC), we note that qualification as bona fide hedging has never been understood to require that hedges, once entered into, must remain static. We expect that entities would move to update their hedges periodically when pricing relationships or other market factors applicable to the hedge change.

²¹⁹ See parts II.A.4.e and II.A.5.a, *infra*. For example, the conclusion that a person's relationship with its counterparties can lead to associated obligations is consistent with the "shingle theory," which implies a duty of fair dealing when a person hangs out its shingle to do business. See note 260, *infra*.

counterparty's needs or demands.²²⁰ Also, a person's activity of seeking out swap counterparties in order to hedge a physical position as defined in the rule generally would not warrant regulations to promote market stability and transparency or to serve the other purposes of dealer regulation.²²¹

At the same time, however, there may be circumstances where a person's activity of entering into swaps is encompassed by the statutory definition of the term "swap dealer," notwithstanding that the swaps have the effect of hedging or mitigating the person's commercial risk.²²² Although these swaps could, in theory, be excluded from the swap dealer analysis, we believe that a broader, per se exclusion for all swaps that hedge or mitigate commercial risk is inappropriate for the swap dealer definition.

First, the hedging exclusion that we are adopting is in the nature of a safe harbor; i.e., it describes activity that will not be considered swap dealing activity. As such, the CFTC believes

²²⁰ In this way, the exclusion from the swap dealer analysis of swaps hedging physical positions as defined in CFTC Regulation § 1.3(ggg)(6)(iii) is similar to the exclusions, discussed below, of swaps between affiliates and swaps between a cooperative and its members. See CFTC Regulation § 1.3(ggg)(6)(i)(ii); see also part II.C, *infra*. However, to the extent a person engages in dealing activities involving swaps, the presence of offsetting positions that hedge those dealing activities would not excuse the requirement that the person register as a swap dealer.

²²¹ Thus, the CFTC's interpretation of the swap dealer definition in this regard draws upon principles in the dealer-trader distinction. See part II.A.4.a. Additional authority for CFTC Regulation § 1.3(ggg)(6)(iii) is provided by subparagraph (B) of the swap dealer definition. This subparagraph provides that a person "may be designated as a swap dealer for a single type or single class or category of swap or activities and considered not to be a swap dealer for other types, classes, or categories of swaps or activities." CEA Section 1a(49)(B), 7 U.S.C. 1a(49)(B). It thereby authorizes a review of a person's various activities with respect to swaps, and a determination that some of the person's activities are covered by a designation as a swap dealer, while other of the person's activities are not. Thus, a person who enters into some swaps for hedging physical positions as defined in CFTC Regulation § 1.3(ggg)(6)(iii), and also enters into other swaps in connection with activities covered by the swap dealer definition, could be designated as a swap dealer only for the latter activities.

²²² For example, "pay floating/receive fixed" swaps entered into by a swap dealer with long exposure to the floating side of a market would have the effect of hedging the dealer's exposure.

that it is appropriate that the interim final rule not be cast broadly.²²³ This does not mean that other types of hedging activity that do not meet the requirements of the interim final rule are necessarily swap dealing activity. Rather, such hedging activity is to be considered in light of all other relevant facts and circumstances to determine whether the person is engaging in activity (e.g., accommodating demand for swaps, making a market for swaps, etc.) that makes the person a swap dealer.

Second, the usefulness of an exclusion of all swaps that hedge or mitigate commercial risk for certain aspects of the major swap participant definition²²⁴ is not a reason to use the same exclusion in the swap dealer definition, since the swap dealer definition serves a different function. The definition of the term “major swap participant,” which applies only to persons who are not swap dealers,²²⁵ is premised on the prior identification, by the swap dealer definition, of persons who accommodate demand for swaps, make a market in swaps, or otherwise engage in swap dealing activity. The major swap participant definition performs the subsequent function of identifying persons that are not swap dealers, but hold swap positions that create an especially high level of risk that could significantly impact the U.S. financial system.²²⁶ Only for this subsequent function is it appropriate to apply the broader exclusion of swaps held for the purpose of hedging or mitigating commercial risk.²²⁷

²²³ While we recognize that a rule delineating the swap activities that do not constitute swap dealing would simplify and make more certain, at least in some contexts, the application of the swap dealer definition, there are also reasons for caution in incorporating a categorical exclusion for hedging.

²²⁴ See part IV.C, *infra*.

²²⁵ See CEA §1a(33)(A)(i), 7 U.S.C. 1a(33)(A)(i).

²²⁶ See CEA §1a(33)(B), 7 U.S.C. 1a(33)(B).

²²⁷ We do not believe that the differences between the exclusion in the major participant definitions for swaps held for the purpose of hedging or mitigating commercial risk and the exclusion in the swap

The CFTC believes that since the over-the-counter swap markets have operated largely without regulatory oversight and encompass swaps used for a wide variety of commercial purposes, no method has yet been developed to reliably distinguish, through a per se rule, between: (i) swaps that are entered into for the purpose of hedging or mitigating commercial risk; and (ii) swaps that are entered into for the purpose of accommodating the counterparty's needs or demands or otherwise constitute swap dealing activity, but which also have a hedging consequence.²²⁸ In contrast, the CFTC notes that it has set forth and modified standards for bona fide hedging transactions and granted exemptions in compliance with such standards for decades.²²⁹ These historically-developed standards form the basis of the interim final rule excluding from the swap dealer analysis certain swaps that hedge the risks associated with a physical position.

The exclusion in CFTC Regulation § 1.3(ggg)(6)(iii) depends not on the effect or consequences of the swap, but on whether the purpose for which a person enters into a swap is to hedge a physical position as defined in the rule. If so, then the swap is excluded from the dealer

dealer definition for certain swaps entered into for the purpose of hedging risks related to physical positions mean that the Commissions, or the CFTC in particular, have implemented two different definitions of hedging. In fact, neither of these exclusions define the term "hedging." Rather, the differences between the two exclusions reflect differences in the parameters that must be satisfied in order to ensure that hedging swaps are appropriately excluded from the two different definitions.

²²⁸ As noted in the preceding paragraph, it is not necessary to make this distinction for purposes of the major swap participant definition.

²²⁹ See, e.g., 42 FR 42751 (Aug. 8, 1977). Although the latest formulation of the definition of bona fide hedging – CFTC Regulation § 151.5(a) – was recently adopted, see CFTC, Position Limits for Futures and Swaps; Final Rule and Interim Final Rule, 76 FR 71626 (Nov. 18, 2011), the bona fide hedging test has been in use for decades.

analysis because using swaps for that purpose is inconsistent with, and is not, dealing activity.²³⁰

On the other hand, if, at the time the swap is entered into, the person's purpose for entering into the swap is not as defined in CFTC regulation § 1.3(ggg)(6)(iii), or if it is unclear whether the swap is for such purpose, then the fact that the swap hedges the person's exposure in some regard does not preclude consideration of that swap in the dealer analysis.²³¹ In this latter case, all relevant facts and circumstances regarding the swap and the person's activity with respect to the swap would be relevant in the determination of whether the person is a swap dealer.²³²

We believe that, based on the CFTC's experience in applying bona fide hedging principles with respect to swaps hedging risks related to physical positions, the exclusion in CFTC Regulation § 1.3(ggg)(6)(iii) at this time is the best means of providing certainty to market participants regarding which swaps may be disregarded in the dealer analysis. However, commenters presented a range of views as to the exclusions from the dealer analysis that may be appropriate in this regard.²³³ Accordingly, the CFTC is implementing this exclusion on an interim rule basis and is seeking comments on all aspects of the interim rule, including any adjustments that may be appropriate in the rule or accompanying interpretive guidance.

²³⁰ To be clear, the swaps a person enters into for hedging physical positions as defined in CFTC Regulation § 1.3(ggg)(6)(iii) are not indicative of dealing activity under any of the prongs of the swap dealer definition.

²³¹ In this regard, CFTC Regulation § 1.3(ggg)(6)(iii) is different from certain of the CFTC's rules regarding bona fide hedging, where a person's purpose in entering into a swap may not be relevant.

²³² We believe that, in practice, the difficulty of distinguishing, in applying the swap dealer definition, swaps entered into for the purpose of hedging from other types of swaps will be resolvable when the facts and circumstances of a person's swap activities are taken into consideration in light of our interpretive guidance.

²³³ See, e.g., letters cited in note 141, supra.

The CFTC also seeks comments on whether a different approach to swaps entered into for the purpose of hedging risk is appropriate to implement the statutory definition of the term "swap dealer."

For example, the CFTC invites commenters to address whether any exclusion of hedging swaps from the swap dealer analysis is appropriate, and if so, how swaps that are entered into for purposes of hedging may be identified and distinguished from other swaps. Commenters are encouraged to address whether it is relevant to distinguish swaps entered into for purposes of hedging from swaps that have a consequential result of hedging, and if so, how such swaps may be distinguished. Also, commenters may address whether the exclusion should be limited to swaps hedging risks related to physical positions or extended to encompass swaps hedging financial risks or other types of risks.

Commenters should address whether the exclusion in CFTC Regulation § 1.3(ggg)(6)(iii) should be consistent with the exclusion in CFTC Regulation § 1.3(kkk). If so, why, and if not, why not? If the two exclusions should be consistent, does consistency require that that exclusions be identical, or would there be variations in application of the two exclusions? Are there market participants whose swap positions would be classified as held for the purpose of hedging or mitigating commercial risk under CFTC Regulation § 1.3(kkk) but would not qualify for the exclusion under CFTC Regulation § 1.3(ggg)(6)(iii)? If so, specifically identify the types of market participants and swaps. If the CFTC were to apply in the swap dealer definition the exclusion in CFTC Regulation § 1.3(kkk) in lieu of the exclusion in CFTC Regulation § 1.3(ggg)(6)(iii), would there be negative market impacts? If so, what are they? Would there be positive market impacts? If so, what are they? In particular, what type(s) of swaps that "hedge or mitigate commercial risk," but that are not excluded under the interim rule,

may constitute dealing activity in light of the rules and interpretive guidance regarding the swap dealer definition set forth in this Adopting Release?

Comments regarding the costs and benefits related to the interim final rule and any alternative approaches, including in particular the quantification of such costs and benefits, are also invited.

Commenters are encouraged, to the extent feasible, to be comprehensive and detailed in providing their approach and rationale. The comment period for the interim final rule will close [[INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]].

f. Swaps entered into by persons registered as floor traders

Commenters discussed whether the swap dealer definition encompasses the activity of entering into swaps on or subject to the rules of a DCM or SEF, and submitted for clearing to a derivatives clearing organization ("DCO"), particularly when firms engage in that activity using only proprietary funds.²³⁴ Because Title VII of the Dodd-Frank Act amended the definition of floor trader specifically to encompass activities involving swaps,²³⁵ the CFTC believes that it would lead to potentially duplicative regulation if floor traders engaging in swaps in their

²³⁴ See letter from Trading Coalition. One commenter specifically discussed floor traders and floor brokers and the regulatory regime that should apply to them following implementation of the Dodd Frank Act. See letter from Christopher K. Hehmeyer.

We note that other commenters suggested that all swaps cleared on an exchange should be excluded from the dealer definitions. See letters cited in note 138, *supra*. However, the discussion here is limited to persons who are registered as floor traders and meet other conditions. Also, the final rule provision discussed here does not exclude floor traders from the definition of the term "swap dealer;" rather, it provides that if the stated conditions are met, certain swaps entered into by floor traders are excluded from the swap dealer analysis.

²³⁵ See section 721(a)(11) of the Dodd-Frank Act (amending the definition of the term "floor trader" in CEA section 1a(23)). The Exchange Act does not have an equivalent regulatory category to floor trader under the CEA, and thus Congress did not make a similar amendment to the Exchange Act.

capacity as floor traders were also required to register as swap dealers. Accordingly, the CFTC believes that it is appropriate not to consider such swaps when determining whether a person acting as a floor trader, as defined under CEA section 1a(23),²³⁶ and registered with the CFTC under CFTC Regulation § 3.11, is a swap dealer if the floor trader meets certain conditions.

Specifically, the final rule provides that, in determining whether a person is a swap dealer, each swap that the person enters into in its capacity as a floor trader as defined by CEA section 1a(23) or on a SEF shall not be considered for the purpose of determining whether the person is a swap dealer, provided that the person:

- (i) is registered with the CFTC as a floor trader pursuant to CFTC Regulation § 3.11;
- (ii) enters into swaps solely with proprietary funds for that trader's own account on or subject to the rules of a DCM or SEF, and submits each such swap for clearing to a DCO;
- (iii) is not an affiliated person of a registered swap dealer;
- (iv) does not directly, or through an affiliated person, negotiate the terms of swap agreements, other than price and quantity or to participate in a request for quote process subject to the rules of a DCM or SEF;
- (v) does not directly or through an affiliated person offer or provide swap clearing services to third parties;
- (vi) does not directly or through an affiliated person enter into swaps that would qualify as hedging physical positions pursuant to CFTC Regulation § 1.3(ggg)(6)(iii) or hedging or mitigating commercial risk pursuant to CFTC Regulation § 1.3(kkk), with the exception of

²³⁶ The definition of the term "floor trader" includes a person entering into swaps on a "contract market." See CEA section 1a(23). This exclusion also encompasses swaps that a registered floor trader enters into on or subject to the rules of a SEF, in addition to on or subject to the rules of a DCM, so long as the swap meets the conditions stated in the exclusion.

swaps that are executed opposite a counterparty for which the transaction would qualify as a bona fide hedging transaction;

(vii) does not participate in any market making program offered by a DCM or SEF; and

(viii) complies with the record keeping and risk management requirements of CFTC Regulation §§ 23.201, 23.202, 23.203, and 23.600 with respect to each such swap as if it were a swap dealer.²³⁷

This rule permits floor traders who might otherwise be required to register as a swap dealer to be registered solely as floor traders with the CFTC. Given the limitations on the scope of the rule, the requirements for floor traders using the relief to comply with recordkeeping and risk management rules applicable to swap dealers as a condition of the relief, and the fact that swaps subject to the rule are traded on a DCM or SEF and cleared through a DCO, the CFTC believes it is not necessary to have floor traders subject to this rule register as both floor traders and swap dealers as a result of swaps activities covered by the rule.²³⁸

g. Additional interpretive issues relating to the “swap dealer” definition

As noted above, the Commissions, in consideration of comments received, are making certain modifications to the interpretive guidance concerning the definition of the term “swap

²³⁷ See CFTC Regulation § 1.3(ggg)(6)(iv).

²³⁸ The Commissions note the rule applies only to CFTC-registered floor traders engaging in swaps on DCMs or SEFs and cleared through DCOs. As noted above, the SEC does not have a regulatory category under the Exchange Act equivalent to floor trader under the CEA and none of these provisions apply in the context of security-based swap dealers or any entity regulated under the Exchange Act. Any person engaging in security-based swap transactions, whether or not these activities are similar to those engaged in by floor traders, will need to independently consider whether they need to register as security-based swap dealers as a result of their activities.

dealer” set out in the Proposing Release. However, the Commissions are retaining certain elements of their proposed interpretation of the term “swap dealer,” as discussed below.

First, with respect to the comments asserting that the proposed interpretive approach is overly broad,²³⁹ we note that the statute provides that the term “swap dealer” means “any person” who engages in the activities described in any of the four prongs of the definition, subject to the exceptions and qualifications set out in the statute. In view of this statutory text, these comments effectively assert that the statute should be interpreted to include preconditions to swap dealer status that are not set forth in the statute. For example, the assertion that the swap dealer definition must be limited to persons who enter into swaps on both sides of the market would impose a requirement that does not exist in the statute. Similarly, the comments to the effect that swap dealers are only those persons who seek to profit by intermediating between swap market participants adds a requirement not set forth in the statute.

We believe, though, that the activities that cause a person to be covered by the swap dealer definition should be addressed in the context of the four prongs of the statutory definition. That is, the relevant question is whether a person engages in any of the types of activities enumerated in the statute, and not whether the person meets any additional, supposedly implicit preconditions to swap dealer status.

Second, the Commissions continue to believe, as stated in the Proposing Release, that accommodating demand and facilitating interest are appropriately used as factors in identifying swap dealers. As noted by commenters, however, the mere fact that a person entering into a particular swap has the effect of “accommodating demand” or “facilitating interest” in swaps

²³⁹ See letters cited at notes 83 to 84, *supra*.

does not conclusively establish that the person is a swap dealer. Instead, the person's overall activities in the swap market (or particular sector of the swap market if the person is active in a variety of sectors) should be compared against these factors. If, in the context of its overall swap activities, a person fulfills a function of accommodating demand or facilitating interest in swaps for other parties, then these factors would be significant in the analysis and the person is likely to be a swap dealer.²⁴⁰

Third, as discussed above, we have adopted some of the objective criteria suggested by commenters with respect to the indicia of holding oneself out as a dealer or being commonly known as a dealer, market making, and the "regular business" prongs of the swap dealer definition.²⁴¹ For instance, allocating staff and technological resources to swap activity, deriving revenue and profit from swap activity, or responding to customer-initiated orders for swaps can all be indicative of having "a regular business" of entering into swaps and, therefore, indicative of being a swap dealer. In addition, activities such as providing advice about swaps or offering oneself as a point of connection to other parties needing access to the swap market are indicative of a person holding itself out as a swap dealer, if the person also enters into swaps in conjunction with such activities.

²⁴⁰ The language of the four statutory tests for swap dealer status (which refer to a person who holds itself out as a dealer, is commonly known as a dealer, makes a market in swaps or regularly enters into swaps with counterparties) contemplate that a dealer is a person who, through its swap activities, functions to create legal relationships that transfer risk between independent persons. See CEA section 1a(49)(A), 7 U.S.C. 1a(49)(A).

See also Proposing Release, 75 FR at 80177 (describing swap dealers as those persons whose function is to serve as the points of connection in the swap markets); letter from COPE I at 4 ("Simply stated, dealers are in the regular business of being a point of connection to the market for others that need access to the market to hedge risk."); Roundtable Transcript at 21 (remarks of Richard Ostrander, Morgan Stanley; "a dealer is someone who is out there willing to enter into trades").

²⁴¹ See part II.B.2.d.iii, supra.

The guidance we have provided about these indicia is responsive to concerns expressed by commenters about the application of the swap dealer definition to energy markets. As described above, some commenters stated that in energy markets, unlike in some other markets, end-users often enter into swaps directly with each other, on both sides of the market, without the involvement of a separate category of businesses serving as intermediaries.²⁴² As a result, according to these commenters, energy swap market participants often engage in some of the activities that are indicative of swap dealer status. Some of these commenters contended that our activity-based interpretation of the swap dealer definition could therefore result in the inappropriate inclusion of energy market participants in the coverage of the definition of the term “swap dealer.”²⁴³

We believe that the language of the statutory “swap dealer” definition supports our activity-based interpretation and does not support categorical exclusions of particular types of persons from the “swap dealer” definition based on the general nature of their businesses. Further evidence that such a categorical exclusion is unwarranted is provided by the fact that a number of energy market participants – BP Plc., Cargill, Incorporated, Centrica Energy Limited, ConocoPhillips, EDF Trading Limited, GASELYS, Hess Energy Trading Company, LLC, Hydro-Quebec, Koch Supply & Trading, LP, RWE Supply & Trading GmbH, Shell Energy North America (US), L.P., STASCO, Totsa Total Oil Trading S.A., and Vattenfall Energy

²⁴² See parts II.A.2.f.ii and iii, *supra*.

²⁴³ See letters cited in note 117, *supra*. Comments expressing concern that the definition of the term “swap dealer” could include physical commodities businesses also were presented to Congress during consideration of legislation leading to passage of the Dodd-Frank Act. See Proposed Legislation by the U.S. Department of the Treasury Regarding the Regulation of Over-The-Counter Derivatives Markets: Hearing Before the H. Comm. On Agriculture, 111th Cong. 103 (2009) (submitted report on behalf of the Working Group of Commercial Energy Firms). However, as noted above, there is no exclusion in the statutory definition for such businesses.

Trading Netherlands N.V. – have voluntarily joined ISDA as primary dealers.²⁴⁴ As previously noted, any business organization that “deals in derivatives shall be eligible for election to membership in the Association as a primary member, provided that no person or entity shall be eligible for membership as a Primary Member if such person or entity participates in derivatives transactions solely for the purpose of risk hedging or asset or liability management.”²⁴⁵ Hence, a categorical exclusion from the “swap dealer” definition based on any particular type of business or general market activity also would be inconsistent with current industry structure and practice.

At the same time, however, the fact that a person engages in some swap activities that are indicative of swap dealer status does not, by itself, mean that the person is covered by the definition of the term “swap dealer.” The “not as part of a regular business” exception and our guidance about its meaning address the issue of swap market participants that engage to some extent in the activities characteristic of swap dealers. The guidance we have provided here therefore provides the appropriate approach to addressing these issues in energy markets as elsewhere.

Although several commenters attempted to articulate bright-line tests that would differentiate swap dealers from other swap market participants, the suggested bright-line tests generally could not be applied across the board to all types of swap market activity. For example, some commenters suggested that swap dealers can be identified as those who profit from entering into swaps on both sides of the market (and under the interpretive approach set

²⁴⁴ The list of ISDA Primary Members is available at <http://www.isda.org/membership/isdamemberslist.pdf>.

²⁴⁵ See note 188, *supra*.

forth in this Adopting Release, such activity may be an indicator of swap dealing).²⁴⁶ But other commenters said that, in certain circumstances, entering into swaps on both sides of the market is not necessarily indicative of swap dealing.²⁴⁷

The ways in which participants throughout the market use swaps are simply too diverse for swap dealer status to be resolved with a single, one-factor test. This is reflected in the statutory definition of the term “swap dealer” itself. Focused as it is on types of activities, with four prongs set forth in the alternative to cover different types of swap dealing activity, the statutory swap dealer definition is not susceptible to the bright-line test that some commenters seek. For these reasons, we continue to believe that it is appropriate to apply the multi-factor interpretive approach set forth in this Adopting Release.

In closing, we emphasize that the purpose of in this part IV.A.4 is to provide guidance as to how the rules further defining the term “swap dealer” will be applied in particular, complex situations where a person’s status as a swap dealer may be uncertain. Even though bright-line tests and categorical exclusions are inappropriate, we recognize that the large majority of market participants use swaps for normal course hedging, financial, investment or trading purposes and are not swap dealers.

5. Final rules and interpretation – definition of “security-based swap dealer”

a. General reliance on the dealer-trader distinction

As discussed above, we are adopting a rule under the Exchange Act that defines “security-based swap dealer” in terms of the four statutory tests and the exclusion for security-

²⁴⁶ See letters cited in note 84, *supra*.

²⁴⁷ See letters cited in note 86, *supra*. As noted above in the discussion of market making, a swap dealer may in some circumstances enter into swaps on only one side of the market.

based swap activities that are not as part of a “regular business.”²⁴⁸ Also, we believe that the dealer-trader distinction²⁴⁹ – which already forms a basis for identifying which persons fall within the longstanding Exchange Act definition of “dealer” – in general provides an appropriate framework for interpreting the meaning of “security-based swap dealer.”²⁵⁰ While there are differences in the structure of those two statutory definitions,²⁵¹ we believe that their parallels – particularly both definitions’ exclusions for activities that are “not part of a regular business” – warrant analogous interpretive approaches for distinguishing dealers from non-dealers.

As discussed above,²⁵² the Commissions note that interpretations of the applicability of the dealer-trader distinction to the “swap dealer” definition under the CEA do not affect existing,

²⁴⁸ See Exchange Act rule 3a71-1(a), (b).

²⁴⁹ See note 31, *supra*.

²⁵⁰ The principles embedded within the “dealer-trader distinction” are not solely useful for distinguishing persons who constitute dealers from active “traders,” but also are applicable to distinguishing dealers from non-dealers such as hedgers or investors. The “dealer-trader” nomenclature has been used for decades. See Loss, *Securities Regulation* 722 (1st ed. 1951) (“One aspect of the ‘business’ concept is the matter of drawing the line between a ‘dealer’ and a trader – an ordinary investor who buys and sells for his own account with some frequency.”).

²⁵¹ For example, while the “dealer” definition encompasses certain persons in the business of “buying and selling” securities, the “security-based swap dealer” definition does not address either “buying” or “selling.” As we noted in the Proposing Release, we do not believe that the lack of those terms in the “security-based swap dealer” definition leads to material interpretive distinctions, as the Dodd-Frank Act amended the Exchange Act definitions of “buy” and “purchase,” and the Exchange Act definitions of “sale” and “sell,” to encompass the execution, termination (prior to its scheduled maturity date), assignment, exchange or similar transfer or conveyance of, or extinguishing of rights or obligations under, a security-based swap. See Proposing Release, 75 FR at 80178 n.26 (citing Dodd-Frank Act sections 761(a)(3), (4), which amend Exchange Act sections 3(a)(13), (14)).

At the same time, we note that the “dealer” definition requires the conjunctive “buying and selling” – which connotes a degree of offsetting two-sided activity. In contrast, the “security-based swap dealer” definition (particularly the “regularly enters into security-based swaps” language of the definition’s third test) lacks that conjunctive terminology.

²⁵² See note 171, *supra*.

or future, interpretations of the dealer-trader distinction under the Exchange Act – both with regard to the “security-based swap dealer” definition, and with regard to the “dealer” definition.

In interpreting the security-based swap dealer definition in terms of the dealer-trader distinction, the Commissions have been mindful that some commenters expressed the view that we instead should rely on other interpretive factors that were identified in the Proposing Release (e.g., accommodating demand). We believe, nonetheless, that the dealer-trader distinction forms the basis for a framework that appropriately distinguishes between persons who should be regulated as security-based swap dealers and those who should not. We also believe that the distinction affords an appropriate degree of flexibility to the analysis, and that it would not be appropriate to seek to codify the distinction.

At the same time, the Commissions recognize that the dealer-trader distinction needs to be adapted to apply to security-based swap activities in light of the special characteristics of security-based swaps and the differences between the “dealer” and “security-based swap dealer” definitions. Relevant differences include:

- Level of activity – Security-based swap markets are marked by less activity than markets involving certain other types of securities (while recognizing that some debt and equity securities are not actively traded). This suggests that in the security-based swap context concepts of “regularity” should account for the level of activity in the market.
- No separate issuer – Each counterparty to a security-based swap in essence is the “issuer” of that instrument; in contrast, dealers in cash market securities generally transact in securities issued by another party. This distinction suggests that the concept of turnover of “inventory” of securities, which has been identified as a factor in connection with the dealer-trader distinction, is inapposite in the context of security-based swaps. Moreover, this distinction –

along with the fact that the “security-based swap dealer” definition lacks the conjunctive “buying and selling” language of the “dealer” definition²⁵³ – suggests that concepts of two-sided markets at times would be less relevant for identifying “security-based swap dealers” than they would be for identifying “dealers.”²⁵⁴

- Predominance of over-the-counter and non-standardized instruments – Security-based swaps thus far are not significantly traded on exchanges or other trading systems, in contrast to some cash market securities (while recognizing that many cash market securities also are not significantly traded on those systems).²⁵⁵ These attributes – along with the lack of “buying and selling” language in the security-based swap dealer definition, as noted above – suggest that concepts of what it means to make a market need to be construed flexibly in the context of the security-based swap market.²⁵⁶
- Mutuality of obligations and significance to “customer” relationship – In contrast to a secondary market transaction involving equity or debt securities, in which the completion of a purchase or sale transaction can be expected to terminate the mutual obligations of the

²⁵³ See note 251, *supra*.

²⁵⁴ The analysis also should account for the fact that a party to a security-based swap can use other derivatives or cash market instruments to hedge the risks associated with the security-based swap position, meaning that two-way trading is not necessary to maintain a flat risk book.

²⁵⁵ Even though we expect trading of security-based swaps on security-based swap execution facilities or exchanges following the implementation of Title VII, we expect there to remain a significant amount of over-the-counter activity involving security-based swaps.

²⁵⁶ For example, the definition of “market maker” in Exchange Act section 3(a)(38) – which is applicable for purposes of the Exchange Act “unless the context otherwise requires” (see Exchange Act section 3(a)) – defines the term “market maker” to mean “any specialist permitted to act as a dealer, any dealer acting in the capacity of block positioner, and any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis.” That definition is useful in the context of systems in which standardized securities are regularly or continuously bought and sold, but would not be apposite in the context of non-standardized securities or securities that are not regularly or continuously transacted.

parties to the transaction, the parties to a security-based swap often will have an ongoing obligation to exchange cash flows over the life of the agreement. In light of this attribute, some market participants have expressed the view that they have “counterparties” rather than “customers” in the context of their swap activities.

It also is necessary to use the dealer-trader distinction to interpret the security-based swap dealer definition so that the statutory provisions that will govern security-based swap dealers are applied in an effective and logical way. Those statutory provisions added by the Dodd-Frank Act advance financial responsibility (e.g., the ability to satisfy obligations, and the maintenance of counterparties’ funds and assets) associated with security-based swap dealers’ activities,²⁵⁷ other counterparty protections,²⁵⁸ and the promotion of market efficiency and transparency.²⁵⁹ As a whole, the relevant statutory provisions suggest that we should apply the dealer-trader distinction to interpret the security-based swap dealer definition in a way that identifies those persons for which regulation is warranted either: (i) due to the nature of their interactions with

²⁵⁷ E.g., capital and margin requirements (Exchange Act section 15F(e)), and requirements for segregation of collateral (Exchange Act section 3E).

²⁵⁸ E.g., requirements with respect to business conduct when transacting with special entities (Exchange Act sections 15F(h)(2), (h)(4), (h)(5)); disclosure requirements (Exchange Act section 15F(h)(3)(B)); requirements for fair and balanced communications (Exchange Act section 15F(h)(3)(C)); other requirements related to the public interest and investor protection (Exchange Act section 15F(h)(3)(D)); and conflict of interest provisions (Exchange Act section 15F(j)(5)).

²⁵⁹ E.g., reporting and recordkeeping requirements (Exchange Act section 15F(f)); daily trading records requirements (Exchange Act section 15F(g)); regulatory standards related to the confirmation, processing, netting, documentation and valuation of security-based swaps (Exchange Act section 15F(i)); position limit monitoring requirements (Exchange Act section 15F(j)(1)); risk management procedure requirements (Exchange Act section 15F(j)(2)); and requirements related to the disclosure of information to regulators (Exchange Act section 15F(j)(3)).

counterparties;²⁶⁰ or (ii) to promote market stability and transparency, in light of the role those persons occupy within the security-based swap markets.²⁶¹

b. Principles for applying the dealer-trader distinction to security-based swap activity

In light of the statutory security-based swap dealer definition, statutory provisions applicable to security-based swap dealers and market characteristics addressed above, the Commissions believe that the factors set forth below are relevant for identifying security-based swap dealers and for distinguishing those dealers from other market participants. This guidance seeks to address commenter requests that we further clarify the scope of the security-based swap dealer definition, and the Commissions believe that these factors provide appropriate guidance without being inflexible or allowing the opportunity for evasion that may accompany a bright-line test. At the same time, the determination of whether a person is acting as a security-based swap dealer ultimately depends on the relevant facts and circumstances. In light of the overall

²⁶⁰ The conclusion that a person's relationship with its counterparties can lead to associated obligations is consistent with the "shingle theory," which implies a duty of fair dealing when a person hangs out its shingle to do business. See Securities and Exchange Commission, Report of the Special Study of Securities Market Part I at 238 (1963) ("An obligation of fair dealing, based upon the general antifraud provisions of the Federal securities laws, rests upon the theory that even a dealer at arm's length impliedly represents when he hangs out his shingle that he will deal fairly with the public."; footnote omitted); Weiss, Registration and Regulation of Brokers and Dealers 171 (1965) ("the solicitation and acceptance by a broker-dealer of orders from customers and the confirmation of transactions do constitute a representation by the broker-dealer that he will deal fairly with his customers and that such transactions will be handled promptly in the usual manner, in accordance with trade custom").

²⁶¹ The importance of regulating dealers due to the centrality of their market role was illustrated by the Government Securities Act of 1986. When Congress provided for the regulation of government securities dealers, Congress specifically cited the lack of regulation as contributing to the failures of several unregulated government securities dealers. See S. Rep. No. 99-426 (1986), as reprinted in 1986 U.S.C.A.N. 5395, 5400-04. The resulting statute provided for a definition of "government securities dealer" that in relevant part is parallel to the definitions of "dealer" and "security-based swap dealer," particularly with regard to sharing an exclusion for activities that are not part of a "regular business." See Exchange Act section 3(a)(44).

context in which a person's activity occurs, the absence of one or more of these factors does not necessitate the conclusion that a person is not a security-based swap dealer.²⁶²

- Providing liquidity to market professionals or other persons in connection with security-based swaps. A market participant might manifest this indication of dealer activity by accommodating demand or facilitating interest expressed by other market participants,²⁶³ holding itself out as willing to enter into security-based swaps, being known in the industry as being available to accommodate demand for security-based swaps, or maintaining a sales force in connection with security-based swap activities.²⁶⁴
- Seeking to profit by providing liquidity in connection with security-based swaps. A market participant may manifest this indication of security-based swap dealer activity – which is consistent with the definition's "regular business" requirement – by seeking compensation in connection with providing liquidity involving security-based swaps (e.g., by seeking a spread, fees or other compensation not attributable to changes in the value of the security-based swap).²⁶⁵ The Commissions do not believe that this necessarily requires that a person

²⁶² Similarly, depending on the relevant facts and circumstances, the presence of certain of the illustrative activities described here does not necessitate the conclusion that the entity is a dealer.

²⁶³ This is to be distinguished from an entity entering into security-based swaps for other business purposes, such as to gain economic exposure to a particular market.

²⁶⁴ A sales force, however, is not a prerequisite to a person being a security-based swap dealer. For example, a person that enters into security-based swaps in a dealing capacity can fall within the dealer definition even if it uses an affiliated entity to market and/or negotiate those security-based swaps (e.g., the person is a booking entity). Depending on the applicable facts and circumstances, the affiliate that performs the marketing and/or negotiation functions may fall within the Exchange Act's definition of "broker" (which was not revised by Title VII). See Exchange Act section 3(a)(4)(A).

²⁶⁵ Indicia of this objective may include, but would not be limited to, maintaining separate profit/loss statements in connection with this type of activity, and/or devoting staff and resources to this type of activity.

be available to take either side of the market at any time, or that a person continuously engage in this type of activity, to be a security-based swap dealer. Although one commenter expressed the view that the security-based swap dealer definition requires that a person be consistently available to take either side of the market,²⁶⁶ in our view such an approach would be underinclusive.²⁶⁷

In this regard, we believe that the issue of whether a person tends to take the prices offered in the market, rather than helping to set those prices (such as by providing quotes, placing limit orders, or otherwise accommodating demand), can be relevant as a factor for distinguishing security-based swap dealers from non-dealers. At the same time, we are mindful that a dealer may also accept the market price as part of its dealer activity (such as when a person enters into a security-based swap to offset the risk it assumes in connection with its security-based swap dealing activity); as a result, the fact that a person regularly takes the market price as part of its security-based swap transactions does not foreclose the possibility that the person may be a security-based swap dealer.

²⁶⁶ See letter from ISDA I.

²⁶⁷ It is possible for a dealer to be compensated for providing liquidity by entering into sequential offsetting positions, or by hedging the security-based swap position by using a different type of security-based swap, a swap or some other financial instrument. Accordingly, a rule of decision that permitted a person to avoid dealer regulation by providing liquidity in connection with security-based swaps, and laying off the associated risk using a different type of security-based swap, a swap or a different instrument entirely, would be susceptible to abuse. Moreover, as noted above, the definition of "security-based swap dealer" does not contain the "buying and selling" language found in the general Exchange Act definition of "dealer." Thus, while being regularly willing to enter into either side of the security-based swap market would suggest that a person is engaged in dealing activity, the absence of such activity should not necessarily lead to an inference that a person is not acting as a dealer.

We also note that some commenters have stated that two-way quoting by itself should not necessarily be enough to make a person a dealer, and some of those commenters specifically stated that a person may use two-sided quotes as part of the price discovery process or to elicit trading interest. See, e.g., letter from MFA I. Here too, it is important to consider whether the activity also has a dealing business purpose, such as seeking to profit by providing liquidity. Moreover, all participants in the security-based swap market, whether or not security-based swap dealers, should be mindful of the potential application of the antifraud and anti-manipulation provisions of the federal securities laws to such activities. Section 10(b) of the Exchange Act and Exchange Act rule 10b-5 particularly proscribe the use of any manipulative or fraudulent device in connection with the purchase or sale of any security, which includes manipulative trading. See Terrance Yoshikawa, Securities Exchange Act Release No. 53731 (Apr. 26, 2006), 87 SEC Docket 2924, 2930-31 & n.19 (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976)). The SEC has characterized manipulation as "the creation of deceptive value or market activity for a security, accomplished by an intentional interference with the free forces of supply and demand." See Swartwood, Hesse, Inc., 50 S.E.C. 1301, 1307 (1992) (citing Hochfelder, 425 U.S. at 199; Schreiber v. Burlington Northern, Inc., 472 U.S. 1 (1985); Feldbaum v. Avon Products, Inc., 741 F.2d 234 (8th Cir. 1984)).

- Providing advice in connection with security-based swaps or structuring security-based swaps. Advising a counterparty as to how to use security-based swaps to meet the counterparty's hedging goals, or structuring security-based swaps on behalf of a counterparty, also would indicate security-based swap dealing activity. It particularly is important that persons engaged in those activities are appropriately regulated so that their counterparties will receive the protections afforded by certain of the statutory business conduct rules (e.g., special entity requirements and communication requirements)²⁶⁸ applicable to security-based swap dealers.²⁶⁹ The Commissions recognize commenter concerns that end-users may also develop new types of security-based swaps,²⁷⁰ but also recognize that the activities of end-users related to the structuring of security-based swaps for purposes of hedging commercial risk are appreciably different than being in the business of structuring security-based swaps on behalf of a counterparty.
- Presence of regular clientele and actively soliciting clients. These dealer-trader factors would reasonably appear to be applicable in the security-based swap context, just as they are applicable in the context of other types of securities, as indicia of a business model that seeks to profit by providing liquidity. The Commissions are mindful that some industry

²⁶⁸ The SEC has proposed rules to implement Title VII provisions relating to external business conduct standards for security-based swap dealers (as well as major security-based swap participants). See Exchange Act Release No. 64766 (June 29, 2011), 76 FR 42396 (July 18, 2011).

²⁶⁹ This factor would also reasonably take into account whether a preexisting relationship involving other types of securities or other financial instruments is present. For example, to the extent a person has an existing broker or dealer relationship with a counterparty in connection with other types of securities, and also enters into a security-based swap with that counterparty, a reasonable inference would be that the person entered into the security-based swap in a dealer capacity. Any other approach would invite abuse, as persons could seek to leverage existing relationships of trust while avoiding regulation as a security-based swap dealer.

²⁷⁰ See letter from FSR I.

participants have highlighted a distinction between “counterparties” and “customers” in connection with swaps, and have suggested that they have no “customers” in the swap context. We do not believe such points of nomenclature are significant for purposes of identifying security-based swap dealers, however.²⁷¹

- Use of inter-dealer brokers. As with activities involving other types of securities, the Commissions would expect that a person’s use of an inter-dealer broker in connection with security-based swap activities to be an indication of the person’s status as a dealer.
- Acting as a market maker on an organized security-based swap exchange or trading system. Acting in a market maker capacity on an organized exchange or trading system for security-based swaps would indicate that the person is acting as a dealer.²⁷² While the Commissions recognize that some commenters have expressed the view that persons who solely enter into security-based swaps on an organized security-based swap exchange or trading system should not be regulated as security-based swap dealers,²⁷³ in our view such an approach would be contrary to the express language of the definition. This is not to say, of course, that the presence of an organized exchange or trading system is a prerequisite to being a market

²⁷¹ For purposes of the dealer-trader analysis, as it applies in the context of security-based swaps or any other security, we would not expect contractual provisions stating that the counterparty is not relying on the person’s advice to have any significance.

²⁷² Under the proposal of the SEC, the Board, the OCC and the FDIC to implement the provisions of section 619 of the Dodd-Frank Act (also known as the “Volcker Rule”), a person who claims the benefit of the market maker exception to that section’s prohibitions and restrictions on proprietary trading in connection with security-based swap activities would be required to register with the SEC as a security-based swap dealer, unless the person is exempt from registration or is engaged in a dealing business outside the U.S., and is subject to substantive regulation in the jurisdiction where the business is located. See Securities Exchange Act Release No. 65545, 76 FR 68846, 68947 (Nov. 7, 2011) (proposed implementing rule § __.4(b)(2)(iv)(C)).

²⁷³ See, e.g., letter from Traders Coalition.

maker for purposes of the security-based swap dealer definition.²⁷⁴ Moreover, acting as a market maker is not a prerequisite to being a security-based swap dealer.²⁷⁵ On the other hand, being a member of an organized exchange or trading system for purposes of trading security-based swaps does not necessarily by itself make a person a security-based swap dealer.²⁷⁶

As with the current application of the dealer-trader distinction to the Exchange Act “dealer” definition, the question of whether a person is acting as a security-based swap dealer ultimately will turn upon the relevant facts and circumstances, as informed by these criteria.

c. Additional interpretive issues

Activity by hedgers. As noted above, a number of commenters raised concerns that an overbroad “security-based swap dealer” definition would inappropriately encompass persons

²⁷⁴ Given the current nature of the security-based swap market, including the present level of activity and the present lack of significant trading of security-based swaps on exchanges or organized trading systems, we believe that it would negate the legislative intent to interpret the definition’s use of market making concepts to require the same use of quotation media that are incorporated into the interpretation of market making concepts in the context of securities that are actively traded on an organized exchange or trading system. At the same time, we recognize that routine activity in the security-based swap market is not necessarily indicative of making a market in security-based swaps. For example, persons may routinely be active in the market for purposes of hedging, to advance their investment objectives, or to engage in proprietary trading.

²⁷⁵ The definition of “security-based swap dealer” contains four alternative tests, only two of which use market making terminology. Moreover, the third test of the security-based swap dealer definition – which addresses persons who regularly enter into security-based swaps as an ordinary course of business for their own account – appears particularly inapt as a proxy for market making activity. Transacting with customers is not an element of this alternative test. A person thus may be a security-based swap dealer even if it transacts exclusively with other market professionals. Cf. OCC, “Risk Management of Financial Derivatives” 3-4 (1997) (stating that OCC has classified banks as “Tier I” dealers if they act as market makers by “providing quotes to other dealers and brokers, and other market professionals”). Compare letter from ISDA I (taking the view that the dealer definition should be interpreted in the context of market-making concepts).

²⁷⁶ The analysis of the status of members of such exchanges and trading systems in part may be influenced by the final Exchange Act rules that govern such systems, as well as the internal rules of such systems.

using security-based swaps for hedging purposes.²⁷⁷ As we stated in the Proposing Release, however, under the dealer-trader distinction the Commissions would expect persons that use security-based swaps to hedge their business risks, absent other activity, likely would not be dealers.²⁷⁸ We maintain that view. In other words, to the extent that a person engages in security-based swap activity to hedge commercial risk, or otherwise to hedge risks unrelated to activities that constitute dealing under the dealer-trader distinction (particularly activities that have the business purpose of seeking to profit by providing liquidity in connection with security-based swaps), the Commissions would not expect those hedging transactions to lead a person to be a security-based swap dealer.²⁷⁹ Of course, to the extent a person engages in dealing activities involving security-based swaps, the presence of offsetting positions that hedge those dealing activities would not excuse the requirement that the person register as a security-based swap dealer.²⁸⁰

²⁷⁷ See, e.g., letter from Church Alliance.

²⁷⁸ See Proposing Release, 75 FR at 80178 n.27. The Proposing Release also noted that if a person's other activities satisfy the definition of security-based swap dealer, the person must comply with the applicable requirements with regard to all of its security-based swap activities, absent an order to the contrary. We further noted in the Proposing Release that we would expect end-users to use security-based swaps for hedging purposes less commonly than they use swaps for hedging purposes.

²⁷⁹ In addition, consistent with the exclusion from the dealer analysis of activities involving majority-owned affiliates, see part II.C, *infra*, to the extent that a person engages in activities to hedge positions subject to the inter-affiliate exclusion, absent other activity, the Commission would not expect those hedging transactions to lead a person to be a security-based swap dealer. Conversely, security-based swap activities connected with the indicia of dealing discussed above (e.g., seeking to profit by providing liquidity in connection with security-based swaps) themselves would suggest security-based swap dealing activity.

²⁸⁰ For example, if a person were to use other instruments to hedge the risks associated with its security-based swap dealing activity, that hedging would not undermine the obligation of the person to register as a security-based swap dealer, notwithstanding the fact that it could be asserted that the dealing positions happen to hedge those other positions.

No predominance test. As discussed in the Proposing Release, the Commissions do not believe that the security-based swap dealer analysis should appropriately turn upon whether a person's dealing activity constitutes that person's sole or predominant business. The separate de minimis exemption, however, may have the effect of excusing from dealer regulation those persons whose security-based swap dealing activities are relatively modest.

Presence or absence of a customer relationship. Although commenters have expressed the view that a person that engages in security-based swap activities on an organized market should not be deemed to be a dealer unless it engages in those activities with customers,²⁸¹ we do not agree. It is true that having a customer relationship can illustrate a business model of seeking to profit by providing liquidity, and thus provide one basis for concluding that a person is acting as a security-based swap dealer. Nonetheless, the presence of market making terminology within the definition is inconsistent with the view that a security-based swap dealer must have "customers." Also, Title VII requirements applicable to security-based swap dealers address interests apart from customer protection.²⁸² Accordingly, to the extent that a person regularly enters into security-based swaps with a view toward profiting by providing liquidity – rather than by taking directional positions – that person may be a security-based swap dealer regardless of whether it views itself as maintaining a "customer" relationship with its counterparties.²⁸³

²⁸¹ See letters from ISDA I and Traders Coalition.

²⁸² Particularly in light of the view expressed by some market participants that they only have "counterparties" in the swap markets, and not "customers," any interpretation of the "security-based swap dealer" definition that is predicated on the existence of a customer relationship may lead to an overly narrow construction of the definition.

²⁸³ For example, a person's activity involving entering into security-based swaps on a SEF may cause it to be a security-based swap dealer even in the absence of a customer relationship with any of its counterparties.

Criteria associated with “holding self out” as a dealer or being “commonly known in the trade” as a security-based swap dealer. The Proposing Release articulated a number of activities that could satisfy the definition’s tests for a person “holding itself out” as a dealer or being “commonly known in the trade” as a dealer.²⁸⁴ Several commenters criticized those proposed criteria, largely on the grounds that those criteria would inappropriately encompass end-users who seek to use security-based swaps for hedging purposes, or otherwise would be overbroad or irrelevant.²⁸⁵ The Commissions recognize the significance of the concerns those commenters raised, and agree that these activities need to be considered within the context of whether a person engages in those activities with the purpose of facilitating dealing activity. While we do not believe that any of those activities by themselves would necessarily indicate that a person is acting as a security-based swap dealer, under certain circumstances they may serve as an indicia of a business purpose of seeking to profit by providing liquidity in connection with security-based swaps.²⁸⁶

²⁸⁴ As noted above, these were: contacting potential counterparties to solicit interest; developing new types of swaps or security-based swaps and informing potential counterparties of their availability and of the person’s willingness to enter into the swap or security-based swap; membership in a swap association in a category reserved for dealers; providing marketing materials describing the type of swaps or security-based swaps the party is willing to enter into; and generally expressing a willingness to offer or provide a range of products or services that include swaps or security-based swaps. See Proposing Release, 75 FR at 80178.

²⁸⁵ See part II.A.2.a, *supra*.

²⁸⁶ While the Proposing Release identified “membership in a swap association in a category reserved for dealers” as a factor in connection with the “holding out” and “commonly known” tests, we recognize that, depending on the applicable facts and circumstances, such membership may not be sufficient to cause a person to be a security-based swap dealer if the person does nothing else to cause it to be considered a dealer.

6. Requests for exclusions from the dealer definitions

Certain commenters have sought to exclude entire categories of persons from the dealer definitions, notwithstanding that some persons in those categories may engage in the activities set forth in the statutory definition (as further defined by the Commissions).²⁸⁷ The final rules nonetheless do not incorporate categorical exclusions of persons from the dealer definitions because the statutory definitions provide that “any person” who engages in the activities enumerated in the definitions is covered by the dealer definitions, unless the person’s activities fall within one of the statutory exceptions.²⁸⁸ In this regard, it is significant that the exceptions in the dealer definitions depend on whether a person engages in certain types of swap or security-based swap activity, not on other characteristics of the person. That is, the exceptions apply for swaps between an insured depository institution and its customers in connection with originating loans,²⁸⁹ swaps or security-based swaps entered into not as a part of a regular business,²⁹⁰ and swap or security-based swap dealing that is below a de minimis level.²⁹¹ The Dodd-Frank Act does not exclude any category of persons from the coverage of the dealer definitions; rather, it excludes certain activities from the dealer analysis.

Given that the statutory dealer definitions focus on a person’s activity, the Commissions believe that it is appropriate to determine whether a person meets any of the tests set forth in

²⁸⁷ See part II.A.2.f, *supra*.

²⁸⁸ See CEA section 1a(49), 7 U.S.C. 1a(49); Exchange Act section 3(a)(71), 15 U.S.C. 78c(a)(71).

²⁸⁹ See CEA section 1a(49)(A), 7 U.S.C. 1a(49)(A).

²⁹⁰ See CEA section 1a(49)(C), 7 U.S.C. 1a(49)(C); Exchange Act section 3(a)(71)(C), 15 U.S.C. 78c(a)(71)(C).

²⁹¹ See CEA section 1a(49)(D), 7 U.S.C. 1a(49)(D); Exchange Act section 3(a)(71)(D), 15 U.S.C. 78c(a)(71)(D).

those statutory definitions, and thus is acting as a swap dealer or security-based swap dealer, on a case-by-case basis reflecting the applicable facts and circumstances.²⁹² If a person's swap or security-based swap activities are of a nature to be covered by the statutory definitions, and those activities are not otherwise excluded, then the person is covered by the definitions. The contrary is equally true – a person who is not engaged in activities covered by the statutory definitions, or whose activities are excluded from the definition, is not covered by the definitions.²⁹³ The per se exclusions requested by the commenters have no foundation in the statutory text, and have the potential to lead to arbitrary line drawing that may result in disparate regulatory treatment and inappropriate competitive advantages.²⁹⁴

The final rules particularly do 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. It is likely, though, that a significant portion of the financial instruments used for risk management by such persons are forward contracts in nonfinancial commodities that are excluded from the definition of the term “swap.”²⁹⁵ Such forward contracts are not relevant in determining whether a person is a swap dealer.

²⁹² The Commissions believe that a facts and circumstances approach is particularly appropriate here, where the broad terms of the statutory dealer definitions indicate that the Commissions should apply their expertise and discretion to interpret the statutory text.

²⁹³ For example, a manufacturer, producer, processor, or merchant that enters into swaps to hedge its currency or interest rate risk, absent any facts and circumstances establishing dealing activity, is not a swap dealer.

²⁹⁴ In response to the commenters concerns, the Commissions have adopted certain tailored exclusions of certain types of swaps and security-based swaps in the final rule.

²⁹⁵ A coalition of not-for-profit power utilities and electric cooperatives has advised that it plans to submit a request for an exemption for transactions between entities described in section 201(f) of the Federal Power Act, as contemplated by section 722(f) of the Dodd-Frank Act. See letter from NFPEEU.

B. “Swap Dealer” Exclusion for Swaps in Connection with Originating a Loan

1. Proposed approach

The statutory definition of the term “swap dealer” excludes an insured depository institution (“IDI”) “to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer.”²⁹⁶ This exclusion does not appear in the definition of the term “security-based swap dealer.”

Proposed CFTC Regulation § 1.3(ggg)(5) would implement this statutory exclusion by providing that an IDI’s swaps with a customer in connection with originating a loan to that customer are disregarded in determining if the IDI is a swap dealer. In order to prevent evasion, the proposed rule further provided that the statutory exclusion does not apply where the purpose of the swap is not linked to the financial terms of the loan; the IDI enters into a “sham” loan; or the purported “loan” is actually a synthetic loan such as a loan credit default swap or loan total return swap.

1. Commenters’ views

Nearly all the commenters on this issue were IDIs seeking a broad interpretation of the exclusion. The commenters addressed four primary issues: (i) the type of swaps that should be covered by the exclusion; (ii) the time period during which parties would be required to enter into the swap in order for the swap to be considered to be “in connection with originating a

Separately, some regional transmission organizations and independent systems operators have expressed interest in submitting an exemption application to the CFTC as well. See generally section 722(e) of the Dodd-Frank Act. Such exemptions, if granted after notice and comment pursuant to CEA section 4(c), 7 U.S.C. 6(c), could further address commenters’ concerns in this regard.

²⁹⁶ See CEA section 1a(49)(A), 7 U.S.C. 1a(49)(A).

loan;" (iii) which transactions should be deemed to be "loans" for purposes of the exclusion; and (iv) which entities should be included within the definition of IDI.

First, regarding the type of swap that should be covered by the exclusion, as proposed, § 1.3(ggg)(5) would require that the rate, asset, liability or other notional item underlying the swap be, or be directly related to, a financial term of the loan (such as the loan's principal amount, duration, rate of interest or currency). Some commenters agreed with the principle of limiting the exclusion to swaps that are connected to the financial terms of the loan, stating that the exclusion should cover any swap between a borrower and the lending IDI, so long as the swap's notional amount is no greater than the loan amount, the swap's duration is no longer than the loan's duration, and the swap's index and payment dates match the index and payment dates of the loan.²⁹⁷ Another commenter, agreeing with the proposed approach, said that there is no basis to extend the loan origination exclusion to swaps related to the borrower's business risks, as opposed to the financial terms of the loan.²⁹⁸

Other commenters, though, said that this limitation to swaps connected to the financial terms of the loan was inappropriate or inconsistent with the Dodd-Frank Act, and that any swap required by the loan agreement or required by the IDI as a matter of prudent lending should be

²⁹⁷ See letters from Branch Banking & Trust Company ("BB&T") dated February 3, 2011 ("BB&T I"), B&F Capital Markets, Inc. ("B&F Capital") dated February 18, 2011 ("B&F Capital I"), Capital One Financial Corporation ("Capital One") and Capstar Bank ("Capstar"); see also joint letter from Atlantic Capital Bank, Cobiz Bank, Cole Taylor Bank, Commerce Bank, N.A., East West Bank, First Business Bank, First National Bank of Pennsylvania, Heartland Financial USA, Inc., Old National Bancorp, Peoples Bancorp of North Carolina, Inc., Susquehanna Bank, The PrivateBank and Trust Co, The Savannah Bank, N.A., The Washington Trust Company, Trustmark National Bank, UMB Financial Corporation, Valley National Bank, Webster Bank NA, WesBanco Bank ("Regional Banks") (general support for limitation to swaps connected to financial terms of the loan).

²⁹⁸ See letter from Better Markets I.

covered by the exclusion.²⁹⁹ Some of the commenters arguing for the broader exclusion emphasized that the exclusion should be available for any swap with the lending IDI which reduces the borrower's risks, such as a commodity swap the borrower uses for hedging, because reduction of commodity price risks faced by the borrower also reduces the risk that the loan will not be repaid to the IDI.³⁰⁰ Commenters said that if the exclusion does not apply to swaps hedging the borrower's commodity price risks, then only IDIs that are able to create a separately capitalized affiliate will be able to offer commodity swaps (because section 716 of the Dodd-Frank Act limits the ability of IDIs to offer commodity swaps), thereby reducing the availability of commodity swaps to borrowers that are smaller companies.³⁰¹

Second, regarding timing, the proposed rule requested comment on whether this exclusion should apply only to swaps that are entered into contemporaneously with the IDI's origination of the loan (and if so, how "contemporaneously" should be defined for this purpose), or whether this exclusion also should apply to swaps entered into during part or all of the duration of the loan. In response, commenters said that the exclusion should apply to swaps entered into in anticipation of a loan or at any time during the loan term.³⁰² Commenters said

²⁹⁹ See letters from BOK dated February 18, 2011 ("BOK II"), FSR I, ISDA I, Midsize Banks, OCC Staff at 6 (noting that "[l]oan underwriting criteria for community and mid-size banks ... may require, as a condition of the loan, that the borrower be hedged against the commodity price risks incidental to its business") and White & Case LLP ("White & Case") and joint letter from Senator Stabenow and Representative Lucas.

³⁰⁰ See letters from BOK II, FSR I, OCC Staff and White & Case.

³⁰¹ See letters from ABA I and BOK I. Other commenters addressed the relationship between the swap dealer definition and section 619 of the Dodd-Frank Act (the "Volcker Rule"). See joint letter from Capital One, Fifth Third Bancorp and Regions Financial Corporation.

³⁰² See letters from BB&T I, B&F Capital I, BOK II, Capital One, Capstar, FSR I, Midsize Banks, Manufacturers and Traders Trust Company ("M&T") dated June 3, 2011 ("M&T I") and September 28, 2011 ("M&T II"), Peoples Bank Co. ("Peoples Bank"), Regional Banks and White & Case.

that application of the exclusion throughout the duration of the loan would give IDIs and borrowers flexibility as to when to fix interest rates in fixed/floating swaps relating to loans and would allow borrowers to make other hedging decisions over a longer time period.³⁰³

Commenters also said that loans such as construction loans, equipment loans and committed loan facilities may allow for draws of loan principal over an extended period of time, and that swaps entered into by the borrower and lending IDI through the course of such a loan should be covered by the exclusion.³⁰⁴

Third, as to which transactions should be deemed "loans" for purposes of the exclusion, the proposal said that the exclusion should be available in connection with all transactions by which an IDI is a source of funds to a borrower, including, for example, loan syndications, participations and refinancings. Commenters agreed that the exclusion should be available for IDIs that are in a loan syndicate, purchasers of a loan, assignees of a loan or participants in a loan.³⁰⁵ On loan syndications and participations in particular, one commenter said that the exclusion should be available even if the notional amount of the swap is more than the amount of the loan tranche assigned to the IDI, so long as the swap notional amount is not more than the entire amount of the loan.³⁰⁶ Another commenter said that the exclusion should not be available

³⁰³ See letters from B&F Capital I, BOK II, Capital One, Capstar and M&T I and M&T II.

³⁰⁴ See letters from FSR dated October 17, 2011 ("FSR VI"), M&T II and Wells Fargo Bank, N.A. ("Wells Fargo") dated August 16, 2011 ("Wells Fargo II").

³⁰⁵ See letters from BB&T I, Midsize Banks, Regional Banks and White & Case; see also letter from Loan Market Association (providing background information on loan participations).

³⁰⁶ See letter from Regional Banks.

if the IDI's participation in the loan drops below a minimum level (such as 20 percent) because such use of the exclusion by minimally-participating IDIs would invite abuse.³⁰⁷

Some commenters said that other types of transactions also should be treated as "loans" for purposes of the exclusion. The transactions cited by commenters in this regard include leases, letters of credit, financings documented as sales of financial assets, bank qualified tax exempt loans and bonds that are credit enhanced by an IDI.³⁰⁸ Other commenters said the exclusion should apply where entities related to an IDI provide financing, such as loans or financial asset purchases by bank-sponsored commercial paper conduits where the IDI provides committed liquidity,³⁰⁹ and transactions where a special purpose entity formed by an IDI is the source of financing and enters into the swap.³¹⁰ Some commenters said the exclusion should encompass all transactions where an IDI facilitates a financing,³¹¹ or all extensions of credit by an IDI,³¹² or all transactions where an IDI provides risk mitigation to a borrower.³¹³

Fourth, with respect to the types of financial institutions that are eligible for the loan origination exclusion, three commenters said that IDIs, for purposes of this exclusion, encompass more than banks or savings associations with federally-insured deposits. The Farm Credit Council said the exclusion should be extended to Farm Credit System institutions because one of these institutions enters into interest rate swaps with borrowing customers identical in function to

³⁰⁷ See letter from Better Markets I.

³⁰⁸ See letters from BB&T I, Capital One, FSR I, M&T I, Midsize Banks and Regional Banks.

³⁰⁹ See letter from FSR I.

³¹⁰ See letter from Midsize Banks.

³¹¹ See letters from Pacific Coast Bankers' Bancshares ("PCBB") and Regional Banks.

³¹² See letters from FSR I and Midsize Banks.

³¹³ See letter from PCBB.

those offered by commercial banks and savings associations in connection with loans, and the institutions are subject to similar regulatory requirements and covered by a similar insurance regime.³¹⁴ Another commenter said that the exclusion should be extended to other regulated financial institutions, such as insurers, so as not to create an unlevel playing field.³¹⁵ And the Federal Home Loan Banks said that the exclusion should be available to them because they are subject to similar regulatory oversight and capital standards and engage in a similar function of extending credit as do commercial banks and savings associations.³¹⁶ In addition, some commenters said the exclusion should be broadly construed as a general matter, to encourage competition in the swap market between smaller and larger banks and to increase borrowers' choice among potential swap providers.³¹⁷

Two commenters asked for clarification of the following technical points in the proposed rule: (i) whether a swap would be covered by the exclusion even if it does not hedge all the risks under the loan, (ii) whether a swap that is within the exclusion could continue to be treated as covered by the exclusion by an IDI if the IDI transfers the loan, and (iii) whether an IDI should

³¹⁴ Consequently, the Farm Credit Council argued, disallowing these institutions from using the exclusion would give commercial banks and savings associations a competitive advantage in agricultural lending. See letters from Farm Credit Council I and dated February 17, 2012 ("Farm Credit Council II"). Another commenter argued that, to the contrary, making Farm Credit System institutions eligible for the exclusion would confer an inappropriate competitive advantage on those institutions. See letter from ABA dated February 14, 2012 ("ABA II"). This commenter said that Farm Credit System institutions have certain advantages over other IDIs, and the commenter asserted that Farm Credit System institutions were left out of the statutory language of the exclusion in order that they would not receive additional competitive advantages. See id.

³¹⁵ See letter from NAIC.

³¹⁶ See letter from FHLB I. The Credit Union National Association said that the Federal Home Loan Banks should not be covered by the swap dealer definition because they do not enter into swaps for their own account as part of a regular business. See letter from CUNA.

³¹⁷ See letters from BB&T I, B&F Capital dated June 1, 2011 ("B&F Capital II"), Capital One, Capstar, M&T I and Peoples Bank.

count swaps covered by the exclusion in determining if its dealing activity is above the de minimis thresholds.³¹⁸ Another commenter asked whether an IDI with swaps that are covered by the exclusion could be a swap dealer based on other dealing activity.³¹⁹ And others asked whether the exclusion would cover swaps used by an IDI to hedge its risks arising from a loan (i.e., a swap which the IDI enters into with a party other than the loan borrower).³²⁰

3. Final rule

The CFTC believes that the extent of this exclusion should be determined by the language of the statutory definition, which relates to an IDI that “offers to enter into a swap with a customer in connection with originating a loan with that customer.” The expansive interpretation of the exclusion advanced by some commenters, however, would read the statute to exclude almost any swap that an IDI enters into with a loan customer. That is not the exclusion that was enacted. Instead, we interpret the statutory phrase “enter into a swap with a customer in connection with originating a loan with that customer” to mean that the swap is directly connected to the IDI’s process of originating the loan to the customer.

Because of the statute’s direct reference to “originating” the loan, it would be inappropriate to construe the exclusion as applying to all swaps entered into between an IDI and a borrower at any time during the duration of the loan. If this were the intended scope of the statutory exclusion, there would be no reason for the text to focus on swaps in connection with “originating” a loan. The CFTC recognizes the concern expressed by commenters that: (i) there be flexibility regarding when the IDI and borrower enter into a swap relating to a loan, and (ii)

³¹⁸ See letters from FSR VI and Midsize Banks.

³¹⁹ See letter from Better Markets I.

³²⁰ See letters from B&F Capital I, FSR I, ISDA I, M&T I and Midsize Banks.

the expectation when an IDI originates a loan with a customer is often that the customer will enter into a swap with the IDI when there is a subsequent advance, or a draw, of principal on the loan. We do not believe, however, that the statutory term “origination” can reasonably be stretched to cover the entire term of every loan that an IDI makes to its customers. At some point, the temporal distance renders the link to loan origination too attenuated, and the risk of evasion too great, to support the exclusion. In order to balance these competing and conflicting considerations, the final rule applies the exclusion to any swap that otherwise meets the terms of the exclusion and is entered into no more than 90 days before or 180 days after the date of execution of the loan agreement, or no more than 90 days before or 180 days after the date of any transfer of principal to the borrower from the IDI (e.g., a draw of principal) pursuant to the loan, so long as the aggregate notional amount of the swaps in connection with the financial terms of the loan at any time is no more than the aggregate amount of the borrowings under the loan at that time.³²¹

Since a loan involves the repayment of funds to the IDI on particular terms, a swap that relates to those terms of repayment should be covered by the exclusion. In addition, we recognize that, as stated by commenters, requirements in an IDI’s loan underwriting criteria relating to the borrower’s financial stability are an important part of ensuring that loans are repaid.³²² Therefore, the final rule modifies the proposed rule to provide that the exclusion applies to swaps between an IDI and a loan borrower that are connected to the financial terms of

³²¹ We note that because the exclusion is available within the specified time period around the execution of the loan agreement and any draw of principal under the loan, any amendment, restructuring, extension or other modification of the loan will, in itself, neither preclude application of the exclusion nor expand application of the exclusion.

³²² See letter from OCC Staff.

the loan, such as, for example, the loan's duration, interest rate, currency or principal amount, or that are required under the IDI's loan underwriting criteria to be in place as a condition of the loan in order to hedge commodity price risks incidental to the borrower's business.³²³ The first category of swaps generally serve to transform the financial terms of a loan for purposes of adjusting the borrower's exposure to certain risks directly related to the loan itself, such as risks arising from changes in interest rates or currency exchange rates. The second category of swaps mitigate risks faced by both the borrower and the lender, by reducing risks that the loan will not be repaid. Thus, both types of swaps are directly related to repayment of the loan. Although some commenters said that this exclusion should also apply to other types of swaps, we believe it would be inappropriate to construe this exclusion as encompassing all swaps that are connected to a borrower's other business activities, even if the loan agreement requires that the borrower enter into such swaps or otherwise refers to them.³²⁴ In contrast to a swap that transforms the financial terms of a loan or is required by the IDI's loan underwriting criteria to reduce the borrower's commodity price risks, other types of swaps serve a more general risk management purposes by reducing other risks related to the borrower or the loan. If the purpose of the exclusion were to cover the broad range of swaps cited by some commenters (such as all swaps reducing a borrower's business risks), then the terms of the statute limiting the exclusion to swaps that are "in connection with originating a loan with that customer" would be

³²³ The final rule provides that the second category of swaps must hedge a price risk related to a commodity other than an excluded commodity because if the price risk relates to an excluded commodity (such as an interest rate) the swap must be connected to the financial terms of the loan in order to be covered by the exclusion.

³²⁴ On the other hand, there is no requirement that the loan agreement reference a swap in order for the swap to be excluded, if the swap otherwise qualifies for the exclusion.

superfluous.³²⁵ To give effect to the statutory text, the exclusion is limited to a swap that is connected to the financial terms of the loan or is required by the IDI's loan underwriting criteria to be in place as a condition of the loan in order to hedge commodity price risks incidental to the borrower's business.

Regarding the types of transactions that will be treated as a "loan" for purposes of the exclusion, courts have defined the term "loan" in other statutory contexts based on the settled meaning of the term under common law. This definition encompasses any contract by which one party transfers a defined quantity of money and the other party agrees to repay the sum transferred at a later date.³²⁶ Rather than examine at this time the many particularized examples of financing transactions cited by some commenters, the term "loan" for purposes of this exclusion should be interpreted in accordance with this settled legal meaning.³²⁷

As stated in the proposed rule, this exclusion is available to all IDIs that are a source of a transfer of money to a borrower pursuant to a loan. The final rule adopts provisions from the proposed rule that the exclusion is available to an IDI that is a source of money by being part of a loan syndicate, being an assignee of a loan, obtaining a participation in a loan, or purchasing a

³²⁵ Also, we believe that the broader range of swaps serving general risk management purposes are more likely to involve concerns regarding market transparency and appropriate business conduct practices addressed by swap dealer regulation than are the narrower range of swaps that are encompassed by the exclusion.

³²⁶ See, e.g., *In Re Renshaw*, 222 F.3d 82, 88 (2d Cir. 2000) ("Because Congress did not define the term "loan" for [11 U.S.C.] § 523(a)(8), we must interpret it according to its settled meaning under common law. The classic definition of a loan [is] ... as follows: To constitute a loan there must be (i) a contract, whereby (ii) one party transfers a defined quantity of money, goods, or services, to another, and (iii) the other party agrees to pay for the sum or items transferred at a later date.") (citing *In re Grand Union Co.*, 219 F. 353, 356 (2d Cir. 1914)).

³²⁷ The final rule adopts provisions from the proposed rule that, in order to prevent evasion, the statutory exclusion does not apply where the IDI originates a "sham" loan; or the purported "loan" is actually a synthetic loan such as a loan credit default swap or loan total return swap. See CFTC Regulation § 1.3(ggg)(5)(iii).

loan.³²⁸ However, the proposed rule did not state explicitly how the notional amount of a swap subject to the exclusion must relate to the amount of money provided by an IDI that is in a loan syndicate or is an assignee of, participant in or purchaser of a loan. In this regard, some commenters said that a borrower and the IDIs in a lending syndicate need flexibility to allocate responsibility for the swap(s) related to the loan as they may agree.³²⁹ We believe that, to allow for this flexibility, the exclusion may apply to a swap (which is otherwise covered by the exclusion) even if the notional amount of the swap is different from the amount of the loan tranche assigned to the IDI. However, we also agree with a commenter that the IDI should have a substantial participation in the loan.³³⁰ The requirement of substantial participation would prevent an IDI from applying the exclusion where the IDI makes minimal lending commitments in multiple loan syndicates where it offers swaps, causing its swap activity to be far out of proportion to its loan activity.³³¹

Therefore, the final rule includes a provision that the exclusion may apply regardless of whether the notional amount of the swap is the same as the amount of the loan, but only if the IDI is the sole source of funds under the loan or is committed to be, under the applicable loan

³²⁸ See CFTC Regulation § 1.3(ggg)(5)(ii). As is also stated in the Proposing Release, if an IDI were to transfer its participation in a loan to a non-IDI, then the non-IDI would not be able to claim this exclusion, regardless of the terms of the loan or the manner of the transfer. Similarly, a non-IDI that is part of a loan syndicate with IDIs would not be able to claim the exclusion.

³²⁹ See, e.g., letter from Regional Banks.

³³⁰ See letter from Better Markets I. This commenter suggested a minimal threshold of at least 20 percent of the loan. However, we believe that a 10 percent commitment constitutes a substantial participation in the loan which supports offering of a swap up to the loan's full amount.

³³¹ For example, an IDI could act as a 0.1 percent participant in one hundred different loans in order to serve as the sole swap counterparty to the borrowers for hedging the borrowers' interest rate risk on the loans. Thus, by lending or committing to lend \$100 million, the IDI could apply the exclusion to swaps with an aggregate notional amount of \$100 billion.

agreements, the source of at least 10 percent of the maximum principal amount under the loan.³³² If the IDI does not meet this 10 percent threshold, the final rule provides that the exclusion may apply only if the aggregate notional amount of all the IDI's swaps with the customer related to the financial terms of the loan is no more than the amount lent by the IDI to the customer.³³³ We also note that, in all cases, application of the exclusion requires that the aggregate notional amount of all swaps entered into by the borrower with any person in connection with the financial terms of the loan at any time is not more than the aggregate principal amount outstanding under the loan at that time.³³⁴

We also reiterate the interpretation in the Proposing Release that the word "offer" in this exclusion includes scenarios where the IDI requires the customer to enter into a swap, or where the customer asks the IDI to enter into a swap, specifically in connection with a loan made by that IDI.

We also continue to emphasize, as stated in the Proposing Release, that the statutory language of the exclusion limits its availability to only IDIs as defined in the statute. Regarding some commenters' statements about the competitive effect of this interpretation of the term "insured depository institution," we believe that the scope of application of the swap dealer definition to various entities should be treated in the de minimis exception, which is available to all persons.

³³² See CFTC Regulation § 1.3(ggg)(5)(i)(D)(1) and (2).

³³³ See CFTC Regulation § 1.3(ggg)(5)(i)(D)(3).

³³⁴ See CFTC Regulation § 1.3(ggg)(5)(i)(E). Paragraphs (D)(3) and (E) of this regulation refer to all swaps "in connection with the financial terms of the loan" in order to clarify that only such swaps are relevant in this regard. For example, if the IDI were to enter into a swap with the customer that is not in connection with the loan's financial terms, the swap would not be relevant because the exclusion would not apply to the swap.

In order to provide clarification in response to certain technical questions raised by commenters, we note that whether a swap hedges all of the risk, or only some of the risk, of a loan is not relevant to application of the exclusion. Nor is it relevant to the exclusion if the IDI later transfers or terminates the loan in connection with which the swap was entered into, so long as the swap otherwise qualifies for the exclusion and the loan was originated in good faith and was not a sham.³³⁵ Further, swaps that are covered by the exclusion should not be considered in determining if an IDI exceeds the de minimis level of swap dealing activity, because the statute provides that swaps covered by the exclusion should not be considered in determining if an IDI is a swap dealer, and the de minimis exception provides that it considers the “quantity of [a person’s] swap dealing.”³³⁶ The application of the exclusion to swaps entered into by an IDI in connection with the origination of loans, however, does not mean that the IDI could not be a swap dealer because of other of the IDI’s activities that constitute swap dealing. Regarding swaps used by an IDI to hedge or lay off its risks arising from a loan, we do not believe it is appropriate to treat such swaps as covered by the exclusion, because the statute explicitly limits the exclusion to swaps “with a customer,” which such hedging swaps are not. However, a swap that an IDI enters into for the purpose of hedging or laying off the risk of a swap that is covered by the IDI exclusion will not be considered in the de minimis determination, or otherwise in evaluating whether the IDI is covered by the swap dealer definition.³³⁷

³³⁵ On the other hand, if the IDI were to transfer the swap (but not the loan) to another IDI, and the IDI that is the transferee of the swap is not a source of money to the borrower under the loan, then the transferee IDI would not be able to apply the exclusion to the swap.

³³⁶ See CEA sections 1a(49)(A) and 1a(49)(D), 7 U.S.C. 1a(49)(A) and 1a(49)(D).

³³⁷ An IDI that is seeking out swap counterparties to enter into swaps in order to hedge or lay off the risk of a swap that is subject to the IDI exclusion would generally not be accommodating demand for swaps or facilitating interest in swaps.

Last, we believe it is appropriate to require that an IDI claiming the exclusion report its swaps that are covered by the exclusion to a swap data repository (“SDR”). This requirement is consistent with the prevailing practice that IDIs handle the documentation of loans made to borrowers, and will provide for consistent reporting of swaps that are covered by the exclusion, thereby allowing the CFTC and other regulators to monitor the use of the exclusion.

In sum, the final rule balances the need for flexibility in response to existing lending practices, consistent with the constraints imposed by the statutory text as enacted, against the risk of establishing a gap in the regulatory framework enacted in Title VII.³³⁸ It provides that the exclusion may be claimed by a person that meets the following conditions: (i) the person is an IDI; (ii) the IDI enters into a swap with the borrower that does not extend beyond the termination of the loan; (iii) the swap is connected to the financial terms of the loan or is required by the IDI’s loan underwriting criteria to be in place as a condition of the loan in order to hedge commodity price risks incidental to the borrower’s business; (iv) the loan is within the common law meaning of “loan” and it is not a sham or a synthetic loan; (v) the IDI is the source of money to the borrower in connection with the loan either directly, or (so long as the IDI is the source of at least 10 percent of the entire amount of the loan) through syndication, participation, assignment, purchase, refinancing or otherwise; (vi) the IDI enters into the swap with the borrower within 90 days before or 180 days after the date the execution of the loan agreement, or within 90 days before or 180 days after any transfer of principal to the borrower from the IDI pursuant to the loan; (vii) the aggregate notional amount of all swaps entered into by the

³³⁸ The final rule text in CFTC Regulation § 1.3(ggg)(5)(i) has been revised to conform the text of the rule to the statutory provision which refers to “an insured depository institution [that] ... enter[s] into a swap with a customer in connection with originating a loan with that customer.” See CEA § 1a(49)(A), 7 U.S.C. § 1a(49)(A)

borrower with all persons in connection with the financial terms of the loan at any time is not more than the aggregate amount of the borrowings under the loan at that time; and (viii) the IDI agrees to report the swap to an SDR.

An IDI that enters into swaps that do not meet these conditions, and thus do not qualify for the statutory exclusion, is not necessarily required to register as a swap dealer. Rather, the IDI would apply the statutory definition and the provisions of the rule (taking into account the applicable interpretive guidance set forth in this Adopting Release), solely with respect to its swaps that are not subject to the IDI exclusion, in order to determine whether it is engaged in swap dealing activity that exceeds the de minimis threshold.

C. Application of Dealer Definitions to Legal Persons and to Inter-Affiliate Swaps and Security-Based Swaps

1. Proposed approach and commenters' views

In the Proposing Release, the Commissions preliminarily concluded that designation as a dealer would apply on an entity-level basis (rather than to a trading desk or other business unit that is not organized as a separate legal person), and that an affiliated group of legal persons could include more than one dealer.³³⁹ The Proposing Release also stated that the dealer analysis should consider the economic reality of swaps and security-based swaps between affiliates, and preliminarily noted that swaps or security-based swaps "between persons under common control may not involve the interaction with unaffiliated persons that we believe is a hallmark of the

³³⁹ See Proposing Release, 75 FR at 80183.

elements of the definitions that refer to holding oneself out as a dealer or being commonly known as a dealer.”³⁴⁰

Commenters supported the view that swaps and security-based swaps among affiliates should be excluded from the dealer analysis.³⁴¹ A number of commenters took the view that the dealer definitions should not apply when there is common control between counterparties, or when common control is combined with the consolidation of financial statements.³⁴² Some commenters suggested that this interpretation regarding the scope of the dealer definitions should incorporate concepts of affiliation that are found in other statutory and regulatory provisions.³⁴³

³⁴⁰ Id. The Proposing Release further noted that sections 721(c) and 761(b)(3) give the Commissions anti-evasion authority, to the extent that an entity were to seek to use transactions between persons under common control to avoid one of the dealer definitions. See id. (erroneously referring to section 721(c) as section 721(b)(3)).

³⁴¹ See, e.g., letters from API I, COPE I, ISDA I, Midsize Banks, ONEOK, Inc. (“ONEOK”) and Peabody.

Several commenters explained the widespread use of central hedging desks to allocate risk within affiliate groups or to gather risk from within a group and lay that risk off on the market. See, e.g., letters from EEL/EPISA, Kraft Foods Inc. (“Kraft”), MetLife and Prudential Financial, Inc. (“Prudential”) dated February 17, 2011 (“Prudential I”).

Some commenters particularly stated that the use of a single entity to face the market on behalf of an affiliate group had several risk-reducing and efficiency-enhancing benefits, and that those benefits would be lost if the dealer definitions were to lead corporate groups to avoid using central trading desks and instead require each affiliate to face the market as an independent end-user. See letters from FSR I, Philip Morris International Inc. (“Philip Morris”), Shell Trading dated June 3, 2011 (“Shell Trading II”) and Utility Group, and joint letter from ABA Securities Association, American Council of Life Insurers (“ACLI”), FSR, Futures Industry Association (“FIA”), Institute of International Bankers, ISDA and SIFMA (“Financial Associations”).

Some commenters also stated that legislative history suggested that Congress did not intend that the dealer definition capture transactions involving the use of an affiliate to hedge commercial risk. See letters from CDEU and Prudential I.

³⁴² See letters from CDEU (common control), Financial Associations (common control and consolidation), MetLife (consolidation), ONEOK (common control, evaluated based on whether the trading interests of the entities are aligned) and Prudential I (citing CFTC letter interpretation regarding common control).

³⁴³ See, e.g., letters from EDF Trading (proposing definition from regulations promulgated by the Federal Energy Regulatory Commission) and Peabody (proposing definition of “affiliate” used in federal

Several commenters also opposed the suggestion (raised as part of the Proposing Release's request for comments) that this interpretation be limited to transactions among wholly owned subsidiaries.³⁴⁴

2. Final interpretation and rule

a. Application to legal persons

Consistent with the Proposing Release, the Commissions interpret "person" as used in the swap dealer and security-based swap dealer definitions to refer to a particular legal person. Accordingly, the dealer definitions will apply to the particular legal person performing the dealing activity, even if that person's dealing activity is limited to a trading desk or discrete business unit,³⁴⁵ unless the person is able to take advantage of a limited designation as a dealer.³⁴⁶

b. Application to inter-affiliate swaps and security-based swaps

The final rules codify exclusions from the dealer definitions for a person's swap or security-based swap activities with certain affiliates.³⁴⁷ These rules are consistent with the

securities laws) and joint letter from the Bank of Tokyo-Mitsubishi UFJ, Ltd., Mizuho Corporate Bank, Ltd. and Sumitomo Mitsui Banking Corp. (suggesting use of control definition in Bank Holding Company Act).

³⁴⁴ See, e.g., letters from Kraft and ONEOK.

³⁴⁵ Within an affiliated group of companies, however, only those legal persons that engage in dealing activities will be designated as dealers; that designation will not be imputed to other non-dealer affiliates or to the group as a whole. A single affiliate group may, however, have multiple swap or security-based swap dealers.

³⁴⁶ Limited designation as a dealer is addressed in more detail below in part II.E.

³⁴⁷ See CFTC Regulation § 1.3(ggg)(6)(i); Exchange Act rule 3a71-1(d). A person's market-facing swap or security-based swap activity may still cause that person to be a dealer, even if that market-facing activity is linked to the inter-affiliate activity, to the extent that the market-facing activity satisfies the dealer definition. However, a person's market-facing swap activity for hedging purposes as defined in CFTC Regulation § 1.3(ggg)(6)(iii) would not cause that person to be a dealer.

Proposing Release's recognition of the need to consider the economic reality of any swaps or security-based swaps that a person enters into with affiliates. Market participants may enter into such 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.

Under the final rules, the dealer analysis will not apply to swaps and security-based swaps between majority-owned affiliates.³⁴⁸ When the economic interests of those affiliates are aligned adequately – as would be found in the case of majority-ownership – such swaps and security-based swaps serve to allocate or transfer risks within an affiliated group, rather than to move those risks out of the group to an unaffiliated third party. For this reason, and as contemplated by the Proposing Release,³⁴⁹ we do not believe that such swaps and security-based swaps involve the interaction with unaffiliated persons to which dealer regulation is intended to apply.

The standard in the final rules differs from the standard suggested by the Proposing Release, which alluded to affiliates as legal persons under “common control.” This change is based on our further consideration of the issue, including consideration of comments that an inter-affiliate exclusion should be available when common control is combined with the

³⁴⁸ See CFTC Regulation § 1.3(ggg)(6)(i); Exchange Act rule 3a71-1(d)(1). For the purposes of these rules, the counterparties are majority-owned affiliates if one party directly or indirectly holds a majority ownership interest in the other, or if a third party directly or indirectly holds a majority interest in both, based on holding a majority of the equity securities of an entity, or the right to receive upon dissolution or the contribution of a majority of the capital of a partnership. See CFTC Regulation § 1.3(ggg)(6)(i); Exchange Act rule 3a71-1(d)(2).

³⁴⁹ See Proposing Release, 75 FR at 80183 (noting that swaps or security-based swaps between affiliates “may not involve the interaction with unaffiliated persons that we believe is a hallmark of the elements of the definitions that refer to holding oneself out as a dealer or being commonly known as a dealer”).

consolidation of financial statements. Although we are not including a requirement that financial statements be consolidated – as we do not believe that the scope of this exclusion should be exposed to the risk of future changes in accounting standards – in our view a majority ownership standard is generally consistent with consolidation under GAAP.³⁵⁰ Absent majority ownership, we cannot be confident that there would be an alignment of economic interests that is sufficient to eliminate the concerns that underpin dealer regulation.

In taking this approach, we have also considered alternatives suggested by commenters. For example, while one commenter suggested that we adopt a definition of “affiliate” as used in the securities laws,³⁵¹ we believe that such an approach would be too broad for the purpose of this exclusion from dealing activity, given that common control by itself does not ensure that two entities’ economic interests are sufficiently aligned.³⁵²

³⁵⁰ See FASB ASC Section 810-10-25, Consolidation – Overall – Recognition (stating that consolidation is appropriate if a reporting entity has a controlling financial interest in another entity and a specific scope exception does not apply).

³⁵¹ See letter from Peabody. The commenter did not specify which definition of “affiliate” in the securities laws it was proposing. For example, Rule 405 of the Securities Act of 1933 defines affiliate in terms of common control, see 17 C.F.R. 230.405, and Section 20(a) of the Exchange Act takes a similar approach. The Investment Company Act of 1940 (“ICA”) defines affiliate to include entities with a common ownership interest as low as 5 percent, ICA section 2(a)(3). Two other commenters proposed using a common control standard, perhaps also in reference to the Rule 405 definition of “affiliate.”

³⁵² The definitions of “affiliate” and “control” found in Rule 405 and other securities law provisions are appropriate in the context of the prophylactic and remedial provisions in which they are found. Rule 405, for example, uses the terms “affiliate” and “control” to identify those persons that have the power to effect registration of an issuer’s securities, and the broad definitions ensure that the persons with that power actually fulfill their obligation to do so. By comparison, the exclusion of inter-affiliate swaps and security-based swaps from the dealer analysis should be more tightly focused to address situations in which counterparties have similar economic interests.

Another commenter noted the definition of “affiliate” found in certain Federal Energy Regulation Commission regulations – which define “affiliate” in terms of a ten percent or five percent common ownership interest. See letter from EDF Trading. Those relatively low ownership thresholds, however, are intended to address different concerns regarding collusion and cross-subsidization, and do not appear appropriate for an interpretation that has the potential to reduce the counterparty and market protections provided by Title VII. See 18 C.F.R. sections 35.36(a)(9), 35.39, 366.2(b), 366.3.

c. Application to cooperatives

Similar considerations apply, in certain situations, to cooperative entities that enter into swaps with their members in order to allocate risk between the members and the cooperative. Commenters identified two general types of such cooperatives – “cooperative associations of producers” as defined in section 1a(14) of the CEA³⁵³ and cooperative financial entities such as Farm Credit System institutions and Federal Home Loan Banks.³⁵⁴ As is the case for affiliated groups of corporate entities, we believe that when one of these cooperatives enters into a swap with one of its members,³⁵⁵ the swap serves to allocate or transfer risks within an affiliated group, rather than to move those risks from the group to an unaffiliated third party, so long as the cooperative adheres to certain risk management practices.

³⁵³ 7 U.S.C. 1a(14). A cooperative association of producers is at least 75 percent owned or controlled, directly or indirectly, by producers of agricultural products and must comply with the Capper-Volstead Act (referred to in the CEA as the Act of February 18, 1922, 7 U.S.C. 291 and 292). See letters from Land O’Lakes II, NCFC I and NMPF.

³⁵⁴ See letters from Farm Credit Council I and FHLB I. The NRU CFC qualifies as a cooperative financial entity, but we understand that it does not enter into a significant amount of swaps with its members; rather, it enters into swaps with unaffiliated third parties. See letter from NRU CFC I and meeting with NRU CFC on January 13, 2011.

³⁵⁵ The term “cooperative association of producers” also includes any organization acting for a group of such associations and owned or controlled by such associations. See CEA section 1a(14), 7 U.S.C. 1a(14). For a cooperative association of producers that is acting for and owned or controlled by such associations, we believe that this conclusion applies to any swap between such cooperative association of producers and any cooperative association of producers that is a member of it, and any producer that is a member of any such cooperative association of producers that is itself a member of the first cooperative association of producers. See CFTC Regulation § 1.3(ggg)(6)(ii)(C).

However, we do not believe that this conclusion applies to any security-based swap that a cooperative association of producers may enter into, nor does it apply to any swap related to a non-physical commodity (such as a rate swap). For this reason, the exclusion for cooperative associations of producers is limited to swaps that are primarily based on a commodity that is not an excluded commodity. See CFTC Regulation § 1.3(ggg)(6)(ii)(A)(3). The term “excluded commodity” is defined in CEA section 1a(19), 7 U.S.C. 1a(19).

Accordingly, the final rules specifically provide that the dealer analysis excludes swaps between a cooperative and its members, so long as the swaps in question are reported to the relevant SDR 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.³⁵⁶ The final rules define the term "cooperative" to include cooperative associations of producers and any entity chartered under Federal law as a cooperative and predominantly engaged in activities that are financial in nature.³⁵⁷ The cooperatives covered by this relief are subject to provisions of Federal law providing for their cooperative purpose. Cooperative associations of producers have been recognized since the passage of the Capper-Volstead Act as being permitted to engage in certain cooperative activities without violating antitrust laws.³⁵⁸ Cooperative financial institutions such as the Farm Credit System institutions and Federal Home Loan Banks are chartered under Federal laws that limit their membership and require that they serve certain public purposes.³⁵⁹

We are aware that other persons commented that their swap activities should be excluded from the dealer analysis because they use swaps in connection with a cooperative or non-profit purpose, or because they aggregate demand for swaps arising from numerous small entities.³⁶⁰

³⁵⁶ See CFTC Regulation § 1.3(ggg)(6)(ii). To be clear, these cooperatives are not excluded from the dealer definitions. See part II.A.6, *supra*. Rather, swaps between a cooperative and its members (and swaps that a cooperative enters into to hedge or lay off the risk of such swaps) are excluded from the dealer analysis. If a cooperative were to engage in other swap activities that are covered by, and not otherwise excluded from, the statutory definition of the term "swap dealer," then it would be required to register as a swap dealer.

³⁵⁷ See CFTC Regulation § 1.3(ggg)(6)(ii)(B).

³⁵⁸ See Capper-Volstead Act section 1, 7 U.S.C. 291.

³⁵⁹ See Farm Credit Act of 1971, 12 U.S.C. 2001 et seq. and Federal Home Loan Bank Act, 12 U.S.C. 1421 et seq.

³⁶⁰ See letter from NFPEEU (not-for-profit power utilities, electric cooperatives and related persons); letters from Farmers' Associations, NGFA I and NMPF (referring to private companies that serve as

However, the key distinction drawn in granting this relief is that cooperatives covered by the exclusion enter into swaps with their members in order to allocate risk between the members and the cooperative. By contrast, the other entities noted above enter into swaps with unaffiliated parties in order to transfer risks between unaffiliated parties.³⁶¹ As noted above, the Commissions believe that the contemplated scope of the statutory definitions does not include instances where a person's swap activities transfer risk within an affiliated group, but does extend to activities that create legal relationships that transfer risk between unaffiliated parties. Thus, it is appropriate that the dealer analysis exclude swaps between a cooperative and its members, but such analysis should include swaps between a cooperative or other aggregator and unaffiliated persons.

D. De Minimis Exception

1. Proposed approach

The Dodd-Frank Act's definitions of "swap dealer" and "security-based swap dealer" require that the Commissions exempt from dealer designation any entity "that engages in a de minimis quantity" of dealing "in connection with transactions with or on behalf of customers."

aggregators for swaps in agricultural commodities or otherwise offer swaps for agricultural risk management); and letter from Northland Energy (small energy firm that aggregates demand for swaps from small energy retailers and consumers).

³⁶¹ See, e.g., letter from NFPEEU (not-for-profit power utilities and electric cooperatives generally enter into swaps between themselves, with large industrial consumers, and a wide range of other counterparties). Indeed, the Dodd-Frank Act permits the CFTC to exempt agreements, contracts or transactions between entities described in section 201(f) of the Federal Power Act, such as certain not-for-profit power utilities and electric cooperatives. See section 722(f) of the Dodd-Frank Act. As noted above, a coalition of not-for-profit power utilities and electric cooperatives has advised that it plans to submit a request for the exemption contemplated by section 722(f) of the Dodd-Frank Act. See note 295 supra.

The statutory definitions further require the Commissions to “promulgate regulations to establish factors with respect to the making of any determination to exempt.”³⁶²

In the Proposing Release, we preliminarily concluded that the de minimis exception “should be interpreted to address amounts of dealing activity that are sufficiently small that they do not warrant registration to address concerns implicated by the regulations governing swap dealers and security-based swap dealers. In other words, the exception should apply only when an entity’s dealing activity is so minimal that applying dealer regulations to the entity would not be warranted.”³⁶³ In taking this view, we rejected the suggestion that the de minimis exception should compare a person’s swap or security-based swap dealing activities to the person’s non-dealing activities.³⁶⁴

At the same time, we recognized that this proposed approach did not appear to “readily translate into objective criteria.” We further recognized that a range of alternative approaches may be reasonable, and we solicited comment as to what factors should be used to implement the exception.³⁶⁵

The proposed de minimis exception was comprised of three factors, all of which a person would have had to satisfy to avail itself of the exception.³⁶⁶ The first proposed factor would have limited the aggregate effective amount, measured on a gross basis, of the swaps or security-based

³⁶² CEA section 1a(49)(D), 7 U.S.C. 1a(49)(D); Exchange Act section 3(a)(71)(D), 15 U.S.C. 78c(a)(71)(D).

³⁶³ Proposing Release, 75 FR at 80179 (footnote omitted).

³⁶⁴ See id. at 80179-80.

³⁶⁵ See id. at 80180.

³⁶⁶ Under the proposal, the factors would consider a person’s swap or security-based swap dealing activity as a whole, rather than separately considering different types of swaps or security-based swaps. See Proposing Release, 75 FR at 80181.

swaps that a person entered into over the prior 12 months in connection with its dealing activities to \$100 million³⁶⁷ (or \$25 million with regard to counterparties that are “special entities”).³⁶⁸

The second proposed factor would have limited a person’s swap or security-based swap dealing activity to no more than 15 counterparties over the prior 12 months (while counting counterparties that are members of an affiliated group as one counterparty for these purposes). The final proposed factor would have limited a person’s dealing activity to no more than 20 swaps or security-based swaps over the prior 12 months (without counting certain amendments as new swaps or security-based swaps).

2. Commenters’ views

a. Basis for the exception

Some commenters sought to link the de minimis exception to systemic risk criteria by taking the position that a person should have to register as a dealer only if its dealing activities

³⁶⁷ See proposed Exchange Act rule 3a71-2(a). The proposed standard reflected our understanding that in general the notional size of a small swap or security-based swap is \$5 million or less, and that the proposed threshold would reflect 20 instruments of that size. The standard also sought to reflect the customer protection issues implicated by swaps and security-based swaps. See Proposing Release, 75 FR at 80180.

The proposed notional threshold would not consider the market risk offsets associated with combining long and short positions. In addition, the proposed notional threshold would not account for the amount of collateral held or posted by the entity, or other risk mitigating factors. See id.

³⁶⁸ See proposed Exchange Act rule 3a71-2(a). As set forth by the statutory business conduct rules applicable to security-based swap dealers (as set forth in Exchange Act section 15F(h)(2)(C)), “special entity” refers to: Federal agencies; States, State agencies and political subdivisions (including cities, counties and municipalities); “employee benefit plans” as defined under the Employee Retirement Income Security Act of 1974 (“ERISA”); “governmental plans” as defined under ERISA; and endowments. Title VII imposes additional business conduct requirements on security-based swap dealers in connection with special entities. See CEA sections 4s(h)(2), 4s(h)(4), 4s(h)(5); Exchange Act section 15F(h)(2), (4), (5).

pose systemic significance.³⁶⁹ One commenter specifically objected to the position in the Proposing Release that the de minimis exception should take into account customer protection principles.³⁷⁰ On the other hand, one commenter supported the rejection of a risk-based de minimis test.³⁷¹

Some commenters argued that the de minimis test should account for proportionality criteria that would excuse entities whose dealing activity is relatively minor compared to their other activities.³⁷²

b. Significance of “customer” language

One commenter took the position that the language within the de minimis exception that specifically referred to “transactions with or on behalf of customers” meant that the exception should be available only for persons who limit their swaps or security-based swaps to those that are entered into with or on behalf of customers.³⁷³ Other commenters posited the opposite view that the “customer” language should be read to mean that a person’s dealing activities with counterparties other than customers may be disregarded for purposes of the exception (*i.e.*, non-

³⁶⁹ See, e.g., letters from CDEU, MFX II, NCGA/NGSA II and SIFMA – Regional Dealers Derivatives Committee (“SIFMA – Regional Dealers”).

³⁷⁰ See letter from WGCEF I (arguing that basing the exception on customer protection principles would be contrary to the statutory framework, given that only ECPs are eligible to participate in off-exchange swap transactions).

³⁷¹ See letter from Better Markets I.

³⁷² See, e.g., letters from FHLB I, IECA-Credit I, NCGA/NGSA I, NRG Energy, Peabody and WGCEF I. One commenter said the proportionality criteria should also consider an entity’s activities with respect to the physical commodity underlying its swaps. See letter from NCGA/NGSA I. But see letter from Better Markets I (supporting rejection of a proportionality test). Some commenters suggested more than one alternative approach.

³⁷³ See letter from Better Markets I. Another commenter said that the “customer” language serves to emphasize that the de minimis exception is available to entities that provide swaps to customers. See letter from NGFA I.

customer transactions would not count against the de minimis thresholds).³⁷⁴ Some commenters argued that transactions entered into in a fiduciary capacity should be disregarded for purposes of the exception.³⁷⁵ One commenter questioned the proposal's use of the term "counterparty" in lieu of the statutory term "customer."³⁷⁶

c. Proposed tests and thresholds

Commenters criticized the proposed de minimis thresholds in a variety of ways. These included arguments that the proposed thresholds were inappropriately low,³⁷⁷ would harm end-users by reducing the number of entities willing to enter into low-value swaps and security-based swaps,³⁷⁸ would be unjustified on a cost-benefit basis,³⁷⁹ and were disproportionately low

³⁷⁴ See letters from ISDA I, Vitol and WGCEF I. Another commenter said that the use of the term "customer" indicates that all transactions with physical commodity customers should be disregarded in determining if a person is a dealer. See letter from EDF Trading.

³⁷⁵ See, e.g., letter from FSR I.

³⁷⁶ See letter from Vitol (suggesting that the proposed language meant that dealing activity involved "customers" but not "counterparties").

³⁷⁷ See, e.g., letters from API I, CDEU, DFA, EDF Trading, Farm Credit Council I, Growmark, Land O'Lakes dated January 13, 2011 ("Land O'Lakes I"), Midsize Banks, NCFC I, NCGA/NGSA II, New York City Bar Association – Committee on Futures and Derivatives Regulation ("NYCBA Committee"), Northland Energy, NRG Energy, Regional Banks and SIFMA – Regional Dealers. Some commenters also said that the thresholds, particularly those for swaps, should vary according to the riskiness of the swap or type of commodity underlying the swap. See letters from BG LNG I, Farm Credit Council I, Gavilon II, ISDA I, NFPEEU, Vitol and WGCEF I.

³⁷⁸ See, e.g., letters from API I, BG LNG I, Farm Credit Council I, Midsize Banks, NCFC I, NGFA I, Regional Banks and SIFMA – Regional Dealers and meetings with Electric Companies on April 13, 2011, the Asset Management Group of SIFMA ("SIFMA – AMG") on February 4, 2011 and WGCEF on April 28, 2011.

³⁷⁹ See, e.g., letters from CDEU and Vitol. Another commenter noted that application of a cost-benefit analysis of the de minimis threshold could be challenging. See Roundtable Transcript at 193-94 (remarks of Camille Rudge, The PrivateBank and Trust Company).

compared to the activities of recognized dealers.³⁸⁰ Other commenters said the de minimis thresholds should be set at a level to allow entities to engage in a meaningful amount of customer-facing swaps or security-based swaps without being required to register as dealers.³⁸¹

A number of commenters particularly criticized the proposed notional threshold, with some commenters suggesting that the threshold should be based on a percentage of the total swap market³⁸² or some other fixed value,³⁸³ or arguing in favor of an exposure-based threshold in lieu of a notional threshold.³⁸⁴ Other commenters said that the aggregate notional amount of

³⁸⁰ See letter from CDEU (citing statistics indicating that the average respondent to an ISDA survey had an annual "event volume" of over 297,000 OTC derivatives trade processing actions); see also letter from Regional Banks.

³⁸¹ See meetings with Electric Companies on April 13, 2011, Gaviion on May 11, 2011 and WGCEF on April 28, 2011.

³⁸² See letter from COPE I (suggesting 0.001% of the total U.S. swap market, amounting to approximately \$3 billion); see also letters from API dated June 3, 2011 ("API II"), EDF Trading, Edison Int'l, EEI/EPISA, IECA-Credit I, NCGA/NGSA II, NextEra, NFPPEU, Utility Group and WGCEF I (suggesting 0.001% of the total U.S. swap market).

³⁸³ See, e.g., meeting with Land O'Lakes on January 6, 2011 (suggesting the threshold be increased by 2 to 5 times – i.e., to \$200 million to \$500 million); letters from Growmark, FHLB I and MFX II (each supporting \$1 billion notional standard); Regional Banks (supporting \$2 billion notional standard); letter from NCFC dated October 31, 2011 ("NCFC III") (supporting alternative notional standards of \$1 billion or \$3 billion depending on certain assumptions); letter from FSR VI and joint letter from Capital One, Fifth Third Bancorp and Regions Financial Corporation (suggesting notional standard of at least \$2 billion); letter from WGCEF dated June 3, 2011 regarding the swap dealer definition ("WGCEF V") (suggesting notional standard of \$3.5 billion); and letter from IPR-GDF Suez Energy North America (suggesting notional standard of \$10 billion). Some commenters suggested more than one possible threshold.

³⁸⁴ See, e.g., letters from Farm Credit Council I, FSR VI and Midsize Banks. Other commenters said the threshold should account for the effect of netting. See letters from API II, Chesapeake Energy, Land O'Lakes I and MFX II. On the other hand, one commenter specifically supported the use of the gross notional amount. See letter from Greenberger.

swaps is not a meaningful measure of an entity's dealing activity.³⁸⁵ A few commenters supported the proposed notional threshold.³⁸⁶

Some commenters argued against basing the de minimis exception on the number of a person's swaps or security-based swaps or the number of a person's counterparties,³⁸⁷ or supported increasing those thresholds above the proposed standard.³⁸⁸ Commenters also suggested a variety of other alternatives to the proposed tests.³⁸⁹

³⁸⁵ See letters from Farm Credit Council I, ISDA I, Land O'Lakes I, Midsize Banks, NCFC I, SIFMA – Regional Dealers and Vitol.

³⁸⁶ See letters from AFR, Better Markets I, Greenberger and NMPF. One of these commenters said that data on credit default swaps analyzed by the SEC's Division of Risk, Strategy, and Financial Innovation indicates that the \$100 million proposed notional thresholds are too high. See letters from Better Markets to CFTC and SEC dated April 6, 2012 ("Better Markets III").

³⁸⁷ See, e.g., letters from API II, Atmos Energy, Chesapeake Energy, COPE I, EEI/EPSC, Gavilon II, IECA-Credit I, Land O'Lakes I, NCGA/NGSA II, NEM, NextEra I, NMPF, NRG Energy, Peabody and Utility Group.

³⁸⁸ See, e.g., letters from ISDA I (suggesting 25 transactions over 12 months); FHLB I (suggesting 25 counterparties and 50 transactions over 12 months); FSR I and Midsize Banks (each suggesting 75 counterparties and 200 transactions over 12 months); Regional Banks (suggesting 100 counterparties and 300 transactions over 12 months); Growmark and MFX II (suggesting thresholds should be increased by a factor of 10) and meeting with Land O'Lakes on January 6, 2011 (suggesting thresholds should be increased by a factor of between 2 and 5).

One commenter said the number of transaction and number of counterparty standards should be disjunctive – i.e., a dealer's activity would be de minimis if it were below either standard. See letter from Northland Energy. Other commenters raised questions about how counterparties or transactions should be counted for purposes of the standard. See letters from CDEU (novations should not be counted as new transactions) and J.P. Morgan (members of an affiliated group should be counted as one counterparty), joint letter from BB&T, East West Bank, Fifth Third Bank, The PrivateBank and Trust Company, Regions Bank, Sun Trust Bank, U.S. Bank National Association and Wells Fargo Bank, N.A. ("Midmarket Banks") (questioning how to count multiple borrower counterparties to a loan and swap) and meeting with Land O'Lakes on January 6, 2011 (members of a cooperative should be counted as one counterparty).

Last, some commenters said that the number of transaction or number of counterparty standards should be deleted because they are not useful as tests of de minimis status. See letters from Gavilon II (eliminate both standards) and SIFMA – Regional Dealers (eliminate number of counterparties standard).

³⁸⁹ See letters from IECA-Credit I (suggesting that exception exclude persons whose positions either are below a notional threshold or are below a combined proportionality and revenue threshold), SIFMA – Regional Dealers (supporting annual threshold of 500 customer-facing or riskless principal swaps,

d. Additional issues

Some commenters emphasized the need to provide protections in connection with “special entities.”³⁹⁰ Certain commenters sought to identify problems related to the application of the proposed thresholds in connection with particular types of businesses or markets,³⁹¹ or to aggregators or cooperatives.³⁹² Other commenters suggested that the exception should focus dealer regulation toward “financial” entities.³⁹³ One commenter emphasized the need for the exception to be available when the end-user is a credit union, bank or thrift.³⁹⁴

Commenters sought clarification that the de minimis criteria would not apply to transactions for hedging or proprietary trading purposes,³⁹⁵ or to inter-affiliate transactions.³⁹⁶

consistent with the de minimis exception from the Exchange Act “broker” definition in connection with bank brokerage activity, as well as SEC rules in connection with the Exchange Act definition of “dealer”), FHLB I (supporting non-quantitative test accounting for relatively small swap-related exposure compared to primary customer activity, collateral that also provides credit support for other business done with the customer, an existing relationship with customer and inability of customer to obtain swaps from entities that primarily are dealers), Gavilon II (alluding to use of non-quantitative tests), MFX II (suggesting establishment of a separate qualitative process by which a dealer may establish why registration is not warranted) and DC Energy (thresholds should be set at a level appropriate to support the capital levels to be required for swap dealers).

³⁹⁰ See letters from AFSCME, Better Markets I (arguing that the de minimis exception should not be available in connection with transactions with special entities), AFR (similar), Greenberger (supporting reduction of the notional threshold for transactions with special entities to \$5 million) and AFSCME. Some commenters said the standard for swaps and security-based swaps with special entities should be a notional value equal to 0.0001% of the total U.S. swap market. See letters from COPE I, EDF Trading, EEI/EPSCA, IECA-Credit I, NFPPEU and Utility Group. One commenter said the threshold for special entities should be eliminated because it is not useful in determining de minimis status. See letter from Gavilon II.

³⁹¹ See letters from BG LNG I (small energy companies), COPE I and Northland Energy (each discussing commodity markets, suggesting that notional thresholds be based on the unit of a commodity), NCFC I (commodity prices), NGFA I (grain elevators) and WGCEF I (energy prices).

³⁹² See, e.g., letters from Growmark and Land O’Lakes I.

³⁹³ See letters from NEM, NextEra I, and NGFA I.

³⁹⁴ See letter from CUNA.

³⁹⁵ See, e.g., letters from API I, EDF Trading, Gavilon II and SIFMA – Regional Dealers.

Commenters also raised issues related to the exception's treatment of the proposed use of a rolling annual period for calculations,³⁹⁷ the proposed use of "effective notional amounts,"³⁹⁸ the possibility of adjusting the thresholds over time,³⁹⁹ how the de minimis tests would apply in the context of affiliated positions,⁴⁰⁰ and how the exception would account for swaps or security-based swaps entered into before the definition's effective date.⁴⁰¹

Some commenters suggested that the de minimis thresholds be set higher initially to provide for efficient use of regulatory resources.⁴⁰² One commenter requested clarification that the exception would apply prospectively without regard to dealing activities taken prior to the effectiveness of Title VII.⁴⁰³ One commenter requested that a person that falls above the de

³⁹⁶ See, e.g., letter from Atmos Energy Holdings, Inc ("Atmos Holdings").

³⁹⁷ See letters from NCGA/NGSA I (supporting measurement of rolling period average over 12 months), NextEra I (supporting evaluation as of the last day of each calendar quarter rather than over the immediate preceding 12 months) and Northland Energy (requesting clarification that if a monetary notional amount is used, the evaluation periods should be fixed rather than rolling).

³⁹⁸ See letters from ISDA I (stating that the use of "effective notional amount" in the test introduces ambiguity and uncertainty) and WGCEF I (notional amounts should be measured on a "delta-equivalent" basis).

³⁹⁹ See letters from Farm Credit Council I (supporting automatic periodic increases to reflect changes in market size, the size of typical contracts and inflation), Greenberger (supporting reevaluation of the de minimis criteria on an ongoing basis), and BG LNG I, EEI/EPSC, NCFC I and WGCEF I (each supporting inflation or market size adjustments).

⁴⁰⁰ See meeting with Edison Int'l (requesting clarification that an entity that is prohibited from coordinating its financial derivatives activities should determine whether it qualifies for the de minimis exception without considering financial derivatives entered into by its affiliated entities).

⁴⁰¹ See letter from Covington & Burling (urging clarification that lookback period will not commence until all the relevant regulations become effective).

⁴⁰² See letters from BGLNG I and WGCEF V. See also Roundtable Transcript at 50-51 (remarks of Ron Oppenheimer, WGCEF), 57 (remarks of Richard Ostrander, Morgan Stanley) and 208-09 (remarks of Bella Sanevich, NISA Investment Advisors).

⁴⁰³ See letter from FSR I.

de minimis tests be able to take advantage of application and re-evaluation periods akin to those associated with the major participant definitions.⁴⁰⁴

Two commenters expressed support for the proposed self-executing approach of the exception.⁴⁰⁵ Some commenters requested clarification that the de minimis exception is independent of the loan origination exclusion in the CEA “swap dealer” definition.⁴⁰⁶

A number of commenters also addressed the application of dealer regulation to non-U.S. entities. While those comments did not specifically address the de minimis exception, the exception may be relevant to addressing these cross-border issues.⁴⁰⁷

One commenter separately addressed the credit default swap data analysis made available by CFTC and SEC staffs.⁴⁰⁸ The commenter expressed the view that this data supported the adoption of a de minimis threshold of \$100 million or less, particularly focusing on the number of entities that may be excluded under particular thresholds.⁴⁰⁹

⁴⁰⁴ See letter from WGCEF I; see also Northland Energy (supporting grace period for registration if the de minimis threshold is exceeded).

⁴⁰⁵ See letters from ISDA I and Northland Energy.

⁴⁰⁶ See letters from FSR VI and Midsize Banks.

⁴⁰⁷ Some commenters particularly took the view that the application of the dealer definitions to non-U.S. persons should solely address those persons’ U.S. dealing activities. See letters from FSR I, ISDA I and Société Générale. Some commenters also specifically identified concerns of international comity in this context. See letters cited in note 148, *supra*.

The Commissions intend to address the application of dealer regulation to non-U.S. persons as part of separate releases that generally will address the application of Title VII to non-U.S. persons.

⁴⁰⁸ See letter from Better Markets III.

⁴⁰⁹ See *id.*

3. Final rules – general principles for implementing the de minimis exception
 - a. Balancing regulatory goals and burdens

The Commissions recognize that implementing the de minimis exception requires a careful balancing that considers the regulatory interests that could be undermined by an unduly broad exception as well as those regulatory interests that may be promoted by an appropriately limited exception.

On the one hand, a de minimis exception, by its nature, will eliminate key counterparty protections provided by Title VII for particular users of swaps and security-based swaps.⁴¹⁰ The broader the exception, the greater the loss of protection.⁴¹¹ Moreover, in determining the scope of the exception, it is important to consider not only the current state of the swap and security-based swap markets, but also to account for how those markets may evolve in the future. This is particularly important because the full implementation of Title VII – including enhancements to pricing transparency and the increased access to central clearing – reasonably may be expected to facilitate new entrants into the swap and security-based swap markets. To the extent that such

⁴¹⁰ A number of commenters expressed particular concerns as to the threats that an overbroad exception would pose to special entities. See letters from AFR (noting that Congress incorporated special protections for special entities in reaction to news reports about special entities losing millions of dollars “after signing up for derivatives deals they did not understand,” and urging the elimination of any de minimis exception for transactions with special entities); Better Markets I (stating that history has shown that special entities are vulnerable to abuse, and that they need capital, collateral and business conduct protections as much as or more than any other category of market participants); and AFSCME (expressing skepticism as to the view that dealer status would preclude firms from entering into transactions with special entities). Some of those commenters also generally supported the proposed \$100 million de minimis threshold. See letters from AFR and Better Markets I; see also letter from Greenberger (stating that the dynamic nature of the derivatives sector of the financial markets should counsel caution, and that the de minimis threshold should be reevaluated on an ongoing basis).

⁴¹¹ Notwithstanding the reduction in protection, however, in the case of swaps and security-based swaps the general antifraud provisions of the CEA and the securities laws, respectively, including rules to be adopted by the SEC pertaining specifically to security-based swaps, will continue to apply to all transactions in security-based swaps. See, e.g., CEA section 4b(2), 7 U.S.C. 6b(2).

entrants engage in dealing activity below the de minimis threshold – either for the long term or until their activity surpasses the threshold – the relative amount of unregistered activity within the market may be expected to increase. Accordingly, a higher de minimis threshold may not only result in a certain percentage of unregistered activity being transacted initially, consistent with the current market, but also may result in an even greater proportion of unregistered activity being transacted in the future.

On the other hand, the Commissions also recognize that Congress included a statutorily mandated de minimis exception for certain swap and security-based swap dealing activity, and that an appropriately calibrated de minimis exception has the potential to advance other interests. For example, the de minimis exception may further the interest of regulatory efficiency when the amount of a person's dealing activity is, in the context of the relevant market, limited to an amount that does not warrant registration to address the concerns implicated by government regulation of swap dealers and security-based swap dealers. To advance this interest, it is necessary to consider the benefits to the marketplace associated with the regulation of dealers against the total burdens and potential impacts on competition, capital formation and efficiency associated with that regulation.⁴¹²

In addition, the exception can provide an objective test for persons who engage in some swap or security-based swap activities that, in their view, potentially raise the risk that they

⁴¹² While we are mindful that the Commissions have yet to adopt all the final substantive rules applicable to swap dealers and security-based swap dealers, we nonetheless believe that we have sufficient understanding of those potential requirements to reasonably balance the relevant factors to identify the initial level of dealing activity that should be considered to be de minimis. Moreover, finalizing the dealer definitions will help provide for the orderly and informed finalization of those other substantive rules governing swap dealers and security-based swap dealers.

would be deemed to be dealers.⁴¹³ The exception also may permit persons that are not registered as dealers to accommodate existing clients that have a need for swaps or security-based swaps in conjunction with other financial services or commercial activities, thus avoiding the need for such clients to establish separate relationships with registered dealers, which may have attendant costs. The exception further may promote competition in dealing activity within the swap or security-based swap markets, by helping to allow non-registered persons to commence providing dealing services while avoiding the costs associated with full-fledged dealers. More competition within the market for swaps and security-based swaps may not only decrease the costs for participants in the market, but also may help to decrease systemic risk by lessening the current apparent concentration of dealing activity among a few major market participants.⁴¹⁴

The statutory requirements that apply to swap dealers and security-based swap dealers include requirements aimed at the protection of customers and counterparties,⁴¹⁵ as discussed above, as well as requirements aimed at helping to promote effective operation and transparency

⁴¹³ "Congress incorporated a de minimis exception to the Swap Dealer definition to ensure that smaller institutions that are responsibly managing their commercial risk are not inadvertently pulled into additional regulation." See 156 Cong. Rec. S6192 (daily ed. July 22, 2010) (letter from Senators Dodd and Lincoln to Representatives Frank and Peterson).

⁴¹⁴ See 478 through 487 and accompanying text, infra.

⁴¹⁵ As discussed above, in part, these customer and counterparty protections derive from the financial responsibility requirements applicable to dealers, particularly: capital and margin requirements (CEA section 4s(e); Exchange Act section 15F(e)), and requirements for segregation of collateral (CEA sections 4d(f), 4s(l); Exchange Act section 3E).

These customer and counterparty protections also derive from certain other requirements applicable to dealers, particularly: requirements with respect to business conduct when transacting with special entities (CEA sections 4s(h)(2), 4s(h)(4), 4s(h)(5); Exchange Act sections 15F(h)(2), (h)(4), (h)(5)); disclosure requirements (CEA section 4s(h)(3)(B); Exchange Act section 15F(h)(3)(B)); requirements for fair and balanced communications (CEA section 4s(h)(3)(D); Exchange Act section 15F(h)(3)(C)); other requirements related to the public interest and investor protection (CEA section 4s(h)(3)(D); Exchange Act section 15F(h)(3)(D)); and conflict of interest provisions (CEA section 4s(j)(5); Exchange Act section 15F(j)(5)).

of the swap and security-based swap markets.⁴¹⁶ The overall economic benefits provided by these requirements in large part will depend on the proportion of swaps and security-based swaps that are transacted subject to these requirements. In other words, the greater the dealing activity of a registered dealer, the more significant the resulting increase in market efficiency,⁴¹⁷ and the greater the reduction in risks faced by the entity's customers and counterparties.⁴¹⁸ These benefits can be expected to accrue over the long term and be distributed over the market and its participants as a whole. This is not to say, however, that it would be insignificant for any particular counterparty if its swaps or security-based swaps were to fall outside of the ambit of dealer regulation. For example, a customer or counterparty that is not protected by the business conduct rules applicable to dealers might be more likely to suffer losses associated with entering into an inappropriate or misunderstood swap or security-based swap than if the instrument was transacted pursuant to the business conduct rules applicable to registered dealers.

In contrast to the benefits associated with dealer regulation, many of the burdens of dealer regulation will accrue in the short term and will fall directly on registered dealers.⁴¹⁹

⁴¹⁶ Relevant provisions are: reporting and recordkeeping requirements (CEA section 4s(f); Exchange Act section 15F(f)); daily trading records requirements (CEA section 4s(g); Exchange Act section 15F(g)); regulatory standards related to the confirmation, processing, netting, documentation and valuation of security-based swaps (CEA section 4s(i); Exchange Act section 15F(i)); position limit monitoring requirements (CEA section 4s(j)(1); Exchange Act section 15F(j)(1)); risk management procedure requirements (CEA section 4s(j)(2); Exchange Act section 15F(j)(2)); and requirements related to the disclosure of information to regulators (CEA section 4s(j)(3); Exchange Act section 15F(j)(3)).

⁴¹⁷ For example, the more swaps or security-based swaps a dealer enters into, the more significant will be the efficiency benefits associated with confirmation, processing, netting documentation and valuation requirements applicable to dealers.

⁴¹⁸ For example, the more swaps or security-based swaps a dealer enters into, the more significant the number of counterparties that will be protected by the disclosure and other business conduct obligations imposed on dealers.

⁴¹⁹ Certain commenters also have expressed concerns that the prospect of regulation may deter certain entities from engaging in limited swap or security-based swap dealing activities, see, e.g., letters

Some of those burdens may be expected to be independent of the amount of an entity's dealing activity (i.e., entities that engage in minimal dealing activity would still be expected to face certain burdens associated with the registration process and the development of compliance and other systems if they are required to register as dealers), while other burdens (e.g., the impact of margin and capital rules applicable to dealers) may be more directly linked to the amount of that entity's dealing activity.

As discussed below, the Commissions have sought to balance the various interests associated with a de minimis exception, as well as the benefits and burdens associated with such an exception, in developing the factors to implement the de minimis exceptions to the "swap dealer" and "security-based swap dealer" definitions.

However, in moving forward with implementing this balancing approach, we recognize that the information that currently is available regarding certain portions of the swap market is limited. Following the full implementation of Title VII, more information will be available to permit us to assess the effectiveness of this balancing for particular markets and to revise the exception as appropriate.

In that context – and in light of the tools currently available to us – we have been influenced, in particular, by comments taking the view that the de minimis factors should take into account the size and unique attributes of the market for swaps and security-based swaps.⁴²⁰ We believe that factors that exclude entities whose dealing activity is sufficiently modest in light

from SIFMA – Regional Dealers and Midsize Banks, which could reduce the availability of those instruments.

⁴²⁰ See, e.g., letters from CDEU (comparing proposed thresholds with statistics regarding the activities of recognized dealers) and EEL/EPISA (recommending that thresholds be set at an amount equal to 0.001 percent of the aggregate size of the U.S. swaps market, and 0.0001 percent for swaps in which the counterparty is a special entity).

of the total size, concentration and other attributes of the applicable markets can be useful in avoiding the imposition of regulatory burdens on those entities for which dealer regulation would not be expected to contribute significantly to advancing the customer protection, market efficiency and transparency objectives of dealer regulation. The Commissions note, however, that they are not of the general view that the costs of extending regulation to any particular entity must be outweighed by the quantifiable or other benefits to be achieved with respect to that particular entity. The Commissions, rather, analyze the overall benefits and costs of regulation, keeping in mind, as noted above, that the benefits may be distributed, accrue over the long-term, and be difficult to quantify or to measure as easily as certain costs.⁴²¹

b. Specific factors implementing the de minimis exception

i. Notional test

Consistent with the proposal, the final rules implementing the de minimis exception take into account the notional amount of an entity's swap or security-based swap positions over the prior 12 months arising from its dealing activity.⁴²² While the Commissions recognize that

⁴²¹ For example, it does not appear possible to demonstrate empirically – let alone quantify – the increase or decrease in the possibility that a financial crisis would occur at a particular future time and with a particular intensity in the absence of financial regulation or as a result of varying levels or types of financial regulation. It also is difficult to demonstrate empirically that the customer protections associated with dealer regulation would increase or decrease the likelihood that any particular market participant would suffer injury (or the degree to which the participant would suffer injury) associated with entering into an inappropriate swap or security-based swap. At the same time, certain costs may also not be readily susceptible to quantification or measurement, for example, the costs that might be associated with diminished presence, if any, of new entrants. The inability to quantify these benefits and costs does not mean that the benefits and costs of dealer regulation are any less substantial.

⁴²² See CFTC Regulation § 1.3(ggg)(4); Exchange Act rule 3a71-2(a)(1). Over the first year following the effective date of the final rules implementing the statutory definition of “swap” and “security-based swap” as set forth in CEA section 1a(47) and Exchange Act section 3(a)(68), respectively, this notional test will be based on the person's dealing activity following that effective date. See *id.* Accordingly, the analysis of whether a person may take advantage of the de minimis exception

notional amounts do not directly measure the exposure or risk associated with a swap or security-based swap position, such measures do reflect the relative amount of an entity's dealing activity.⁴²³ Moreover, although some commenters have posited measures of risk or exposure as alternatives to notional measures, such risk or exposure measures could, to the extent they allow for netting or collateral offsets, potentially allow an unregistered entity to engage in large amounts of swap or security-based swap dealing activity while remaining within the de minimis exception so long as that entity nets or collateralizes its swap or security-based swap positions. Such an outcome could undermine the customer protection and market operation benefits associated with dealer regulation. As with the proposed rules, the notional factor in the final rules is based on the notional positions of an entity over a 12 month period, rather than capping the current notional amount of a position at any time, to better reflect the amount of an entity's current activity.

The final rules, like the proposed rules, include lower notional thresholds for dealing activities in which the counterparty is a "special entity."⁴²⁴ This is consistent with the fact that Title VII's requirements applicable to swap dealers and security-based swap dealers provide

will not encompass the person's dealing activity prior to that effective date, given the need for the person to know whether an instrument is a swap or security-based swap for purposes of the analysis.

⁴²³ "Changes in notional volumes are generally reasonable reflections of business activity, and therefore can provide insight into potential revenue and operational issues. However, the notional amount of derivatives contracts does not provide a useful measure of either market or credit risks." OCC Quarterly Report at 8.

⁴²⁴ For these purposes, "special entity" means: (i) a Federal agency; (ii) a state, state agency, city, county, municipality, or other political subdivision of a state; (iii) any employee benefit plan, as defined in section 3 of the Employee Retirement Income Security Act of 1974 ("ERISA"); (iv) any governmental plan, as defined in section 3 of ERISA; or (v) any endowment, including an endowment that is an organization described in section 501(c)(3) of the Internal Revenue Code of 1986. See CEA section 4s(h)(2)(C) and CFTC Regulation § 23.401(c); Exchange Act section 15F(h)(2)(C).

heightened protection to those types of entities.⁴²⁵ It is important that the de minimis exception not undermine those statutory protections.⁴²⁶ Also, consistent with the Proposing Release, these notional standards will be based on “effective notional” amounts when the stated notional amount is leveraged or enhanced by the structure of the swap or security-based swap.⁴²⁷

ii. Other tests from the Proposing Release

The proposed rules limited the number of swaps or security-based swaps that an entity could enter into in a dealing capacity, and the number of an entity’s counterparties in a dealing capacity. The final rules do not include those measures. In part, this reflects commenter concerns that a standard based on the number of swaps or security-based swaps or counterparties can produce arbitrary results by giving disproportionate weight to a series of smaller transactions or counterparties.⁴²⁸

⁴²⁵ See CEA sections 4s(h)(2), (4), (5); see also CFTC, Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties; Final Rule, 77 FR 9733 (Feb. 17, 2012); Exchange Act sections 15F(h)(2), (4), (5) (providing additional requirements for dealers that advise special entities or that enter into swaps or security-based swaps with special entities).

⁴²⁶ The importance of the statutory protections for special entities has been highlighted by the SEC’s recent action in connection with the inappropriate sale of notes linked to the performance of synthetic collateralized debt obligations to a number of school districts. According to a complaint filed in federal district court, these securities were unsuitable for the investment needs of the school districts, were sold to school districts that lacked the requisite sophistication and experience to independently evaluate the risks of the investment, and exposed the school districts to a heightened risk of catastrophic loss ultimately led to a complete loss of their investments. “SEC Charges Stifel, Nicolaus and Former Executive with Fraud in Sale of Investments to Wisconsin School Districts,” SEC Litigation Release No. 22064 (Aug. 10, 2011) (<http://www.sec.gov/litigation/litreleases/2011/lr22064.htm>).

⁴²⁷ For example, if an exchange of payments associated with a \$1 million notional equity swap was based on three times the return associated with the underlying equity, the effective notional amount of the equity swap would be \$3 million.

⁴²⁸ See, e.g., letter from COPE I.

c. Significance of statutory “customer” language

Consistent with the Proposing Release, the final rules implementing the de minimis exception do not require the presence of any type of defined “customer” relationship.

In adopting these rules the Commissions have considered alternative approaches suggested by commenters, including one commenter’s suggestion that the de minimis exception should be available only in connection with swaps or security-based swaps entered into as part of a “customer” relationship.⁴²⁹ In considering that alternative view, however, we believe that it is significant that the statutory exception lacks terminology such as “existing” or “preexisting” that limits the availability of the exception or otherwise distinguishes a “customer” relationship from other types of counterparty relationship. Also, while that alternative view could still permit an unregistered person to provide limited dealer services as an accommodation to an existing customer or counterparty, an interpretation that predicates the exception on the presence of a particular type of “customer” relationship would not advance other potential benefits associated with a de minimis exception, including the benefit of providing certainty in connection with the swap or security-based swap activities of end-users.⁴³⁰ Accordingly, we do not believe that the “customer” reference standing alone provides a sufficient basis to conclude that the exception should only be available if there is an existing relationship of some type, and the final rules neither require that a dealer accommodate the demand of an existing customer nor require the presence of a preexisting relationship for the exception to apply.

We also are not persuaded by the different commenter suggestion that the statutory de

⁴²⁹ See letter from Better Markets I.

⁴³⁰ As discussed above, see note 413, supra, there is legislative history that suggests that an intended purpose of the exception would be to ensure that the dealer definition does not encompass “smaller institutions that are responsibly managing their commercial risk.”

de minimis exception's "customer" language means that an unregistered dealer should be permitted to engage in unlimited dealing activity so long as its counterparties are not customers.⁴³¹ Such an unlimited exception would appear to be contrary to the express language of the statutory exception. In addition, such an approach would lead to the perverse result of discouraging entities from entering into swaps or security-based swaps to facilitate risk management activities of customers (while encouraging other dealing activities), which appears contrary to Title VII's general approach of seeking to limit undue impacts on the swap and security-based swap activities of commercial end-users.

d. Focus on "dealing" activity

Some commenters suggested that we clarify that the limitations associated with the de minimis exception apply only in connection with a person's dealing activities, and not to the person's hedging or proprietary trading activities.⁴³² The Commissions agree that the de minimis exception is intended to permit an unregistered person to engage in a limited amount of dealing activity without regard to the person's non-dealing activity. Thus, to the extent that a particular swap or security-based swap position is not connected to dealing activity under the applicable interpretation of the statutory dealer definition, it will not count against the de minimis thresholds. Conversely, if a swap or security-based swap position is connected to the person's dealing activity, the position will count against those thresholds.⁴³³

⁴³¹ See, e.g., letter from ISDA I.

⁴³² See, e.g., letters from SIFMA – Regional Dealers and EDF Trading.

⁴³³ For purposes of the de minimis exception to the security-based swap dealer definition, we note that one indicator of dealing activity under the dealer-trader distinction is that a person profit by providing liquidity in connection with security-based swaps. Accordingly, for purposes of the de minimis exception to the security-based swap dealer definition, a security-based swap position that hedges or otherwise

Commenters also requested clarification that the de minimis thresholds do not apply to a person's inter-affiliate swaps and security-based swaps, nor apply to swaps covered by the exclusion for swaps entered into by insured depository institutions in connection with the origination of loans to customers.⁴³⁴ Consistent with the discussion above,⁴³⁵ such swaps or security-based swaps do not constitute dealing activity and should not be counted against the de minimis thresholds. Similarly, swaps between a cooperative and its members, as provided in CFTC Regulation § 1.3(ggg)(6)(ii), and swaps entered into for the hedging purpose defined in CFTC Regulation § 1.3(ggg)(6)(iii) should not be counted against the de minimis threshold.⁴³⁶

In light of the increased notional thresholds of the final rules, and the resulting opportunity for a person to evasively engage in large amounts of dealing activity if it can multiply those thresholds, the final rules provide that the notional thresholds to the de minimis exception encompass swap and security-based swap dealing positions entered into by an affiliate controlling, controlled by or under common control with the person at issue.⁴³⁷ This is necessary

offsets a position that was entered into as part of dealing activity would itself comprise part of the person's dealing activity, and hence count against the de minimis thresholds.

For purposes of the de minimis exception to the swap dealer definition, we take the view that the relevant question in determining whether swaps count as dealing activity against the de minimis thresholds is whether the swaps fall within the swap dealer definition under the statute and the final rules, as further interpreted by this Adopting Release. If hedging or proprietary trading activities did not fall within the definition, including because of the application of CFTC Regulation § 1.3(ggg)(6), they would not count against the de minimis thresholds.

⁴³⁴ See, e.g., letters from Atmos Holdings and FSR I.

⁴³⁵ See parts II.B and II.C, *supra*.

⁴³⁶ Swaps and security-based swaps that hedge, mitigate, or offset the types of swaps and security-based swaps discussed in the foregoing paragraph, which do not constitute dealing activity, similarly should not be counted against the de minimis thresholds.

⁴³⁷ See CFTC Regulation § 1.3(ggg)(4)(i); Exchange Act rule 3a71-2(a)(1). For these purposes, we interpret control to mean the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract

to prevent persons from avoiding dealer regulation by dividing up dealing activity in excess of the notional thresholds among multiple affiliates.⁴³⁸

e. Alternative approaches we are not following

Certain commenters have suggested alternative approaches to implementing the de minimis exception. While the Commissions have considered those suggested alternatives, we do not believe that they provide the optimal framework for implementing the exception.

For example, some commenters took the position that the de minimis exception should focus dealer regulation on those entities whose dealing activities pose systemic risk, and excuse other dealers from having to register.⁴³⁹ Such an approach, however, would fail to account for regulatory interests apart from the control of systemic risk that are addressed by dealer regulation, including statutory provisions that protect customers and counterparties in other ways, and that promote effective market operations and transparency.⁴⁴⁰

or otherwise. This is consistent with the definition of “control” and “affiliate” in connection with Exchange Act rules regarding registration statements. See Exchange Act rule 12b-2.

The final rules use a control standard in connection with the de minimis notional thresholds as a means reasonably designed to prevent evasion of the limitations of that exception. This contrasts with the majority-ownership standard used by the inter-affiliate exclusions from the dealer and major participant definitions. See parts II.C.2 and IV.G.2, *infra*. That majority-ownership standard, which in application will not be expected to be satisfied in all circumstances in which a control standard is satisfied, is reasonably designed to reflect the economic alignment that appropriately underpins those exclusions.

⁴³⁸ In other words, for example, if a parent entity controls two subsidiaries which both engage in activities that would cause the subsidiaries to be covered by the dealer definitions, then each subsidiary must aggregate the swaps or security-based swaps that result from both subsidiaries’ dealing activities in determining if either subsidiary qualifies for the de minimis exception.

The SEC expects to address the application of this principle to the security-based swap activities of non-U.S. persons in a separate release.

⁴³⁹ See, e.g., letters from CDEU and SIFMA – Regional Dealers.

⁴⁴⁰ We also disagree with the suggestion that it would be inconsistent with the Title VII framework to consider customer protection issues in setting the de minimis factors. See letter from WGCEF I. While the restrictions on the availability of swaps and security-based swaps to non-ECPs help to mitigate

Some commenters also have suggested that the de minimis exception should subsume a proportionality standard, whereby an entity may be excluded from dealer regulation if its dealing activity comprises only a relatively small portion of its overall activities (or its overall swap or security-based swap activities), or if its dealing activity is “tangential” to its principal business.⁴⁴¹ We are not incorporating that type of approach into the de minimis factors, however, because that approach would not appear to provide a logical way to balance the benefits and burdens of dealer regulation. A proportionality approach could permit a large entity to engage in a significant amount of dealing activity without being subject to dealer regulation, thus undermining the benefits of dealer regulation. Moreover, a proportionality approach could lead to arbitrary results by excusing a large entity from dealer regulation while requiring the registration of a smaller entity that engages in less total dealing activity (if that smaller amount of dealing activity comprises a greater portion of the smaller entity’s total activity).⁴⁴²

Some commenters also supported the use of non-quantitative standards in connection with the de minimis exception.⁴⁴³ Although we recognize that such an approach may help us weigh the facts and circumstances associated with a particular person’s dealing activity, we believe that it is more appropriate to base the exception on an objective quantitative standard, to allow the exception to be self-executing, and to promote predictability among market

certain customer protection concerns, Title VII includes specific safeguards designed to protect dealers’ customers and counterparties regardless of whether those are ECPs. It would not be consistent with Title VII to ignore those interests.

⁴⁴¹ See letter from FHLB I.

⁴⁴² As discussed below, if an entity is a dealer, the regulations applicable to dealers in general will govern all of the entity’s swap or security-based swap activities and positions. Depending on the applicable facts and circumstances, however, the entity may be able to avail itself of a limited purpose designation as a dealer. See part II.E, infra.

⁴⁴³ See letters from FHLB I, Gavilon II, and MFX II.

participants and the efficient use of regulatory resources. Unlike the overall definitions of “swap dealer” and “security-based swap dealers,” which consider the entirety of a person’s activities with respect to swaps, the de minimis exception is only relevant to persons who have determined that they are engaged in swap or security-based swap dealing, and are looking to determine whether the quantity of their dealing activity is de minimis. For this more particular and focused determination, an objective quantitative standard is more appropriate.

Commenters also made various suggestions as to the types of factors and accompanying thresholds that should be used in connection with the de minimis exception. Those suggestions are addressed more specifically below in the specific context of the swap dealer and security-based swap dealer de minimis exceptions.

4. Final rules – de minimis exception to swap dealer definition

a. Overview of the final rule

After considering commenters’ views, the final rule implementing the de minimis exception caps an entity’s dealing activity involving swaps at \$3 billion over the prior 12 months.⁴⁴⁴ This amount is based on input from commenters and is supported by several rationales, including the estimated size of the domestic swap market, among others.

⁴⁴⁴ CFTC Regulation § 1.3(ggg)(4). As noted above, for the first year following the effective date of the rules implementing the definition of “swap” the analysis would only address activity following that effective date. For clarity, the final rule also has been revised from the proposal to provide that persons taking advantage of the exception “shall be deemed not to be” swap dealers (the proposed rule used the phrasing “shall not be deemed to be” swap dealers). The final rule also reflects certain structural changes consistent with the substantive changes from the proposed rule. In addition, as discussed above, see part II.D.3.d, supra, the final rule has been revised to provide that the notional thresholds to the de minimis exception encompass swap dealing positions entered into by an affiliate controlling, controlled by or under common control with the person at issue.

As noted above, commenters who suggested a fixed notional standard proposed that the standard be set at a level between \$200 million and \$3.5 billion in notional amount of swaps entered into over a period of twelve months.⁴⁴⁵ In considering these comments, we are mindful of the variety of uses of swaps in various markets and therefore it is understandable that various commenters would reach different conclusions regarding the appropriate standard. At the same time, we see value in setting a single standard for all swaps so that there is a “level playing field” for all market participants and so that the standard can be implemented easily without the need to categorize swaps. Considering the written input of the commenters as well as the discussions of the de minimis standard at the Commissions’ joint roundtable and numerous meetings with market participants, and the benefits of the regulation of swap dealers (i.e., protection of customers and counterparties, and promotion of the effective operation and transparency of the swap markets), we believe a notional standard at a level of \$3 billion appropriately balances the relevant regulatory goals.

As noted above, several commenters suggested that the standard be set at an amount equal to 0.001 percent of the overall domestic market for swaps. The Commissions note, however, that comprehensive information regarding the total size of the domestic swap market is incomplete, with more information available with respect to certain asset classes than others. The CFTC evaluated data regarding one particular type of swap – credit default swaps (“CDS”) based on indices of debt securities known as “index CDS” – that was provided by the SEC.⁴⁴⁶

⁴⁴⁵ One commenter suggested a threshold of \$3 billion. See letter from COPE I (suggesting 0.001% of the total U.S. swap market, amounting to approximately \$3 billion). Other commenters also supported a threshold of 0.001% of the total U.S. swap market. See letters cited in note 382, supra.

⁴⁴⁶ The CFTC analysis was made available to the public. See memorandum to the public comment file from the CFTC Office of the Chief Economist.

As noted in the CFTC analysis of this data, however, the information is not filtered to reflect activity that would constitute swap dealing under the Dodd-Frank Act, so it is not possible to use the data to draw conclusions regarding any specific entity's status as a swap dealer.⁴⁴⁷ The data reflects only activity relating to index CDS, which constitute a very narrow part of the overall swap market, and, as noted in the CFTC analysis, similar data regarding other types of swaps is not available.⁴⁴⁸ Subject to these limitations, the data may help evaluate the impact of alternative approaches to implementing the de minimis exception.

One often-cited measure of the market, the Quarterly Report on Bank Trading and Derivatives Activities issued by the OCC ("OCC Quarterly Report") is both limited, in that it includes only data related to the activities of U.S. bank holding companies, commercial banks and trust companies, and over-inclusive, in that it includes activities related to instruments that are not or may not be included in the final definition of "swap" (including futures, forwards, certain foreign exchange instruments, and certain options) and it includes both swaps and security-based swaps. Nonetheless, the Commissions believe that the available (imperfect) data suggests that a \$3 billion notional standard is generally consistent with the commenters' suggestion of basing the standard on a percentage of the overall domestic market for swaps.

The total notional value of \$333.1 trillion in "derivatives" stated in the most recent OCC Quarterly Report includes approximately \$221.1 trillion in "swaps" and "credit derivatives."⁴⁴⁹

⁴⁴⁷ See id.

⁴⁴⁸ See id.

⁴⁴⁹ See Office of the Comptroller of the Currency, "Quarterly Report on Bank Trading and Derivatives Activities, Second Quarter 2011" at tables 1 and 2 (<http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq211.pdf>). These totals reflect the sum of the amounts reported for the top 25 bank holding companies reported in table 1 and for all but the top 25 commercial banks and trust companies reported in table 2.

Since some instruments that are security-based swaps are included in this total,⁴⁵⁰ the total notional value of swap positions at U.S. bank holding companies, commercial banks and trust companies at the end of the second quarter of 2011 of may be estimated to be somewhat less than \$221.1 trillion.

This total notional value is by nature under-inclusive, because it reflects only swap positions at U.S. bank holding companies, commercial banks and trust companies and not the swap positions of other market participants. However, there are also reasons that the information from the OCC Quarterly Report may overstate the notional value of swaps that would be relevant to estimating the size of the domestic swap market for purposes of the de minimis standard. While we believe the data is not sufficiently precise at this time to serve as the sole basis for the notional standard, a standard of \$3 billion seems that it is likely generally consistent with 0.001 percent of the domestic swap market that would be relevant to a potential dealer's de minimis swap activity figure. First, the large majority of derivatives in the OCC Quarterly Report (approximately \$229 trillion in notional value for commercial banks and trust companies) are derivatives between "dealers" (as defined for the purposes of the report.)⁴⁵¹ Thus, it is likely that a large part of the derivatives in the OCC Quarterly Report reflect transactions between financial

However, this adjustment is only approximate, because the definitions of "swap" and "credit derivative" used in the OCC Quarterly Report are likely to be significantly different from the final definition of "swap" and "security-based swap" for purposes of the Dodd-Frank Act. For the same reason, it is uncertain how many of the notional value of \$54.5 trillion in options reported in the OCC Quarterly Report are swaps or security-based swaps.

Also, data from the CDS trade information warehouse maintained by the Depository Trust & Clearing Corporation ("DTCC") indicates that total global notional CDS positions on indices amount to approximately \$10.47 trillion. See http://dtcc.com/products/derivserv/data_table_i.php?tbid=3 (data for the week ending October 7, 2011, obtained on October 17, 2011).

⁴⁵⁰ See part II.D.5, infra, for a discussion of the size of the security-based swap market.

⁴⁵¹ See OCC Quarterly Report at Graph 1.

institutions that will be swap dealers. It is also notable that approximately \$204.6 trillion in notional value of the derivatives (i.e., not only swaps) reported by U.S. commercial banks were interest rate contracts, many of which are swaps entered into by IDIs with customers in connection with the origination of loans which will be excluded from the determination of whether the IDIs are swap dealers.⁴⁵² Finally, the OCC Quarterly Report measures swap positions held at a certain point in time, rather than the level of swap activity over a certain time period, again indicating that the figures are broader than those that would be subject to the de minimis figure. Accordingly, it appears that notional amount of the overall domestic market for swaps that actually would be relevant to determining the notional standard, and thus the appropriate basis for the 0.001 percent calculation, may be significantly lower than \$331 trillion.

Because there is merit in the 0.001 percent ratio suggested by several commenters, we believe an appropriate balance of the goal of promoting the benefits of regulation (while recognizing the unquantifiable nature of those benefits) against the competing goal of avoiding the imposition of burdens on those entities for which regulation as a dealer would not be associated with achieving those benefits in a significant way, would be reached by setting the notional standard for swaps at a level that is near (taking into account the uncertainties noted above) 0.001 percent of a reasonable estimate of the overall domestic market for all swaps between all counterparties. We believe a \$3 billion notional value standard is appropriate taking all these considerations into account.

⁴⁵²

See OCC Quarterly Report at Graph 3.

b. Dealing activity involving special entities

For swaps in which the counterparty is a special entity, the final rules set a notional standard consistent with the proposal of \$25 million over the prior 12 months.⁴⁵³ The Commissions believe that this notional standard is appropriate in light of the special protections that Title VII affords to special entities. In adopting this threshold, we recognize the serious concerns raised by commenters stating that the de minimis exception should not permit any dealing activities (by persons who are not registered as swap dealers) involving special entities, in light of losses that special entities have incurred in the financial markets.⁴⁵⁴ However, the final rule does not fully exclude such dealing activity from the exception, in light of the potential benefits that may arise from a de minimis exception. In this way, the threshold would not completely foreclose the availability of swaps to special entities from unregistered dealers, but the threshold would limit the financial and other risks associated with those positions for a special entity, which would in turn limit the possibility of inappropriately undermining the special protections that Title VII provides to special entities.

c. Phase-in procedure

The Commissions believe that a phase-in period for the de minimis threshold would facilitate the orderly implementation of Title VII by permitting market participants and the Commissions to familiarize themselves with the application of the swap dealer definition and swap dealer requirements and to consider the information that will be available about the swap market, including real-time public reporting of swap data and information reported to swap data

⁴⁵³ CFTC Regulation § 1.3(ggg)(4)(i).

⁴⁵⁴ See letters from AFR and Better Markets I.

repositories. In addition, a phase-in period would afford the Commissions additional time to study the swap markets as they evolve in the new regulatory framework and allow potential swap dealers that engage in smaller amounts of activity (relative to the current size of the market) additional time to adjust their business practices, while at the same time preserving a focus on the regulation of the largest and most significant swap dealers. The Commissions also recognize that the data informing their current view of the de minimis threshold is based on the markets as they exist today, and that the markets will evolve over the coming years in light of the new regulatory framework and other developments.

We have also considered that there may be some uncertainty regarding the exact level of swap dealing activity, measured in terms of a gross notional amount of swaps, that should be regarded as de minimis. While some quantitative data regarding the usage of swaps is available, there are many aspects of the swap markets for which definitive data is not available. We have also considered comments suggesting that the de minimis thresholds should be set higher initially to provide for efficient use of regulatory resources,⁴⁵⁵ or that implementation of the dealer requirements should be phased.⁴⁵⁶ For all these reasons, the Commissions believe it is appropriate that the final rules provide for a phase-in period following the effective date during which higher de minimis thresholds would apply.

In particular, during this phase-in period, a person's swap dealing activity over the prior 12 months is capped at a gross notional value of \$8 billion.⁴⁵⁷ With respect to swaps with special

⁴⁵⁵ See letters cited in footnote 402, supra.

⁴⁵⁶ See, e.g., Roundtable Transcript at 35 (remarks of Ron Filler, New York Law School) and letters from FSR dated May 12, 2011 ("FSR III") and WGCEF V.

⁴⁵⁷ See CFTC Regulation § 1.3(ggg)(4)(i).

entities, the Commissions believe it is appropriate that the \$25 million gross notional value threshold apply during the phase-in period.⁴⁵⁸ In light of the available data – and the limitations of that data in predicting how the full implementation of Title VII will affect dealing activity in the swap markets – the Commissions believe that the appropriate threshold for the phase-in period is an annual gross notional level of swap dealing activity of \$8 billion or less. In particular, the \$8 billion level should still lead to the regulation of persons responsible for the vast majority of dealing activity within the swap markets.

Accordingly, the Commissions believe that while a \$3 billion notional threshold reflects an appropriate long-term standard based on the available data,⁴⁵⁹ it also is appropriate to allow a degree of latitude in applying the threshold over time in the event that subsequent developments in the markets or the evaluation of new data from swap data reporting facilities suggest that the thresholds should be adjusted. In particular, the implementation of swap data reporting under the Dodd-Frank Act may result in new data that would be useful in confirming the Commissions' determination to establish the \$3 billion threshold which applies after the phase-in period.

For these reasons, review of the de minimis exception will comprise an important part of the reports that the CFTC is directing its staff to conduct with regard to the swap dealer definition during the phase-in period. Among other topics, the report should consider market data addressing swap dealing activity over a period of approximately two years, and any resulting changes in swap dealing activity, by dealers above and below the \$8 billion phase-in threshold, and above and below the \$3 billion level applicable after the phase-in period. The

⁴⁵⁸ This limitation regarding swaps with special entities during the phase-in period is consistent with the Dodd-Frank Act's goal of helping special entities be in a position to benefit from the counterparty protections associated with the regulation of registered swap dealers under Title VII.

⁴⁵⁹ See, e.g., part II.D.4.a, supra.

report is required to be completed by the CFTC staff no later than 30 months following the date that a swap data repository first receives swap data under the CFTC's regulations, and the report will be published for public comment.⁴⁶⁰ The CFTC will take this report, in conjunction with any public comment on it, into account in weighing further action on the de minimis exception at the end of the phase-in period.

The final rules provide that nine months after publication of its staff report, the CFTC may, in its discretion, either promulgate an order that the phase-in period will end as of the date set forth by the CFTC in that order, or issue for public comment a notice of proposed rulemaking to modify the de minimis threshold, in which case the CFTC would also issue an order establishing the date that the phase-in period will end.⁴⁶¹ The period of nine months provided in the rule is intended to provide the CFTC an opportunity to consider its staff report, public comments on the staff report and any other relevant information.

The CFTC recognizes that the determination of the appropriate de minimis threshold is a significant issue requiring thorough consideration of a variety of regulatory and market factors. At the same time, the CFTC recognizes the need for predictability in how the de minimis exception will apply. Therefore, the final rules include a finality provision, stating that the phase-in period will end no later than five years after the date that a swap data repository first receives swap data under the CFTC's regulations.⁴⁶²

Persons who are able to avail themselves of the higher de minimis threshold that applies during the phase-in period will not be required to do so. In particular, a person that is engaged in

⁴⁶⁰ See CFTC Regulation § 1.3(ggg)(4)(ii)(C).

⁴⁶¹ See CFTC Regulation § 1.3(ggg)(4)(ii)(C).

⁴⁶² See CFTC Regulation § 1.3(ggg)(4)(ii)(D).

dealing activity involving swaps in excess of the \$3 billion threshold may choose to commence the process for registering as a swap dealer during the phase-in period.⁴⁶³

d. CFTC staff report

As noted above, the CFTC is directing its staff to report to the CFTC as to whether changes are warranted to the rules implementing the swap dealer definition, including the rule implementing the de minimis exception. We are mindful that following the full implementation of Title VII – which itself is contingent on the implementation of the dealer definition – more data will be available to the CFTC via swap data repositories. We expect that this additional data will assist the CFTC in testing the assumptions and addressing the effects of the final rule we are adopting to implement the de minimis exception. For example, this data should help the CFTC assess, among other things, the nature and amount of unregulated dealing activity that occurs under the \$3 billion threshold. The CFTC will make this report available for public comment so that it may benefit from additional input and analysis regarding the swap dealer definition.

By making use of post-implementation data, the staff report (together with public comment on the report) will help the CFTC better evaluate the exception in light of potential market changes resulting from the full implementation of Title VII – including market changes resulting from the de minimis exception itself – as part of determining whether revised de minimis thresholds would be appropriate. The report and public comment thereon will also be taken into consideration by the CFTC in determining what action, if any, to take with respect to the phase-in period associated with the de minimis exception.

⁴⁶³

See CFTC Regulation § 1.3(ggg)(4)(vi).

The final rules provide, moreover, that the CFTC may change the requirements of the de minimis exception by rule or regulation.⁴⁶⁴ Through this mechanism, the CFTC may revisit the rule implementing the exception and potentially change that rule, for example, if data regarding the post-implementation swap market suggests that different de minimis thresholds would be appropriate.⁴⁶⁵ In determining whether to revisit the thresholds, the CFTC intends to pay particular attention to whether the de minimis exception results in a swap dealer definition that encompasses too many entities whose activities are not significant enough to warrant full regulation under Title VII, or, alternatively, whether the de minimis exception leads an undue amount of dealing activity to fall outside of the ambit of the Title VII regulatory framework, or leads to inappropriate reductions in counterparty protections (including protections for special entities). The CFTC also intends to pay particular attention to whether alternative approaches would more effectively promote the regulatory goals that may be associated with a de minimis exception.

5. Final rules – de minimis exception to “security-based swap dealer” definition

a. Overview of the final rule

The final rule implementing the de minimis exception to the “security-based swap dealer” definition has been revised from the proposal in a number of ways. As discussed above, the final

⁴⁶⁴ CFTC Regulation § 1.3(ggg)(4)(v). CEA section 1a(49)(D) (like Exchange Act section 3(a)(71)(D)) particularly states that the “Commission” – meaning the CFTC – may exempt de minimis dealers and promulgate related regulations. We do not interpret the joint rulemaking provisions of section 712(d) of the Dodd-Frank Act to require joint rulemaking here, because such an interpretation would read the term “Commission” out of CEA section 1a(49)(D) (and Exchange Act section 3(a)(71)(D)), which themselves were added by the Dodd-Frank Act.

⁴⁶⁵ See letter from Greenberger (stating that the dynamic nature of the derivatives sector of the financial markets should counsel caution, and that the de minimis threshold should be reevaluated on an ongoing basis).

rule does not incorporate proposed limits on the number of security-based swaps that a person may enter into in a dealing capacity, or on the number of security-based swap counterparties a person may have when acting in a dealing capacity.⁴⁶⁶ Moreover, the provisions of the exception that cap an unregistered person's annual notional dealing activity with counterparties other than "special entities" have been increased from the proposed \$100 million threshold.⁴⁶⁷ Instead, the final rule caps such dealing activity involving security-based swaps that are credit default swaps – which largely would consist of single-name credit default swaps – at \$3 billion in notional amount over the prior 12 months.⁴⁶⁸ For other types of security-based swaps (e.g., single-name or narrow-based equity swaps or total return swaps), the exception caps an unregistered person's dealing activity at \$150 million in notional amount over the prior 12 months.⁴⁶⁹ Also, as

⁴⁶⁶ See part II.D.3.b, *supra*.

⁴⁶⁷ For clarity, the final rule also has been revised from the proposal to provide that persons taking advantage of the exception "shall be deemed not to be" dealers (the proposed rule used the phrasing "shall not be deemed to be" dealers), and to provide that such persons "shall not be subject to Section 15F of the Exchange Act and the rules, regulations and interpretations issued thereunder." See Exchange Act rule 3a71-2(a). The final rule also reflects certain structural changes consistent with the substantive changes from the proposed rule.

In addition, as discussed above, see part II.D.3.d, *supra*, the final rule has been revised to provide that the notional thresholds to the *de minimis* exception encompass swap and security-based swap dealing positions entered into by an affiliate controlling, controlled by or under common control with the person at issue.

⁴⁶⁸ Exchange Act rule 3a71-2(a)(1)(i). The final rule, like the proposal, requires the analysis of *de minimis* levels to be based on effective notional amounts to the extent that the stated notional amount is leveraged or enhanced by the structure of the security-based swap (such as, for example, if the exchange of payments associated with an equity swap was based on a multiple of the return associated with the underlying equity). See Exchange Act rule 3a71-2(a)(3).

It is important to recognize that while these types of *de minimis* principles are relevant to the "security-based swap dealer" definition, they are not applicable to the general definitions of "broker" and "dealer" under the Exchange Act, or the broker-dealer registration requirements of Exchange Act section 15(a). Unlike the "security-based swap dealer" definition, those other definitions, with the exception of the bank-broker definition in section 3(a)(4)(B)(xi) of the Exchange Act, lack *de minimis* exceptions.

⁴⁶⁹ Exchange Act rule 3a71-2(a)(1)(ii).

addressed below, the final rule provides for phase-in levels in excess of those \$3 billion and \$150 million thresholds for a certain period of time.

In addition, consistent with the proposal, the final rule caps an unregistered person's security-based swap dealing activity involving counterparties that are "special entities" at \$25 million in notional amount over the prior 12 months.⁴⁷⁰ The final rule further provides that the SEC may establish alternative methods of determining the scope of the de minimis exception by rule or regulation.⁴⁷¹

b. Interests associated with a de minimis exception

In developing this final rule, we have sought to balance the interests advanced by the de minimis exception against the protections that would be weakened were the exception applied in an overbroad manner. In making this evaluation, we have taken into account data regarding the security-based swap market and especially data regarding the activity – including activity that may be suggestive of dealing behavior – of participants in the single-name credit default swap market.⁴⁷²

⁴⁷⁰ Exchange Act rule 3a71-2(a)(1)(iii).

⁴⁷¹ Exchange Act rule 3a71-2(d); see part II.D.5.f, infra.

⁴⁷² Certain data has been addressed by an analysis regarding the market for single-name credit default swaps performed by the SEC's Division of Risk, Strategy, and Financial Innovation. See "Information regarding activities and positions of participants in the single-name credit default swap market" (Mar. 15, 2012) (available at <http://www.sec.gov/comments/s7-39-10/s73910-154.pdf>) ("CDS Data Analysis"). We believe that the data underlying this analysis provides reasonably comprehensive information regarding the credit default swap activities and positions of U.S. market participants, but note that the data does not encompass those credit default swaps that both: (i) do not involve U.S. counterparties; and (ii) are based on non-U.S. reference entities. Our reliance on this data, which we believe to be the best available, should not be interpreted to indicate our views as to the nature or extent of the application of Title VII to non-U.S. persons; instead, the SEC anticipates that issues regarding the extraterritorial application of Title VII will be addressed in a separate release.

As discussed below, see notes 476 and 485, infra, we also have considered more limited publicly available data regarding equity swaps.

As discussed above, a de minimis exception eliminates key Title VII protections for some market participants by regulating less dealer activity. Conversely, an appropriately applied de minimis exception may provide an objective test when there is doubt as to whether particular activities may cause a person to be deemed to be a dealer;⁴⁷³ allow non-dealers to accommodate the incidental security-based swap needs of existing clients; and help to facilitate competition by allowing the entry of new dealers into the market. In addition, as discussed above, a de minimis exception may promote regulatory efficiency by providing a framework to help focus dealer regulation upon those entities for which such regulation is warranted, rather than upon entities that engage in relatively limited amounts of dealing activity.⁴⁷⁴

i. Providing for regulatory coverage of the vast majority of dealing activity

In seeking to develop a de minimis exception that preserves key counterparty and market protections while promoting regulatory efficiency, we have considered the comparative amount of security-based swap dealing activity that could fall outside the ambit of dealer regulation as a result of the exception. In doing so we have considered not only the security-based swap market as it currently exists, but also how the market reasonably may be expected to change after the full implementation of Title VII.

The CDS Data Analysis also included an appendix of data regarding index credit default swaps. We do not consider that data for purposes of the analysis described in this section because the statutory definition of “security-based swap” in relevant part encompasses swaps based on single securities or on narrow-based security indices. See Exchange Act sec. 3(a)(68)(A); see also Exchange Act Release No. 64372, 76 FR 29818 (May 23, 2011) (proposed rules further defining “security-based swap” and certain other terms).

⁴⁷³ We believe that the application of the dealer-trader distinction and the guidance we have provided that distinguishes hedging activities from dealing activities in the security-based swap market will also help dealers meet their obligations.

⁴⁷⁴ See part II.D.3.a, supra.

In performing this comparative exercise we are, in part, drawing inferences from the CDS Data Analysis, a dataset released by the SEC staff that characterizes nearly all transactions in single-name credit default swaps during the 2011 calendar year.⁴⁷⁵ Though the final rules apply to all security-based swaps, not just single-name credit default swaps, the SEC believes that these data are sufficiently representative of the market to help inform the analysis because an estimated 95 percent of all security-based swap transactions appear likely to be single-name credit default swaps.⁴⁷⁶ The SEC also recognizes that although the de minimis exception is applicable to persons only with respect to their dealing activity, the CDS Data Analysis contains transactions reflecting both dealing activity and non-dealing activity, including transactions by persons who may engage in no dealing activity whatsoever.⁴⁷⁷

⁴⁷⁵ See note 472, *supra*.

⁴⁷⁶ While recognizing that the Commissions have yet to adopt final rules defining a “security-based swap,” we believe that single-name credit default swaps will constitute roughly 95 percent of the market, as measured on a notional basis, for instruments that will fall within that definition, with certain equity swaps (in other words, total return swaps based on single equities or narrow-based indices of equities) constituting the primary example of security-based swaps that are not credit default swaps.

In particular, according to data published by BIS, the global notional amount outstanding in equity forwards and swaps as of June 2011 was \$2.03 trillion, and the notional amount outstanding in credit default swaps was approximately \$32.4 trillion. See Statistical Annex, BIS Quarterly Review (December 2011), at A10 (available at http://www.bis.org/publ/qtrpdf/r_qsl1112.pdf). Although the BIS data reflects the global OTC derivatives market, and not just U.S. market, we have no reason to believe that these ratios differ significantly in the U.S. market. In fact, OCC data regarding U.S. entities generally confirms these ratios, in that as of June 30, 2011, U.S. commercial banks and trust companies held \$15.23 trillion in notional outstanding credit derivative positions and \$677 billion in equity derivative positions, meaning that credit derivatives accounted for approximately 95 percent of the total credit and equity derivative positions held by these entities. See OCC Quarterly Report at tables 1 and 10. Cf. letter from Greenberger (referencing OCC data as relevant to determining size of swap market).

⁴⁷⁷ A person that is engaged in security-based swap dealing activity, for example, may also engage in proprietary trading involving security-based swaps that would be reflected in the transaction data. Even accounting for such possibilities, however, the SEC believes that the data nonetheless support the broad conclusion described below that dealing activity within the security-based swap market is highly concentrated.

As described more fully in the CDS Data Analysis, to ascertain which entities might be transacting as dealers, and which may not be, various criteria were employed as indicia of possible dealing activity. In each case, the results suggest the great extent to which there is currently a high degree of concentration of potential dealing activity in the single-name credit default swap market. For example, using the criterion that dealers are likely to transact with many counterparties who themselves are not dealers, analysis of 2011 transaction data show that only 28 out of 1,084 market participants have three or more counterparties that themselves are not recognized as dealers by ISDA.⁴⁷⁸ As the data show, 15 of these 28 potential dealers exceeded a threshold of \$100 billion notional transacted in single-name credit swaps during 2011, which accounts for over 98 percent of the 28 entities' total activity.⁴⁷⁹ At a lower threshold of \$10 billion notional, 21 of the 28 potential dealers are included (representing 99.7 percent of the activity of potential dealers), and at an even lower threshold of \$3 billion notional, 25 potential dealers are included (representing 99.9 percent).⁴⁸⁰

⁴⁷⁸ See CDS Data Analysis at table 3c. The SEC recognizes that the analysis of this transaction data is imperfect as a tool for identifying dealing activity, given that the presence or absence of dealing activity ultimately turns upon the relevant facts and circumstances of an entity's security-based swap transactions, as informed by the dealer-trader distinction. Criteria based on the number of an entity's counterparties that are not recognized as dealers nonetheless appear to be useful for identifying apparent dealing activity in the absence of full analysis of the relevant facts and circumstances, given that engaging in security-based swap transactions with non-dealers would be consistent with the conduct of seeking to profit by providing liquidity to others, as anticipated by the dealer-trader distinction. In emphasizing this criterion for identifying dealing activity, we are not seeking to predict with precision how many entities ultimately may register as security-based swap dealers. The ultimate number of dealers that may register can also be expected to reflect growth in the market, new dealing entrants, and in some cases the registration of multiple dealing entities within an affiliated group.

⁴⁷⁹ See CDS Data Analysis at table 3c. In particular, those 15 entities engaged in a total of \$11.01 trillion in notional single-name credit default swap transactions over 2011, which reflects 98.5 percent of the total \$11.18 trillion in notional transactions over 2011 for the 28 total identified possible dealers.

⁴⁸⁰ See *id.* The 21 possible dealers with a 2011 notional in excess of \$10 billion account for a total of \$11.15 trillion in notional single-name credit default swap transactions in 2011, or over 99.7 percent of

Other criteria for identifying possible dealing activity based on the number of an entity's non-dealer counterparties similarly suggest a high degree of concentration of dealing activity within the current security-based swap market.⁴⁸¹ Criteria that consider the number of an entity's total single-name security-based swap counterparties,⁴⁸² criteria that consider alternative factors

the total. The 25 possible dealers in excess of \$3 billion account for almost \$11.18 in notional transactions in 2011, or over 99.9 percent of the total.

⁴⁸¹ For example, two other criteria consider the number of an entity's non-dealer counterparties (in those cases identifying as dealers those persons that have seven or more, or five or more, counterparties not recognized as dealers by ISDA) also indicate that potential dealers with notional amounts in excess of \$100 billion in 2011 account for over 98 percent of the notional transactions of all entities meeting the applicable criteria in 2011. Potential dealers with notional transactions above \$10 billion in 2011 (let alone those with notional transactions above \$3 billion) reflect all or virtually the entire notional amount of all dealers identified by those criteria. *See id.* at tables 3a and 3b.

⁴⁸² The CDS Data Analysis also sought to identify dealing activity based on the total number of an entity's counterparties. *See id.* at tables 2a through 2c. Those criteria similarly suggest a high degree of concentration of dealing activity within the single-name credit default swap market:

- i. A criterion that identifies potential dealing activity based on an entity having twenty or more counterparties in single-name security-based swaps identified 16 possible dealers. Fourteen of those entities had notional transactions in excess of \$100 billion in 2011, reflecting over 99 percent of the total associated with all 16. The remaining two identified entities had notional transactions in excess of \$10 billion in 2011. *See id.* at table 2a.

- ii. A criterion that identifies potential dealing activity based on an entity having 15 or more counterparties in single-name security-based swaps identified 33 possible dealers. Fifteen of those entities had notional transactions in excess of \$100 billion in 2011, reflecting over 97 percent of the total associated with all 33. A total of 27 of those entities had notional transactions in excess of \$10 billion in 2011, and a total of 32 of those entities had notional transactions in excess of \$3 billion in 2011, both reflecting over 99 percent of the total. *See id.* at table 2b.

- iii. A criterion that identifies potential dealing activity based on an entity having 10 or more counterparties in single-name security-based swaps identified 154 possible dealers. Fifteen of those exceeded \$100 billion in notional transactions in 2011, reflecting over 90 percent of the total; 49 of those exceeded \$10 billion in notional transactions in 2011, reflecting over 97 percent of the total; and 93 exceeded \$3 billion in notional transactions in 2011, reflecting over 99 percent of the total. *See id.* at table 2c.

In considering the data we are weighing these criteria less heavily than we are weighing the criteria based on the number of counterparties who are not identified by ISDA as dealers. This is because it is reasonable to foresee a non-dealer making use of multiple dealers to get the best possible price or to make use of special expertise possessed by certain dealers, meaning that the criteria discussed in this footnote are more likely to identify entities not engaged in dealing activity.

for identifying dealing activity,⁴⁸³ and certain combined criteria⁴⁸⁴ further suggest a high concentration of dealing activity within the security-based swap market.

While less data are available in connection with other types of instruments constituting security-based swaps, such as equity swaps, the available data similarly suggest a high concentration of positions in those instruments among potential dealers.⁴⁸⁵

⁴⁸³ Other criteria in the CDS Data Analysis sought to identify dealing activity based on whether an entity maintains a relatively flat book. Those criteria also indicated that entities with notional transactions in excess of \$100 billion in 2011 represented over 97 percent of the total for all entities identified by those criteria, while entities with notional transactions in excess of \$10 billion in 2011 represented over 99 of the total for all entities identified by those criteria. *See id.* at tables 4 and 5. We are weighing those criteria less heavily than we are weighing the counterparty-based criteria discussed above because an entity that engages in directional trades could also appear to have a flat book if its portfolio contained transactions representing various directional bets, but of similar aggregate notional sizes on both sides of the market. *See id.* at 3.

The analysis also included one criterion that considers potential dealing activity based on a low propensity to post margin. *See id.* at table 6. While we do not believe that this analysis deserves the same degree of weight as the others, given concerns about the completeness of the data (*see id.* at 4), we note that this criterion nonetheless also indicates a high concentration of dealing activity in the market. *See id.* at table 6 (indicating that of the 473 entities identified by this criterion, the 14 entities with notional transactions in excess of \$100 billion in 2011 account for roughly 94 percent of the total notional transaction activity associated with all 473 entities over 2011).

⁴⁸⁴ Finally, the CDS Data Analysis also included criteria that identified potential dealing activity based on an entity meeting two or three of the other criteria considered. *See id.* at tables 7 and 8. These criteria again indicate a high degree of concentration of dealing activity in the market. The analysis that addressed whether an entity met two of the other criteria identified 92 possible dealers, with the 15 entities having notional transactions in excess of \$100 billion in 2011 representing over 96 percent of the total activity of those 92 entities in 2011. *See id.* at table 7. The analysis that addressed whether an entity met three of the other criteria identified 41 possible dealers, with the 15 entities having notional transactions in excess of \$100 billion in 2011, representing over 98 percent of the total activity of those 41 entities in 2011. *See id.* at table 8.

⁴⁸⁵ For example, OCC data shows that, of the five largest bank or trust companies, four have notional equity derivative positions of above \$1 billion, and that those four entities account for \$630 billion in notional positions out of \$677 billion for all U.S. commercial banks or trust companies, which constitutes approximately 93 percent of the total. *See* OCC Quarterly Report at table 10. Similarly, a review of the equity swaps positions of the 50 largest U.S. bank holding companies shows that nine bank holding companies have notional equity swap positions exceeding \$1 billion, and account for 99.5 percent of the total positions held by such companies, and 29 have no positions in equity swaps. (Data was compiled from each bank holding company's FR 9-YC, available at <http://www.ffiec.gov/nicpubweb/nicweb/Top50Form.aspx>). *Cf.* letter from WGCEF V (referencing swap

Though inspection of the data does not seem to suggest a single precise de minimis threshold, the above analysis of potential dealing activity is useful in that it reveals a range of possible thresholds from \$100 billion to \$3 billion that would cover anywhere from 98 percent through 99.9 percent of the total activity of all potential dealers in 2011. However, these thresholds – and their implied market coverage ratios – only reflect levels of activity that exist in today's highly concentrated market. In order to further narrow the range of possible thresholds, and to select an appropriate level for the de minimis exception, the analysis must consider the potential state of the market as it might reasonably exist after the implementation of Title VII.

ii. Avoiding gaps resulting from the regulatory changes in conjunction with the exception

Although the overall portion of security-based swap activity that would appear to be subject to dealer regulation based on current measures of dealing concentration in the market constitutes an important factor to consider in balancing the regulatory burdens and benefits associated with a de minimis exception, analysis of the current market should not serve as the sole mechanism for setting the exception.

In particular, sole reliance on an approach that focuses on current measures of market concentration would not adequately account for likely changes to the market associated with the implementation of regulation. In part, these changes may be a direct result of the full implementation of Title VII – including enhancements to transparency and increases in central clearing – as those changes reasonably may be expected to reduce the concentration of dealing

position data from bank holding companies' Forms FR Y-9C as relevant to determining size of the swap market).

activity within the market over time.⁴⁸⁶ Also, to the extent implementation of Title VII permits new dealers to enter the market, the availability of a de minimis exception would mean those new dealing entrants would fall outside the ambit of dealer regulation, either for the long term or until their dealing activity surpasses the applicable notional threshold.⁴⁸⁷ Accordingly, de minimis thresholds that are based solely on the current state of the market, including the current concentration of dealing activity within the market, may reasonably be expected to fail to account for the amount of dealing activity that in the future could fall outside of the ambit of dealer regulation due to the exception.⁴⁸⁸

For example, as discussed above, when possible dealers in single-name credit default swaps are identified by an entity having three or more counterparties that are not recognized by ISDA as being dealers, entities with notional transactions in excess of \$100 billion over a 12 month period represent over 98 percent of the total activity of all such possible dealers over that

⁴⁸⁶ Cf. Bessembinder and Maxwell, "Transparency and the Corporate Bond Market," *Journal of Economic Perspectives*, Spring 2008, at 217, 226 (noting that after reporting of U.S. OTC bond transactions through the Trade Reporting and Compliance Engine ("TRACE") became mandatory, the portion of trades completed by the 12 largest dealers fell from 56 percent to 44 percent).

⁴⁸⁷ We understand that large dealers have competitive advantages under the current market, in light of the desire of counterparties to engage in security-based swap transactions with large, well capitalized and highly rated dealers. See, e.g., Craig Pirrong, Rocket Science, Default Risk and The Organization of Derivatives Markets, Working Paper, University of Houston (2006) (available at <http://www.cba.uh.edu/spirrong/Derivorg1.pdf>). The lower business costs associated with being unregulated may prove to partially offset that advantage. At the same time, we reasonably may expect that informed counterparties will take into account the lower protections – and higher risks – associated with transactions with unregulated dealers in determining whether to use regulated or unregulated dealers as counterparties.

⁴⁸⁸ We note that there also are benefits to increased competition and a decrease in concentration of dealer activity, as contemplated by Title VII, including potentially lower costs for market participants and a decrease in systemic risk.

period, leaving two percent of possible dealing activity below that level.⁴⁸⁹ However, a de minimis threshold of \$100 billion would allow new entrants to commence engaging in unregulated dealing in competition with persons who are regulated as dealers pursuant to Title VII, which, depending on the number and size of such entrants, could significantly decrease the portion of dealing activity in the market done by registered dealers (at least until the point that new entrants cross the de minimis threshold, if they do at all). For example, if 15 new entrants⁴⁹⁰ were to engage in security-based swap dealing activity up to a \$100 billion threshold, the result could be that nearly 15 percent of dealing activity within the single-name credit default swap market would be left outside of the ambit of dealer regulation.⁴⁹¹

⁴⁸⁹ See CDS Data Analysis at table 3c; see also note 479, *supra*. As noted above, these amounts may not only reflect dealing activity by an entity. Thus, even putting aside the possibility of new unregulated entrants into the market, the portion of dealing activity in the market that is represented by entities whose trailing notional dealing activity exceeds \$100 billion may in fact be less than 98 percent.

⁴⁹⁰ The illustrative use of new entrants for purposes of this discussion is intended to reflect the potential that new entrants to the market could take advantage of a de minimis threshold in a way that leads to a higher level of unregulated dealing activity within the market. In using this illustration we are not seeking to explicitly predict how many new entrants may come into the market in response to any particular de minimis threshold, nor are we seeking to predict how many new entrants may seek to stay under the de minimis thresholds and how many instead would seek to use the exception as a step on the way to eventually registering as a security-based swap dealer. Rather, we simply are illustrating why it is important to account for market changes in connection with setting the de minimis threshold.

The OTC Derivatives Supervisors Group – a group chaired by the Federal Reserve Bank of New York and consisting of the CFTC and SEC as well as other international supervisors and major over-the-counter derivatives market participants – currently recognizes 15 major OTC derivatives dealers. Accordingly, as an illustrative example, we have assumed that this number of significant security-based swap dealers would approximately double – i.e., include 15 new dealers – in the wake of the various regulatory changes contemplated by the Dodd-Frank Act, many of which may result in increased access and competition in the security-based swap market (e.g., enhanced priced transparency and increased access to central clearing). However, we emphasize that this number has been selected as an illustrative example, and have accordingly provided similar examples assuming ten and five new entrants.

⁴⁹¹ Fifteen new entities that each engage in \$100 billion in dealing activity would reflect \$1.5 trillion in additional dealing activity outside the ambit of dealer regulation, which could lead to roughly 14.9 percent of total dealing activity being outside the ambit of dealing regulation (with that \$1.5 trillion being added to the existing \$168 billion reflected by entities that fall below the \$100 billion threshold, and that sum divided by \$11.18 trillion, under the assumption that the new entrants displace business from the

Similarly, a de minimis threshold of \$25 billion may also lead to a material reduction in the portion of the market covered by registered dealers. For example, using the same assumptions as above, 15 new entrants up to a \$25 billion threshold could leave over four percent of dealing activity in the market outside of the ambit of dealing regulation.⁴⁹² When other metrics are used to identify possible dealing activity, the possibility of a significant regulatory gap remains.⁴⁹³

fifteen entities above the de minimis threshold). To further illustrate, under the same assumptions and analysis, the implied unregulated market share would be roughly 10.4 percent for ten new entities and 6.0 percent for five new entities.

In certain regards these illustrations, on the one hand, may overestimate the effect of new entrants because of the assumption that such entrants engage in dealing activities up to, but not surpassing, the de minimis threshold. While it is not impossible that some entities may seek to use the de minimis exception to conduct business as an unregulated niche dealer, it also is plausible that entities generally may seek to use the exception to commence engaging in dealing activity, with the goal of ultimately becoming registered dealers that are not constrained by the de minimis threshold.

On the other hand, these illustrations in certain respects may underestimate the amount of dealing activity that can fall outside of the regulatory ambit. For example, the amounts of security-based swap activity of persons identified in the analysis as dealers may not exclusively constitute dealing activity, meaning that persons whose notional transactions over a 12-month period exceed a particular threshold in fact may not be engaged in that amount of dealing activity, and hence may still be able to take advantage of the de minimis exception. Also, these illustrations do not seek to reflect increased activity by existing dealers that already fall below the assumed threshold.

⁴⁹² Fifteen new entities each engaged in \$25 billion in dealing activity would reflect \$375 billion in additional dealing activity outside the ambit of dealer regulation, which could lead to 4.1 percent of total dealing activity being outside the ambit of dealing regulation (with that \$375 billion being added to the existing \$80.2 billion reflected by entities that fall below the \$25 billion threshold, and that sum divided by \$11.18 trillion, under the assumption that the new entrants displace business from the seventeen entities above the de minimis threshold). To further illustrate, under the same assumptions and analysis, the implied unregulated market share would be 3.0 percent for 10 new entities and 1.8 percent for 5 new entities. Obviously, these illustrations are subject to the same limitations as are discussed above in the context of the \$100 million threshold illustration.

⁴⁹³ For example, similar results are obtained when possible dealing activity is identified based on whether an entity passes at least three of the other metrics discussed above. See CDS Data Analysis at table 8. Using the same types of assumptions as are discussed above, with fifteen new entities, a de minimis threshold of \$100 billion could lead to 15.0 percent of dealing activity falling outside the ambit of dealer regulation, while a de minimis threshold of \$25 billion could lead to 4.2 percent of dealing activity falling outside of regulation.

Overall, it is reasonable to conclude that the higher the de minimis threshold, the greater the likelihood that the exception, combined with other changes resulting from the implementation of Title VII that may encourage new entrants, will lead to a proportionately larger amount of unregulated (except with respect to antifraud and anti-manipulation prohibitions) dealing activity.⁴⁹⁴ We believe that it is reasonable to interpret the statutory language of the de minimis exception in a way that prevents a proportionately large amount of dealing activity within the security-based swap market from falling outside the ambit of dealer regulation. Accordingly, choosing to set a lower de minimis threshold from among the range of potential thresholds would limit the amount of potential future dealing activity that could be transacted without being subject to dealer rules and regulations.⁴⁹⁵

iii. Promoting statutory counterparty protections

Sole reliance on an approach based on overall market coverage in balancing regulatory burdens and benefits would also threaten to unduly discount important counterparty protection interests, as discussed above and highlighted in the proposal.⁴⁹⁶ For example, in light of data indicating that \$5 million constitutes a common notional size for a single-name credit default

⁴⁹⁴ As noted above, encouraging new entrants also has benefits flowing from increased competition and a decrease in concentration of dealer activity. See note 488, *supra*.

⁴⁹⁵ For example, 15 new dealer entrants engaged in up to \$3 billion in dealing activity would account for up to \$45 billion in dealing activity. This result would mean approximately 0.4 percent of total potential future dealing activity could be transacted by unregistered dealers, as opposed to the potential for approximately 15 percent of potential future dealing activity to be transacted by unregistered dealers if the de minimis were set to \$100 billion. See CDS Data Analysis at table 3c. As with the illustrative examples above, these calculations assume that the new entrants displace business from the entities above the de minimis threshold.

⁴⁹⁶ See part II.D.3.a, *supra*; see also Proposing Release at 80180 (highlighting “customer protection issues raised by swaps and security-based swaps – including risks that counterparties may not fully appreciate when entering into swaps and security-based swaps”).

swap position,⁴⁹⁷ a de minimis notional threshold of \$25 billion annually would permit an unregistered dealer to engage in as many as 5000 trades of that size. The counterparties to these unregistered dealers would not receive the benefit of the protections that Title VII affords to the counterparties of registered dealers. These include, among others, the segregation protections afforded to persons who post margin to dealers in connection with over-the-counter security-based swap transactions.⁴⁹⁸ Accordingly, this consideration also suggests that choosing a de minimis threshold closer to the lower end of the range of potential thresholds would better preserve the counterparty protections contemplated by Title VII.

⁴⁹⁷ See Federal Reserve Bank of New York staff report, “An Analysis of CDS Transactions: Implications for Public Reporting” (2011) at 8 (stating that for dollar-denominated single name CDS on corporate or sovereign reference entities, \$5 million represented the most common notional size) (available at http://www.newyorkfed.org/research/staff_reports/sr517.pdf); see also Proposing Release at 80180 (noting “that in general the notional size of a small swap or security-based swap is \$5 million or less”).

We note, by comparison, that Congress has determined that a de minimis amount of securities broker activity by banks entails 500 trades annually. See Exchange Act section 3(a)(4)(B)(xi) (excluding from the “broker” definition a bank that annually effects no more than 500 securities transactions, other than transactions subject to certain other exceptions, so long as the transaction is not effected by a bank employee that also is a broker-dealer employee).

We further note that, while the number of counterparties or transactions potentially implicated by unregistered dealing activity is an important consideration in establishing an initial de minimis level, it does not alter our view, described above, that a single de minimis standard based on notional value – rather than the proposal’s framework of three distinct standards based on notional value, number of counterparties, and number of transactions – is an appropriate choice in light of concerns expressed by commenters that a standard based on the number of transactions or counterparties can produce arbitrary results. See part II.D.3.b.ii, *supra*.

⁴⁹⁸ Exchange Act section 3E, which was added by section 763(d) of the Dodd-Frank Act, provides a series of requirements in connection with the segregation of assets held as collateral in security-based swap transactions. These include requirements that security-based swap dealers and major security-based swap participants provide their counterparties with notice that they have the right to require segregation, and that such segregation must be at an independent third-party custodian.

- c. Balancing reflected in the final rules – credit default swaps that constitute security-based swaps

The final thresholds that implement the de minimis exception (and corresponding phase-in levels) address security-based swaps that are credit default swaps separately from other types of security-based swaps, in light of differences in the respective markets.

- i. General threshold for credit default swaps that constitute security-based swaps

We conclude that \$3 billion over the prior 12 months constitutes an appropriate notional threshold for applying the de minimis exception in connection with dealing activity involving credit default swaps that constitute security-based swaps.

In reaching this conclusion, we recognize the significance of comments that supported the proposed \$100 million threshold,⁴⁹⁹ and that urged caution in raising that proposed threshold,⁵⁰⁰ as well as commenters who supported increases to the threshold.⁵⁰¹ We further recognize the importance of applying the de minimis exception in a way that promotes regulatory efficiency. We also recognize the range of potential thresholds suggested by the data currently available. Based on the competing factors described above, we believe that \$3 billion reflects a reasonable notional threshold – though not necessarily the only such threshold.

In our view, the currently available data regarding the single-name credit default swap market indicates that a notional threshold of \$3 billion would be expected to result in the regulation, as dealers, of persons responsible for the vast majority of dealing activity within that

⁴⁹⁹ See letters from Better Markets I and AFR.

⁵⁰⁰ See letter from Greenberger.

⁵⁰¹ See, e.g., letter from COPE I.

market, both as of today and, as described above, in the future as the benefits of the other Title VII rules are implemented and new dealer entrants come to market.⁵⁰²

In providing for a \$3 billion notional threshold, we also recognize the threshold would permit an unregistered dealer annually to engage in up to 600 security-based swaps (as opposed to 20 transactions under the proposed threshold, assuming a \$5 million average notional size). In this regard, we note that Congress, in another statutory de minimis exception within the Exchange Act, determined that 500 securities transactions annually constituted a de minimis amount of transactions for banks under the “broker” definition.⁵⁰³ We further believe that a \$3

⁵⁰² Of the 28 market participants that have three or more security-based swap counterparties that themselves are not recognized by dealers by ISDA, 25 had notional single-name credit default swap positions in excess of \$3 billion in 2011. The remaining three entities in total accounted for only \$3.59 billion in notional transactions in 2011, reflecting less than 0.1 percent of the \$11.18 trillion total for those 28 market participants. See CDS Data Analysis at table 3c.

The other criteria set forth in the analysis for identifying possible dealing activity in general similarly indicate that entities with notional transactions in excess of \$3 billion in 2011 account for more than 99 percent of the total notional transactions of all identified entities in 2011. See *id.* at tables 2a-c, 3a-b, 4, 5, 7 and 8. While the criterion based on the posting of initial margin only indicates 98 percent coverage for all of the 473 identified entities, see *id.* at table 6, as discussed above we believe it is appropriate to provide less weight to that criterion, which is based on voluntary reporting.

As noted above, see note 478, *supra*, we recognize that the underlying market data encompasses all of the security-based swap activity of persons identified as dealers, not only their dealing activity. Because the thresholds that implement the de minimis exception address only a person’s dealing activity, this raises the possibility that the analysis overstates the extent to which a \$3 billion threshold would encompass persons responsible for dealing activity within the single-name security-based swap market. Even with that possibility, however, we believe that the data indicates such a high concentration of dealing activity within the market that it is reasonable to conclude that a \$3 billion threshold likely would encompass persons responsible for the vast majority of dealing activity within the market.

⁵⁰³ See Exchange Act section 3(a)(4)(B)(xi); see also letter from SIFMA – Regional Dealers (supporting a threshold of 500 trades consistent with the statutory de minimis exception in connection with bank brokerage activity).

billion threshold appropriately addresses commenter concerns regarding the de minimis exception being unduly narrow.⁵⁰⁴

In adopting this \$3 billion threshold, we have carefully considered one commenter's view that the CDS Data Analysis suggests that the proposed \$100 million threshold in fact is too high, and that any increase in that proposed \$100 million threshold would be arbitrary and capricious.⁵⁰⁵ In reaching these conclusions, the commenter focused on the number of entities that potentially are engaged in dealing activity but that could be excluded based on particular de minimis thresholds. For example, the commenter indicated that pursuant to one of the CDS Data Analysis's combined metrics for identifying dealing activity, a de minimis threshold of \$3 billion could lead to the exclusion of up to 58 percent of all persons engaged in possible dealing activity. The commenter further suggested that some entities engaged in dealing activity may reduce their activities to take advantage of the de minimis exception and hence reduce liquidity, and argued that there would be no basis for the exception to be based on a market participant's percentage of total security-based swap activity.⁵⁰⁶

⁵⁰⁴ For example, \$3 billion is equal to the threshold suggested by many commenters in the context of the swap market, which is much larger than the security-based swap market. See letter from COPE (supporting a 0.001 percent notional threshold based on the overall swaps market, which would amount to \$3 billion). Indeed, this \$3 billion threshold appears to reflect roughly 0.024 percent of the overall market for single-name credit default swaps, a percentage that is much greater than the 0.001 percent multiplier that a number of commenters (see, e.g., letters cited in note 382, supra) suggested in the swap market context. See CDS Data Analysis at table 1 (indicating that participants in the single-name credit default swap market engage in a total of \$12.6 trillion in single-name credit default swap transactions in 2011).

⁵⁰⁵ See letter from Better Markets III.

⁵⁰⁶ The letter also raised issues regarding the "customer" language of the exception and argued that the de minimis exception should not represent a risk-based test. We address those issues elsewhere. See parts II.D.3.c (regarding "customer" language) and II.D.3.e (regarding rejection of risk-based and proportionality tests), infra.

In addition, the letter expressed the view that a percentage-based formula would be difficult to implement, by requiring market participants to repeatedly calculate the ratio of their activity to total

It is important to recognize that while the commenter focused on the number of entities that might be excluded pursuant to the exception, and suggested that higher notional dollar amount thresholds could lead to the exclusion of a larger number of entities, the statutory provision for the de minimis exception does not require the exemption of a “de minimis number” of dealers. The statute instead requires the exemption of persons engaged in a “de minimis quantity” of dealing activity.⁵⁰⁷ The statutory language therefore indicates that the focus of the rule implementing the exception should be the amount of an entity’s dealing activity, not how many entities ultimately may be able to take advantage of the exception.

Also, although the commenter implied that there would be no basis for the rule implementing the exception to take into account a market participant’s security-based swap dealing activity compared to total dealing activity in the market, for the reasons discussed in this section we believe that such an approach can appropriately provide for the regulatory coverage of the vast majority of dealing activity in a way that promotes regulatory efficiency, without leading to unwarranted regulatory gaps. In contrast, in our view the commenter did not persuasively articulate a strong rationale for adopting the alternative approach proposed in the letter, which would appear to lead to the registration of a number of dealers that proportionately engage in a very small amount of dealing activity.⁵⁰⁸

market activity. We concur. The \$3 billion threshold we are adopting reflects a fixed dollar amount, and does not share the complications that would arise from an approach based on a particular percentage of the market.

⁵⁰⁷ See Exchange Act section 3(a)(71)(D).

⁵⁰⁸ The commenter correctly pointed out that the regulatory requirements applicable to registered dealers encompass counterparty protection requirements, and that the de minimis exception should not defeat those requirements. We recognize that the implementation of the exception should take those counterparty protections into account, and we have sought to do so. We do not believe, however, that those important counterparty protection goals require a de minimis approach that focuses on the number

In support of its approach, the commenter emphasized data regarding persons who meet certain combined criteria outlined in the CDS Data Analysis. As discussed above, we believe that criteria based on the number of an entity's counterparties that are not recognized as dealers deserve special weight due to the potential consistency of those criteria with the dealer-trader distinction.⁵⁰⁹ Identifying dealer activity using those criteria does not support the view that a \$3 billion threshold would lead to the exclusion of a large number of entities engaged in dealing activity.⁵¹⁰

Finally, we also are not persuaded by the commenter's suggestion that a number of entities engaged in dealing activity would reduce those activities to take advantage of a \$3 billion de minimis threshold, and hence reduce liquidity in the market by five percent. To reach that

of entities that would be excluded, in lieu of the statutory focus on whether a particular entity engages in a de minimis quantity of dealing activity.

⁵⁰⁹ See notes 478, 482, and 483, supra.

⁵¹⁰ For example, the CDS Data Analysis identifies:

- three possible dealers with notional transactions below \$3 billion in 2011 – out of a total of 28 possible dealers – when possible dealing activity is based on having three or more counterparties that themselves are not identified as dealers;
- one possible dealer with notional transactions below \$3 billion in 2011 – out of a total of 20 possible dealers – when possible dealing activity is based on having five or more counterparties that themselves are not identified as dealers; and
- zero possible dealers with notional transactions below \$3 billion in 2011 – out of a total of 16 possible dealers – when possible dealing activity is based on having seven or more counterparties that themselves are not identified as dealers.

See CDS Data analysis at tables 3c, 3b and 3a.

In addition, as described above, an approach focused on the quantity of activity is supported by relatively consistent results depending on which criterion from the CDS Data Analysis is applied – i.e., each criterion shows a high amount of concentration and a commensurately low quantity of activity below the \$3 billion threshold. By contrast, applying different criteria results in very different numbers of entities excluded under any specified threshold, suggesting that an approach focused on the number of entities may be highly dependent on how the possible dealing activity of those entities is defined.

figure, the commenter needed to exclude the vast majority of dealing activity in the market.⁵¹¹

While we recognize that it is possible that current market participants may adjust their dealing activity in light of the de minimis threshold, and that this potentially could reduce the liquidity provided by certain entities, we also recognize that the de minimis exception has the potential to promote liquidity by facilitating new entrants into the market.

- ii. Phase-in period in connection with dealing activity involving credit default swaps that constitute security-based swaps

The final rules further provide that persons with notional dealing activity of \$8 billion or less over the prior 12 months involving credit default swaps that constitute security-based swaps would be able to avail themselves of a phase-in period.⁵¹² Those persons would not be subject to the generally applicable compliance date that occurs no later than 60 days following publication of these final rules in the Federal Register.⁵¹³

The use of a phase-in period – in connection with a person's status as a security-based swap dealer and in connection with the other regulatory requirements that are appurtenant to dealer status – is intended to facilitate the orderly implementation of Title VII. In addition, the

⁵¹¹ In particular, in arguing that this incentive would reduce liquidity by five percent, the commenter excluded all business done by entities within the top two brackets (i.e., above \$100 billion notional), on the grounds that those entities "are assumed to transact mostly with larger entities." Based on the criteria on which the commenter relied, those 15 entities are responsible for over 96 percent of the activity of all possible dealers. See CDS Data Analysis at tables 7 and 8. Absent that exclusion, the estimated reduction of liquidity would amount to a small fraction of a percent.

⁵¹² Exchange Act rule 3a71-2(a)(2).

⁵¹³ Even with the general 60 day compliance period, however, market participants will not necessarily be security-based swap dealers at the end of 60 days. In particular, for the first year following the effective date of the final rules implementing the definition of "security-based swap" pursuant to the Exchange Act section 3(a)(68), the de minimis analysis would only address security-based swap dealing activity following that effective date. See Exchange Act rule 3a71-2(a)(1). Among other things, this means that until the rules defining "security-based swap" are effective, no market participants would be deemed to be security-based swap dealers.

phase-in period will afford the SEC additional time to study the security-based swap market as it evolves in the new regulatory framework and will allow potential dealers that engage in smaller amounts of activity (relative to the current size of the market) additional time to adjust their business practices, while at the same time preserving the focus of the regulation on the largest and most significant dealers. The SEC also recognizes that the data informing its current view of the de minimis threshold is based on the market as it exists today, and that the market will evolve over the coming years in light of the new regulatory framework and other developments.

Accordingly, while the SEC believes that a \$3 billion notional threshold reflects an appropriate long-term standard based on the currently available data,⁵¹⁴ it also is appropriate to provide for a phase-in period for those entities with \$8 billion or less in dealing activity, because subsequent developments in the market or the evaluation of new data from the security-based swap reporting facilities contemplated by the Dodd-Frank Act may suggest that the threshold should be increased or decreased. In particular, the implementation of security-based swap data reporting under the Dodd-Frank Act will result in significant new data and afford an opportunity to review the Commission's determination to establish a \$3 billion threshold.

For these reasons, an important part of the report that the SEC is directing its staff conduct with regard to the definitions of "security-based swap dealer" and "major security-based swap participant" (described in detail below) will be a consideration of the operation of the de minimis exception following the full implementation of Section 15F under Title VII.⁵¹⁵ The SEC will take into account this report, along with public comment on the report, in determining

⁵¹⁴ See note 502, *supra*.

⁵¹⁵ See Exchange Act rule 3a71-2A(a)(1); see also part V, *infra*.

whether to propose any changes to the rule implementing the de minimis exception, including any increases or decreases to the \$3 billion threshold. The report will be linked to the availability of data regarding the activity of regulated security-based swap market participants in that it must be completed no later than three years⁵¹⁶ following a “data collection initiation date” that is the later of: the last compliance date for the registration and regulatory requirements for security-based swap dealers and major security-based swap participants under Section 15F of the Exchange Act; or the first date on which compliance with the trade-by-trade reporting rules for credit-related and equity-related security-based swaps to a registered security-based swap data repository is required.⁵¹⁷

In light of the available data – and the limitations of that data in predicting how the full implementation of Title VII will affect dealing activity in the security-based swap market – the SEC believes that \$8 billion constitutes an appropriate level for the availability of the phase-in period. The available data indicate that such a level generally comports with the balance of interests that informed the determination of the appropriate long-term threshold of \$3 billion described above. In particular, the \$8 billion level should still lead to the regulation of persons responsible for the vast majority of dealing activity within the market.⁵¹⁸ In addition, we do not

⁵¹⁶ See Exchange Act rule 3a71-2A(b).

⁵¹⁷ The SEC will announce the data collection initiation date on its website and publish it in the Federal Register. See Exchange Act rule 3a71-1(a)(2)(iii).

⁵¹⁸ Of the 28 market participants that have three or more security-based swap counterparties that themselves are not recognized by dealers by ISDA, 23 had notional single-name credit default swap transactions in excess of \$8 billion in 2011. The remaining five entities in total accounted for only \$12.3 billion in notional transactions in 2011, reflecting roughly 0.1 percent of the \$11.18 total for the 28 market participants. See CDS Data Analysis at table 3c. Only two of the 28 entities identified as possible dealers by that criterion had annual notional transactions between \$3 billion and \$8 billion in 2011.

Most of the other criteria set forth in the analysis for identifying possible dealing activity in general similarly indicate that entities with notional transactions in excess of \$8 billion in 2011 account

believe that providing a phase-in period for persons with notional dealing activity over the prior 12 months of less than \$8 billion would lead to a risk of an undue portion of the market falling outside of the ambit of dealer regulation, even after considering the potential entry of unregulated new dealers into the market.⁵¹⁹

The final rule provides that the phase-in period will continue until the “phase-in termination date” that the SEC will publish on its website and in the Federal Register.⁵²⁰ In particular, the rule provides that nine months following publication of that report, and after giving due consideration of the report and associated public comment, the SEC may either: (1) terminate the phase-in period and by order establish and publish the phase-in termination date; or (2) determine that it is necessary or appropriate in the public interest to propose an alternative de minimis threshold, in which case the SEC, by order published in the Federal Register, will provide notice of that determination and establish the phase-in termination date.⁵²¹ If the SEC does not establish the phase-in termination date in either of those ways, the phase-in termination

for more than 99 percent of the total notional transactions of all identified entities that year. See id. at tables 2a-b, 3a-b, 4 and 5. While the criterion based on an entity having 10 or more counterparties only indicates 98 percent coverage for all of the 154 identified entities at an \$8 billion transaction level, see id. at table 2c, as noted above this criterion may identify persons who in reality are not engaged in dealing activity. See note 482, supra. Also, while the criterion based on the posting of initial margin only indicates 97 percent coverage for all of the 473 identified entities at an \$8 billion transaction level, see id. at table 6, as discussed above that criterion is based on voluntary reporting.

⁵¹⁹ For example, 15 new dealer entrants up to \$8 billion in annual notional dealing activity would account for \$120 billion in dealing activity. This would amount to roughly 1.2 percent of the total notional single-name security-based swap activity over 12 months of entities identified as possible dealers by virtue of having three or more counterparties that are not recognized by dealers by ISDA. See CDS Data Analysis at table 2c.

⁵²⁰ Exchange Act rule 3a71-2(a)(2)(i).

⁵²¹ Exchange Act rule 3a71-2(a)(2)(iii)(A).

date shall automatically occur in any event on what would be a date certain, which will be five years following the data collection initiation date.⁵²²

These provisions should allow sufficient time for the staff to complete its report, for the SEC to receive and review public comment on the report, and for the SEC to draw conclusions regarding establishing the phase-in termination date or proposing potential changes to the rule implementing the de minimis exception, in a way that also promotes the orderly and predictable termination of the phase-in period.⁵²³

This phase-in period will not be available in connection with the \$25 million threshold for dealing activity involving special entities, discussed below. In addition, the final rule provides that this phase-in period will not be available in connection with security-based swap dealing activities involving natural persons, other than natural persons who qualify as ECPs by virtue of CEA section 1a(18)(A)(xi)(II), which addresses natural persons who have \$5 million or more invested on a discretionary basis and who enter into a security-based swap to manage the risk associated with their assets and liabilities.⁵²⁴ These limitations to the availability of the

⁵²² Exchange Act rule 3a71-2(a)(2)(iii)(B).

⁵²³ This approach balances the fact that the SEC believes that its \$3 billion and \$150 million de minimis thresholds are appropriate in light of the currently available data and the market's need for a degree of certainty as to the length of this phase-in period, on the one hand, against the possibility that the staff report and the accompanying public comment may demonstrate that revision to these thresholds is necessary, on the other hand.

⁵²⁴ See Exchange Act rule 3a71-2(a)(2)(i). In other words, the phase-in period will still be available in connection with dealing activities with natural persons who are ECPs because they have entered into a security-based swap for hedging purposes. While we recognize the importance of Title VII protections to natural persons who engage in security-based swap activity, we also recognize the benefit of facilitating such persons' use of security-based swaps as hedges. Accordingly, persons who engage in dealing activity with natural persons who are ECPs under other provisions of the ECP definition will be subject to the applicable de minimis threshold for all of their dealing activity, without the availability of the phase-in period.

phase-in period are consistent with the Dodd-Frank Act's goal of helping special entities be in a position to benefit from the counterparty protections associated with the regulation of registered security-based swap dealers under Title VII, as well as the SEC's mandate to protect participants in the securities markets.

Persons who are able to avail themselves of the phase-in period, of course, will not be required to do so. Any person that chooses to register with the SEC as a security-based swap dealer shall be deemed to be a security-based swap dealer subject to all applicable regulatory requirements for such registrants, regardless of whether the person engages in security-based swap dealing activity in an amount that is below the applicable de minimis threshold or phase-in level.⁵²⁵

d. Balancing reflected in the final rules – other types of security-based swaps

The final rule provides that the de minimis exception for dealing activity involving security-based swaps other than credit default swaps will be based on a threshold of \$150 million notional over the prior 12 months.⁵²⁶ In addition, a phase-in period will be available in connection with persons whose dealing activity involving those instruments is \$400 million or less in notional amount over the prior 12 months.

Persons who engage in dealing activity with natural persons who are not ECPs will fall within the Exchange Act definition of "dealer," which has no de minimis exception. See Exchange Act section 3(a)(5)(A) (generally excluding dealers in security-based swaps from the Exchange Act definition of "dealer," unless the counterparty is not an ECP).

⁵²⁵ See Exchange Act rule 3a71-2(e).

⁵²⁶ Exchange Act rule 3a71-2(a)(1)(ii). The proposal requested comment on whether different segments of the security-based swap market should be treated differently. See Proposing Release at 80101 ("Commenters further are requested to address ... whether the [de minimis] exemption's factors should vary depending on the type of swap or security-based swap at issue.").

These amounts reflect roughly one-twentieth of the corresponding amounts associated with the exception for credit default swaps that constitute security-based swaps. As discussed above, while less data is available regarding other types of security-based swaps than is available regarding single-name credit default swaps, the available data is consistent in indicating that those other types of security-based swaps on a notional basis currently comprise roughly one-twentieth of the total amount of instruments that will be expected to constitute security-based swaps.⁵²⁷ In light of this significantly smaller market, we believe that a \$3 billion notional threshold would threaten to cause an overly large portion of dealing activity within the market to fall outside the ambit of dealer regulation.

In this regard, we note that it is likely that there are fewer barriers to entry in connection with acting as a dealer in security-based swaps such as equity swaps and total return swaps on debt than there are in connection with acting as a dealer in single-name credit default swaps.⁵²⁸ We also note that because equity swaps and total return swaps on debt can serve as close economic proxies for equity and debt securities, an overly broad de minimis threshold in connection with such instruments could threaten to undermine the Exchange Act framework for regulating persons who act as dealers in equity and debt.

At the same time – notwithstanding the smaller scope of this market and the lesser availability of data regarding dealing activity within the market – we do not believe that it is necessary to make the de minimis exception unavailable in connection with dealing activity

⁵²⁷ See note 476, supra.

⁵²⁸ For example, persons registered with the SEC as broker-dealers in connection with other types of securities would appear to be well positioned to act as dealers in connection with equity swaps, as such broker-dealers already would be expected to have systems in place to enter into equity positions to hedge their equity swap dealing positions.

involving security-based swaps that are not credit default swaps. In this regard we particularly note that the limited available data regarding equity swaps suggests a high degree of concentration in dealing activity involving those instruments,⁵²⁹ which indicates that an appropriately sized de minimis threshold can be expected to promote regulatory efficiency.

Balancing those factors, we conclude that a \$150 million annual notional threshold is appropriate to implement the de minimis exception in connection with security-based swaps that are not credit default swaps, consistent with our understanding of the comparative size of that market as applied to the threshold applicable to credit default swap dealing activity. For reasons similar to those described above, we conclude that there should be a phase-in period available to persons whose annual notional dealing activity in connection with security-based swaps that are not credit default swaps is no more than \$400 million in annual 12-month notional amount. This phase-in period is subject to the same limitations regarding transactions involving special entities and natural persons as apply to the phase-in period for credit default swaps. It also will be subject to the same provisions regarding the termination of the phase-in period as apply in connection with credit default swaps.⁵³⁰ The comparative lack of data involving these markets – in contrast to the market for single-name credit default swaps – particularly highlights how the

⁵²⁹ As noted above, four commercial banks and trust companies accounted for 93 percent of all equity positions held by such companies as of June 30, 2011; and nine bank holding companies accounted for over 99 percent of all equity positions held by the fifty largest such companies as of December 2011. See note 485, supra.

⁵³⁰ See Exchange Act rule 3a71-2(a)(2); see also notes 520 through 522, supra, and accompanying text.

use of a phase-in period that is linked to the availability of post-implementation data is appropriate.⁵³¹

As above, a person who is eligible to take advantage of the phase-in period in connection with these types of security-based swaps may nonetheless register as a security-based swap dealer.

e. Dealing activity involving special entities

Consistent with the proposal, the final rules in general will cap an entity's dealing activity involving security-based swaps at no more than \$25 million notional amount over the prior 12 months when the counterparty to the security-based swap is a special entity.⁵³² There will be no phase-in period in connection with transactions involving special entities. In adopting this threshold, we recognize the serious concerns raised by commenters that stated that the de minimis exception should not permit any dealing activities involving special entities in light of losses that special entities have incurred in the financial markets,⁵³³ as well as the special protection that Title VII affords special entities.⁵³⁴

⁵³¹ The SEC expects that the staff report should be especially helpful for providing data regarding dealing activity in connection with those other types of security-based swaps to consider the impact of the termination of the phase-in period, as well as potential changes to the de minimis exception in connection with these instruments.

⁵³² Exchange Act rule 3a71-2(a)(1)(iii).

⁵³³ See letters from AFR and Better Markets I.

⁵³⁴ In this regard we note that Title VII authorizes the SEC to impose special business conduct requirements when a security-based swap dealer is counterparty to a special entity. See Exchange Act section 15F(h)(5). In proposing rules to implement these requirements, the SEC requested comment regarding the scope of the "special entity" definition, including, for example, regarding whether the SEC should interpret "special entity" to exclude a collective investment vehicle in which one or more special entities have invested. See Exchange Act Release No. 64766 (June 29, 2011), 76 FR 42396, 42422 (July 18, 2011). For purposes of interpreting this special entity threshold to the de minimis exception – particularly with regard to when a special entity would be a counterparty to a person that is engaged in dealing activity – the SEC believes that it will be appropriate to be guided by final interpretations

At this time, the final rule does not fully exclude such dealing activity from the exception, in light of the potential benefits that may arise from a de minimis exception. In this way, the threshold would not completely foreclose the availability of security-based swaps to special entities from unregistered dealers – as \$25 million would annually accommodate up to five single-name credit default swaps of a \$5 million notional size – but the threshold would limit the financial and other risks associated with those positions for a special entity, which would in turn limit the possibility of inappropriately undermining the special protections that Title VII provides to special entities.

In reaching this conclusion we recognize that special entities do participate in the single-name credit default swap market, given that an analysis of market data indicates that in 2011 special entities were parties to over \$40 billion in single-name credit default swap transactions.⁵³⁵ At the same time, the impact of this \$25 million threshold – particularly concerns that the threshold may foreclose the ability of special entities to access dealers in the market – appears to be mitigated by the fact that the counterparties to those special entities tend to engage in notional transactions in single-name credit default swap well in excess of the general de minimis standards.⁵³⁶ In light of the underlying counterparty protection issues, we see no basis to distinguish between types of security-based swaps in setting this special entity threshold.

regarding when a dealer will be a counterparty to a special entity for purposes of those business conduct requirements.

⁵³⁵ See CDS Data Analysis at table 9.

⁵³⁶ See id. at n.8 (noting that the average notional activity of those 16 counterparties was \$680 billion, with the lowest being approximately \$9 billion).

For similar reasons, in the future as we consider whether to amend the de minimis exception we expect to pay particular attention to whether the threshold for transactions involving special entities should further be lowered.

f. Future revisions to the rule

As noted above and described in detail below in part V, the SEC is directing its staff to report on whether changes are warranted to the rules and interpretations implementing the security-based swap dealer definition, including the rule implementing the de minimis exception.⁵³⁷ The SEC will take the report and associated public comment into account in determining whether to propose any changes to the rule implementing the exception.⁵³⁸ Consistent with that possibility, the final rule provides that the SEC may change the requirements of the de minimis exception by rule or regulation.⁵³⁹ Through this mechanism, the SEC may revisit the rule implementing the exception and potentially change that rule, for example, if data regarding the security-based swap market following the implementation of Section 15F under Title VII suggests that different de minimis thresholds would be appropriate.⁵⁴⁰ In determining whether to revisit the thresholds, the SEC intends to pay particular attention to whether the de minimis exception results in a dealer definition that

⁵³⁷ See Exchange Act rule 3a71-2A(a)(1).

⁵³⁸ See notes 520 through 522, *supra*, and accompanying text.

⁵³⁹ Exchange Act rule 3a71-2(d). Exchange Act section 3(a)(71)(D) particularly states that the “Commission” – meaning the SEC – may exempt de minimis dealers and promulgate related regulations. We do not interpret the joint rulemaking provisions of section 712(d) of the Dodd-Frank Act to require joint rulemaking here, because such an interpretation would read the term “Commission” out of Exchange Act section 3(a)(71)(D), which itself was added by the Dodd-Frank Act.

⁵⁴⁰ See letter from Greenberger (stating that the dynamic nature of the derivatives sector of the financial markets should counsel caution, and that the de minimis threshold should be reevaluated on an ongoing basis).

encompasses too many entities whose activities are not significant enough to warrant full regulation under Title VII, or, alternatively, whether the de minimis exception leads an undue amount of dealing activity to fall outside of the ambit of the Title VII regulatory framework, or leads to inappropriate reductions in counterparty protections (including protections for special entities). The SEC also intends to pay particular attention to whether alternative approaches would more effectively promote the regulatory goals that may be associated with a de minimis exception.

6. Registration period for entities that exceed the de minimis factors

The de minimis exception raises implementation issues akin to those associated with the major participant definition, in that both provisions use tests that have retrospective elements to determine whether an entity must register and be subject to future regulation. As a result, some commenters have suggested that entities that surpass the de minimis thresholds should be able to take advantage of a grace period to undertake the process of registering as swap dealers or security-based swap dealers.⁵⁴¹ Otherwise, absent such a “roll-in” period, entities whose dealing activities surpass the relevant de minimis factors would immediately be in violation of dealer registration requirements. In light of these concerns, and the interest of avoiding undue market disruptions, the Commissions believe that it is appropriate to provide entities that exceed applicable the de minimis factors a period of time to register as dealers.

Accordingly, the final rules have been revised from the proposal to provide for a timing standard that is similar to what we are using in connection with the major participant

⁵⁴¹ See letters from Northland Energy and WGCEF I.

definition.⁵⁴² That is, if an entity that has relied on the de minimis exception no longer is able to rely on the exception because its dealing activity exceeds a relevant threshold, the entity would have two months, following the end of the month in which it no longer is able to take advantage of the exception, to submit a completed application to register as a swap dealer or security-based swap dealer.⁵⁴³

Also, akin to the major participant definitions,⁵⁴⁴ a person registered as a swap dealer or security-based swap dealer may apply to withdraw that registration, while continuing to engage in a limited amount of dealing activity in reliance on the de minimis exception, if that person has been registered as a dealer for at least 12 months.⁵⁴⁵ This should help ensure that persons do not rapidly move in and out of dealer status based on short-term fluctuations in their swap or security-based swap activities.

The final rules implementing the de minimis exception do not provide any reevaluation period for entities that engage in a level of dealing activity above the de minimis thresholds, in

⁵⁴² Compare CFTC Regulation § 1.3(hhh)(3); Exchange Act rule 3a67-8(a) (providing that persons who meet the criteria to be major participants will have two months to submit a completed registration application).

⁵⁴³ See CFTC Regulation § 1.3(ggg)(4)(ii); Exchange Act rule 3a71-2(b). As discussed below with regard to the implementation period for the major participant definitions, persons will have additional time to comply with the applicable requirements following the submission of a completed application. See part IV.L.3, *infra*.

⁵⁴⁴ Compare CFTC Regulation § 1.3(hhh)(5); Exchange Act rule 3a67-8(c) (providing that a major participant may be deemed to no longer be a major participant if its swap or security-based swap positions are below the relevant thresholds for four quarters).

⁵⁴⁵ See CFTC Regulation § 1.3(ggg)(4)(ii); Exchange Act rule 3a71-2(c). Consistent with this approach, moreover, the final rule has been revised from the proposal to clarify that the de minimis exception in general is not available to a registered swap dealer or security-based swap dealer. See CFTC Regulation § 1.3(hhh)(1)(i); Exchange Act rule 3a71-2(a)(1) (revised language clarifying availability of exception to a person that is not a swap dealer or security-based swap dealer).

contrast to the major participant definitions.⁵⁴⁶ We do not believe that there is an appropriate basis for such a provision, particularly given that dealer regulation addresses customer protection and market operation and transparency concerns apart from risk concerns.

E. Limited Purpose Designation as a Dealer

1. Proposed approach

The definitions of the terms “swap dealer” and “security-based swap dealer” provide that the Commissions may designate a person as a dealer for one type, class or category of swap or security-based swap, or specified swap or security-based swap activities, without the person being considered a dealer for other types, classes, categories or activities.⁵⁴⁷

In the Proposing Release, we noted that these provisions represent permissive grants of authority that do not require the Commissions to provide limited designations.⁵⁴⁸ We further stated that a person that is covered by the definitions of the terms “swap dealer” or “security-based swap dealer” would be considered a dealer for all types, classes or categories of the person’s swaps or security-based swaps, or activities involving swaps or security-based swaps, in light of the difficulty of seeking to separate a person’s dealing activities from their non-dealing activities involving swaps or security-based swaps, unless such person sought and received designation as a dealer for only specified categories of swaps or security-based swaps, or

⁵⁴⁶ Compare CFTC Regulation § 1.3(hhh)(4); Exchange Act rule 3a67-8(b) (providing for a reevaluation period in connection with the major participant definitions when a person does not exceed any applicable threshold by more than 20 percent in a calendar quarter).

⁵⁴⁷ CEA section 1a(49)(B); Exchange Act section 3(a)(71)(B).

⁵⁴⁸ See Proposing Release, 75 FR at 80182.

specified activities.⁵⁴⁹ We explained that this would provide persons the opportunity to seek a limited designation based on applicable facts and circumstances, and that we anticipated that a dealer could seek a limited designation at the time of its initial registration or later.⁵⁵⁰

In the Proposing Release, the CFTC further noted that non-financial entities such as physical commodity firms potentially may conduct dealing activity through a division rather than through a separately incorporated subsidiary, and that such an entity's swap dealing activity would not be a core component of its overall business. The CFTC added that if this type of entity registered as a dealer, certain swap dealer requirements would apply to the dealing activities of the division, but not necessarily to the swap activities of other parts of the entity.⁵⁵¹

2. Commenters' views

A number of commenters addressed the limited designation of dealers in conjunction with the limited designation of major participants. Many of the issues those commenters raised thus are relevant to both sets of definitions.

a. Presumption of full designation

A number of commenters objected to the proposed presumption that an entity would be designated as a dealer (or major participant) for all categories of swaps or security-based swaps and all of the person's activities connected to swaps or security-based swaps. Several

⁵⁴⁹ See id.; see also proposed CFTC Regulation § 1.3(ggg)(3); proposed Exchange Act rule 3a71-1(c).

⁵⁵⁰ See Proposing Release, 75 FR at 80182.

⁵⁵¹ See id.

commenters argued that this approach would be contrary to Congressional intent,⁵⁵² conflict with the statutory language,⁵⁵³ or conflict with underlying policy concerns.⁵⁵⁴ One commenter suggested that the Commissions lack the statutory authority to apply swap dealer requirements to an entity's non-swap dealing activities.⁵⁵⁵

b. Potential types of limited designations

A number of commenters addressed potential types of limited designations. One expressed support for limited swap dealer designations for particularized business units and for particular swap categories,⁵⁵⁶ while another requested that limited swap dealer designations be available based on any reasonable commercial groupings.⁵⁵⁷ Some commenters urged that limited dealer designations should be available for the branches or business units of foreign swap dealers and security-based swap dealers with U.S.-based customers or U.S. business lines.⁵⁵⁸

⁵⁵² See letters from Cargill Incorporated ("Cargill"), CDEU and Investment Company Institute ("ICI") dated February 22, 2011 ("ICI I").

⁵⁵³ See letters from MetLife and WGCEF I.

⁵⁵⁴ See letter from Cargill (stating that limited designation promotes the policy of encouraging non-financial firms that primarily are engaged in non-dealing businesses to continue to conduct limited dealing activities, adding that such firms "do not present the potential systemic risks of financial firms," and that their full designation as dealers would discourage them from providing risk management products).

⁵⁵⁵ See letter from EDF Trading.

⁵⁵⁶ See letter from Capital One.

⁵⁵⁷ See letters from NCGA/NGSA II (particularly referring to groupings based on individual physical commodities) and WGCEF dated June 9, 2011 ("WGCEF VII") (limited designation should permit firms to structure organization of limited purpose registrants as appropriate in particular circumstances).

⁵⁵⁸ See letters cited in note 148, *supra*.

c. Applications for limited designations

A number of commenters addressed issues relating to the application process for limited designations. Some commenters supported the ability of a person to apply for limited designations at the time of initial registration,⁵⁵⁹ while one commenter sought clarification on how and when a person could apply for limited swap dealer status.⁵⁶⁰ Some commenters suggested that entities should be considered to have a provisional limited designation upon the filing of a completed application for limited dealer designation.⁵⁶¹

Some commenters requested further clarification as to what factors or criteria would be considered relevant to limited designation determinations.⁵⁶² One commenter stated that non-financial companies should have a presumption of limited swap dealer designation under certain circumstances.⁵⁶³ Another commenter took the view that commercial firms should be able to determine whether to register a legal entity or a division as a dealer.⁵⁶⁴ One commenter suggested the analysis consider the complexity of an entity's dealing and non-dealing activities,

⁵⁵⁹ See letters from MFA I (specifically requesting that the rules provide that an entity can receive a limited purpose designation at the time of their initial registration) and FSR I.

⁵⁶⁰ See letter from National Futures Association ("NFA").

⁵⁶¹ See letters from Capital One, Farm Credit Council I and FHLB I.

⁵⁶² See letters from BG LNG I and ISDA I.

⁵⁶³ See letter from Cargill (arguing that a firm should be presumptively entitled to limited swap dealer status if: it is a non-financial company; its non-dealing activities include (but need not be limited to) production, merchandising or processing of physical commodities; the firm's dealing activities take place in a separately identifiable division or business unit with separate management; and dealing revenues are less than 30 percent of the firm's total revenues in the firm's most recent fiscal year).

⁵⁶⁴ See letter from WGCEF VII (stating that so long as a registered swap dealer bears the onus of demonstrating compliance with regulatory requirements, regulators "should not dictate" whether the firm registers a legal entity or a division as a dealer; also requesting guidance as to how applicable regulatory requirements may apply to a subdivision of a legal entity that registers as a dealer, and requesting a safe harbor from enforcement action when a decision to register only a particular desk or division as a dealer is made in good faith).

and further suggested that limited designations should automatically be available if an entity's dealing activities do not exceed 50 percent of its total swap activities.⁵⁶⁵ Commenters also raised issues related to how a person's status as a financial or a non-financial entity affects a person's eligibility for limited designations.⁵⁶⁶

d. Application of regulatory requirements to limited dealers

Commenters also addressed issues related to the application of regulatory requirements to limited dealers. One commenter recommended that dealer regulatory requirements generally should apply only to a division undertaking limited dealing activities; that commenter further stated that capital requirements should be calculated based only on the activities of that division, while recognizing that capital must be held by the entity as a whole.⁵⁶⁷ Other commenters argued that capital and margin requirements should only be applied to an entity on a limited basis.⁵⁶⁸

e. Miscellaneous issues

One commenter recommended that non-financial entities that are deemed to be limited dealers (or major participants) be permitted to be treated as end-users for the aspects of their

⁵⁶⁵ See letter from Capital One.

⁵⁶⁶ Compare letter from Capital One (stating that all market participants, including financial institutions, should be allowed to apply for limited swap dealer designations) with letter from Cargill (suggesting that an entity's status as a financial company should be relevant to limited dealer determinations).

⁵⁶⁷ See letter from Cargill.

⁵⁶⁸ See letter from FSR I (recommending that to the extent that capital requirements are tied to swap activity or exposures, that only activities or exposures in the designated category be reflected in the calculation).

businesses that are not subject to the limited designation.⁵⁶⁹ The commenter further suggested that the swaps “push-out” rule requirements of section 716 of the Dodd-Frank Act be interpreted so that an insured depository institution that is a limited purpose dealer would only have to push out the dealing portion of its swap business, and be allowed to retain the other aspects of its swaps business.⁵⁷⁰ One commenter requested clarification as to whether a person that is a limited purpose dealer in connection with one category of swap could be a major participant in connection with another category (in light of the statutory language excluding dealers from the major participant definitions).⁵⁷¹

3. Final rules and general principles

Consistent with the proposal, the final rules retain the presumption that a person who meets one of the dealer definitions will be deemed to be a dealer with regard to all of its swaps or security-based swaps activities, unless the CFTC or SEC exercises its authority to limit the person’s designation as a dealer to specified categories of swaps or security-based swaps, or specified activities.⁵⁷² As discussed in the Proposing Release, moreover, a person may apply for a limited designation when it submits a registration application, or at a later time.⁵⁷³ The final

⁵⁶⁹ See *id.* (recommending that the corporate treasurer of an entity with a limited designation as a swap dealer for “other commodity swaps” as a result of its energy derivatives activity be able to hedge the entity’s interest rate and currency risk without being subject to the business conduct, reporting, recordkeeping or other rules applicable to dealers and major participants).

⁵⁷⁰ See *id.*

⁵⁷¹ See letter from NFA. As discussed below, see 752, *infra*, a person who is designated as a dealer in connection with particular types of swaps or security-based swaps may be major participants with regard to other types.

⁵⁷² CFTC Regulation§ 1.3(ggg)(3); Exchange Act rule 3a71-1(c).

⁵⁷³ The SEC expects to address the process for submitting an application for limited designation as a security-based swap dealer, along with principles to be used by the SEC in analyzing such applications, as part of separate rulemakings.

rules also contain a technical change from the proposed rules to clarify that limited designations may be based on a particular type, class or category of swap or security-based-swap.⁵⁷⁴

a. Default presumption of full designation

Consistent with the proposal, the final rules retain the standard that a person that satisfies the “swap dealer” or “security-based swap dealer” definition in general would be considered a dealer for all types, classes or categories of the person’s swaps or security-based swaps, or all activities involving swaps or security-based swaps.

The Commissions are not persuaded by the suggestion that this presumption is inconsistent with the statute, legislative intent or underlying policy. Not only is the relevant statutory language written as a grant of authority rather than a specific mandate to designate certain entities as limited purpose dealers, but the presumption also reasonably reflects the difficulty of separating a dealer’s dealing activities from its non-dealing activities, and the challenges of applying dealer regulatory requirements to only a portion of a dealer’s swap or security-based swap activities.⁵⁷⁵

⁵⁷⁴ The rules particularly have been revised from the proposal to add “type” and “class” language to supplement the use of the term “category.” This change is consistent with the statutory language. In addition, the final rules related to limited designations for “security-based swap dealers” corrects an erroneous reference to major participant designation.

⁵⁷⁵ This approach also is consistent with the treatment of dealers of other types of securities under the Exchange Act. When a person’s securities activities cause them to be a “dealer” for purposes of the Exchange Act, the statutory requirements and regulations applicable to dealers will apply to all of that person’s securities activities, regardless of whether particular activities would not have caused the entity to fall within the “dealer” definition. For example, Exchange Act section 15(c)(3)(A) prohibits brokers and dealers from engaging in certain securities-related activity in contravention of SEC-prescribed rules with respect to financial responsibility or related practices. This provision does not distinguish between those activities that cause a person to fall within the “broker” or “dealer” definitions, and other activities that themselves do not cause that person to be a broker or dealer. The SEC’s authority extends to all securities activities by those brokers or dealers.

We similarly are not persuaded by the view that the Commissions lack the authority to apply dealer regulation to non-dealing activities of a registered swap dealer or security-based swap dealer.⁵⁷⁶ Certain of the statutory requirements applicable to swap dealers and security-based swap dealers – such as capital requirements – simply do not distinguish between a person’s dealing activities and their non-dealing activities.⁵⁷⁷ In other words, absent a limited designation, the statutory requirements applicable to dealers address the regulation of all of a dealer’s swap or security-based swap activities.⁵⁷⁸

b. Demonstration of compliance with dealer requirements

The Commissions will consider limited purpose applications on an individual basis through analysis of the unique circumstances of each applicant, given that the types of entities that engage in swap or security-based swap dealing are diverse and their organization and activities are varied.⁵⁷⁹

Regardless of the type of limited designation being requested, the Commissions will not designate a person as a limited purpose dealer unless it can demonstrate that it can fully comply with the requirements applicable to dealers.

⁵⁷⁶ See letter from EDF Trading.

⁵⁷⁷ See, e.g., CEA section 4s(e); Exchange Act section 15F(e).

⁵⁷⁸ The substantive regulations applicable to dealers, of course, can account for the nature of a dealer’s particular swap or security-based swap activities.

The SEC also intends to address limited designation issues in the context of a separate release addressing the application of Title VII to non-U.S. entities.

⁵⁷⁹ Consistent with this approach, applications to limit a person’s dealer designation to “specified categories” of swaps or security-based swaps (see CFTC Regulation § 1.3(ggg)(3); Exchange Act rule 3a71-1(c)), would not be required to interpret the term “category” consistently with the use of that term in connection with the major participant definitions. CFTC Regulation § 1.3(iii) and Exchange Act rule 3a67-2, defining the terms “major swap category” and “major security-based swap category,” respectively, do not apply for this purpose.

Certain of the statutory requirements applicable to dealers particularly focus on the entity's swap or security-based swap activities and positions. These include, among other aspects, requirements related to trading records, documentation and confirmations.⁵⁸⁰ An applicant for a limited purpose designation would have to demonstrate how it would satisfy those transaction-specific requirements in the context of a limited designation.

Other statutory requirements applicable to dealers particularly focus on the entity itself. These include requirements related to registration, capital, risk management, supervision, and chief compliance officers.⁵⁸¹ Here too, an applicant for a limited purpose designation would have to demonstrate how it would satisfy those requirements in the context of limited designations.

A limited purpose designation might be appropriate, for example, where a commercial agricultural company is a dealer in swaps related to a thinly-traded commodity, such as a particular fertilizer, but is not a dealer in, and does not wish to be subject to the swap dealer

⁵⁸⁰ See, e.g., CEA section 4s(h)(3), Exchange Act section 15F(h)(3) (business conduct standards, including disclosure requirements, for dealers); CEA section 4s(g), Exchange Act section 15F(g) (daily trading record requirements for dealers); CEA section 4s(i); Exchange Act section 15F(i) (documentation requirements for dealers).

⁵⁸¹ See, e.g., CEA section 4s(a)(1), Exchange Act section 15F(a)(1) (registration requirements for dealers); CEA section 4s(e), Exchange Act section 15F(e) (capital and margin requirements for dealers). The Dodd-Frank Act provides that in setting the capital requirements for swap dealers and security-based swap dealers (as well as major participants) that are subject to a limited designation, the Commissions and the prudential regulators must take into account the risks associated with other types, classes, or categories of swaps or security-based swaps engaged in, and the other swap or security-based swap activities conducted by, that person "that are not otherwise subject to regulation applicable to that person by virtue of the status of the person" as a dealer or major participant. See CEA section 4s(e)(2)(C); Exchange Act section 15F(e)(2)(C). In the case of a commercial agricultural or energy company that obtains a limited purpose designation for a particular business unit, the CFTC does not expect that this provision will generally require the limited purpose designee to calculate its required capital on the basis of swaps engaged in, or activities conducted by, other business units within the company, to the extent those swaps or activities do not generate risk beyond the agricultural or energy company's ordinary commercial line of business.

requirements with respect to its swaps that relate to broadly-traded commodities like corn or wheat (or where, say, a commercial energy company is a dealer in swaps involving a commodity to be delivered at a particular location and does not wish to be subject to the swap dealer requirements for its swaps involving that commodity to be delivered at other locations, for which it is not a swap dealer). A limited designation might also be appropriate so that the swap dealer requirements do not apply to interest rate or currency swaps that the agricultural or energy company enters into in managing its financial risk.

A limited purpose designee could be a particular business unit within a company. Additionally, a limited designation might be considered to "split the desk" by applying the swap dealer requirements solely to the designee's limited activities involving swaps not entered into for the purpose of hedging a physical position as defined in CFTC Regulation § 1.3(ggg)(6)(iii). Any particular limited purpose application will be analyzed in light of the unique circumstances presented by the applicant.

A key challenge that any applicant to a limited dealer designation will face is the need to demonstrate full compliance with the requirements that apply to the type, class or category of swap or security-based swap, or the activities involving swaps or security-based swaps, that fall within the swap dealer designation.

III. Amendments to the Definition of Eligible Contract Participant

A. Background

The Dodd-Frank Act makes it unlawful for a person that is not an eligible contract participant ("ECP") to enter into a swap other than on, or subject to the rules of, a DCM.⁵⁸² In addition, section 763(e) of the Dodd-Frank Act makes it unlawful for a person to effect a transaction in a security-based swap with or for a person that is not an ECP unless the transaction is effected on a national securities exchange registered with the SEC.⁵⁸³ Moreover, section 768(b) of the Dodd-Frank Act makes it unlawful for a person to offer to sell, offer to buy or purchase, or sell a security-based swap to a person that is not an ECP unless a registration statement under the Securities Act of 1933 ("Securities Act")⁵⁸⁴ is in effect with respect to that security-based swap.⁵⁸⁵ These provisions mean that persons can engage in neither swaps nor

⁵⁸² In particular, section 723(a)(2) of the Dodd-Frank Act adds new subsection (e) to CEA section 2 (7 U.S.C. 2(e)), providing that "[i]t shall be unlawful for any person, other than an eligible contract participant, to enter into a swap unless the swap is entered into on, or subject to the rules of, a board of trade designated as a contract market under section 5."

⁵⁸³ In particular, section 763(e) of the Dodd-Frank Act adds paragraph (1) to Exchange Act section 6 (15 U.S.C. 78f(1)), providing that "[i]t shall be unlawful for any person to effect a transaction in a security-based swap with or for a person that is not an eligible contract participant, unless such transaction is effected on a national securities exchange registered pursuant to subsection (b)."

⁵⁸⁴ 15 U.S.C. 77a et seq.

⁵⁸⁵ In particular, section 768(b) of the Dodd-Frank Act adds paragraph (d) to Securities Act section 5 (15 U.S.C. 77e(d)), providing that "[n]otwithstanding the provisions of section 3 or 4, unless a registration statement meeting the requirements of section 10(a) is in effect as to a security-based swap, it shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell, offer to buy or purchase or sell a security-based swap to any person who is not an eligible contract participant as defined in section 1a(18) of the Commodity Exchange Act (7 U.S.C. 1a(18))." The Commissions note that market participants must make the determination of ECP status with respect to the parties to transactions in security-based swaps and mixed swaps prior to the offer to sell or the offer to buy or purchase the security-based swap or mixed swap.

security-based swaps transactions with persons that are not ECPs on SEFs, on security-based SEFs, or on a bilateral, off-exchange basis.

The Dodd-Frank Act also amended the ECP definition by:⁵⁸⁶ (i) providing that, for purposes of CEA sections 2(c)(2)(B)(vi) and 2(c)(2)(C)(vii), the term ECP does not include a commodity pool in which any participant is not itself an ECP; (ii) raising the monetary threshold that governmental entities may use to qualify as ECPs, in certain situations, from \$25 million in investments owned and invested on a discretionary basis to \$50 million in investments owned and invested on a discretionary basis;⁵⁸⁷ and (iii) replacing the “total asset” standard for individuals to qualify as ECPs with an “amounts invested on a discretionary basis” standard.⁵⁸⁸

Commodity pools may, among other things, enter into transactions involving foreign currency. ECP status is important for commodity pools that enter into the following types of foreign currency transactions (such commodity pools, “Forex Pools”): (i) off-exchange foreign currency futures; (ii) off-exchange options on foreign currency futures; (iii) off-exchange options on foreign currency; (iv) leveraged or margined foreign currency transactions; and (v) foreign currency transactions that are financed by the offeror, the counterparty or a person acting in

⁵⁸⁶ See Sections 741(b)(10) and 721(a)(9) of the Dodd-Frank Act; see also Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation, available at http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf, at 48–49 (June 17, 2009).

⁵⁸⁷ See CEA section 1a(18)(A)(vii), 7 U.S.C. 1a(18)(A)(vii).

⁵⁸⁸ See CEA section 1a(18)(A)(xi), 7 U.S.C. 1a(18)(A)(xi). The Dodd-Frank Act did not amend the monetary thresholds for individuals to qualify as ECPs. As such, an individual can qualify as an ECP if such individual has amounts invested on a discretionary basis, the aggregate of which is in excess of (i) \$10,000,000, or (ii) \$5,000,000 if such individual also enters into the agreement, contract, or transaction in order to manage the risk associated with an asset owned or liability incurred, or reasonably likely to be owned or incurred, by such individual.

concert with the offeror or counterparty on a similar basis.⁵⁸⁹ In some cases, discussed below in detail, if a Forex Pool does not satisfy the ECP definition applicable to commodity pools engaging in the types of foreign currency transactions noted above⁵⁹⁰ and it engages in these types of foreign currency transactions (such transactions, “retail forex transactions” and such commodity pools, “Retail Forex Pools”), the transactions will be subject to a regulatory regime that imposes certain requirements and restrictions on the counterparties to the Retail Forex Pool, and, if the Retail Forex Pool engages in retail forex transactions other than with certain counterparties, on the commodity pool operator (“CPO”) who operates the Retail Forex Pool. These requirements and restrictions do not apply if the Forex Pool satisfies the ECP definition applicable to commodity pools engaging in the types of foreign currency transactions noted above.

The Commissions are adopting further definitions of the term “eligible contract participant” in the following six respects: (i) generally prohibiting a Forex Pool from qualifying as an ECP if such Forex Pool directly enters into retail forex transactions⁵⁹¹ and has one or more

⁵⁸⁹ See CEA sections 2(c)(2)(B)(vi) and 2(c)(2)(C)(vii), 7 U.S.C. 2(c)(2)(B)(vi) and 7 U.S.C. 2(c)(2)(C)(vii). In this context, the term “off-exchange” means other than on or subject to the rules of an organized exchange, as defined in CEA section 1a(37), 7 U.S.C. 1a(37).

⁵⁹⁰ See CEA section 1a(18)(A)(iv), 7 U.S.C. 1a(18)(A)(iv); see also CFTC Regulation § 1.3(m)(5) (exporting the look-through language of CEA section 1a(18)(A)(iv) to CEA section 1a(18)(A)(v)). The Dodd-Frank Act amended the ECP definition to include a provision that specifically applies to Forex Pools engaging in these types of foreign currency transactions. See Section 741(b)(10) of the Dodd-Frank Act (adding a provision to CEA section 1a(18)(A)(iv), 7 U.S.C. 1a(18)(A)(iv), stating “provided, however, that for purposes of section 2(c)(2)(B)(vi) and section 2(c)(2)(C)(vii), the term ‘eligible contract participant’ shall not include a commodity pool in which any participant is not otherwise an eligible contract participant.”). See part III.B below for a discussion of this provision. This provision applies only with respect to retail forex transactions. This means that a Retail Forex Pool, as defined above, that is not an ECP for retail forex transaction purposes could be an ECP for other transactions it enters into that are not retail forex transactions.

⁵⁹¹ In many commodity pool structures, this is the master fund alone.

direct participants that are not ECPs;⁵⁹² (ii) clarifying that, in determining whether a direct participant in a Forex Pool is an ECP, the indirect participants in the Forex Pool will not be considered unless such Forex Pool, a commodity pool holding a direct or indirect (through one or more intermediate tiers of pools) interest in such Forex Pool, or any commodity pool in which such Forex Pool holds a direct or indirect interest has been structured to evade Subtitle A of Title VII of the Dodd-Frank Act;⁵⁹³ (iii) prohibiting a commodity pool from qualifying as an ECP unless it has total assets exceeding \$5 million and is operated by a person described in CEA section 1a(18)(A)(iv)(II);⁵⁹⁴ (iv) explicitly including swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants in the definition of ECP; (v) permitting a non-ECP to qualify as an ECP, with respect to certain swaps, based on the collective net worth of its owners, subject to several conditions, including that the owners are ECPs; and (vi) permitting a Forex Pool to qualify as an ECP notwithstanding that it has one or more direct participants that are not ECPs if the Forex Pool (a) is not formed for the purpose of evading regulation under CEA sections 2(c)(2)(B) or (C) or related rules, regulations or orders, (b) has total assets exceeding \$10 million and (c) is formed and operated by a registered CPO or by a CPO who is exempt from registration as such pursuant to § 4.13(a)(3). In addition, the Commissions are issuing interpretive guidance regarding the definition of ECP to correct an inaccurate statutory cross-reference with respect to the ability of government entities to qualify

⁵⁹² But see note 652, *infra*, with respect to single level Forex Pools using retail forex transactions solely to hedge.

⁵⁹³ Section 721(c) of the Dodd-Frank Act requires the CFTC to adopt a rule to further define the terms “swap,” “swap dealer,” “major swap participant,” and “eligible contract participant,” in order “[t]o include transactions and entities that have been structured to evade” subtitle A of Title VII (or an amendment to the CEA made by subtitle A).

⁵⁹⁴ 7 U.S.C. 1a(18)(A)(iv)(II).

as ECPs under CEA section 1a(18)(A)(vii).⁵⁹⁵ The Commissions also are issuing interpretive guidance with respect to the ECP status of Forex Pools whose participants are limited solely to non-U.S. persons and which are operated by CPOs located outside the United States, its territories or possessions.

The Commissions note that commenters raised interpretive and other issues related to the ECP definition that the Commissions may consider in the future.⁵⁹⁶

B. Commodity Pool Look-Through for Retail Forex Transactions

1. Statutory Provisions

Prior to the Dodd-Frank Act, clause (A)(iv) of the ECP definition provided that a commodity pool was an ECP if it had \$5 million in total assets and was operated by a person regulated under the CEA, regardless of whether each participant in the commodity pool was itself an ECP.⁵⁹⁷ Section 741(b)(10) of the Dodd-Frank Act added a proviso to clause (A)(iv)⁵⁹⁸

⁵⁹⁵ 7 U.S.C. 1a(18)(A)(vii).

⁵⁹⁶ These issues include: (i) the ECP status of jointly and severally liable borrowers and counterparties, non-ECPs guaranteed by ECPs, and non-ECP swap collateral providers; (ii) whether bond proceeds count toward the "owns and invests on a discretionary basis \$50,000,000 or more in investments" element of the governmental ECP prong (CEA section 1a(18)(A)(vii), 7 U.S.C. 1a(18)(A)(vii)); (iii) the relationship between the ECP and eligible commercial entity definitions for purposes of CEA section 1a(18)(A)(vii), 7 U.S.C. 1a(18)(A)(vii); (iv) the scope of the "proprietaryship" element of the entity prong of the ECP definition in CEA section 1a(18)(A)(v), 7 U.S.C. 1a(18)(A)(v) (which the Commissions are addressing to a limited extent in the discussion of the new line of business ECP category in part III.F, *infra*, and in Regulation § 1.3(m)(7)(ii)(C) under the CEA); (v) the meaning of the new "amounts invested on a discretionary basis" element of the individual prong of the ECP definition (CEA section 1a(18)(A)(xi), 7 U.S.C. 1a(18)(A)(xi)); (vi) whether persons can be ECPs in anticipation of receiving, but before they have, the necessary assets; and (vii) that swap dealers are not among the entities listed in CEA section 2(c)(2)(B)(i)(II), 7 U.S.C. 2(c)(2)(B)(i)(II), as acceptable counterparties to non-ECPs engaging in retail forex transactions.

⁵⁹⁷ Clause (A)(iv) of the pre-Dodd-Frank Act ECP definition also included a commodity pool operated by a foreign person performing a similar role or function as a person regulated under the CEA and subject as such to foreign regulation (regardless of whether the foreign person was itself an ECP).

⁵⁹⁸ The proviso states "provided, however, that for purposes of section 2(c)(2)(B)(vi) and section 2(c)(2)(C)(vii), the term 'eligible contract participant' shall not include a commodity pool in which any

stating that a Forex Pool will not qualify as an ECP, solely for purposes of CEA sections 2(c)(2)(B)(vi) or 2(c)(2)(C)(vii) (i.e., retail forex transactions) if any participant in the Forex Pool is itself not an ECP.⁵⁹⁹

Thus, for purposes of retail forex transactions, the Dodd-Frank Act imposed a requirement to “look through” a Forex Pool—meaning that ECP status would be limited to Forex Pools in which each participant is itself an ECP. This is important for two reasons. First, a Forex Pool that does not qualify as an ECP can enter into a retail forex transaction described in CEA section 2(c)(2)(B)(i)(I) only with one of the federally-regulated counterparties enumerated in CEA sections 2(c)(2)(B)(i)(II)(aa) (U.S. financial institutions),⁶⁰⁰ (bb) (certain brokers, dealers and their associated persons),⁶⁰¹ (cc) (certain futures commission merchants (“FCMs”) and their

participant is not otherwise an eligible contract participant.” CEA section 1a(18)(A)(iv); 7 U.S.C. 1a(18)(A)(iv).

⁵⁹⁹ See CEA section 1a(18)(A)(iv); 7 U.S.C. 1a(18)(A)(iv). In other words, the proviso in section 1a(18)(A)(iv) does not reference or implicate ECP status for purposes of (i) CEA section 2(e), 7 U.S.C. 2(e) (which, as discussed above, permits non-ECPs to trade swaps only on or subject to the rules of a DCM); (ii) Securities Act section 5(d) (which, as discussed above, makes it unlawful for a person to offer to sell, offer to buy or purchase, or sell a security-based swap to a person that is not an ECP unless a registration statement under the Securities Act is in effect with respect to that security-based swap); or (iii) Exchange Act section 6(l) (which as discussed above, makes it unlawful for a person to effect a transaction in a security-based swap with or for a person that is not an ECP unless the transaction is effected on a national securities exchange registered with the SEC). The look-through proviso does not expressly state that indirect participants, as well as direct participants, in the Forex Pool must be ECPs for the Forex Pool to be an ECP. But see notes 636 and 638, infra (discussing the authority for such an approach).

⁶⁰⁰ 7 U.S.C. 2(c)(2)(B)(i)(II)(aa). The term “financial institution” is defined in CEA Section 1a(21), 7 U.S.C. 1a(21).

⁶⁰¹ 7 U.S.C. 2(c)(2)(B)(i)(II)(bb). This category is comprised of each:

(AA) [] broker or dealer registered under section 15(b) (except paragraph (11) thereof) or 15C of the Securities Exchange Act of 1934 (15 U.S.C. 78o(b), 78o-5); [and] (BB) [] associated person of a broker or dealer registered under section 15(b) (except paragraph (11) thereof) or 15C of the Securities Exchange Act of 1934 (15 U.S.C. 78o(b), 78o-5) concerning the financial or securities activities of which the broker or

affiliated persons),⁶⁰² (dd) (certain financial holding companies)⁶⁰³ or (ff) (certain retail foreign exchange dealers (“RFEDs”))⁶⁰⁴ (each an “Enumerated Counterparty” and collectively “Enumerated Counterparties”); the counterparty restriction does not apply to retail forex transactions described in CEA section 2(c)(2)(C)(i)(I)(bb)⁶⁰⁵ entered into by a Forex Pool that does not qualify as an ECP, though such transactions are subject to antifraud protections and related enforcement provisions if entered into with a counterparty other than an Enumerated

dealer makes and keeps records under section 15C(b) or 17(h) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-5(b), 78q(h)).

⁶⁰² 7 U.S.C. 2(c)(2)(B)(i)(II)(cc). This category is comprised of each:

(cc)(AA) [] futures commission merchant that is primarily or substantially engaged in the business activities described in section 1a of this Act, is registered under this Act, is not a person described in item (bb) of this subclause, and maintains adjusted net capital equal to or in excess of the dollar amount that applies for purposes of clause (ii) of this subparagraph; [and] (BB) [] affiliated person of a futures commission merchant that is primarily or substantially engaged in the business activities described in section 1a of this Act, is registered under this Act, and is not a person described in item (bb) of this subclause, if the affiliated person maintains adjusted net capital equal to or in excess of the dollar amount that applies for purposes of clause (ii) of this subparagraph and is not a person described in such item (bb), and the futures commission merchant makes and keeps records under section 4f(c)(2)(B) of this Act concerning the futures and other financial activities of the affiliated person.

⁶⁰³ 7 U.S.C. 2(c)(2)(B)(i)(II)(dd). The enumerated counterparty in this category is “a financial holding company (as defined in section 2 of the Bank Holding Company Act of 1956).”

⁶⁰⁴ 7 U.S.C. 2(c)(2)(B)(i)(II)(ff). This category is comprised of each:

retail foreign exchange dealer that maintains adjusted net capital equal to or in excess of the dollar amount that applies for purposes of clause (ii) of this subparagraph and is registered in such capacity with the [CFTC], subject to such terms and conditions as the [CFTC] shall prescribe, and is a member of a futures association registered under section 17 [of the CEA].

⁶⁰⁵ 7 U.S.C. 2(c)(2)(C)(i)(I)(bb).

Counterparty described in CEA section 2(c)(2)(B)(i)(II)(aa), (bb) or (dd).⁶⁰⁶ Second, the operator of a Retail Forex Pool engaging in retail forex transactions with an Enumerated Counterparty that is an FCM, specified affiliated person of an FCM or RFED must register with the CFTC as a CPO,⁶⁰⁷ unless the CPO also is an Enumerated Counterparty under

⁶⁰⁶ The counterparty limitation with respect to CEA section 2(c)(2)(B)(i)(I) retail forex transactions is a function of the fact that the CEA's exchange-trading requirement generally applies with respect to foreign currency futures, foreign currency options on futures, and foreign currency options. See CEA section 4(a), 7 U.S.C. 6(a) (generally requiring futures contracts to be traded on or subject to the rules of a DCM); CEA section 4c(b), 7 U.S.C. 6c(b) (prohibiting trading options subject to the CEA contrary to CFTC rules, regulations or orders permitting such trading); Part 32 of the CFTC's rules, 17 C.F.R. Part 32 (generally prohibiting entering into options subject to the CEA) and CFTC Regulation § 33.3(a), 17 CFR 33.3(a) (prohibiting entering into options on futures other than on or subject to the rules of a DCM). Because CEA section 4(a) would render an off-exchange futures contract illegal but for CEA section 2(c)(2)(B) permitting such transactions with an Enumerated Counterparty, it would be illegal for a non-Enumerated Counterparty to enter into a futures contract described in 2(c)(2)(B)(i)(I) with a non-ECP. Similarly, because options can be conducted only pursuant to CFTC authority and the CFTC has proposed to treat commodity options within its jurisdiction as swaps, CEA section 2(e) would prohibit such options, if on foreign exchange and entered into with a non-ECP, but for the fact that 2(c)(2)(B) permits them if traded with an Enumerated Counterparty.

The lack of a counterparty limitation with respect to CEA section 2(c)(2)(C)(i)(I)(bb) retail forex transactions is a function of the different structures of CEA sections 2(c)(2)(B) and (C). Whereas CEA section 2(c)(2)(B)(i) covers transactions that would be illegal but for compliance with CEA section 2(c)(2)(B) (due to such section's incorporation of the entire CEA, including, for example, the exchange-trading requirement discussed above), falling within CEA section 2(c)(2)(C)(i)(I), by that section's own terms, merely brings a covered transaction within the scope of CEA section 2(c)(2)(C), which does not include the exchange-trading requirement of CEA section 4(a). Because CEA section 2(c)(2)(C)(i)(I) covers transactions that may or may not also be transactions described in section 2(c)(2)(B)(i)(I) and the far fewer requirements imposed by CEA section 2(c)(2)(C) invite characterization of such difficult-to-categorize transactions as falling solely within CEA section 2(c)(2)(C), the CFTC will interpret such dually characterizable transactions as governed by CEA section 2(c)(2)(B). If such transactions fall only within CEA section 2(c)(2)(C), however, because they would be subject to neither the exchange-trading requirement of CEA section 4(a) nor the CFTC's plenary options authority under CEA section 4c(b) (while CEA section 2(c)(2)(C)(ii)(I), 7 U.S.C. 2(c)(2)(C)(ii)(I), reserves the CFTC's section 4c(b) authority, in this scenario, the contract in question is not an option), a person other than an Enumerated Counterparty may act as counterparty to a non-ECP. Such contracts would, however, be subject to two of the CEA's antifraud provisions, sections 4(b) and 4b, 7 U.S.C 6(b) and 7 U.S.C 6b, respectively, as if they were futures contracts. See CEA section 2(c)(2)(C)(iv), 7 U.S.C. 2(c)(2)(C)(iv). Such contracts also would be subject to related enforcement provisions. See CEA section 2(c)(2)(C)(ii)(I), 7 U.S.C. 2(c)(2)(C)(ii)(I).

⁶⁰⁷ See CEA sections 2(c)(2)(B)(iv)(I) and (C)(iii)(I) (requiring registration for CPOs of Retail Forex Pools entering into retail forex transactions with FCMs, specified affiliated persons thereof or RFEDs).

2(c)(2)(B)(i)(II)(aa), (bb) or (dd)⁶⁰⁸ or an exemption from CPO registration applies.⁶⁰⁹

Moreover, CEA section 2(c)(2)(E)(ii)(I),⁶¹⁰ which was added by section 742(c)(2) of the Dodd-Frank Act, prohibits an Enumerated Counterparty from entering into retail forex transactions described in CEA section 2(c)(2)(B)(i)(I) with a person that is not an ECP “except pursuant to a

By contrast, those sections exclude from the CPO registration requirement CPOs of Retail Forex Pools engaging in retail forex transactions with Enumerated Counterparties described in CEA section 2(c)(2)(B)(i)(II)(aa), (bb), (ee) and (ff). While the cited CEA sections refer to counterparties not described in “any of item (aa), (bb), (ee), or (ff)” of subparagraph (B)(i)(II), the CFTC Reauthorization Act of 2008 (“CRA”), included as Title XIII of the Food, Conservation and Energy Act of 2008, Pub.L. 110-246, 122 Stat. 1651 changed item (ee) to item (dd) (a financial holding company as defined in section 2 of the Bank Holding Company Act of 1956) and removed item (ff) (formerly an investment bank holding company (as defined in section 17(i) of the Exchange Act (15 U.S.C. 78q(i))). Therefore, the Commissions interpret the reference in CEA sections 2(c)(2)(B)(iv)(I)(cc) and 2(c)(2)(C)(iii)(I)(cc) to items (aa), (bb), (ee), or (ff) to be references to items (aa), (bb) and (dd). *Cf.* Retail Foreign Exchange Transactions; Conforming Changes to Existing Regulations in Response to the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR 56103 (Sept. 12, 2011) (providing background on related incorrect internal references in CEA sections 2(c)(2)(B) and (C)). *See also* CFTC Regulation § 5.3(a)(2)(i), 17 C.F.R. § 5.3(a)(2)(i), which requires a CPO, as defined in CFTC Regulation § 5.1(d)(1), 17 C.F.R. § 5.1(d)(1), to register as such. CFTC Regulation § 5.1(d)(1), in turn, defines a CPO, for purposes of Part 5 of the CFTC’s Regulations, 17 C.F.R. Part 5, as “any person who operates or solicits funds, securities or property for a pooled investment vehicle that is not an [ECP] as defined in section 1a(18) of the Act, and that engages in retail forex transactions.” The CFTC interprets the references in Regulation § 5.1(d)(1) to ECPs as defined in CEA section 1a(18) to include the ECP definition as further defined or interpreted by the Commissions under authority conferred by the Dodd-Frank Act or otherwise amended or interpreted by the Commissions or a court. While the statutory CPO definition in CEA section 1a(11)(A), 7 U.S.C. 1a(11)(A), does not include transactions described in CEA section 2(c)(2)(B)(i), the Commissions believe this was an oversight. In any case, CEA section 1a(11)(B), 7 U.S.C. 1a(11)(B), grants the CFTC the authority to further define the term CPO, which the CFTC has done in CFTC Regulation § 5.1(d)(1). Therefore, a person operating a commodity pool engaging in transactions described in CEA section 2(c)(2)(B)(i) is a CPO.

⁶⁰⁸ See CEA sections 2(c)(2)(B)(iv)(II) and 2(c)(2)(C)(iii)(II). While CEA sections 2(c)(2)(B)(iv)(II) and 2(c)(2)(C)(iii)(II) refer to counterparties described in item (aa), (bb), (ee), or (ff) of subparagraph (B)(i)(II), the CFTC Reauthorization Act of 2008 changed item (ee) to item (dd) and removed item (ff). Therefore, the Commissions interpret the reference in CEA sections 2(c)(2)(B)(iv)(II) and 2(c)(2)(C)(iii)(II) to items (aa), (bb), (ee), or (ff) to be references to items (aa), (bb) and (dd). *Cf.* Retail Foreign Exchange Transactions; Conforming Changes to Existing Regulations in Response to the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR 56103 (Sept. 12, 2011) (providing background on related incorrect internal references in 2(c)(2)(B) and (C)).

⁶⁰⁹ See, e.g., CFTC Regulation § 4.13(a)(3) (exempting from CPO registration operators of commodity pools engaged in a *de minimis* amount of trading in CFTC-jurisdictional contracts).

⁶¹⁰ 7 U.S.C. 2(c)(2)(E)(ii)(I).

rule or regulation of [the appropriate Federal regulator of such Enumerated Counterparty allowing such transactions] under such terms and conditions as [such regulator] shall prescribe.” CEA section 2(c)(2)(E)(iii)(II)⁶¹¹ requires that such rules or regulations treat similarly all agreements, contracts, and transactions in foreign currency that are functionally or economically similar to CEA section 2(c)(2)(B)(i)(I) agreements, contracts, and transactions.

Separately, subclause (A)(v)(III) of the ECP definition, both before and after enactment of the Dodd-Frank Act, provides that a corporation, partnership, proprietorship,⁶¹² organization, trust or other business entity may qualify as an ECP if it has a net worth exceeding \$1 million and “enters into an agreement, contract, or transaction in connection with the conduct of the entity’s business or to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by the entity in the conduct of the entity’s business.”⁶¹³

2. Proposed Approach

The Commissions stated in the Proposing Release that “in some cases commodity pools unable to satisfy the conditions of clause (A)(iv) of the ECP definition may rely on clause (A)(v) to qualify as ECPs instead for purposes of retail forex” and that permitting such reliance would

⁶¹¹ 7 U.S.C. 2(c)(2)(E)(iii)(II).

⁶¹² Individuals also are covered by a different prong of the ECP definition. An individual can qualify as an ECP under clause (A)(xi) of the ECP definition. See CEA section 1a(18)(A)(xi), 7 U.S.C. 1a(18)(A)(xi).

⁶¹³ There are two other ways a person can qualify as an ECP under clause (A)(v): (i) being an entity with total assets exceeding \$10 million; or (ii) being an entity the obligations of which under an agreement, contract, or transaction are guaranteed or otherwise supported by a letter of credit or keepwell, support, or other agreement by an entity with total assets exceeding \$10 million or an entity described in clause (A)(i), (ii), (iii), (iv) or (vii), or paragraph (C), of the ECP definition. See CEA section 1a(18)(A)(v)(I) and (II), 7 U.S.C. 1a(18)(A)(v)(I) and (II), respectively.

frustrate the intent of Congress in imposing the look-through requirement on Forex Pools in clause (A)(iv) of the ECP definition.⁶¹⁴

The Commissions proposed to further define the term "eligible contract participant" to preclude a Forex Pool from qualifying as an ECP for purposes of retail forex transactions in reliance on clause (A)(v) of the ECP definition if such Forex Pool has any participant that is not an ECP and, therefore, is not an ECP due to the look-through provision added to clause (A)(iv). Further, because commodity pools can be structured in various ways and can have one or more feeder funds and/or pools, the Commissions proposed to preclude a Forex Pool from being an ECP for purposes of retail forex transactions if there was any non-ECP participant at any level of the pool structure (e.g., the pool itself, a direct participant that invests in the pool, or any indirect participant that invests in that pool through other pools or vehicles).

3. Commenters' views

One commenter supported the Commissions' efforts to close the potential loophole of Forex Pools that are unable to qualify as ECPs due to the new look-through provision in clause (A)(iv) of the ECP definition instead qualifying as ECPs under clause (A)(v) of the ECP definition.⁶¹⁵ This commenter indicated that it shares the Commissions' concern that Forex Pools that do not satisfy the amended ECP definition due to the look-through provision for commodity pools in clause (A)(iv) may alternatively rely upon clause (A)(v) of the ECP

⁶¹⁴ Proposing Release, 75 FR at 80185.

⁶¹⁵ See letter from the NFA. The NFA indicated that it recently took separate emergency actions against two firms that did not qualify under the NFA's requirements for retail forex transactions. In one case, the commodity pool fell short of the \$5 million total asset requirement in clause (A)(iv) of the ECP definition; in the other case, the firm never properly formed a commodity pool. The NFA cautioned in its letter, "these cases illustrate that firms will attempt to obtain ECP status to shield themselves from the jurisdiction of regulators to the detriment of pool participants."

definition to qualify as an ECP for purposes of retail forex transactions.⁶¹⁶ This commenter further stated that Congressional intent in requiring a look-through for Forex Pools would be frustrated if fraudulent pool operators could avail themselves of this alternative.⁶¹⁷

However, several commenters recognized the importance of the concern about a potential loophole⁶¹⁸ but stated that the Commissions should revise the proposal to mitigate the potential adverse consequences to market participants. One commenter, for example, commented on the expected effects of the proposed rule on funds of funds (“FOFs”).⁶¹⁹ According to this commenter, FOFs (i) normally face as counterparties foreign subsidiaries of U.S. banks and foreign banks, and (ii) would incur substantial counterparty, documentation and operational costs in moving their retail forex transactions onto DCMs or toward the Enumerated Counterparties.

⁶¹⁶ Id.

⁶¹⁷ Id.

⁶¹⁸ See, e.g., letters from SIFMA – AMG dated September 15, 2011 (“SIFMA AMG IV”) (acknowledging some form of ECP look-through is appropriate to prevent evasion where circumvention otherwise could occur and stating that it is sympathetic to the Commissions’ implicit objective of ensuring that a person that would not qualify as an ECP not be permitted to accomplish indirectly what it is not permitted to do directly), Sidley Austin LLP (“Sidley”) (stating that the commenter fully appreciates that Congress added the look-through language to the ECP definition to prevent unscrupulous forex market participants from avoiding the retail forex provisions of the CEA and the CFTC’s rules by “engineering” an ECP by pooling the capital of a large group of retail customers, thus depriving those investors of the protections otherwise afforded to them), AIMA I (stating that “we understand Congress has made a decision to try to protect retail investors by amending the definition of ECP under Section 1a(1[8]) of the [CEA] to include that, for a commodity pool to qualify as an ECP under sub-section (A)(iv), the pool’s underlying participants must also qualify as ECPs under section 1a(1[8])).”

⁶¹⁹ See letter from Sidley. Sidley noted that FOF managers’ retail forex transactions are largely undertaken for hedging purposes and that most FOF managers offer investments to non-U.S. persons, a significant number of which pay for their investments in FOF interests using their own currency. Sidley further noted that, because most FOFs accept investments only in U.S. dollars, FOF managers must convert to U.S. dollars the foreign currency received from such investors and invest those dollars in underlying funds, and that they enter into a hedging transaction to reduce the risk of exchange rate changes between an investor’s currency and the U.S. dollar.

In a similar vein, two commenters advised that a substantial number of hedge funds, as well as publicly offered commodity pools, would, under the Commissions' proposal, fail to qualify as ECPs for purposes of retail forex transactions, as most such funds have at least one direct or indirect non-ECP participant.⁶²⁰ These commenters indicated that this would disrupt the trading strategies employed by many commodity trading advisors ("CTAs") on behalf of commodity pools.⁶²¹ One of these commenters suggested an anti-evasion approach combining a lower level of pool assets with a requirement that the commodity pool not be formed for the purpose of evading the regulatory requirements applicable to retail forex transactions.⁶²²

Another commenter argued that Congress did not include the look-through provision in clause (A)(v) of the ECP definition because of its effect on bona fide hedgers.⁶²³ This commenter also advised that the primary entities affected are hedge fund and private equity fund managers investing in securities who use retail forex transactions solely to hedge investment portfolio currency risks, and/or because they accept subscriptions in currencies other than U.S. dollars.⁶²⁴

Several commenters disagreed with the Commissions' statement in the proposal that extending the look-through provision in clause (A)(iv) of the ECP definition to clause (A)(v) would effectuate Congressional intent. Two commenters noted that there is no specific Dodd-

⁶²⁰ See letters from Willkie Farr & Gallagher LLP ("Willkie Farr") and the NYCBA Committee.

⁶²¹ Id.

⁶²² See letter from Willkie Farr.

⁶²³ See letter from Akin Gump Strauss Hauer & Feld LLP ("Akin Gump").

⁶²⁴ Id.

Frank Act provision requiring such a change.⁶²⁵ Two other commenters argued that clause (v) of the ECP definition provides an independent basis for qualification as an ECP, which should not be affected by the changes in clause (A)(iv) of the ECP definition.⁶²⁶

One commenter indicated that the extraterritorial application of the proposed rules regarding the ECP definition is unclear.⁶²⁷ Among other things, this commenter indicated it is unnecessary to extend the scope of the look-through to protect possible retail investors outside of the U.S., especially where a CPO has not marketed a pool in the U.S. and does not otherwise have any U.S. investors.⁶²⁸

Commenters proposed several alternative approaches that they believed would address the Commissions' concerns. One commenter suggested that the Commissions create a new category of ECPs for Forex Pools comprised entirely of qualified eligible persons ("QEPs")⁶²⁹ and operated by persons subject to regulation under the CEA.⁶³⁰ This commenter also suggested that the Commissions create a new category of ECPs for Forex Pools that satisfy a monetary threshold for total assets or for the minimum initial investment of a Forex Pool to be sufficiently

⁶²⁵ See letters from AIMA I and Ropes & Gray LLP ("Ropes & Gray").

⁶²⁶ See letters from Akin Gump, Sidley and Skadden, Arps, Slate, Meagher & Flom LLP ("Skadden"). Sidley also indicated that there seems to be no compelling reason to treat commodity pools worse than other sophisticated market participants with respect to retail forex transactions with non-Enumerated Counterparties, and no reason to treat them worse than a corporation or other entity with only \$10 million in total assets that therefore qualifies as an ECP under clause (A)(v) of the ECP definition to trade retail forex transactions although it may have no particular expertise in such markets.

⁶²⁷ See letter from AIMA I.

⁶²⁸ Id.

⁶²⁹ The term "qualified eligible person" is defined in CFTC Regulation §§ 4.7(a)(2) and (3).

⁶³⁰ See letter from Sidley.

large that, in general, only legitimate pools would exceed such thresholds.⁶³¹ Finally, this commenter suggested that the Commissions create a category of ECPs for non-U.S. persons.⁶³² A second commenter suggested that the Commissions create a category of ECPs for commodity pools that are operated by a CPO or advised by a CTA subject to regulation by a foreign regulator comparable to the CFTC.⁶³³

One commenter suggested (i) allowing commodity pools and their counterparties to rely, for the duration of an investment and each time commodity pool participants make an investment decision, on participant ECP representations provided in connection with an initial investment, provided that each participant covenants to update such representations if they become inaccurate, and (ii) providing specific relief for FOFs because they generally invest all or substantially all of their assets in underlying portfolio funds and use retail forex transactions to reduce foreign exchange exposure.⁶³⁴

4. Final rule

After considering commenters' concerns, the Commissions are adopting final rules that have been revised from the proposal. In particular, consistent with the statutory text of the Dodd-Frank Act, CFTC Regulation § 1.3(m)(5)(i) further defines the term "eligible contract participant" to prohibit a Forex Pool that directly enters into a retail forex transaction (i.e., a

⁶³¹ Id.

⁶³² Id. Sidley cited to the approach in Regulation S under the Securities Act (17 CFR 230.901 et seq.), Sections 3(c)(1) and (7) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(c)(1) and (7)), and CFTC Regulation § 4.7(a)(2)(xi).

⁶³³ See letter from Willkie Farr.

⁶³⁴ See letter from Sidley.

transaction-level commodity pool)⁶³⁵ from qualifying as an ECP under clause (A)(iv) or clause (A)(v) of the ECP definition, solely for purposes of entering into retail forex transactions, if the pool has one or more direct participants that are not ECPs. In response to commenters' concerns described above, CFTC Regulation § 1.3(m)(5)(ii) is revised to provide that, in determining whether a commodity pool that is a direct participant in a transaction-level Forex Pool is an ECP, the indirect participants in the transaction-level Forex Pool⁶³⁶ will not be considered unless such Forex Pool, a commodity pool holding a direct or indirect (through one or more intermediate tiers of pools) interest in such Forex Pool, or any commodity pool in which such Forex Pool holds a direct or indirect interest has been structured to evade Subtitle A of Title VII of the Dodd-Frank Act by permitting persons that are not ECPs to participate in agreements, contracts, or transactions described in section 2(c)(2)(B)(i) or section 2(c)(2)(C)(i) of the Commodity Exchange Act. That is, absent evasion, the Commissions are changing the proposed "indefinite look-through" to an "evasion-based look-through" in the final rule.⁶³⁷

⁶³⁵ Commodity pool structures can take various forms. One common commodity pool structure is a "master-feeder" fund structure. In such a structure, investors purchase interests in "feeder funds," which in turn purchase interests in a "master fund." Typically, the only fund in a commodity pool structure that enters into retail forex transactions (and other transactions) directly is the master fund; the feeder funds (and their investors) typically would participate indirectly by receiving the profit or loss from such retail forex transactions (and other transactions) as distributions based on the feeder funds' interests in the master fund. Notwithstanding that the master-feeder structure is common, other structures exist. Thus, each fund in a commodity pool structure that directly enters into retail forex transactions is a transaction-level commodity pool.

⁶³⁶ A fund that does not itself engage in retail forex transactions but that holds an interest in a transaction-level Forex Pool that engages in retail forex transactions is itself a commodity pool. *Cf.* U.S. Regulation of the International Securities and Derivatives Markets - Greene, Beller, Rosen, Silverman, Braverman and Sperber, §12.13[1], n.351 and related text.

⁶³⁷ The Commissions caution, however, that they will closely monitor developments in this part of the market and will not hesitate to revisit their decision to limit the look-through provision pursuant to 1.3(m)(5)(ii) should they observe a pattern of evasion or misconduct.

In adding the look-through provision to the commodity pool prong of the ECP definition, Congress made a decision to protect retail foreign exchange investors by requiring that the participants in a Forex Pool qualify as ECPs for the Forex Pool itself to qualify as an ECP. The Commissions believe that the intent of the look-through provision – protecting Forex Pool participants from fraudulent and abusive conduct -- must be given effect to comply with this Congressional mandate. Nevertheless, the Commissions acknowledge commenters' concerns about potential unintended consequences of applying an indefinite look-through to every direct and indirect participant of a Forex Pool, as proposed. Accordingly, to avoid unintended consequences and related costs for Forex Pools whose operators and managers have not historically presented the risks that the look-through provision was intended to address,⁶³⁸ the

⁶³⁸ The proposed rule was based on the CFTC's longstanding, broad view of what constitutes a "pool," a view recently codified in the "commodity pool" definition by section 721(a)(5) of the Dodd-Frank Act in CEA section 1a(10), 7 U.S.C. 1a(10), and recognized by courts, and thus applied the look-through provision at each level of a Forex Pool's investment structure. *See* CFTC, Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations, 77 FR 11252 (Feb. 24, 2012) ("CPO/CTA Compliance Release") (advising that "it is the position of the [CFTC] that a fund investing in an unaffiliated commodity pool is itself a commodity pool" and "[t]his interpretation is consistent with the statutory definition of commodity pool, which draws no distinction between direct and indirect investments in commodity interests"); *CFTC v. Equity Financial Group*, 572 F.3d 150, 157-158 (July 13, 2009) (concluding, in the context of a commodity pool that invested all of its assets with a commodity pool operated by a different CPO, that the CFTC's commodity pool regulations "cover pools that invest in other pools" and that "the remedial purposes of the statute would be thwarted if the operator of a fund could avoid the regulatory scheme simply by investing in another pool rather than trading"). The same logic applies to a master-feeder structure operated by the same CPO: the remedial purpose of the look-through proviso in clause (A)(iv) of the statutory ECP definition would be thwarted if the look-through could be defeated simply by funneling pool participants into a master fund through a feeder fund.

The proposed rule also was borne of the CFTC's long history of combating fraudulent practices by typically unregistered individuals or entities that prey upon often unsophisticated retail customers through complex and highly leveraged off-exchange transactions in foreign currency. However, the operators and managers of commodity pool FOFs, master-feeder structures and hedge funds for sophisticated investors have not generally been the subject of CFTC enforcement actions with respect to retail forex transactions. For an in depth discussion of the history of the CFTC's authority over retail forex transactions, the abuses giving rise to that authority, and related enforcement actions, *see* CFTC, Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries, 75 FR 3282 (Jan. 20, 2010). Congress acted three times in a decade to clarify the CFTC's authority to prosecute the

Commissions are replacing the proposed indefinite look-through of every participant in a Forex Pool with a limited, evasion-based look-through pursuant to which a transaction-level Forex Pool will qualify as an ECP, for purposes of retail forex transactions, if all of such Forex Pool's direct participants are ECPs, and will look through a commodity pool participant in such Forex Pool only if it, at any level, has been structured to evade the look-through provision in clause (A)(iv) of the ECP definition.

The Commissions believe the final rule strikes the right balance between implementing strong protections for non-ECP commodity pool participants and not imposing undue burdens or costs on CPOs, CTAs and commodity pool participants related to retail forex transactions. In addition, the Commissions believe that replacing the indefinite look-through with the limited, evasion-based look-through alleviates many of the commenters' concerns. Accordingly, the Commissions believe it is appropriate to limit the look-through provision to the level of a commodity pool structure that enters into retail forex transactions and to look through commodity pools to their ultimate participants only in those cases in which it is required to prevent evasion of the protections for those persons whom Congress intended to be subject to retail forex transactions restrictions.

At the same time, the Commissions do not believe that Forex Pools failing to qualify as ECPs due to the look-through provision in clause (A)(iv) of the ECP definition should,

rampant fraud seen in this area – first in the Commodity Futures Modernization Act of 2000, Public Law 106-554, 114 Stat. 2763 (Dec. 21, 2000) in 2000, then again in the CRA, and finally in the Dodd-Frank Act in 2010.

nonetheless, be permitted unfettered access to ECP status under clause (A)(v).⁶³⁹ The look-through provision for Forex Pools provides heightened investor protection from forex fraud for Forex Pool participants that are not themselves ECPs. Thus, the Commissions believe that permitting Forex Pools with one or more non-ECP participants to achieve ECP status by relying on clause (A)(v) of the ECP definition, which applies to business entities generally, would serve to undermine the look-through provision that Congress specifically imposed on Forex Pools under clause (A)(iv).⁶⁴⁰

Moreover, developments subsequent to the issuance of the Proposing Release should ameliorate commenters' concerns that CEA section 2(c)(2)(E)(ii)(I) significantly limits the

⁶³⁹ In section 712(d)(2)(A) of the Dodd-Frank Act, Congress granted the Commissions the authority to adopt such rules regarding the ECP definition as the Commissions determine are necessary and appropriate, in the public interest, and for the protection of investors.

⁶⁴⁰ The Commissions note that several commenters requested clarification regarding the relationship between the look-through provision set forth in CFTC Regulation § 1.3(m)(5) and the prohibition on a commodity pool qualifying as an ECP under clause (A)(v) of the ECP definition if it does not qualify as an ECP under clause (A)(iv) of the ECP definition set forth in CFTC Regulation § 1.3(m)(6). *See, e.g.*, meeting with SIFMA – AMG on August 2, 2011. The look-through provision is limited to determining ECP status under clause (A)(iv) or clause (A)(v) of the ECP definition for purposes of retail forex transactions entered into by Forex Pools. The look-through provision does not reference or implicate ECP status for purposes of CEA section 2(e) (which prohibits non-ECPs from entering into swaps other than on or subject to the rules of a DCM), Securities Act section 5(d) (which prohibits a person from offering to sell, offering to buy or purchase, or selling a security-based swap to a person that is a non-ECP unless a registration statement under the Securities Act is in effect with respect to that security-based swap), or Exchange Act section 6(l) (which prohibits a person from effecting a transaction in a security-based swap with or for a person that is a non-ECP unless the transaction is effected on a national securities exchange registered with the SEC). The prohibition in CFTC Regulation § 1.3(m)(6) on a commodity pool qualifying as an ECP under clause (A)(v) of the ECP definition if it does not qualify as an ECP under clause (A)(iv) of the ECP definition does not involve any look-through. Rather, in contrast with CFTC Regulation § 1.3(m)(5), CFTC Regulation § 1.3(m)(6) applies for purposes of all agreements, contracts and transactions for which ECP status is relevant. *See* part III.C, *infra*, for a discussion of the prohibition on a commodity pool qualifying as an ECP under clause (A)(v) of the ECP definition if it does not qualify as an ECP under clause (A)(iv) of the ECP definition.

universe of possible retail forex transaction counterparties.⁶⁴¹ At the time the Commissions issued the Proposing Release and throughout the comment period, the CFTC was the only Federal regulatory agency that had issued final rules governing retail forex transactions by its regulated persons and entities.⁶⁴² Since then, though, both the OCC and the FDIC finalized (effective July 15, 2011) rules governing retail forex transactions by Enumerated Counterparties regulated by those agencies.⁶⁴³ In addition, the SEC has issued interim temporary final rules (also effective July 15, 2011) governing retail forex transactions by registered broker-dealers.⁶⁴⁴ Also, the Federal Reserve Board proposed rules to govern retail forex transactions by its regulated banks on August 3, 2011.⁶⁴⁵ As a result of these regulatory actions, Forex Pools that are not ECPs due to the look-through provision and who are subject to a counterparty

⁶⁴¹ See also part III.G, *infra*, discussing CFTC Regulation § 1.3(m)(8), one effect of which is to eliminate the retail forex transaction counterparty restriction for Forex Pools qualifying as ECPs.

⁶⁴² See generally Part 5 of the CFTC's regulations, 17 C.F.R. § 5, and CFTC, Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries, 75 FR 55410 (Sept. 10, 2010). See also CFTC, Retail Foreign Exchange Transactions; Conforming Changes to Existing Regulations in Response to the Dodd-Frank Wall Street Reform and Consumer Protection Act 76 FR 56103 (Sept. 12, 2011).

⁶⁴³ See FDIC, Retail Foreign Exchange Transactions, 76 FR 40779 (July 12, 2011) (final FDIC retail forex rules); OCC, Retail Foreign Exchange Transactions, 76 FR 41375 (July 14, 2011) (final OCC retail forex rules); see also OCC, Retail Foreign Exchange Transactions, 76 FR 56094 (Sept. 12, 2011) (interim final OCC retail forex rules for federal savings associations and their operating subsidiaries).

⁶⁴⁴ See SEC, Retail Foreign Exchange Transactions, 76 FR 41676 (July 15, 2011). In the release accompanying the rules, the SEC requested comment on broker-dealers' involvement in retail forex transactions to inform the SEC in developing permanent rules to regulate these activities. See *id.* at 46181-83.

⁶⁴⁵ See Board, Retail Foreign Exchange Transactions (Regulation NN), 76 FR 46652 (Aug. 3, 2011) (proposed Board rules for retail forex transactions).

limitation⁶⁴⁶ may enter into retail forex transactions with any Enumerated Counterparty but for those regulated by the Federal Reserve Board.⁶⁴⁷

The Commissions believe that the final rules reasonably address commenters' concerns. In this regard, the Commissions note that in applying the look-through provision, the Commissions will consider the indirect participants in a transaction-level Forex Pool if such Forex Pool, a commodity pool holding a direct or indirect (through one or more intermediate tiers of pools) interest in such Forex Pool, or any commodity pool in which such Forex Pool holds a direct or indirect interest has been structured to evade Subtitle A of Title VII of the Dodd-Frank Act by permitting persons that are not ECPs to participate in agreements, contracts, or transactions described in section 2(c)(2)(B)(i) or section 2(c)(2)(C)(i) of the Commodity Exchange Act. One example of a scheme to evade would be if a commodity pool tier has been included in the structure of the Forex Pool primarily to provide non-ECP participants exposure to retail forex transactions rather than to achieve any other legitimate business purpose.⁶⁴⁸ One example of a "legitimate business purpose" that would not trigger the look-through provision is a

⁶⁴⁶ See part III.B.1, *supra*, discussing the applicability of the counterparty limitation.

⁶⁴⁷ Of course, upon the Board's finalization of its retail forex rules, U.S. financial institutions regulated by the Board also will be acceptable counterparties.

⁶⁴⁸ Feeder funds are usually added to commodity pool structures for purposes such as tax efficiency. A master-feeder structure "[permits] U.S. taxable investors to take advantage of investing in a U.S. limited partnership feeder fund, which[,] through certain elections made at the time the structure is established, is tax effective for such U.S. taxable investors" and "[permits] [n]on-U.S. and U.S. tax-exempt investors [to] subscribe via a separate offshore feeder company so as to avoid coming directly within the U.S. tax regulatory net applicable to U.S. taxable investors." Effie Vasilopoulos & Katherine Abrat, *The Benefits of Master-Feeder Fund Structures for Asian-based Hedge Fund Managers*, Hedge Fund Monthly (April 2004), available at http://www.eurekahedge.com/news/04apr_archive_Sidley_master_feeder.asp. Other benefits can include efficiencies gained by the use of only a single trading entity, avoiding the need to split trade tickets, eliminating the need to duplicate agreements with counterparties and greater economies of scale in administering the fund. *Id.*

FOF operated primarily for the purpose of investing in underlying funds and using retail forex transactions solely to hedge the currency risk posed by an unfavorable change in the exchange rate between the currency in which underlying funds accept investments and the currency in which FOF investors pay for their investments in the FOF.⁶⁴⁹ Similarly, the Commissions would not consider a commodity pool using retail forex transactions solely for bona fide hedging purposes⁶⁵⁰ with respect to currency risk as being structured to avoid the look-through provision.⁶⁵¹ The “participate in agreements, contracts, or transactions described in section 2(c)(2)(B)(i) or section 2(c)(2)(C)(i) of the Act” language of CFTC Regulation § 1.3(m)(5)(ii) is aimed at exposure to retail forex transactions as an asset class, investment strategy, or an end in itself, not at exposure to retail forex transactions solely designed for bona fide hedging purposes with respect to foreign exchange exposure arising in the course of a commodity pool’s business.⁶⁵²

⁶⁴⁹ Sidley notes that the typical FOF operates in this manner. See generally letter from Sidley for a more detailed discussion of these transactions.

⁶⁵⁰ In this context, bona fide hedging purposes means bona fide hedging purposes within the meaning and intent of CFTC Regulation § 1.3(z)(1), except that the requirement therein that the transaction or position be on a DCM or SEF that is a trading facility will not be a factor in the bona fide hedging purpose analysis. Compare CFTC Regulation § 4.5(c)(2)(iii)(A) (relying in part on the bona fide hedging concepts in CFTC Regulations §§ 1.3(z)(1) and 151.5 to provide relief from the CPO definition). See also CPO/CTA Compliance Release at 11256-11257 (discussing and declining to adopt commenters’ request to expand the definition of bona fide hedging to include risk management). Where a Forex Pool’s counterparty, but not the Forex Pool, is hedging its risks, it is not the case that the Forex Pool is entering the retail forex transaction solely to hedge its own risk.

⁶⁵¹ The examples mentioned in text should not be construed to mean that any other fact pattern does or does not constitute evasion, which must be determined on a case-by-case basis.

⁶⁵² Based on the same reasoning, the Commissions do not believe it was the intent of the look-through proviso in CEA section 1a(18)(A)(iv) to subject to a retail forex regime a single level commodity pool engaging in retail forex transactions solely for bona fide hedging purposes with respect to foreign exchange exposure arising in the course of a commodity pool’s operations. Consequently, the Commissions will interpret such a commodity pool as an ECP if it otherwise satisfies the terms of CEA section 1a(18)(A)(iv) even if such a pool has one or more non-ECP participants.

In applying the limited look-through provision in the final rule, the Commissions would consider a Forex Pool's direct participants to include not only persons that initially hold interests in the level of the commodity pool structure that enters into retail forex transactions, but also persons that can acquire those interests or that subsequently hold those interests. As applied to exchange-traded products ("ETPs") that are Forex Pools, any person that acquires an interest in the ETP Forex Pool in secondary market transactions would be a direct participant. ETPs typically issue shares only in the large aggregations or blocks (such as 50,000 ETP shares) called "Creation Units." An authorized purchaser, usually an investment bank, broker dealer or large institutional investor, may purchase a Creation Unit. After purchasing a Creation Unit, the authorized purchaser may hold the Creation Unit, or sell some or all of the ETP shares in the Creation Unit to investors in secondary market transactions by splitting up the Creation Unit and selling the individual ETP shares on a national securities exchange or in off-exchange transactions. The ability to break up the Creation Unit into ETP shares permits other investors, such as non-ECPs, to purchase the individual ETP shares in secondary market transactions.

All participants in an ETP Forex Pool must be ECPs when they purchase or otherwise acquire an interest in the ETP Forex Pool. In addition, an ETP Forex Pool will not be able to verify whether the persons that acquire interests in the ETP Forex Pool in exchange transactions are ECPs. The ability of non-ECPs to acquire interests in an ETP Forex Pool and the inability of the ETP Forex Pool to verify ECP status with respect to exchange transactions create a presumption that ETP Forex Pools are not ECPs and, therefore, are Retail Forex Pools. This presumption would not apply in the case of a Forex Pool that is structured in a manner that does not involve exchange trading and in which the Forex Pool would be able to verify the ECP status of its participants.

One commenter suggested that the Commissions allow commodity pools and their counterparties to rely on participant ECP representations provided in connection with an initial investment.⁶⁵³ The Commissions note that the obligation to determine that the parties to retail forex transactions are ECPs is imposed on the CPOs of Forex Pools and the counterparties looking to enter into retail forex transactions with Forex Pools. In making that determination, the Commissions expect CPOs and retail forex transaction counterparties to Forex Pools to be guided by the principles for verifying the ECP status of a swap dealer's or major swap participant's counterparty discussed in the CFTC's recently adopted external business conduct standards, including the safe harbor.⁶⁵⁴ Thus, solely for purposes of CEA section 1a(18)(A)(iv) and CFTC Regulation § 1.3(m)(5), the Commissions will permit CPOs and retail forex transaction counterparties to rely on written representations from, as applicable, pool participants or potential pool participants that the person making the representation is an ECP (or is a non-U.S. person; as discussed below in this section III.B.4., solely for purposes of CEA section 1a(18)(A)(iv) and CFTC Regulation § 1.3(m)(5), the Commissions will consider Forex Pools whose participants are limited solely to non-U.S. persons (and which are operated by CPOs located outside of the U.S., its territories or possessions) to be ECPs), or from Forex Pools that the Forex Pool is an ECP, provided that the CPO or retail forex transaction counterparty has a reasonable basis to so rely, just as swap dealers and major swap participants are permitted to do pursuant to the safe harbor in new CFTC Regulation § 23.430(d), 17 C.F.R. § 23.430(d). Solely for purposes of CEA section 1a(18)(A)(iv) and CFTC Regulation § 1.3(m)(5), a CPO or retail

⁶⁵³ See letter from Sidley.

⁶⁵⁴ See CFTC, Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties; Final Rule, 77 FR 9733 (Feb. 17, 2012).

forex transaction counterparty will have a reasonable basis to rely on such written representations if the person making the representation specifies therein the provision(s) of, as applicable, section 1a(18) of the CEA or CFTC Regulation § 4.7(a)(1)(iv) pursuant to which the person qualifies as an ECP or a non-U.S. person, respectively, unless it has information that would cause a reasonable person to question the accuracy of the representation.⁶⁵⁵ Solely for purposes of CEA section 1a(18)(A)(iv) and CFTC Regulation § 1.3(m)(5), persons representing that they qualify as non-U.S. persons based on CFTC Regulation § 4.7(a)(1)(iv)(D) must represent that they are relying on such provision as modified as discussed below (*i.e.*, without the 10% carve-out for U.S. persons).

Furthermore, the CFTC recognizes that, despite a counterparty's reasonable good faith efforts to ensure that Forex Pools do not in fact have any U.S. participants, a situation may arise where a Forex Pool does turn out to have U.S. participants. If a counterparty has reasonable policies and procedures in place to verify the ECP status of Forex Pool counterparties and, notwithstanding such reasonable good faith efforts and following such policies and procedures, enters into retail forex transactions with such a Forex Pool in good faith and it was subsequently determined that U.S. participants represented no more than a de minimis number of participants or amount of ownership of the Forex Pool, absent other material factors, the CFTC would not expect to bring an enforcement action against the counterparty for entering into a retail forex transaction in contravention of the requirements of the retail forex regime. For purposes of this analysis only, and without this being viewed as a de minimis threshold for purposes of this rule or otherwise, the CFTC would consider as de minimis, ownership of units of participation of a

⁶⁵⁵ Cf. CFTC Regulation §§ 23.430(d), 23.402(d).

Forex Pool held by U.S. participants of less than 10% of the beneficial interest in the Forex Pool. The fact that, absent other material factors, the CFTC would not expect to bring an enforcement action against a forex transaction counterparty in such case does not relieve any obligation on the part of the CPO of the Forex Pool either to register as a CPO, claim the 4.13(a)(3) exemption therefrom or redeem the U.S. participants as described above.

One commenter suggested that the Commissions allow commodity pools and their counterparties to rely on participant ECP representations provided in connection with an initial investment.⁶⁵⁶ The Commissions believe that if participants make ECP representations in connection with an initial investment in a Forex Pool, absent an additional investment (which would require a new ECP verification, other than in the case of automatically reinvested distributions), the subsequent loss of a participant's ECP status would not cause the Forex Pool to lose its own ECP status for purposes of retail forex transactions so long as the operating agreement of the Forex Pool or the subscription or other agreement pursuant to which the participant invested in the Forex Pool requires the participant to advise the CPO of the Forex Pool promptly of a loss of the participant's ECP status. In the event of the loss of ECP status of a participant, the CPO would be required to redeem the non-ECP from the Forex Pool at the first opportunity following notification to avoid the Forex Pool losing its ECP status for subsequent retail forex transactions.

The Commissions are mindful that several commenters indicated that CPOs do not customarily include a question or representation as to ECP status in subscription agreements for

⁶⁵⁶ See letter from Sidley. The Commissions note that the obligation to determine that the parties to retail forex transactions are ECPs is imposed on the CPOs of Forex Pools and the persons looking to engage in retail forex transactions with Forex Pools.

pool participants, and stated that requiring CPOs to qualify or redeem existing participants due to the new look-through provision would be expensive, burdensome and disruptive.⁶⁵⁷ In this regard, the Commissions note that the look-through requirement for commodity pools was imposed by statute. As a result of the Commissions adopting the limited look-through in the final rule (as compared to the proposed indefinite look-through), however, the number of commodity pools subject to the look-through provision should be dramatically reduced, reducing the number of pools subject to regulation of their retail forex transactions, and the associated costs, accordingly.⁶⁵⁸

Also, in response to commenter concerns that the look-through provision would be applied to entities other than commodity pools (e.g., operating companies),⁶⁵⁹ the Commissions revised the text of CFTC Regulation § 1.3(m)(5)(i) to reflect their intent to apply the look-through provision solely to commodity pools qualifying as ECPs, if at all, under clause (A)(iv) and clause (A)(v) of the ECP definition.⁶⁶⁰ This is consistent with the statutory text, which is

⁶⁵⁷ See, e.g., letter from SIFMA AMG IV.

⁶⁵⁸ The adoption of CFTC Regulation § 1.3(m)(8), discussed in part III.G, *infra*, also should reduce the number of pools subject to regulation of their retail forex transactions, and the associated costs, accordingly.

⁶⁵⁹ See, e.g., letter from Sandalwood Securities, Inc. (expressing concern that “the Proposed Rule extends Dodd-Frank’s limited look-through provision to all sub-sections of section 1a(12)”).

⁶⁶⁰ Thus, for example, investment companies qualifying under clause (A)(iii) of the ECP definition and employee benefit plans qualifying under clause (A)(vi) of the ECP definition (and, as stated in each clause, “a foreign person performing a similar role or function subject as such to foreign regulation”) would not be covered by the look-through provision. To the extent that other entities would otherwise be captured by the look-through as proposed (such as collective investment trusts whose investors are ERISA plans not excluded from the commodity pool definition by CFTC Regulation § 4.5(a)(4) and which qualify as ECPs under clause (A)(v) of the ECP definition), the Commissions believe that focusing on the level of the Forex Pool entering into the retail forex transactions, and such Forex Pool’s direct participants (absent evasion), should alleviate such concerns.

limited to looking through commodity pools under clause (A)(iv) of the ECP definition, and the intent behind the look-through provision, as it relates to clause (A)(v) thereof.

Commenters also stated that Retail Forex Pools will no longer be able to enter into retail forex transactions with foreign financial institutions.⁶⁶¹ As discussed in section III.B.1. above, however, this is not the case with respect to retail forex transactions described in CEA section 2(c)(2)(C)(i)(I)(bb). With respect to retail forex transactions described in CEA section 2(c)(2)(B)(i)(I), this is a consequence of the express statutory text of the Dodd-Frank Act, which removed non-U.S. financial institutions from the list of Enumerated Counterparties eligible to enter into retail forex transactions with non-ECPs.⁶⁶²

Commenters further suggested generally that the Commissions create additional categories of ECPs to address the Commissions' concerns regarding the potential loophole of Retail Forex Pools that are unable to qualify as ECPs due to the new look-through provision in clause (A)(iv) of the ECP definition qualifying as an ECP under clause (A)(v) of the ECP definition. While one commenter proposed adopting a new rule clarifying that Forex Pools comprised entirely of QEPs and operated by persons subject to regulation under the CEA are ECPs,⁶⁶³ Congress chose to look to ECP status of Forex Pool participants, not QEP status, as the basis for determining whether such Forex Pools are ECPs. Therefore, it is more appropriate to

⁶⁶¹ Cf. letters from Sidley and Millburn Ridgefield Corporation ("Millburn").

⁶⁶² See section 742(c) of the Dodd-Frank Act, amending CEA section 2(c)(2)(B)(i)(II)(aa), 7 U.S.C. 2(c)(2)(B)(i)(II)(aa).

⁶⁶³ See letter from Sidley. This commenter also suggested deeming non-U.S. persons to be ECPs by definition. The Commissions have addressed this comment below in this section in response to the comment regarding the extraterritorial impact of the proposed ECP rules.

rely on Retail Forex Pool participants' ECP status than to rely on QEP status to establish ECP status.

One commenter stated a concern regarding what it characterized as the lack of clarity surrounding the extraterritoriality impact of the proposed ECP rules.⁶⁶⁴ The Commissions recognize the potential consequences of the broad look-through language in CEA section 1a(18)(A)(iv)⁶⁶⁵ and are providing guidance as to the application of the look-through to Forex Pools whose participants are limited solely to non-U.S. persons and which are operated by CPOs located outside the United States, its territories or possessions.

As discussed below, while foreign entities are not necessarily immune from U.S. jurisdiction for commercial activities undertaken with U.S. counterparties or in U.S. markets, canons of statutory construction "assume that legislators take account of the legitimate sovereign interests of other nations when they write American laws,"⁶⁶⁶ particularly when limited U.S. interests are at stake.⁶⁶⁷

⁶⁶⁴ See letter from AIMA I.

⁶⁶⁵ 7 U.S.C. 1a(18)(A)(iv).

⁶⁶⁶ See F. Hoffman-LaRoche, Ltd. v. Empagran S.A., 542 U.S. 155, 164 (2004), citing Murray v. Schooner Charming Betsy, 2 Cranch 64, 118, 2 L.Ed. 208 (1804) ("[A]n act of congress ought never to be construed to violate the law of nations if any other possible construction remains"); Hartford Fire Insurance Co. v. California, 509 U.S. 764 (1993) (Scalia, J., dissenting). See also Restatement (Third) Foreign Relations Law § 403 (scope of a statutory grant of authority must be construed in the context of international law and comity including, as appropriate, the extent to which regulation is consistent with the traditions of the international system).

⁶⁶⁷ See also CFTC, Exemption From Registration for Certain Foreign Persons, 72 FR 63976 (Nov. 14, 2007) (where the CFTC stated that:

given this agency's limited resources, it is appropriate at this time to focus [the Commission's] customer protection activities upon domestic firms and upon firms soliciting or accepting orders from domestic users of the futures markets and that the protection of foreign customers of firms confining their activities to areas outside this country, its territories, and possessions may best be for local authorities in such areas)

The Commissions do not believe that Congress intended for Forex Pools with no U.S. participants and operated by CPOs located outside the United States, its territories or possessions to be subject to a U.S. retail forex regime and, therefore, will consider Forex Pools whose participants are limited solely to non-U.S. persons and which are operated by CPOs located outside the United States, its territories or possessions to be ECPs for purposes of CFTC Regulation § 1.3(m)(5). For this purpose, a Forex Pool participant is a non-U.S. person if it satisfies the definition of "Non-United States person" in CFTC Regulation 4.7(a)(1)(iv); provided, however, that, if a participant is an entity organized principally for passive investment, such as a pool, investment company or other similar entity, such entity will be considered to be a Non-United States person under paragraph (D) of CFTC Regulation 4.7(a)(1)(iv) for purposes of CFTC Regulation § 1.3(m)(5) solely if all units of participation in such passive investment vehicle participant are held by Non-United States persons.⁶⁶⁸ A broader interpretation or relief is not appropriate at this time.⁶⁶⁹

(citing CFTC, Introducing Brokers and Associated Persons of Introducing Brokers, Commodity Trading Advisors and Commodity Pool Operators; registration and Other Regulatory Requirements, 48 FR 35248, 35261 (Aug. 3, 1983)).

⁶⁶⁸ CFTC Regulation § 4.7(a)(i)(iv)(D) lists the following as one category of non-United States person:

An entity organized principally for passive investment such as a pool, investment company or other similar entity; Provided, That units of participation in the entity held by persons who do not qualify as Non-United States persons or otherwise as qualified eligible persons represent in the aggregate less than 10% of the beneficial interest in the entity, and that such entity was not formed principally for the purpose of facilitating investment by persons who do not qualify as Non-United States persons in a pool with respect to which the operator is exempt from certain requirements of part 4 of the Commission's regulations by virtue of its participants being Non-United States persons.

It would be inappropriate to disregard the presence of U.S. persons constituting as much as 10% of such entities' participants in the context of this interpretive guidance. As discussed elsewhere herein, however,

C. ECP Status for Commodity Pools under Clause (A)(v) vs. under Clause (A)(iv) of the ECP Definition

1. Proposed Approach

The Commissions stated in the Proposing Release that they believe “some commodity pools unable to satisfy the total asset or regulated status components of clause (A)(iv) of the ECP definition may rely on clause (A)(v) to qualify as ECPs instead.”⁶⁷⁰ The Commissions further stated in the Proposing Release that “a commodity pool that cannot satisfy the monetary and regulatory status conditions prescribed in clause (A)(iv) should not qualify as an ECP in reliance on clause (A)(v) of the ECP definition.”⁶⁷¹ Based on those views, the Commissions proposed to further define the term “eligible contract participant” to prevent such a commodity pool from qualifying as an ECP pursuant to clause (A)(v) of the ECP definition. This proposal applied to all commodity pools, not just Forex Pools engaged in retail forex transactions.

2. Commenters’ views

Two commenters argued that, had Congress wished to prevent commodity pools from relying on the general ECP provision for business entities in clause (A)(v), it could have expressly excluded commodity pools from clause (A)(v).⁶⁷² Another commenter attempted to

entities described in CEA section 1a(18)(A)(iii) or (vi), 7 U.S.C. 1a(18)(A)(iii) or (vi), are not subject to the look-through and are ECPs irrespective of the ECP status of their participants.

⁶⁶⁹ Cf. CPO/CTA Compliance Release at 11264 (stating that “it is prudent to withhold consideration of a foreign advisor exemption until the [CFTC] has received data regarding such firms on Forms CPO-PQR and/or CTA-PR . . . to enable the [CFTC] to better assess [which] firms . . . may be appropriate to include within the exemption, should the [CFTC] decide to adopt one”).

⁶⁷⁰ Proposing Release, 75 FR at 80185.

⁶⁷¹ Id.

⁶⁷² See letters from Sidley and Skadden.

illustrate that clause (A)(v) of the ECP definition is an independent basis for qualifying as an ECP by distinguishing clause (A)(v) from clause (A)(iv).⁶⁷³

One commenter expressed the view that it is unclear whether “subject to regulation under this Act” in CEA section 1a(18)(A)(iv)(II)⁶⁷⁴ means a registered CPO or something else (*e.g.*, a person excluded from the definition of a CPO, a CPO exempt from registration conditioned in part upon making a filing to claim such relief).⁶⁷⁵

3. Final rule

The Commissions are adopting CFTC Regulation § 1.3(m)(6) as proposed, which states that “[a] commodity pool that does not have total assets exceeding \$5,000,000 or that is not operated by a person described in subclause (A)(iv)(II) of section 1a(18) of the Act is not an eligible contract participant pursuant to clause (A)(v) of such Section.”⁶⁷⁶ As noted, the Commissions are concerned that clause (A)(v) of the ECP definition may undermine the protections that specifically apply to commodity pool participants pursuant to the limitations on ECP status for commodity pools set forth in clause (A)(iv) of the ECP definition. Allowing a commodity pool

⁶⁷³ See letter from Akin Gump. Akin Gump noted that “[a]s opposed to [clause] (A)(iv), [clause] (A)(v) includes as one means of satisfying its criteria that the entity be entering into a contract for hedging purposes.” While correct, clause (A)(v) also includes as another means of satisfying its criteria that an entity enter into agreements, contracts or transactions in connection with the conduct of the entity’s business, which would be a much lower standard.

⁶⁷⁴ 7 U.S.C. 1a(18)(A)(iv)(II).

⁶⁷⁵ See letter from SIFMA AMG IV. CEA Section 1a(18)(A)(iv)(II) refers to a commodity pool that “is formed and operated by a person subject to regulation under this Act or a foreign person performing a similar role or function subject as such to foreign regulation (regardless of whether each investor in the commodity pool or the foreign person is itself an eligible contract participant) provided, however, that for purposes of section 2(c)(2)(B)(vi) and section 2(c)(2)(C)(vii), the term ‘eligible contract participant’ shall not include a commodity pool in which any participant is not otherwise an eligible contract participant.”

⁶⁷⁶ The Commissions have made certain technical corrections to proposed CFTC Regulation § 1.3(m)(6)(i) as concerns its citations to the CEA.

that cannot satisfy the monetary and regulatory status conditions prescribed for commodity pools in clause (A)(iv) to qualify as an ECP under clause (A)(v) would undermine these protections.

The Commissions acknowledge the comments stating that clause (A)(v) of the ECP definition is an independent basis for qualifying as an ECP and that Congress did not explicitly provide that a commodity pool that fails to qualify as an ECP under clause (A)(iv) cannot do so under clause (A)(v). However, when specifically legislating for commodity pools, Congress determined that total assets of \$5 million and operation by a person subject to regulation under the CEA (or a foreign equivalent) are necessary to assure appropriate protection for non-ECP participants in a commodity pool. Furthermore, the commenters' view that Congress's use of the disjunctive term "or" between clauses (A)(x) and (A)(xi) of the ECP definition means that an entity can rely on clause (A)(v) of the ECP definition, notwithstanding that such entity cannot satisfy a prong more specific to it, would largely render superfluous each clause under subparagraph (A) of the ECP definition other than clause (v) and clause (xi) (for individuals).⁶⁷⁷ As such, the Commissions believe that the final rule adopted in this release is consistent with Congressional intent.

The Commissions also are mindful that one commenter expressed a concern that the Commissions' reliance on clause (A)(iv) of the ECP definition might cause commodity pools to lose their ability to claim ECP status under clauses of the ECP definition, other than clause (v), and asked the Commissions to clarify the meaning of the phrase "formed and operated by a person subject to regulation under the [CEA]" in clause (A)(iv).⁶⁷⁸ In response, the

⁶⁷⁷ Interpreting statutory language as surplusage is disfavored. Effect should be given to every clause and word of a statute. See Negonsott v. Samuels, 507 U.S. 99 (1993).

⁶⁷⁸ See letter from SIFMA AMG IV.

Commissions note that a commodity pool that does not qualify for ECP status under clause (A)(iv) of the ECP definition may still qualify as an ECP under either of the two clauses of the ECP definition other than clause (A)(v) applicable to subcategories of commodity pools. Thus, registered investment companies and foreign equivalents may qualify as ECPs under clause (A)(iii) of the ECP definition, and ERISA plans and the other entities described in clause (A)(vi) of the ECP definition may qualify as ECPs thereunder. The Commissions' actions in this release do not change that result.

Also, with regard to that commenter's request for clarification, for purposes of CFTC Regulation § 1.3(m)(6), the Commissions interpret the language "subject to regulation under the [CEA]" in clause (A)(iv) of the ECP definition as requiring lawful operation of the commodity pool by a person excluded from the CPO definition, a registered CPO, or a person properly exempt from CPO registration.⁶⁷⁹ Congress did not limit ECP status under clause (A)(iv) to commodity pools operated by persons registered as CPOs; it used the more encompassing phrase "subject to regulation" under the CEA.⁶⁸⁰ On the other hand, to construe that phrase to include

⁶⁷⁹ For these purposes, the Commissions would take the same approach to insignificant deviations from exemptive filings as the CFTC does in CFTC Regulation § 4.7(e).

⁶⁸⁰ If the Commissions interpreted the "subject to regulation under this Act" language in CEA section 1a(18)(A)(iv)(II) to mean that the commodity pool operator must be registered as a CPO and limited CPOs to claiming ECP status solely under clause (iv) of the ECP definition, then the operators of all commodity pools trading swaps would have to register as CPOs to be ECPs. While more CPOs will be registering with the CFTC because the CFTC has withdrawn CFTC Regulation § 4.13(a)(4), see CPO/CTA Compliance Release, and the Dodd-Frank Act has expanded the scope of the transactions within the CFTC's jurisdiction, thus reducing the number of CPOs who can rely on the 5 percent threshold in CFTC Regulation § 4.13(a)(3) and thus claim the CPO registration exemption, the CFTC did not withdraw 4.13(a)(3), so some CPOs will be able to continue to rely on it. Also, not all persons operating commodity pools will be CPOs. See CFTC Regulation § 4.5 (exclusion from the definition of the term "commodity pool operator"). The Commissions do not believe Congress intended commodity pool ECP status to require CPO registration by the commodity pools' operators in all cases.

any person operating a commodity pool would render the phrase superfluous.⁶⁸¹ The commenters' view would enable a CPO that fails to register as required to claim that the commodity pool it operates is an ECP under clause (A)(v) and thus is not subject to regulation of its retail forex transactions. The Commissions believe that construing the phrase "formed and operated by a person subject to regulation under the [CEA]" to refer to a person excluded from the CPO definition, registered as a CPO or properly exempt from CPO registration appropriately reflects Congressional intent.

D. Dealers and Major Participants as ECPs

1. Proposed Approach

The Commissions proposed to add swap dealers, security-based swap dealers, major swap participants and major security-based swap participants to the ECP definition on the basis that such persons "are likely to be among the most active and largest users of swaps and security-based swaps."⁶⁸²

2. Commenters' views

Several commenters supported the proposed addition of swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants to the ECP definition.⁶⁸³ No commenter opposed this aspect of the proposal.

3. Final rule

⁶⁸¹ If the mere act of forming or operating a commodity pool means that a person is "subject to regulation" under the CEA, then the "subject to regulation" language would not be needed.

⁶⁸² Proposing Release, 75 FR at 80184.

⁶⁸³ One representative commenter stated that "the proposed definition in CFTC Proposed CFTC Regulation § 1.3(m)(1)-(4) fills important gaps left by Congress by ensuring that major swap participants, major security-based swap participants, swap dealers and security-based swap dealers are treated as ECPs." See letter from Sidley.

The Commissions are adopting the new ECP categories as proposed. The rules as adopted clarify that the terms “swap dealer,” “security-based swap dealer,” “major swap participant,” and “major security-based swap participant” have their respective meanings as defined in the CEA and the Exchange Act and as otherwise further defined by the Commissions.⁶⁸⁴

E. Government Entities: Incorrect Cross-Reference

1. Description of the Issue

Clause (A)(vii) of the ECP definition conditions the ECP status of governmental entities, and their political subdivisions, agencies, instrumentalities and departments (collectively, “government entities”), in part, on the identity of their counterparties. Specifically, a government entity may qualify as an ECP under the provision in clause (A)(vii) that requires the entity’s counterparty to be “listed in any of subclauses (I) through (VI) of section 2(c)(2)(B)(ii)” of the CEA.⁶⁸⁵ However, subclauses (I) through (III) of CEA section 2(c)(2)(B)(ii)⁶⁸⁶ are unrelated to counterparty types (rather, they describe the dollar amounts that apply for purposes of retail forex transactions under CEA section 2(c)(2)(B)), and subclauses (IV) through (VI) of CEA section 2(c)(2)(B)(ii) no longer exist in the statute. Read literally, then, this provision of the ECP definition is inherently a nullity and, thus, cannot enable government entities to qualify as ECPs.⁶⁸⁷

⁶⁸⁴ These new ECP categories are set forth in new CFTC Regulation § 1.3(m)(1)-(4).

⁶⁸⁵ CEA section 1a(18)(A)(vii)(cc), 7 U.S.C. 1a(18)(A)(vii)(cc).

⁶⁸⁶ 7 U.S.C. 2(c)(2)(B)(ii)(I)-(III).

⁶⁸⁷ A government entity, though, can still qualify as an ECP under the other provisions of clause (A)(vii) if it is a certain type of “eligible commercial entity” as defined in CEA section 1a(17), 7 U.S.C. 1a(17), or owns and invests on a discretionary basis \$50 million or more in investments.

2. Commenters' views

One commenter traced the history of the relevant provisions and concluded that the reference to subclauses (I) through (VII) of CEA section 2(c)(2)(B)(ii) in clause (A)(vii) of the ECP definition is erroneous.⁶⁸⁸ This commenter pointed instead to CEA section 2(c)(2)(B)(i)(II)⁶⁸⁹ as the reference that should be included in clause (A)(vii) of the ECP definition because it lists the entities that are eligible to serve as counterparties in retail forex transactions.

This commenter noted that the cross-reference in clause (A)(vii) of the ECP definition was correct when it was added to the CEA as part of the CFMA, but that it became incorrect in 2008 when an unrelated amendment to the CEA was enacted⁶⁹⁰ that changed the numbering of the CEA's provisions governing retail forex transactions but that failed to make a conforming amendment to clause (A)(vii) of the ECP definition. As a result of this 2008 amendment to the CEA, the list of entities that formerly appeared in subclauses (I) through (VI) of CEA sections 2(c)(2)(B)(ii) now appear in items (aa) through (ff) of CEA section 2(c)(2)(B)(i)(II) instead.⁶⁹¹ This commenter requested that "the Commissions correct this clearly erroneous reference in the definition of ECP through interpretive guidance, rulemaking or Commission order."⁶⁹²

3. Interpretive Guidance

⁶⁸⁸ See letter from Wells Fargo dated June 3, 2011 ("Wells Fargo I").

⁶⁸⁹ 7 U.S.C. 2(c)(2)(B)(i)(II).

⁶⁹⁰ See section 13101 of the CRA.

⁶⁹¹ 7 U.S.C. 2(c)(2)(B)(i)(II)(aa)-(ff).

⁶⁹² See letter from Wells Fargo I.

Clause (A)(vii) of the ECP definition contains an erroneous cross-reference to subclauses (I) through (VI) of CEA section 2(c)(2)(B)(ii). Accordingly, the Commissions are issuing interpretive guidance by identifying the counterparties with which a governmental entity can enter into swaps to attain ECP status under the provision in clause (A)(vii) that requires the entity's counterparty to be "listed in any of subclauses (I) through (VI) of section 2(c)(2)(B)(ii)" of the CEA. The Commissions consider a government entity covered by the counterparty limitation in clause (A)(vii) to be an ECP with respect to an agreement, contract, or transaction that is offered by, and entered into with, a person that is listed in items (aa) through (ff) of section 2(c)(2)(B)(i)(II) of the CEA. The limitation of ECP status "with respect to" a particular transaction is consistent with Congress' determination that, for purposes of this provision of clause (A)(vii), governmental entities may derive their ECP status from the status of their counterparty.

F. Qualification as an ECP with respect to swaps used to hedge or mitigate commercial risk in connection with the conduct of an entity's business

1. Proposing Release

In the Proposing Release, the Commissions requested comment on whether any additional categories should be added to the definition of ECP, "such as the following categories suggested by commenters [on the ANPRM]: Commercial real estate developers; energy or agricultural cooperatives or their members; or firms using swaps as hedges pursuant to the terms of the CFTC's Swap Policy Statement."⁶⁹³ As noted above, the ECP definition is important

⁶⁹³ See Proposing Release, 75 FR at 80185. The reference to the "Swap Policy Statement" is to the CFTC's Policy Statement Concerning Swap Transactions, 54 FR 30694 (July 21, 1989). The Swap Policy Statement "identifie[d] those swap transactions which [were] not . . . regulated as futures or commodity option transactions under the [CEA] or the related regulations." 54 FR at 30694. One element of the Swap Policy Statement required that the swap be entered into in connection with each swap

because the Dodd-Frank Act amended the CEA to prohibit a person that is not an ECP from entering into swaps other than on or subject to the rules of a DCM.⁶⁹⁴

2. Commenters' views

Several commenters supported the addition of categories to the definition of ECP because, these commenters said, not all current swap market participants are ECPs. Many of these commenters said that non-ECPs have entered into swaps in reliance on the Swap Policy Statement.⁶⁹⁵ Commenters highlighted, among other things, the importance of the Swap Policy Statement to pass-through entities used by farmers,⁶⁹⁶ operating companies⁶⁹⁷ and commercial

counterparty's line of business. *Id.* at 30697. The Swap Policy Statement was applicable to cash-settled swaps only, with foreign exchange considered to be cash for this purpose. *Id.* at 30696. The Swap Policy Statement required that the terms of the relevant swap be individually tailored, meaning that the material terms of the swap had to be negotiated, the parties had to make individualized credit determinations, and the swap documentation could not be fully standardized. *Id.* at 30696-97. The Swap Policy Statement did not apply to swaps subject to exchange-style offset, swaps that were cleared or subject to a margin system, or swaps marketed to the public. *Id.* As noted in the Product Definitions Proposal, the Dodd-Frank Act supersedes the Swap Policy Statement. 76 FR at 29829, n. 74.

⁶⁹⁴ The discussion in this section relates only to swaps and has no effect on the laws or regulations applicable to security-based swaps, security-based swap agreements or mixed swaps.

As noted above, the Dodd-Frank Act also amended the Exchange Act and the Securities Act to make it unlawful for a person to effect a transaction in a security-based swap with or for a person that is not an ECP unless the transaction is effected on a national securities exchange registered with the SEC, and to make it unlawful for a person to offer to sell, offer to buy or purchase, or sell a security-based swap to a person that is not an ECP unless a registration statement under the Securities Act is in effect with respect to that security-based swap.

⁶⁹⁵ See letter from CDEU. One commenter estimated that swap transactions completed by regional and community banks in reliance on the Swap Policy Statement constituted 30-40% of all of such banks' swaps, representing approximately 7,000 to 10,000 swaps per year and \$15 to \$20 billion in related loan principal. See letter from B&F I. Another commenter advised that it has entered 11 swaps, with a total notional of \$26 million, since its formation in 2007, almost all of the counterparties to which "qualified for the swap under the [Swap Policy Statement] business purpose exemption." See letter from Capstar. The CFTC stated when issuing the Swap Policy Statement that it "reflects the [CFTC]'s view that at this time most swap transactions, although possessing elements of futures or options contracts, are not appropriately regulated as such under the [CEA] and [CFTC] regulations." Swap Policy Statement at 30694.

⁶⁹⁶ See, e.g., letter from Rabobank, N.A., Rabo AgriFinance, Inc. and Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A. ("Rabobank, New York Branch") (relating that "[f]or a variety of estate

property developers,⁶⁹⁸ noting that such entities may not meet the ECP criteria. According to these commenters, these pass-through entities often are small and medium-sized businesses that enter into interest rate swaps with lending financial institutions in reliance on the Swap Policy Statement.⁶⁹⁹ The commenters explained that the loans usually are guaranteed by the principals of the entity entering into the swap, and that the borrower would qualify as an ECP if structured as a single-level corporate entity or sole proprietorship.⁷⁰⁰ Commenters said that if these non-ECP entities were limited to swaps that are available on or subject to the rules of a DCM, many regional bank borrowers would lose the ability to use swaps, real estate companies would have less flexibility in risk management, and smaller lenders would be at a competitive disadvantage.⁷⁰¹ Another commenter said that Dodd-Frank Act provisions such as the end-user clearing exception indicate that Congress intended to preserve the availability of swaps used for business reasons rather than for investment or speculation.⁷⁰²

planning and regulatory purposes, farmers commonly hold their ownership interests in land, buildings and farm equipment indirectly, through a network of legal entities”).

⁶⁹⁷ See, e.g., letter from Fifth Third Bank and Union Bank, N.A. (advising that “[i]t is common for an operating business to organize a separate limited liability company (for tax and legal reasons) to acquire . . . assets . . . and to lease these assets to the operating company[, which] becomes the borrow[er] . . . for the loan used to acquire those assets” and that “[t]he limited liability company often does not maintain sufficient capital to qualify as an ECP”).

⁶⁹⁸ See, e.g., letters from Capstar, Frost National Bank, FTN Financial Capital Markets, Midsize Banks and NAREIT.

⁶⁹⁹ See letters from BB&T I and B&F I. Commenters said that these businesses may intentionally maintain less than \$1 million in equity primarily for tax and legal reasons. See letters from Capital One and Columbia State Bank (stating that over 65% of its borrowers are structured as limited liability companies or S corporations and intentionally maintain less than \$1 million in equity at the entity entering into the swap).

⁷⁰⁰ See letter from Columbia State Bank. See also letter from BB&T I.

⁷⁰¹ See letters from BB&T I, Capital One, Capstar, Columbia State Bank, Midsize Banks, NAREIT and Wells Fargo II.

⁷⁰² See letter from FSR I.

To mitigate the impact of restricting non-ECPs to swaps that are available on or subject to the rules of DCMs, some commenters said that an entity should be able to qualify as an ECP based on the financial qualifications of related entities, so long as various conditions proposed by the commenters are satisfied. Some commenters said that an entity should be eligible to be an ECP if its swap obligations are guaranteed by an ECP,⁷⁰³ or if its controlling entity qualifies as an ECP under clause (A)(v) of the statutory definition.⁷⁰⁴ Another commenter suggested revisions to the ECP definition that included looking to the ECP status or sophistication of the majority owner of an entity in determining if the entity itself is an ECP.⁷⁰⁵ Other commenters suggested other provisions to allow non-ECPs to enter into swaps other than on or subject to the rules of a DCM, so long as the non-ECP meets various conditions indicating that the swap is used in connection with its line of business.⁷⁰⁶

Other commenters argued for per se ECP qualification based on their status as certain types of persons, such as farmers⁷⁰⁷ or for ECP status based solely on a combination of a person's status and the swap being related to a person's line of business with no additional conditions.⁷⁰⁸

⁷⁰³ See letters from BB&T I, Midsize Banks and Wells Fargo II.

⁷⁰⁴ See letters from CDEU and Regional Banks.

⁷⁰⁵ See letter from NAREIT.

⁷⁰⁶ See letters from the American Public Gas Association ("APGA"), Capital One and Gavilon dated December 23, 2010 ("Gavilon I").

⁷⁰⁷ See meeting with Ron Eliason on December 16, 2010 (in which Mr. Eliason contended that farmers should be able to enter into swaps, even if they do not meet the income or asset tests in the current ECP definition and, therefore, would not be permitted to enter into swaps other than on or subject to the rules of a DCM).

⁷⁰⁸ See letter from APGA (requesting that "the [CFTC] exercise its authority under section 1a(18)(C) of the Act and determine that public natural gas distribution companies, including member-owned co-

3. Final rules and interpretation

In response to the commenters' concerns, the CFTC is adopting CFTC Regulation § 1.3(m)(7) to permit an entity, in determining its net worth for purposes of subclause (A)(v)(III) of the ECP definition,⁷⁰⁹ to include the net worth of its owners, solely for purposes of determining its ECP status for swaps used to hedge or mitigate commercial risk, provided that all of its owners are themselves ECPs (disregarding shell companies). Under CFTC Regulation § 1.3(m)(7) as adopted, an entity seeking to qualify under subclause (A)(v)(III) of the ECP definition in order to enter into a swap used to hedge or mitigate commercial risk is permitted to count the net worth of its owners in determining its own net worth, so long as all its owners are ECPs. This regulation applies only to entities that are otherwise eligible to rely on subclause (A)(v)(III) to determine ECP status; it does not expand or change the scope of application of that paragraph.⁷¹⁰

CFTC Regulation § 1.3(m)(7) as adopted applies only when determining ECP status for swaps used to hedge or mitigate commercial risk. This new regulation does not apply when determining ECP status for other swaps or for security-based swaps, security-based swap

operatives, that enter into swaps in connection with their business of supplying customers with natural gas are ECPs within the meaning of section 1a(18) of the Act").

⁷⁰⁹ CEA section 1a(18)(A)(v)(III) provides that the term "eligible contract participant" includes "a corporation, partnership, proprietorship, organization, trust, or other entity . . . that (aa) has a net worth exceeding \$1,000,000; and (bb) enters into an agreement, contract, or transaction in connection with the conduct of the entity's business or to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by the entity in the conduct of the entity's business." 7 U.S.C. 1a(18)(A)(v)(III).

⁷¹⁰ For example, if a commodity pool were precluded by CFTC Regulation § 1.3(m)(6) from relying on clause (A)(v) of the statutory definition to qualify as an ECP, such pool would not be able to rely on CFTC Regulation § 1.3(m)(7) to qualify as an ECP.

agreements, mixed swaps, or agreements, contracts or transactions that are not swaps (regardless of the purpose for which they are used).

The Commissions have considered the comments indicating that, as currently structured, many businesses are owned by multiple legal entities and/or individuals, and the net worth of all the owners in the aggregate in some cases would satisfy the \$1 million net worth requirement in subclause (A)(v)(III), even though the particular legal entity that enters into a swap does not have a net worth exceeding \$1 million.⁷¹¹ While the Commissions recognize that the requirement, in subclause (A)(v)(III)(aa) of the ECP definition, that the entity relying on that paragraph have a net worth exceeding \$1 million evidences Congress' intent that only entities with this level of financial resources should be eligible for ECP status under this paragraph of the definition, the Commissions agree with commenters that application of this requirement in these circumstances would inappropriately limit the ability of business entities to use swaps to hedge or mitigate commercial risk. As a result, the Commissions are persuaded that in this limited situation, the entity should qualify as an ECP and be eligible to enter into swaps other than on or subject to the rules of a DCM, so long as the entity is using the swap to hedge or mitigate commercial risk and all of the owners of the entity are ECPs (other than shell companies).

In response to those commenters requesting per se ECP status or the ability to qualify as an ECP based on a combination of status and engaging in swaps related to a line of business,

⁷¹¹ See, e.g., letters from B&F I (stating that "[i]f the customer does not . . . [itself] meet the ECP definition, then the transaction would have to be guaranteed by any entity or individual who is an owner . . . [who] meets the \$10,000,000 total asset test of section 1(a)(18)(A)(v)(I) of the Act or the \$1,000,000 net worth test of section 1(a)(18)(A)(v)(III) of the Act."), NAREIT (urging that the Commissions impute ECP status to non-ECP entities involved in specified real estate businesses to such entities whose "majority owner or controlling entity" is an ECP) and Midsize Banks (recommending that the ECP determination be made with respect to a non-ECP entity's owners based on criteria including qualifying natural persons as ECPs based on a \$1,000,000 net worth).

without further restriction, the Commissions do not believe it is necessary or appropriate to further define the term ECP to such an extent in order to address most commenters' concerns. The Commissions note that such approaches would undermine the prohibition in CEA section 2(e)⁷¹² on non-ECPs executing swaps other than on or subject to the rules of a DCM. The Commissions also note that focusing solely on a link between a swap and a line of business would undermine the application of the ECP definition to swaps in that the various prongs of the ECP generally are linked to dollar thresholds, regulated status, or a combination of the two.

The Commissions also note that it currently is considering a draft petition for relief pursuant to CEA section 4(c)(6)(C)⁷¹³ for certain entities described in Federal Power Act section 201(f),⁷¹⁴ which may address the concerns of some commenters. Additionally, the Commissions are developing joint rules to further define the term "swap," including the forward exclusion from the swap definition which, in turn, may result in certain transactions not being considered swaps. Further, the CFTC also is considering today a form of trade option exemption, which may further address commenters' concerns.

With respect to farmers, in response to the CFTC's Commodity Options and Agricultural Swaps rulemaking proposal,⁷¹⁵ commenters generally were of the view that the ECP definition is appropriate in its current form.⁷¹⁶ While the Commissions may consider providing further relief

⁷¹² 7 U.S.C. 2(e).

⁷¹³ 7 U.S.C. 6(c)(6)(C).

⁷¹⁴ 16 U.S.C. 824(f).

⁷¹⁵ 76 FR 6095 (Feb. 3, 2011).

⁷¹⁶ See, e.g., letters from NCFC dated April 4, 2011 ("NCFC II") (stating "[o]n behalf of the more than two million farmers and ranchers who belong to one or more farmer cooperative(s), the [NCFC] . . . [believes] the limitation on participation [in agricultural swaps] to [ECPs] outside of a DCM . . . should limit [agricultural swap] participation to appropriate persons" and that "[t]he ECP requirement with a

should experience show, after the ECP definition becomes effective, that further relief is warranted, neither the ECP definition nor the various actions cited in the foregoing paragraph are final, so providing further relief is premature. The Commissions' measured approach, which builds on the existing net worth requirement in the general entity ECP category, provides broad relief to many of the commenters (e.g., borrowers generally) while otherwise adhering to the existing ECP categories.

The Commissions note that commenters said that, because of the way some businesses are structured for tax, estate planning or other purposes, they enter into swaps through a legal entity that does not, by itself, qualify as an ECP even though the net worth of the business and its owners, taken in the aggregate, would qualify as an ECP pursuant to subclause (A)(v)(III) of the ECP definition. The Commissions believe that the best way to address this concern is to allow such a business to consider the net worth of all its owners in determining whether the net worth requirement in subclause (A)(v)(III) is satisfied.⁷¹⁷

CFTC Regulation § 1.3(m)(7) is available only to an entity that seeks to qualify as an ECP under subclause (A)(v)(III) of the statutory definition in order to enter into a swap that will be used to hedge or mitigate commercial risk. The Commissions limited CFTC Regulation

threshold of \$1 million in net worth to be allowed to use swaps and options, other than on a DCM, is appropriate for the products cooperatives offer their members"), ; letter from NGFA dated April 4, 2011 ("NGFA II") (stating that "[t]he use of agricultural swaps has been constrained relative to other swaps by virtue of being subject to CFTC regulatory requirements, while other swaps have been exempted from CFTC oversight," "the Dodd-Frank Act . . . institutes a number of safeguards, including the limitation that only [ECPs] may engage in swaps unless entered into on a designated contract market," and "[t]he NGFA believes that these safeguards provide more-than-ample protection in the swaps marketplace for both agricultural and non-agricultural swaps and that there is no compelling reason to place additional burdens on agricultural swaps.").

⁷¹⁷ The Commissions note that this regulation provides an alternative means for certain business entities to qualify as ECPs. It neither diminishes nor qualifies in any way the requirement in CEA section 2(e) that persons that are not ECPs enter into swaps only on or subject to the rules of a DCM

§ 1.3(m)(7) to subclause (A)(v)(III) because this provision of the ECP definition is available to a business entity that uses swaps in connection with the conduct of its business or to manage risks associated with assets or liabilities related to the conduct of its business.⁷¹⁸

The purpose of CFTC Regulation § 1.3(m)(7) is to maintain the ability of business entities to enter into swaps other than on or subject to the rules of a DCM for limited purposes. This regulation therefore is available only with respect to a swap that is used to hedge or mitigate commercial risk within the meaning of CFTC Regulation § 1.3(kkk).⁷¹⁹ CFTC Regulation § 1.3(m)(7) applies only if all of an entity's owners qualify as ECPs under the provision of the ECP definition applicable to such owner. Although some commenters suggested that an entity should be able to qualify as an ECP based on the status of its majority or controlling owners,⁷²⁰ the Commissions believe that CFTC Regulation § 1.3(m)(7) should be available only when all of an entity's owners qualify as ECPs. The Commissions do not believe it would be appropriate to impair the protection of non-ECPs that flows from the requirement that non-ECPs enter into swaps only on or subject to the rules of a DCM.⁷²¹ In order to maintain these protections and prevent evasion, CFTC Regulation § 1.3(m)(7) provides that any shell company will be

⁷¹⁸ CEA section 1a(18)(A)(v)(III)(bb), 7 U.S.C. 1a(18)(A)(v)(III)(bb). The Commissions note that an entity that would qualify as an ECP under subclause (A)(v)(III) without application of CFTC Regulation § 1.3(m)(7) is not required to meet the conditions stated in, this regulation.

⁷¹⁹ See part IV.C. The use of the phrase "hedge or mitigate commercial risk" in CFTC Regulations §§ 1.3(m)(7) and 1.3(kkk) is similar to the use of the same phrase in the exception to the mandatory clearing requirement in CEA section 2(h)(7), 7 U.S.C. § 2(h)(7).

⁷²⁰ See, e.g., letter from NAREIT.

⁷²¹ See CEA section 2(e), 7 U.S.C. 2(e).

disregarded, and in order to determine if the underlying entity may use CFTC Regulation § 1.3(m)(7), each owner of such shell company must be an ECP.⁷²²

Correspondingly, in aggregating net worth for purposes of determining the ECP status of an entity pursuant to CFTC Regulation § 1.3(m)(7), if the entity is owned by a shell company, then it is the net worth of the owners of that shell company that is relevant, not the net worth of the shell company.⁷²³

Last, also in order to prevent evasion, CFTC Regulation § 1.3(m)(7)(ii)(C) specifies that an individual may rely on the proprietorship provision of clause (A)(v) of the statutory definition for purposes of determining its status as an ECP owner of an entity only if the proprietorship⁷²⁴

⁷²² See CFTC Regulation § 1.3(m)(7)(ii).

The term “shell company” means any entity that limits its holdings to direct or indirect interests in entities that are ECPs through reliance on CFTC Regulation § 1.3(m)(7). Any entity that holds at least one direct or indirect interest in an entity not relying on CFTC Regulation § 1.3(m)(7) would not be a shell company. The ECP status of owners of entities that are not shell companies is not relevant for purposes of CFTC Regulation § 1.3(m)(7), which should permit wider financing of small businesses using swaps to hedge or mitigate commercial risk.

To be clear, an individual will never be considered to be a shell company for purposes of CFTC Regulation § 1.3(m)(7).

⁷²³ This provision may apply repeatedly in a “chain.” For example, if in determining whether an entity may rely on CFTC Regulation § 1.3(m)(7), an owner of that entity that is a shell company is disregarded, then if the owner of that shell company is also a shell company, that second shell company also is disregarded, and so on.

⁷²⁴ A proprietorship generally is a business that a person operates in a personal capacity and with respect to which that person directly owns all the assets and directly is responsible for all of the liabilities, rather than through a corporation, partnership or other structure conveying limited liability. See letters from Midmarket Banks and Wells Fargo II (stating that “proprietors . . . typically are not separate legal entities”); see also State of California Franchise Tax Board Web site (advising that “[t]he business and the owner are one. There is no separate legal entity and thus no separate legal person”), at https://www.ftb.ca.gov/businesses/bus_structures/soleprop.shtml. A proprietorship is not a separate taxable entity but reports the income or loss of the business, which is taxed along with a sole proprietor’s other income, on a separate schedule attached to his or her individual federal income tax return. See letter from Midmarket Banks. See also 2011 Form 1040 Schedule C: Profit or Loss from Business (Sole Proprietorship), available at <http://www.irs.gov/pub/irs-pdf/f1040sc.pdf>; 2011 Instructions for Schedule C, available at <http://www.irs.gov/pub/irs-pdf/i1040sc.pdf>.

status arises independent of the business conducted by such entity⁷²⁵ and the individual proprietor acquires his/her interest in such entity (i) in connection with the conduct of the individual's proprietorship or (ii) to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by the proprietorship.⁷²⁶ The Commissions are adopting CFTC Regulation § 1.3(m)(7)(ii)(C) because they believe that the only circumstance in which a proprietorship should be considered an ECP for purposes of CFTC Regulation § 1.3(m)(7)(i) is if it is making an investment related to the proprietorship.⁷²⁷ The ECP status of an individual acting other than with respect to its proprietorship is determined based on the ECP clause applicable to individuals. The Commissions note that they have authority to take action to prevent evasion of the provisions regarding shell companies and proprietorships by entities relying on CFTC Regulation § 1.3(m)(7) to establish ECP status.

G. ECP Status for Forex Pools Operated by Registered CPOs or CPOs Exempt from Registration under Certain Conditions

1. Description of the Issue and Commenters' Views

Notwithstanding the modifications to the look-through provisions for Forex Pools discussed above in section III.B., the Commissions acknowledge commenters' concerns about the potential for unintended consequences arising from the look-through provisions of the Dodd-Frank Act. Several commenters asserted that many Forex Pools are operated by sophisticated,

⁷²⁵ CFTC Regulation § 1.3(m)(7)(ii)(C)(I) is designed to ensure that the individual qualifies as a proprietorship, if at all, other than due to its interest in either an entity seeking to qualify as an ECP under CFTC Regulation § 1.3(m)(7)(i) or in any other entity.

⁷²⁶ See CFTC Regulation § 1.3(m)(7)(ii)(C)(IV). This language is modeled on the language in 7 U.S.C. 1a(18)(A)(v)(III)(bb).

⁷²⁷ The Commissions note that this guidance regarding proprietorships applies only when an entity is relying on CFTC Regulation § 1.3(m)(7). The Commissions do not intend that this guidance would expand or limit the circumstances when a proprietorship may otherwise rely on clause (A)(v) of the statutory definition in establishing its ECP status.

professional managers that do not need the protections of a retail forex regime designed to protect non-ECPs that are engaging in retail forex transactions.⁷²⁸ More specifically, some commenters, based on CFTC enforcement actions involving Forex Pools, suggested that commodity pools of a sufficient size, and/or operated by a registered or exempt CPO, do not pose the risks of fraud and abuse of non-ECP customers that the statutory look-through provision is intended to address.⁷²⁹

As a result, commenters suggested that the look-through provision should not apply in determining ECP status of commodity pools that meet certain conditions. For example, commenters suggested that the look-through not be applied to a commodity pool with \$10 million in total assets paired with another or other factors, such as not being structured to evade,⁷³⁰ being subject to regulation under the CEA⁷³¹ or the CPO being registered as such.⁷³²

⁷²⁸ See, e.g., letters from Millburn (characterizing the proposed rules as “greatly limit[ing] the ability of entities managed by sophisticated money managers that are subject to registration and examination by regulators to qualify as ECPs”) and Sidley (describing “[a] commodity pool, like a registered investment company or an employee benefit plan, [a]s a pool of assets from investors of varying (and, in some cases, undetermined) levels of sophistication that are advised by a sophisticated adviser”).

⁷²⁹ See joint letter from the Global Foreign Exchange Division (“GXFD”) and MFA dated January 19, 2011 (“GXFD II”) (describing 35 CFTC Forex Pool enforcement cases from 2010 and 2011 and noting that in 80% of these cases, the amount at issue in the misconduct was less than \$10 million, and that only one case involved a registered CPO where the amount at issue in the misconduct was more than \$10 million; two additional cases involved misconduct involving CPOs exempt from registration as such under CFTC Regulation § 4.13(a). While the commenter did not characterize these amounts as “total assets” (instead, the commenter used terms such as “fraudulently obtained” or “sustained losses of” to modify the cited dollar amounts) in most cases, it is clear that these amounts are equivalent to, or subsets of, total assets. For instance, for a CPO to have fraudulently obtained \$10 million from commodity pool participants, the CPO must have taken in \$10 million from them, resulting in the commodity pool at one time having \$10 million in total assets. See also letter from Sidley (providing 26 examples of CFTC Forex Pool-related enforcement cases, all but one of which involved Forex Pools with less than \$50 million in total assets). A number of the cases cited by GXFD and Sidley overlap; in the aggregate, these commenters appear to have presented data on 45 different cases rather than 61.

⁷³⁰ See letter from GXFD II.

⁷³¹ See letters from GXFD II and Skadden.

Another commenter suggested requiring the total assets or minimum initial investment of a Forex Pool to be sufficiently large that, in general, only legitimate pools would exceed such thresholds.⁷³³ This commenter suggested a total asset threshold of \$50 million.⁷³⁴

Separately, one commenter also claimed that the statutory look-through, if strictly implemented, might inappropriately preclude Forex Pools and their CPOs, many of whom are registered, from engaging in retail forex transactions with swap dealers because swap dealers are not Enumerated Counterparties (and some swap dealers also may not be Enumerated Counterparties in a different capacity, such as being a U.S. financial institution).⁷³⁵ This commenter stated that such a result could reduce close out netting opportunities in the event of the insolvency of a counterparty.

2. Final Rule

In response to commenters, the CFTC is adopting CFTC Regulation § 1.3(m)(8), pursuant to which certain Forex Pools may qualify as ECPs notwithstanding the look-through requirement. As adopted, CFTC Regulation § 1.3(m)(8) enables a Forex Pool that enters into a

⁷³² See meeting with SIFMA on January 20, 2012 (in which representatives of SIFMA proposed a new non-exclusive set of criteria for a Forex Pool to qualify as an ECP, which included, as one of several alternatives in one element of the proposed criteria, that a Forex Pool be operated by a registered CPO). See also letter from Willkie Farr (observing that “[i]t may be time to regulate certain previously unregulated transactions and traders, so that more CPOs are registered” and that “many commodity pools are operated and advised by registered professionals”).

⁷³³ See letter from Sidley.

⁷³⁴ See *id.*

⁷³⁵ See joint letter from the GFXD and MFA dated January 10, 2012 (“GFXD I”). These commenters indicated that, while

[s]ome swap dealers may be dually licensed as a bank or a broker-dealer [and therefore] eligible to transact in OTC foreign exchange with retail investors as well as swaps with institutional investors . . . as an operational matter, it is not clear that firms will be able to and find it efficient to structure their business so that the retail foreign exchange platform is conducted from the same entity as the institutional swaps business.

retail forex transaction to qualify as an ECP with respect thereto, irrespective of whether each participant in the Forex Pool is an ECP, if the Forex Pool satisfies the following conditions:

- it is not formed for the purpose of evading CFTC regulation under Section 2(c)(2)(B) or Section 2(c)(2)(C) of the CEA or related CFTC rules, regulations or orders governing Retail Forex Pools and retail forex transactions);
- it has total assets exceeding \$10 million; and
- it is formed and operated by a registered CPO or by a CPO who is exempt from registration as such pursuant to CFTC Regulation § 4.13(a)(3).

CFTC Regulation § 1.3(m)(8) as adopted requires that the Forex Pool not be formed for the purpose of evading CFTC regulation of Retail Forex Pools and retail forex transactions under CEA Section 2(c)(2)(B) or (C). A Forex Pool that is formed for that purpose would not be an ECP under new CFTC Regulation § 1.3(m)(8).

CFTC Regulation § 1.3(m)(8) as adopted also requires that the Forex Pool have total assets exceeding \$10 million to qualify as an ECP. The \$10 million threshold is twice the current total asset threshold for a commodity pool to qualify as an ECP under CEA section 1a(18)(A)(iv). The Commissions believe the \$10,000,000 threshold is appropriate in light of the potential regulatory burdens a higher threshold might impose on smaller commodity pools. The Commissions believe that such a threshold, coupled with the other conditions of the rule, is sufficiently high to assure that the protections provided to retail forex transactions are not needed for these types of commodity pools. The Commissions will vigilantly monitor developments with respect to Forex Pools, including enforcement activity, and revisit this total asset threshold if warranted by subsequent events.

Finally, CFTC Regulation § 1.3(m)(8) as adopted requires that Forex Pool be formed⁷³⁶ and operated by a CPO registered as such with the CFTC or by a CPO who is exempt from registration as such pursuant to CFTC Regulation § 4.13(a)(3). The Commissions believe that the registered CPO aspect of this condition is appropriate for several reasons, including that it will ensure that the NFA oversees compliance by those registered CPOs relying on this new regulation.⁷³⁷ CPO registration also provides a clear means of addressing wrongful conduct.⁷³⁸ Although some commenters suggested that a CPO need only be “subject to regulation under the CEA” in order for a Forex Pool operated by that CPO to qualify as an ECP notwithstanding the look-through requirements, CFTC Regulation § 1.3(m)(8) instead requires that the CPO of a Forex Pool be registered as a CPO or be a CPO who is exempt from registration as such pursuant to CFTC Regulation § 4.13(a)(3), alternative conditions supported by other commenters. The

⁷³⁶ Given that (i) many CPOs will be registering as such for the first time due to the CFTC’s recent rescission of the exemption from CPO registration set forth in CFTC Regulation § 4.13(a)(4) or its modification of the criteria for claiming the exclusion from the CPO definition in CFTC Regulation § 4.5 and (ii) such pools were formed prior to their CPOs’ registration as such, commodity pools formed prior to December 31, 2012 need not have been “formed” by a registered CPO or by a CPO exempt from registration as such pursuant to CFTC Regulation § 4.13(a)(3) in order to be qualified as ECPs under the new prong, so long as they are operated by a registered CPO on or before such date.

⁷³⁷ See CPO/CTA Compliance Release at 11254 (noting that “registration allows the Commission to ensure that all entities operating collective investment vehicles participating in the derivatives markets meet minimum standards of fitness and competency”). See <http://www.nfa.futures.org/NFA-registration/cpo/index.html> for an overview of registration and related requirements for CPOs, their principals and their associated persons and <http://www.nfa.futures.org/NFA-compliance/NFA-commodity-pool-operators/index.html> for an overview of the compliance regime for registered CPOs overseen by the NFA. The CFTC anticipates that more CPOs will register in the coming months now that it has withdrawn the CFTC Regulation § 4.13(a)(4)-exemption from CPO registration, increasing the number of registered CPOs, in turn increasing the number of CPOs who can satisfy the registered CPO alternative under CFTC Regulation § 1.3(m)(8)(iii).

⁷³⁸ See CPO/CTA Compliance Release at 11254 (stating that “the [CFTC] has clear authority to take punitive and/or remedial action against registered entities for violations of the CEA or of the [CFTC]’s regulations . . . [and] to deny or revoke registration, thereby expelling an individual or entity from serving as an intermediary in the industry” and that the CFTC’s reparations program and the NFA’s arbitration program also are available avenues “to seek redress for wrongful conduct by a [CFTC] registrant”).

Commissions are requiring operation by a registered CPO, or by a CPO who is exempt from registration as such pursuant to CFTC Regulation § 4.13(a)(3), as a condition for a Forex Pool to qualify for ECP status under CFTC Regulation § 1.3(m)(8) because, based on the data presented by commenters, CFTC enforcement actions involving Forex Pools rarely involve registered CPOs or CPOs exempt from registration as such.⁷³⁹

While NFA oversight of CPOs operating Retail Forex Pools is a useful criterion to determine whether an exclusion from the look-through provisions of CEA section 1a(8)(A)(iv) and CFTC Regulation § 1.3(m)(5) is warranted, the Commissions believe that Retail Forex Pools operated by CPOs exempt from registration as such pursuant to CFTC Regulation § 4.13(a)(3) also merit relief from those look-through provisions. On September 10, 2010, the CFTC published in the Federal Register a final rule revising the CPO registration exemption in CFTC Regulation § 4.13(a)(3) to incorporate retail forex transactions into the transactions subject to the alternative caps on the use of commodity interests⁷⁴⁰ by CPOs claiming the exemption.⁷⁴¹ The CFTC explained in the related Federal Register proposing release that the proposed change to CFTC Regulation § 4.13(a)(3) was part of a proposal to adopt a comprehensive regulatory scheme to implement the CRA with respect to retail forex transactions ("CRA-Related Forex

⁷³⁹ As discussed above in note 729, only one of the 45 unique cases presented by commenters involved a pool with more than \$10 million in total assets and a registered CPO. Only two of those cases involved a pool operated by CPOs exempt from registration: in both of those cases, however, the CPO raised less than \$10 million. In addition, one of those CPOs relied on the CFTC Regulation § 4.13(a)(4) CPO registration exemption. As discussed above, the CFTC has withdrawn that exemption.

⁷⁴⁰ The term "commodity interest" is defined in CFTC Regulation § 1.3(yy), and includes "[a]ny contract, agreement or transaction subject to [CFTC] jurisdiction under section 2(c)(2) of the [CEA]." CFTC Regulation § 1.3(yy)(3).

⁷⁴¹ See CFTC, Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries; Final Rules, 75 FR 55410 (Sept. 10, 2010).

Proposal”).⁷⁴² The CFTC also explained that “the NFA-specified minimum security deposit for off-exchange retail forex transactions would be included among the amounts that cannot exceed 5 percent of the liquidation value of the pool’s portfolio in order for the operator to claim the exemption from registration under Regulation 4.13(a)(3)”⁷⁴³ and that “such amounts are roughly equivalent to initial margin and option premiums).”⁷⁴⁴ The CFTC also described the CRA-Related Forex Proposal as “amend[ing] existing regulations as needed to clarify their application to, and inclusion in, the new regulatory scheme for retail forex.”⁷⁴⁵ More recently, notwithstanding the Dodd-Frank Act’s addition of the look-through provision in CEA section 1a(8)(A)(iv), the CFTC determined to retain the exemption from CPO registration under Regulation 4.13(a)(3), reasoning that “overseeing entities with less than five percent exposure to commodity interests is not the best use of the Commission’s resources.”⁷⁴⁶

⁷⁴² CFTC, Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries; Proposed Rules, 75 FR 3282 (Jan. 10, 2010).

⁷⁴³ Section 12 of the NFA’s Financial Requirements impose the following minimum security deposit requirements for retail forex transactions: (i) 2% of the notional value of transactions in the British pound, the Swiss franc, the Canadian dollar, the Japanese yen, the Euro, the Australian dollar, the New Zealand dollar, the Swedish krona, the Norwegian krone, and the Danish krone; (ii) 5% of the notional value of other transactions; (iii) for short options, the above amount plus the premium received; and (iv) for long options, the entire premium. See NFA Manual, available at <http://www.nfa.futures.org/nfamanual/NFAManual.aspx?RuleID=SECTION%2012&Section=7>.

⁷⁴⁴ CFTC, Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries; Proposed Rules, 75 FR 3282, 3287 (Jan. 10, 2010).

⁷⁴⁵ Id. at 3282.

⁷⁴⁶ CPO/CTA Compliance Release at 11261. The CFTC also stated that:

[t]he Commission believes that trading exceeding five percent of the liquidation value of a portfolio, or a net notional value of commodity interest positions exceeding 100 percent of the liquidation value of a portfolio, evidences a significant exposure to the derivatives markets, and that such exposure should subject an entity to the Commission’s oversight.

Id. at 11263.

Given that, shortly before the adoption of the Dodd-Frank Act, the CFTC proposed to add retail forex transactions to those that can be entered into by CPOs claiming relief from registration as such under CFTC Regulation § 4.13(a)(3), that it finalized that action shortly after the Dodd-Frank Act was adopted and that it recently left CFTC Regulation § 4.13(a)(3) in place despite having proposed to withdraw that CPO registration exemption, and for the reasons described above, the Commissions believe CPOs exempt from registration as such pursuant to CFTC Regulation 4.13(a)(3) and operating Retail Forex Pools should be able to continue to do so outside the retail forex regime.

Section 712(d)(2)(A) of the Dodd-Frank Act grants the Commissions the authority to adopt such rules related to the ECP definition as the Commissions determine are necessary and appropriate, in the public interest, and for the protection of investors. Based on commenters' views, the Commissions have determined that CFTC Regulation § 1.3(m)(8) as adopted is necessary and appropriate because the statutory look-through provision, if strictly implemented, would subject Forex Pools operated by CPOs that are sophisticated, professional asset managers to an array of additional compliance costs and deprive them of access to swap dealers as counterparties when engaging in retail forex transactions.⁷⁴⁷ The Commissions also have determined that it is appropriate to limit the availability of ECP status under CFTC Regulation § 1.3(m)(8) to Forex Pools operated by registered CPOs or by CPOs exempt from registration as

⁷⁴⁷ The nature of a swap dealer's business activities and assets may detract from what is considered regulatory capital for an FCM or RFED engaging in retail forex transactions, thereby making it difficult for some swap dealers to dually register both as such and as an FCM or RFED in order to do retail forex business. As an ECP, a Forex Pool's choice of retail forex transaction counterparties will not be limited to Enumerated Counterparties, and thus may include swap dealers.

such pursuant to CFTC Regulation § 4.13(a)(3).⁷⁴⁸ The conditions in CFTC Regulation § 1.3(m)(8) also are appropriate in that they require Forex Pools seeking ECP status thereunder to have total assets exceeding \$10 million. Historically, CFTC enforcement actions have involved fewer instances of misconduct by CPOs of Forex Pools with total assets above this threshold.⁷⁴⁹

The Commissions have determined that CFTC Regulation § 1.3(m)(8) is in the public interest in that it will make available a category of counterparty (i.e., swap dealers) that likely would not otherwise be available, and help to assure that sophisticated, professional managers operating qualifying Forex Pools can continue to engage in retail forex transactions. The Commissions have determined that the conditions of CFTC Regulation § 1.3(m)(8) are sufficient for the protection of investors for the reasons discussed above, such as a significant reduction in the incidence of Forex Pool misconduct among CPOs, whether registered as such or exempt therefrom, operating Forex Pools with more than \$10 million in total assets. The Commissions intend to monitor developments in the Forex Pool area and will revisit the conditions of this regulation as warranted by subsequent events.

IV. Definitions of “Major Swap Participant” and “Major Security-Based Swap Participant”

The statutory definitions of “major swap participant”⁷⁵⁰ and “major security-based swap participant”⁷⁵¹ (collectively, “major participant”) encompass any person that is not a swap dealer

⁷⁴⁸ The Commissions note that the statistics presented by commenters indicate that Forex Pool misconduct by registered CPOs and those exempt from CPO registration is significantly rarer than Forex Pool misconduct by otherwise unregistered CPOs. See letter from the GFXD II.

⁷⁴⁹ See letter from Sidley (showing that 6 of the 27 cases presented involved more than \$10 million).

⁷⁵⁰ CEA section 1a(33).

⁷⁵¹ Exchange Act section 3(a)(67).

or security-based swap dealer⁷⁵² and that satisfy any one of three alternative statutory tests that encompass a person: (i) that maintains a “substantial position” in swaps or security-based swaps for any of the major swap categories as determined by the Commissions; (ii) whose outstanding swaps or security-based swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets;⁷⁵³ or (iii) that is a “financial entity” that is “highly leveraged” relative to the amount of capital it holds (and that is not subject to capital requirements established by an appropriate Federal banking agency) and maintains a “substantial position” in outstanding swaps or security-based swaps in any major category as determined by the Commissions.⁷⁵⁴ The first – and only the first – of those three statutory tests explicitly excludes: (i) positions held for “hedging or mitigating commercial risk,” and (ii) positions maintained by any employee benefit plan as defined in sections 3(3) and (32) of ERISA for the “primary purpose of hedging or mitigating any risk directly associated with the operation of the plan.”⁷⁵⁵

The statutory definitions require the Commissions to define the term “substantial position” at the threshold determined to be prudent for the effective monitoring, management, and oversight of entities that are systematically important or can significantly impact the financial system of the U.S. In setting these thresholds, the Commissions are required to

⁷⁵² As discussed above, a person may be designated as a dealer for particular activities involving swaps or security-based swaps, or particular swap or security-based swap activities, without being deemed to be a dealer with regard to other categories or activities. See part II.E, *supra*. To the extent that a person is subject to that type of limited designation as a swap dealer or security-based swap dealer, the person may be subject to being a major swap participant or a major security-based swap participant in connection with positions that fall outside of that limited dealer designation.

⁷⁵³ See CEA section 1a(33)(A)(ii); Exchange Act section 3(a)(67)(A)(ii)(II).

⁷⁵⁴ See CEA section 1a(33)(A)(iii); Exchange Act section 3(a)(67)(A)(ii)(III).

⁷⁵⁵ See CEA section 1a(33)(A)(i); Exchange Act section 3(a)(67)(A)(ii)(I).

consider the person's relative position in uncleared as opposed to cleared swaps and may take into consideration the value and quality of collateral held against counterparty exposures.⁷⁵⁶

The statutory definitions further permit the Commissions to limit the scope of the major participant designations so that a person may be designated as a major participant in certain categories of swaps or security-based swaps, but not all categories.⁷⁵⁷

In addition, the "major swap participant" definition excludes certain entities whose primary business is providing financing and that use derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company.⁷⁵⁸ The "major security-based swap participant" definition does not contain this type of exclusion.

As detailed in the Proposing Release, the major participant definitions focus on the market impacts and risks associated with a person's swap and security-based swap positions.⁷⁵⁹ This is in contrast to the definitions of "swap dealer" and "security-based swap dealer," which focus on a person's activities and account for the amount or significance of those activities only in the context of the de minimis exception. However, persons that meet the major participant definitions in large part must follow the same statutory requirements that will apply to swap

⁷⁵⁶ See CEA section 1a(33)(B) and Exchange Act section 3(a)(67)(B).

⁷⁵⁷ See CEA section 1a(33)(C); Exchange Act section 3(a)(67)(C).

⁷⁵⁸ See CEA section 1a(33)(D).

⁷⁵⁹ See Proposing Release, 75 FR at 80185.

dealers and security-based swap dealers.⁷⁶⁰ In this way, the statute applies comprehensive regulation to entities whose swap or security-based swap activities do not cause them to be dealers, but nonetheless could pose a high degree of risk to the U.S. financial system generally.⁷⁶¹

Although the two major participant definitions are similar, they address instruments that reflect different types of risks and that can be used by end-users and other market participants for different purposes. Interpretation of the definitions must account for those differences as appropriate.

The Commissions in the Proposing Release proposed to further define the “major swap participant” and “major security-based swap participant” definitions, by specifically addressing: (i) the “major” categories of swaps or security-based swaps; (ii) the meaning of “substantial position”; (iii) the meaning of “hedging or mitigating commercial risk”; (iv) the meaning of “substantial counterparty exposure that could have serious adverse effects on the financial

⁷⁶⁰ In particular, under CEA section 4s and Exchange Act section 15F, dealers and major participants in swaps or security-based swaps generally are subject to the same types of margin, capital, business conduct and certain other requirements, unless an exclusion applies. See CEA section 4s(h)(4), (5); Exchange Act section 15F(h)(4), (5). See also CFTC, Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties; Final Rule, 77 FR 9733 (Feb. 17, 2012); Notice of Proposed Rulemaking: Capital requirements of swap dealers and major swap participants, 76 FR 27802 (May 12, 2011); and SEC, Notice of Proposed Rulemaking: Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, Securities Exchange Act Release No. 64766, 76 FR 42396 (July 18, 2011).

⁷⁶¹ As discussed below, the tests of the major participant definitions use terms — particularly “systemically important,” “significantly impact the financial system” or “create substantial counterparty exposure” — that denote a focus on entities that pose a high degree of risk through their swap and security-based swap activities. In addition, the link between the major participant definitions and risk was highlighted during the Congressional debate on the statute. See 156 Cong. Rec. S5907 (daily ed. July 15, 2010) (colloquy between Senators Hagen and Lincoln, discussing how the goal of the major participant definitions was to “focus on risk factors that contributed to the recent financial crisis, such as excessive leverage, under-collateralization of swap positions, and a lack of information about the aggregate size of positions”).

stability of the United States banking system or financial markets”; and (v) the meanings of “financial entity” and “highly leveraged.” The proposal also addressed the period of time that a major participant would have to register (as well as the minimum length of time for being a major participant), the limited purpose designations of major participants, the exclusion for ERISA plan hedging positions, and certain additional interpretive issues.

After considering commenters’ views, the Commissions are adopting final rules further defining the meaning of major participant.

As discussed below, the Commissions also are directing their respective staffs to report separately as to whether changes are warranted to any of the rules implementing the major participant definitions. These staff reports will help the Commissions evaluate the “major swap participant and “major security-based swap participant” definitions, including whether new or revised tests or approaches would be appropriate for identifying major participants.⁷⁶²

A. “Major” Categories of Swaps and Security-Based Swaps

1. Proposed approach

The first and third tests of the statutory major participant definitions encompass entities that maintain a substantial position in a “major” category of swaps or security-based swaps.⁷⁶³

In the Proposing Release, the Commissions proposed to designate four “major” categories of swaps and two “major” categories of security-based swaps. These categories sought to reflect the risk profiles of the various types of swaps and security-based swaps, and the different purposes for which end-users use those instruments. The Proposing Release also noted

⁷⁶² See part V, *infra*.

⁷⁶³ See CEA section 1a(33)(A)(i), (iii); Exchange Act section 3(a)(67)(a)(2)(i), (iii).

the importance of not parsing the "major" categories so finely as to base the "substantial position" thresholds on unduly narrow risks and reduce those thresholds' effectiveness as risk measures.⁷⁶⁴

The proposed four "major" categories of swaps were rate swaps, credit swaps, equity swaps and other commodity swaps.⁷⁶⁵ Rate swaps would encompass any swap which is primarily based on one or more reference rates, such as swaps of payments determined by fixed and floating interest rates, currency exchange rates, or other monetary rates. Credit swaps would encompass any swap that is primarily based on default, bankruptcy and other credit-related risks related to, or the total returns on, instruments of indebtedness (including loans), including but not limited to any swap primarily based on one or more broad-based indices related to debt instruments, and any swap that is a broad-based index credit default swap or total return swap. Equity swaps would encompass any swap that is primarily based on equity securities, such as any swap primarily based on one or more broad-based indices of equity securities, including any total return swap on one or more broad-based equity indices. Other commodity swaps would encompass any swap not included in any of the first three categories, and would generally include, for example and not by way of limitation, any swap for which the primary underlying item is a physical commodity or the price or any other aspect of a physical commodity. The four categories were intended to cover all swaps, and each swap would be in the category that most closely describes the primary item underlying the swap.⁷⁶⁶

⁷⁶⁴ See Proposing Release, 75 FR at 80186-87.

⁷⁶⁵ See proposed CFTC Regulation § 1.3(iii).

⁷⁶⁶ The statutory definition of "swap" lists 22 different types of swaps.

The Commissions proposed to designate two "major" categories of security-based swaps.⁷⁶⁷ The first category would encompass any security-based swap that is based, in whole or in part, on one or more instruments of indebtedness (including loans), or a credit event relating to one or more issuers or securities, including but not limited to any security-based swap that is a credit default swap, total return swap on one or more debt instruments, debt swaps, or debt index swaps. The second category would encompass any other security-based swaps not included in the first category, including for example, swaps on equity securities or narrow-based security indices comprised of equity securities.⁷⁶⁸ These proposed categories were based on the different uses of these types of security-based swaps, and were consistent with market statistics and infrastructures that distinguish between those types of security-based swaps.⁷⁶⁹

2. Commenters' views

Certain commenters requested clarification regarding how the major categories would be applied. One commenter particularly requested additional clarity as to how the proposed categories will apply to mixed swaps and to swaps that are based on debt that is convertible to equity,⁷⁷⁰ while another commenter requested additional clarity as to the status of certain mortgage-related transactions.⁷⁷¹

One commenter suggested that the final rules should include a catch-all provision to allow the Commissions to review large positions that appear to be structured to evade proper

⁷⁶⁷ See proposed Exchange Act rule 3a67-2.

⁷⁶⁸ The second category also encompasses all security-based swaps on narrow based indices that are comprised of both debt and equity components.

⁷⁶⁹ See Proposing Release, 75 FR at 80187.

⁷⁷⁰ See letter from ISDA I.

⁷⁷¹ See letter from Freddie Mac.

categorization, and that market participants should suggest the protocols for categorization of swaps or security-based swaps.⁷⁷²

One commenter suggested that the rate swap category should be divided between interest rates and currencies, and that energy, agriculture and metals swaps should be separate categories.⁷⁷³ Another commenter expressed the view that creation of a separate category for cross currency swaps could lead to confusion among market participants who may feel obligated to bifurcate cross currency swaps between two categories.⁷⁷⁴ Some commenters expressed general support for the major categories as proposed.⁷⁷⁵

3. Final rules

After considering the issue in light of comments received, the Commissions are adopting final rules designating “major” categories of swaps and security-based swaps consistent with the proposal. Accordingly, the final rules provide that the four “major” categories of swaps are rate

⁷⁷² See meeting with Professor Darrell Duffie, Stanford University Graduate School of Business (“Duffie”) on February 2, 2011.

⁷⁷³ See letter from Better Markets I.

⁷⁷⁴ See letter from ACLI.

⁷⁷⁵ See letters from Barnard, ISDA I and MetLife; see also letter from American Insurance Association (“AIA”) (agreeing that the defined major categories would cover substantially all significant swaps and security-based swaps).

swaps, credit swaps, equity swaps and other commodity swaps.⁷⁷⁶ The two “major” categories of security-based swaps are debt security-based swaps⁷⁷⁷ and other security-based swaps.⁷⁷⁸

The Commissions believe that it is not necessary to further divide the proposed categories or add new categories for swaps and security-based swaps for purposes of the major participant definitions. We believe that maintaining a large number of narrow categories of swaps and security-based swaps would increase the possibility of confusion by market participants with regard to categorizing the swaps and security-based swaps in which they transact. The Commissions also continue to believe that it is important not to parse the “major” categories so finely as to base the “substantial position” thresholds on unduly narrow groupings that would reduce those thresholds’ effectiveness as risk measures. Categories that are broad and clearly delineated further should help prevent action to evade designation as a major participant in a particular “major” category.

While we believe that these rules in general are sufficiently clear to allow each swap and security-based swap to be placed in the appropriate category, we are mindful of the commenters’

⁷⁷⁶ See CFTC Regulation § 1.3(iii). The four major categories of swaps are the same as the asset classes used in the CFTC Regulations relating to SDRs and reporting, except that the asset classes for interest rate swaps and foreign exchange transactions are combined into the single rate swap major category of swaps. See CFTC, Swap Data Repositories: Registration Standards, Duties and Core Principles; Final Rule, 76 FR 54538 (Sept. 1, 2011) and Swap Data Recordkeeping and Reporting Requirements; Final Rule, 77 FR 2136 (Jan. 13, 2012).

⁷⁷⁷ The name of the first major category of security-based swaps has been changed to “debt security-based swaps” in this Adopting Release from “security-based credit derivatives” in the Proposing Release. This change more accurately reflects the products encompassed by this category, particularly total return swaps on debt instruments. See Exchange Act rule 3a67-2(a).

In addition, the final rules defining the major categories for purposes of the major participant definitions remove a cross-reference to the corresponding dealer definitions under the CEA or the Exchange Act to clarify that the rules apply only in the context of the major participant definitions, and not the dealer definitions. See CFTC Regulation § 1.3(iii); Exchange Act rule 3a67-2.

⁷⁷⁸ See Exchange Act rule 3a67-2(b).

request for guidance with regard to certain circumstances. In the case of mixed swaps, we would expect that the instrument would be placed in the “swap” and “security-based swap” categories that are consistent with the underlying attributes that cause such instrument to be a mixed swap.⁷⁷⁹ Also, swaps or security-based swaps that are based on more than one item, instrument or risk, should be placed in the category that most closely describes the primary item, instrument or risk underlying the swap or security-based swap.⁷⁸⁰

B. “Substantial Position”

1. Proposed approach

The major participant definitions require that the Commissions define a “substantial position” in swaps or security-based swaps at a threshold that we determine to be “prudent for the effective monitoring, management, and oversight” of entities that are systemically important or can significantly impact the U.S. financial system. The definitions further require that we consider a person’s relative position in uncleared and cleared swaps or security-based swaps, and permit us to consider the value and quality of collateral held against counterparty exposure.⁷⁸¹

The proposed rules provided that a person would have a “substantial position” in swaps or security-based swaps if the daily average current uncollateralized exposure associated with its swap or security-based swap positions in a major category in a calendar quarter amounted to \$1 billion or more (or \$3 billion in the case of rate swaps).⁷⁸² A person also would have a

⁷⁷⁹ The Commissions have proposed rules regarding the regulation of mixed swaps. See Product Definitions Proposal, note 3, *supra*.

⁷⁸⁰ In the case of instruments on debt securities that are convertible into equity, in general we would expect the instrument to be categorized based on its status (as debt or equity) at the time of evaluation.

⁷⁸¹ See CEA section 1a(33)(B); Exchange Act section 3(a)(67)(B).

⁷⁸² See proposed CFTC Regulation § 1.3(jjj)(1); proposed Exchange Act rule 3a67-3(a)(1), (d).

“substantial position” if the daily average of the sum of the current uncollateralized exposure plus the potential future exposure associated with its positions in a major category in a calendar quarter amounted to \$2 billion or more (or \$6 billion for the rate swap category).⁷⁸³

The proposed rules did not prescribe any particular methodology for measuring current exposure or valuing collateral posted, and instead provided that the method used should be consistent with counterparty practices and industry practices generally.⁷⁸⁴ The proposed rules also provided that an entity could calculate its current uncollateralized exposure by accounting for netting agreements on a counterparty-by-counterparty basis,⁷⁸⁵ and the Proposing Release set forth a method for allocating any residual uncollateralized exposure to a counterparty that remains following netting.⁷⁸⁶

The proposed potential future exposure test was based on the risk-adjusted notional amount of the entity’s swap and security-based swap positions, consistent with a test used by bank regulators for purposes of setting capital standards.⁷⁸⁷ The test also excluded or lowered the potential exposure associated with certain lower-risk positions.⁷⁸⁸ In addition, the measures of potential future exposure would be discounted by up to 60 percent to reflect the risk mitigation

⁷⁸³ See proposed CFTC Regulation § 1.3(jjj)(1); proposed Exchange Act rule 3a67-3(a)(2), (d).

⁷⁸⁴ See proposed CFTC Regulation § 1.3(jjj)(2)(ii); proposed Exchange Act rule 3a67-3(a)(2)(i).

⁷⁸⁵ See proposed CFTC Regulation § 1.3(jjj)(2)(iii); proposed Exchange Act rule 3a67-3(b)(3).

⁷⁸⁶ See Proposing Release, 75 FR at 80190.

⁷⁸⁷ See *id.* at 80191-92.

⁷⁸⁸ See proposed CFTC Regulation § 1.3(jjj)(3)(iii); proposed Exchange Act rule 3a67-3(c)(2)(i)(C), (D).

provided by netting agreements,⁷⁸⁹ and would further be decreased by 80 percent for positions subject to central clearing or daily mark-to-market margining.⁷⁹⁰

2. Commenters' views

a. Basis for regulating major participants and alternative approaches for identifying "substantial positions"

Several commenters expressed the view that the major participant definition is intended to address entities whose swap or security-based swap positions pose systemic risk,⁷⁹¹ while one commenter took the contrary view that the definition also is intended to address the significance of an entity's swap or security-based swap positions (as well as the risk those positions pose).⁷⁹²

One commenter stated that the proposal inappropriately sought to account for the risk posed by the potential default of multiple entities, rather than a single entity.⁷⁹³ Some commenters suggested that the analysis should account for the concentration of the risk posed by an entity's positions,⁷⁹⁴ and one commenter suggested that the analysis should not account for individual categories of swaps or security-based swaps.⁷⁹⁵

⁷⁸⁹ See proposed CFTC Regulation § 1.3(jjj)(3)(ii)(B); proposed Exchange Act rule 3a67-3(c)(2)(ii).

⁷⁹⁰ See proposed CFTC Regulation § 1.3(jjj)(3)(iii)(A); proposed Exchange Act rule 3a67-3(c)(3)(i). This discount for daily margining would be available even in the presence of a threshold or a minimum transfer amount, so long as the threshold and the minimum transfer amount (if the latter exceeds \$1 million) are separately added to the entity's current exposure for purposes of the current exposure plus potential future exposure test. See proposed CFTC Regulation § 1.3(jjj)(3)(iii)(B); proposed Exchange Act rule 3a67-3(c)(3)(ii).

⁷⁹¹ E.g., letters from BlackRock I and MFA I.

⁷⁹² See letter from Better Markets I.

⁷⁹³ See letter from BlackRock I.

⁷⁹⁴ See letters from Black Rock I (suggesting a two-step process that accounts for the reduced risk associated with entities whose positions are distributed among several counterparties); CCMR I and APG Algemene Pensioen Groep NV ("APG").

⁷⁹⁵ See letter from NYCBA Committee.

b. Levels of proposed “substantial position” thresholds

A number of commenters expressed the view that the proposed thresholds are inappropriately low.⁷⁹⁶ Some commenters stated the thresholds initially should be high, with later revisions based on market data.⁷⁹⁷

Some commenters did not oppose the proposed thresholds or expressed support for the thresholds (though many of those commenters separately raised issues about the underlying tests),⁷⁹⁸ while two commenters supported lowering the proposed thresholds.⁷⁹⁹ Some commenters took the position that the thresholds should be adjusted over time to reflect factors such as inflation or market characteristics.⁸⁰⁰

⁷⁹⁶ See letters from ABC/CIEBA (indirectly referring to AIG Financial Products, and noting that it had \$400 billion in notional positions and defaulted when it was required to post approximately \$100 billion in collateral); BG LNG I (alluding to lack of systemic impact associated with Enron’s failure, and suggesting that the Commissions convene an advisory committee to develop thresholds); NCGA/NGSA I (alluding to corporate financial losses involving derivatives that have exceeded the proposed thresholds without significantly impacting the U.S. financial system); ACLI (supporting increase in proposed thresholds under the CEA to \$4 billion current uncollateralized exposure and \$8 billion current uncollateralized exposure plus potential future exposure); and Chesapeake Energy.

⁷⁹⁷ See letters from MFA dated February 25, 2011 (“MFA II”) (stating that thresholds initially should be set higher, while later survey-based thresholds should be based on potential systemic risk impact and the cost of performing the calculations); CCMR I (stating that the Commissions presently have insufficient data to determine appropriate thresholds, and that thresholds initially should be high); BlackRock I (stating that the Commissions should refrain from establishing thresholds if sufficient information is not available); and Freddie Mac. Two commenters particularly addressed the proposed thresholds applicable to rate swaps. See letters from ACLI and MetLife.

⁷⁹⁸ See, e.g., letters from ACLI, Fidelity, SIFMA AMG dated Feb. 22, 2011 (“SIFMA AMG II”) and Vanguard (supporting proposed limits for credit swaps, equity swaps and other commodity swaps, but not rate swaps).

⁷⁹⁹ See letters from AFR (supporting use of a \$500 million uncollateralized exposure threshold, or a \$1 billion current exposure plus potential future exposure threshold, with higher thresholds for rate swaps) and Greenberger.

⁸⁰⁰ See, e.g., letters from MFA I (referring to inflation and measures such as the amount of equity in the U.S. banking system) and ISDA I (referring to evolution of the size and fundamental characteristics of the markets, and changes to valuation methodologies and economic conditions).

c. Current uncollateralized exposure test

Measures of exposure and valuation of collateral – A number of commenters supported the Proposing Release's position that the current exposure analysis not prescribe any methodology for measuring exposure or valuing collateral.⁸⁰¹ On the other hand, some commenters requested explicit approval of particular methodologies,⁸⁰² a good faith safe harbor,⁸⁰³ or regulator-prescribed measurement standards.⁸⁰⁴ Some commenters emphasized the need to be able to post non-cash collateral in connection with positions.⁸⁰⁵ Two commenters requested codification of the proposal's position that operational delays associated with the daily exchange of collateral would not lead to current uncollateralized exposure for purposes of the analysis.⁸⁰⁶

Netting issues – Some commenters stated that the proposed netting provisions should be expanded to encompass additional products that may be netted for bankruptcy purposes.⁸⁰⁷ One commenter took the view that these provisions should be expanded across multiple netting

⁸⁰¹ See letters from Fidelity, ICI I, ISDA I and MFA I.

⁸⁰² See letter from BlackRock I. Consistent with the proposal, the final rules contemplate the use of industry standard practices in the calculation of current exposure and potential future exposure. As with other rules adopted by the Commissions, a market participant may raise questions with the Commissions about the participant's approach to addressing the final rules – including its use of particular methodologies – for further guidance as may be necessary or appropriate.

⁸⁰³ See letter from FSR I (particularly noting difficulty of valuing illiquid or bespoke positions).

⁸⁰⁴ See letter from Better Markets I.

⁸⁰⁵ See, e.g., letters from ACLI, CDEU and MetLife.

⁸⁰⁶ See letters from SIFMA AMG II and Vanguard.

⁸⁰⁷ See letters from ISDA I (specifically addressing securities contracts and forward contracts); NRG Energy (specifically addressing forwards); and APG (specifically addressing securities options and forwards).

agreements to the extent that offsets are permitted.⁸⁰⁸ One commenter asked for clarification as to the scope of the netting provisions,⁸⁰⁹ and one commenter expressed general support for the proposed netting provisions.⁸¹⁰

Allocation of uncollateralized exposure – Some commenters requested that the final rules incorporate the principles, articulated in the Proposing Release, for allocating any uncollateralized exposure that remains following netting.⁸¹¹ Other commenters raised concerns that those principles were based on an unwarranted assumption that collateral is specifically earmarked to particular transactions.⁸¹²

d. Potential future exposure test

General concerns and suggested alternative approaches – Some commenters disagreed with the Proposing Release's statement that the potential future exposure analysis would evaluate potential changes in the value of a swap or security-based swap over the remaining life of the contract; those commenters stated that the test instead should focus on potential volatility during the time it would take for a non-defaulting party to close out a defaulting party's positions.⁸¹³

⁸⁰⁸ See letter from FSR I.

⁸⁰⁹ See letter from Fidelity (seeking confirmation that "master netting agreement" can include an ISDA Master Agreement).

⁸¹⁰ See letter from ACLI.

⁸¹¹ See letters from SIFMA AMG II and Vanguard.

⁸¹² See letters from FSR I and ISDA I; see also letter from MetLife (suggesting pro rata allocation of uncollateralized current exposure among each major category with current exposure).

⁸¹³ See letters from SIFMA AMG II and Vanguard.

Some commenters criticized the tables setting forth the risk adjustments used to calculate potential future exposure.⁸¹⁴ Commenters further suggested using, as alternatives, value-at-risk measures or other models,⁸¹⁵ or the “standardized method” under Basel II.⁸¹⁶ Commenters also argued that risk adjustments should provide a greater discount to credit swaps on “investment grade” instruments than to other credit swaps, that index CDS should be subject to a greater discount than single name CDS, and that there should be a lower discount factor for CDS of shorter maturity.⁸¹⁷ One commenter generally supported the proposed conversion factors and adjustments.⁸¹⁸

Some commenters expressed the view that measures of potential future exposure should be superseded by negotiated independent amounts or regulator-required initial margin.⁸¹⁹ Some commenters also argued that excess posted collateral or net in-the-money positions should be offset against potential future exposure.⁸²⁰

⁸¹⁴ See letters from Riverside Risk Advisors LLC (“Riverside Risk Advisors”) (criticizing, among other aspects, discontinuities in table, a failure to account for how far a swap is in or out of the money, the use of a single discount factor for credit default swaps, the fact that the risk factor for short-term equity swaps is lower than the risk factor for credit swaps, and the fact that equity swaps do not distinguish between high-volatility and low-volatility stocks, as well as the failure to address portfolio effects of diversification and correlation, and “wrong-way” risk in the form of “an adverse correlation between counterparty default risk and the value of its derivatives contracts”); and ISDA I (noting that the conversion factors were calibrated more than 15 years ago and were not designed for later instruments such as credit products).

⁸¹⁵ See letters from Riverside Risk Advisors (supporting giving end-users the option to use a model-based approach); and Better Markets I (supporting use of a value-at-risk calculation).

⁸¹⁶ See letter from ISDA I.

⁸¹⁷ See letters from AIMA I and MFA I.

⁸¹⁸ See letter from MetLife.

⁸¹⁹ See letters from SIFMA AMG II and Vanguard.

⁸²⁰ See, e.g., letters from AIMA I, Fidelity, MFA I, SIFMA AMG II and Vanguard.

Potential future exposure measures for lower-risk positions – Some commenters stated that the proposal to cap potential future exposure when a person buys credit protection using a credit default swap should be expanded to apply to any position with a fixed downside risk.⁸²¹ Commenters also suggested that the potential future exposure associated with purchases of credit protection be further discounted,⁸²² while one commenter took the position that purchases of credit default swaps should be excluded from the potential future exposure test.⁸²³ Commenters also addressed the appropriate discount rate for calculating the net present value of unpaid premiums.⁸²⁴

Netting issues – One commenter stated that the proposal's netting provisions did not adequately account for the risk mitigation associated with hedged positions,⁸²⁵ while another commenter asked that the proposed netting provisions be clarified and simplified.⁸²⁶ One commenter supported the proposed netting approach.⁸²⁷

Discount for cleared or margined positions – Several commenters took the view that cleared positions should be excluded entirely from the potential future exposure analysis, rather than only being subject to an 80 percent discount,⁸²⁸ and some commenters also supported a

⁸²¹ See letters from MFA I (citing fixed portions of interest rate swaps), MetLife (citing purchased options as well as CDS), ACLI and Ropes & Gray.

⁸²² See letters from MFA I (arguing that the tightening of credit spreads would imply a healthy credit environment) and AIMA; see also meeting with MFA on February 14, 2011.

⁸²³ See letter from Vanguard.

⁸²⁴ See letter from MFA I (suggesting the possible use of the LIBOR/Swap rate) and AIMA I.

⁸²⁵ See letter from ISDA I.

⁸²⁶ See letter from SIFMA AMG II.

⁸²⁷ See letters from ACLI.

⁸²⁸ See, e.g., letters from MFA I, SIFMA AMG II and Vanguard.

complete exclusion for positions subject to daily mark-to-market margining.⁸²⁹ One commenter suggested a minimum 98 percent reduction for positions subject to central clearing or mark-to-market margining,⁸³⁰ while one commenter suggested that there be a higher discount for positions subject to the posting of initial margin.⁸³¹

Some commenters also stated that there should be a partial discount provided in connection with positions for which mark-to-market margining is done less than daily,⁸³² and that there should be a discount for positions that are margined using security interests or liens.⁸³³ On the other hand, one commenter stated that there is no basis for providing any discount for marked-to-market positions.⁸³⁴

One commenter requested that the rule language codify language in the Proposing Release as to when a position is subject to daily mark-to-market margining.⁸³⁵ A number of commenters addressed proposed rule language that was intended to clarify that the discount for

⁸²⁹ See letters from BG LNG I, Fidelity and ICI I.

⁸³⁰ See letter from ISDA I.

⁸³¹ See letter from FHLB I (suggesting 90 percent discount for cleared swaps and for uncleared swaps for which initial margin has been posted; alternatively suggesting that posted initial margin be subtracted from the calculated amount).

⁸³² See letters from Fidelity and Canadian Master Asset Vehicle I and Master Asset Vehicle II ("Canadian MAVs").

⁸³³ See letter from FHLB I (giving as an example swaps collateralized by security interests in real estate, oil or gas interests, or by first liens on financial assets).

⁸³⁴ See letter from Better Markets I; see also letter from AFR (generally opposing use of risk adjustments, but suggesting that any such discounts should be larger for cleared positions).

⁸³⁵ See letter from SIFMA AMG II.

daily mark-to-market margining would be available even in the presence of thresholds and minimum transfer amounts.⁸³⁶

Two commenters supported the proposed approach in general.⁸³⁷ One commenter specifically supported the proposed 80 percent reduction for positions subject to daily mark-to-market margining,⁸³⁸ and one commenter specifically supported a reduction for cleared positions.⁸³⁹

Additional issues regarding the potential future exposure test – Some commenters argued that the Commissions should clarify how the categories in the proposed potential future exposure tables would be applied, given how those differ from the proposed “major” categories of swaps and security-based swaps.⁸⁴⁰

Some commenters raised concerns that the proposed use of an instrument’s “effective notional” amount is ambiguous.⁸⁴¹ Commenters also took the position that for purposes of the potential future exposure calculation, notional amounts should be adjusted to reflect delta weighting,⁸⁴² that the measure of duration for options on swaps should consider whether the

⁸³⁶ See letter from CDEU (stating that the proposal could overstate an entity’s future exposure, and favoring use of the lower of the calculated potential future exposure or the CSA threshold); see also letters from SIFMA AMG II and Vanguard.

⁸³⁷ See letters from ACLI and MetLife.

⁸³⁸ See letter from Vanguard.

⁸³⁹ See letter from Better Markets I.

⁸⁴⁰ See letters from SIFMA AMG II and Vanguard.

⁸⁴¹ See letters from FSR I, SIFMA AMG II and Vanguard.

⁸⁴² See letters from MFA I and Ropes & Gray.

underlying swap is cash-settled,⁸⁴³ and that the adopting release should set forth examples of potential future exposure calculations.⁸⁴⁴

e. Cost concerns

Some commenters emphasized the need to avoid an overbroad major participant definition,⁸⁴⁵ and highlighted concerns about being subject to unnecessary regulation.⁸⁴⁶

f. Additional issues

One commenter suggested there be an explicit presumption against imposing major participant (or dealer) regulation on end-users.⁸⁴⁷ Some commenters requested that the current uncollateralized exposure test explicitly exclude cleared positions, net in-the-money positions, and fully collateralized out-of-the-money positions,⁸⁴⁸ and one commenter also supported excluding those positions from the potential future exposure analysis.⁸⁴⁹ That commenter also supported excluding swaps on government securities from the substantial position analysis.⁸⁵⁰

⁸⁴³ See letter from MFA I.

⁸⁴⁴ See *id.*

⁸⁴⁵ See joint letter from Representatives Bachus and Lucas.

⁸⁴⁶ See, e.g., letters from SIFMA AMG II (stating that the commenter's suggested changes in connection with the substantial position analysis would reduce burdens and costs to market participants, and more closely align the tests with the objectives they are meant to achieve) and ABC/CIEBA; see also letter from NFPEEU (reserving the right to dispute the cost-benefit analysis associated with the proposed dealer and major participant rules until all relevant Dodd-Frank Act releases could be analyzed as a whole).

⁸⁴⁷ See letter from CDEU.

⁸⁴⁸ See letters from ICI I, SIFMA AMG II and Vanguard.

⁸⁴⁹ See letter from ICI I.

⁸⁵⁰ See letter from ICI I (noting size of government security market and Federal Reserve control over supply and demand, and stating that the proposed thresholds are ill-suited to address the "vast" government securities market).

One commenter requested confirmation that dealers and major participants would not be required to compute, assist with, or verify computations for counterparties that may be major participants, and also that market participants can enlist third-party services to assist in performing the calculations.⁸⁵¹ One commenter requested clarification that the proposed focus on uncollateralized exposure does not mean that end-users themselves should not demand collateral from dealers.⁸⁵²

3. Final rules

a. Guiding principles

The final rules defining “substantial position” focus on identifying persons whose large swap and security-based swap positions pose market risks that are significant enough that it would be “prudent” to regulate those persons. In developing these rules we have been mindful of the costs associated with regulating major participants, and have considered cost and benefit principles as part of the analysis of what level of swap and security-based swap positions reasonably form the lower bounds for identifying when it would be “prudent” that particular entities be subject to monitoring, management and oversight of entities that may be systemically important or may significantly impact the U.S. financial system.⁸⁵³

⁸⁵¹ See letter from ISDA I.

⁸⁵² See letter from FHLB I.

⁸⁵³ At the same time, as discussed above in the context of the de minimis exception to the dealer definitions, we are mindful that the benefits of financial regulation cannot be quantified. For example, while the regulation of major participants will comprise one component of Title VII’s comprehensive regulatory framework that should be expected to help lessen the amount and frequency of financial crises, we cannot place a dollar figure on the contribution of major participant regulation to those benefits. In light of those factors, we believe that it would be “prudent” to regulate, as major participants, those persons whose swap or security-based swap positions are large enough to pose a material potential of causing significant counterparty impacts, consistent with the levels set forth in the final rules. The

The final rules implementing the “substantial position” definition follow the basic approach that the Commissions proposed, including the combined use of current exposure and potential future exposure tests.⁸⁵⁴ While we have carefully considered the views of commenters who suggested alternative approaches, we have concluded that it is appropriate to adopt the basic approach that was proposed, as described below.

- Focus on default-related credit risks. The final rules implement tests that seek to reflect the credit risk that a person’s swap or security-based swap positions would pose in the event of default. In arguing that the analysis should consider factors in addition to default-related risks, commenters have noted that certain regulations applicable to major participants address business conduct issues that are distinct from systemic risk issues.⁸⁵⁵ We nonetheless believe that the statutory definition of “substantial position” indicates that the analysis should focus on default-related credit risks, because a default-related approach is more closely linked to the statutory criteria that the definition focus on entities that are “systemically important” or can “significantly impact” the U.S. financial system than would be an approach that focuses on the potential for disruptive market movements.⁸⁵⁶

Commissions will further address the comparative costs and benefits associated with regulating major participants in the context of the substantive rules applicable to major participants.

⁸⁵⁴ As with the proposal, the final rules apply these tests to swap and security-based swap positions in a “major” category. See CFTC Regulation § 1.3(jjj)(1); Exchange Act rule 3a67-3(a). The final rules have been modified from the proposal, however, by removing a reference to “positions excluded from consideration.” We have concluded that this reference is unnecessary because the first statutory major participant test explicitly provides that positions that are subject to the commercial risk hedging and the ERISA hedging exclusions of the first major participant test need not be considered for purposes of that test.

⁸⁵⁵ See, e.g., letter from Better Markets I.

⁸⁵⁶ We also believe that the statutory definition should focus on all default-related credit risks associated with swap or security-based swap positions. We do not see a basis for excluding any class of risks (e.g., risks associated with swaps based on government securities) from the analysis.

- Failure of multiple entities close in time. The final rules that implement the “substantial position” definition seek to reflect the risks that would be posed by the default of multiple entities close in time. Although one commenter took the view that the purpose of major participant regulation is to prevent the credit exposure of a single person from having a systemic impact,⁸⁵⁷ we do not believe that the major participant definitions should be construed so narrowly. The events of recent years demonstrate that market stress may lead to the failure and near-failure of multiple entities with large financial positions over a relatively short time period. We do not believe that it would be prudent or well-reasoned to presume that recent history cannot repeat itself, and to assume that future failures of entities with large financial positions will be isolated events.

- Aggregate risk. The final rules address the aggregate risk posed by an entity’s swap or security-based swap positions, rather than seeking to focus on principles of concentration (such as by using a threshold that addresses an entity’s largest exposure to an individual counterparty) or on converse principles of interconnection. The statutory “substantial position” definition is specifically written in terms of market risk concerns (i.e., “systemically important” and “can significantly impact the financial system of the United States”), and measures of aggregate risk appear to be best geared to reflect this standard.⁸⁵⁸

- Use of objective, quantitative criteria. The final rules provide for a “substantial position” analysis that is based on objective, quantitative criteria that would permit a market

⁸⁵⁷ See letter from BlackRock I.

⁸⁵⁸ Moreover, a test that focuses on the concentration of an entity’s swap or security-based swap exposure toward one or a few individual parties potentially poses a tension with the view that interconnections of exposure among multiple parties are important to establishing systemic risk.

participant to determine which level of swap or security-based swap positions would cause it to be a major participant. Although one commenter has suggested the use of a two-step approach that uses thresholds as a safe harbor and that would be accompanied by a second-level determination,⁸⁵⁹ we do not believe that such an approach would be consistent with the statutory language or with principles of regulatory efficiency.⁸⁶⁰ Accordingly, a person whose swap or security-based swap positions satisfy the applicable thresholds will be a major participant, with no further layer of review provided.⁸⁶¹

b. Current uncollateralized exposure test

Consistent with the proposal, the final rules implementing the “substantial position” definition include a test that accounts for the current uncollateralized exposure posed by an entity’s swap or security-based swap positions in a major category.⁸⁶² This provides a measure

⁸⁵⁹ See letter from BlackRock I.

⁸⁶⁰ The major participant definitions specifically require that the term “substantial position” be defined “by rule or regulation” via a “threshold.” That language would not appear to anticipate the use of a multi-tier approach that accounts for subjective criteria.

In this respect, the major participant definitions may be compared with section 113 of the Dodd-Frank Act, which authorizes the Financial Stability Oversight Council (“FSOC”) to provide for a non-bank financial company to be supervised by the Board if the FSOC “determines that material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States.” Section 113 further provides that these designations will result from a vote of the FSOC based on a variety of factors. The “major participant” definition does not provide for this type of entity-specific determination, and we believe that the “major participant” definition more appropriately is implemented by objective factors that allow market participants to determine whether they will fall within the definition.

⁸⁶¹ In addition, the final rules provide that the “substantial position” analysis that implements the first (and third) major participant test will be based on the “major” categories of swaps and security-based swaps. Notwithstanding commenter concerns that this approach will require market participants to analyze their swaps and security-based swaps in new ways and will result in additional costs, this focus on “major” categories is dictated by the plain language of the statute.

⁸⁶² CFTC Regulation § 1.3(jjj)(1); Exchange Act rule 3a67-3(b)(2). The final rules contain technical changes from the proposal to clarify the steps entailed by this calculation.

of the amount of potential risk that an entity would pose to its counterparties if the entity currently were to default.⁸⁶³

As with the proposal, a person would apply this test by examining the positions it maintains with each of its counterparties in a particular major category of swaps or security-based swaps. For each counterparty, the person would determine the dollar value of the aggregate current exposure arising from each of its swap or security-based swap positions with negative value in that major category by marking-to-market using industry standard practices, and deduct from that amount the aggregate value of the collateral the entity has posted with respect to the swap or security-based swap positions.⁸⁶⁴ The “aggregate uncollateralized outward exposure” would be the sum of those uncollateralized amounts over all counterparties with which the person has entered into swaps or security-based swaps in that major category.⁸⁶⁵

The final rules implementing this test largely are the same as the rules the Commissions proposed, but with certain modifications to address issues raised by commenters.

i. Measure of exposure and valuation of collateral

Consistent with the proposal, the final rules do not prescribe any particular methodology for measuring current exposure or for valuing collateral posted, but instead require the use of

⁸⁶³ See Proposing Release, 75 FR at 80188.

⁸⁶⁴ As we noted in the Proposing Release, we recognize that there may be operational delays between changes in exposure and the resulting exchanges of collateral, and in general we would not expect that operational delays associated with the daily exchange of collateral would be considered to lead to uncollateralized exposure for these purposes. See Proposing Release, 75 FR at 80189 n.92. Although we are not codifying this principle within the final rules, we will be mindful of the principle when enforcing those rules.

⁸⁶⁵ CFTC Regulation § 1.3(jjj)(2); Exchange Act rule 3a67-3(b)(2).

industry standard practices.⁸⁶⁶ In this regard we do not concur with commenter requests that we approve or prescribe particular methodologies, or provide a safe harbor for measures or valuations made in good faith.⁸⁶⁷ Instead, it is appropriate that the final rules provide market participants with the flexibility to use the same methodologies that they use in connection with their business activities. Accordingly, we would expect entities to value current uncollateralized exposure based on the amounts that would be payable if the transaction were terminated.

To the extent the measure of exposure or the valuation of collateral is subject to other rules or regulations, we also would expect those measures and valuations for purposes of the major participant calculations to be consistent with those other applicable rules.⁸⁶⁸ In addition, the “substantial position” analysis may take into account the posting of non-cash collateral to the extent that the posting of such collateral, and the valuation of that collateral, is consistent with industry standard practices or applicable regulation.⁸⁶⁹

⁸⁶⁶ CFTC Regulation § 1.3(jjj)(2); Exchange Act rule 3a67-3(b)(1). As we noted in the Proposing Release, collateral may be posted to a third-party custodian, directly to the counterparty, or in accordance with the rules of a derivatives clearing organization or clearing agency. See Proposing Release, 75 FR at 80189 n.94.

⁸⁶⁷ See letters from BlackRock I, Better Markets I and FSR I.

⁸⁶⁸ These principles should apply even in the case of valuing illiquid or bespoke positions. Market participants have the flexibility to use commercially reasonable approaches that are consistent with their financial statements, tax calculations and compliance with other regulations.

⁸⁶⁹ For non-cash collateral to be considered for purposes of these calculations, the collateral must be available for the counterparty’s use if the entity posting the collateral were to default. At a minimum, this would require that the counterparty possess a perfected security interest in that collateral. As we noted in the Proposing Release, while we expect that other regulatory requirements applicable to the valuation of swap or security-based swap positions and collateral would be relevant to certain calculations relating to major participant status, these rules would not necessarily be relevant for other purposes, such as in the context of capital and margin requirements. See Proposing Release, 75 FR at 80189 n.95.

ii. Netting

The final rules build upon the proposal with regard to the measure of uncollateralized current exposure in the presence of netting arrangements. In particular, to address commenter concerns these provisions have been modified from the proposal to account for the fact that two counterparties may have multiple netting agreements for which offsets are permitted, and to extend the netting principles to any financial instruments that may be netted for purposes of applicable bankruptcy law (rather than limiting those instruments to swaps, security-based swaps and securities financing transactions).

Accordingly, the final rules provide that an entity may calculate its exposure on a net basis by applying the terms of one or more master netting agreements with a counterparty. The entity may account for offsetting positions entered into with that particular counterparty involving swaps or security-based swaps as well as securities financing transactions (consisting of securities lending and borrowing, securities margin lending and repurchase and reverse repurchase agreements), and other financial instruments and agreements that are subject to netting offsets for purposes of applicable bankruptcy law, to the extent consistent with the offsets provided by those master netting agreements.⁸⁷⁰ These revisions should permit the current

⁸⁷⁰ CFTC Regulation § 1.3(jjj)(2)(iii); Exchange Act rule 3a67-3(b)(3)(i). This provision provides for netting under the master netting agreement of any instruments, contracts or agreements (including contracts on physical commodities), that would qualify for netting under applicable bankruptcy law. As we noted in the Proposing Release, the proposed rules regarding possible offsets of various positions are for purposes of determining major participant status only. Other rules proposed by the Commissions may address the extent to which, if any, persons such as dealers and major participants may offset positions for other purposes. See Proposing Release, 75 FR at 80189 n.98. As proposed, Exchange Act rule 3a67-3(b)(3)(i) referred to "security-based swaps (in any swap category)"; this reference has been revised in the final rule to "security-based swaps (in any security-based category)."

uncollateralized exposure test to more accurately reflect the degree of credit risk that an entity poses to its counterparty in the event of default.

As discussed in the proposal, these netting provisions apply only to offsetting positions with a single counterparty.⁸⁷¹ The provisions do not extend to the market risk offsets associated with an entity's positions with multiple counterparties, because such offsets would not directly mitigate the risks that an individual counterparty would face in the event of the entity's default.⁸⁷²

iii. Allocation of uncollateralized exposure following netting

The final rules build upon the proposal by codifying the method, discussed in the Proposing Release, related to the allocation of any uncollateralized exposure that remains following netting and the posting of collateral. This type of allocation can be necessary because, with netting, it otherwise may not be possible to directly attribute residual uncollateralized exposure to a particular major category of swap or security-based swap.⁸⁷³ Some commenters have requested that the final rules codify this method to provide more certainty to market participants.⁸⁷⁴

Accordingly, the final rules incorporate a formula which, for purposes of the substantial position analysis, provides that the amount of net uncollateralized exposure that is attributable to

⁸⁷¹ CFTC Regulation § 1.3(jjj)(2)(iii); Exchange Act rule 3a67-3(b)(3)(ii).

⁸⁷² The fact that positions with third parties do not offset exposure to a particular counterparty was recently highlighted by a decision finding that the Bankruptcy Code does not permit excess collateral held by one creditor to offset amounts that the debtor owed to the creditor's affiliates. See In re Lehman Brothers Inc., Case No. 08-01420 (JMP) (SIPA), slip op. (Bankr. S.D.N.Y. Oct. 4, 2011).

⁸⁷³ Such allocation would not be necessary, of course, to the extent that an entity has no current uncollateralized exposure to a counterparty following netting and the posting of collateral.

⁸⁷⁴ See letters from SIFMA AMG II and Vanguard.

a particular major category of swap or security-based swap would be allocated pro rata in a manner that compares the amount of the entity's out-of-the-money positions in that major category to its total out-of-the-money positions in all categories that are subject to the netting arrangements with that counterparty.⁸⁷⁵ This approach does not require that any collateral be specifically earmarked to particular swaps or security-based swaps, and can be followed so long as collateral is posted based on the net exposure associated with all instruments subject to the applicable netting agreements with that particular counterparty.⁸⁷⁶

iv. Application of current exposure test to cleared, fully collateralized or net in-the-money positions

Although certain commenters have requested that the current uncollateralized exposure test explicitly exclude swap or security-based swap positions that are cleared, fully collateralized or net in-the-money,⁸⁷⁷ the final rules do not provide such exclusions. As we recognized in the Proposing Release, centrally cleared swaps and security-based swaps are subject to mark-to-

⁸⁷⁵ CFTC Regulation § 1.3(jjj)(2)(iii)(A); Exchange Act rule 3a67-3(b)(4). Under this formula, for example, if an entity's exposure to a particular counterparty is \$120 million after accounting for netting and the posting of collateral, and, subject to netting, the entity has \$40 million in out-of-the-money positions in security-based credit derivatives, \$90 million in out-of-the-money positions in other security-based swaps, and \$120 million in out-of-the-money positions in swaps and other instruments subject to the netting agreements, then \$19.2 million in net uncollateralized exposure would be attributed to the "security-based credit derivatives" category (equal to \$120 million · (\$40 million / (\$40 million + \$90 million + \$120 million))), and \$43.2 million in net uncollateralized exposure would be attributed to the "other security-based swaps" category (equal to \$120 million · (\$90 million / (\$40 million + \$90 million + \$120 million))).

⁸⁷⁶ Although one commenter suggested that the analysis should further consider whether there are collateral posting requirements that are specific to a particular position, we believe that the test we are adopting is flexible enough to address that possibility. To the extent that the parties' collateral arrangements provide that collateral be earmarked to particular swap or security-based swap positions, an entity may calculate its potential future exposure with respect to that counterparty with regard to the applicable major category of swaps or security-based swaps, without accounting for netting across categories or instruments.

⁸⁷⁷ See letters from ICIL, SIFMA AMG II and Vanguard.

market margining that would largely eliminate the uncollateralized exposure associated with a position, effectively resulting in the cleared position being excluded from the analysis.⁸⁷⁸ Also, by definition, fully collateralized positions are not associated with current uncollateralized exposure, and thus would be excluded from the analysis. As such, we do not believe that it would be necessary to explicitly exclude such positions from the analysis.⁸⁷⁹

Similarly, we do not believe that it is necessary for the rules to explicitly exclude net in-the-money swap or security-based swap positions. If an entity does not have any current uncollateralized exposure to a particular counterparty – after accounting for the entity’s netting agreement with that counterparty and the posting of collateral – then the entity may disregard its positions with that counterparty for purposes of calculating current uncollateralized exposure. Otherwise, it is appropriate to consider the contribution of all swaps or security-based swaps to current uncollateralized exposure, as determined by the allocation methodology discussed above.⁸⁸⁰

c. Potential future exposure analysis

The “substantial position” analysis also will consider an entity’s “aggregate potential outward exposure,” which would reflect the potential exposure of the entity’s swap or security-based swap positions in the applicable “major” category of swap or security-based swaps, subject

⁸⁷⁸ See Proposing Release, 75 FR at 80189 n.92.

⁸⁷⁹ Moreover, to the extent that such positions are associated with uncollateralized amounts, such as those that arise from thresholds or minimum transfer amounts pursuant to the applicable credit support annex, then those amounts present counterparty risk that should be considered as part of the major participant analysis.

⁸⁸⁰ Under that allocation approach, if none of the entity’s swap or security-based swap positions in a major category with that counterparty are out-of-the-money, then none of the current exposure resulting from the netting agreement would be attributed to that major category.

to certain adjustments.⁸⁸¹ The final rules implementing this test in general follow the proposed approach, but have been revised to address commenter concerns.

i. Purpose underlying the potential future exposure test

As discussed in the proposal, a potential future exposure test addresses the fact that a sole focus on current uncollateralized exposure could fail to identify risky entities until some time after they begin to pose the level of risk that should subject them to regulation as major participants.⁸⁸² A potential future exposure test would allow the substantial position analysis to account for this risk by addressing how the value of an entity's swap or security-based swap positions may move against the entity over time.⁸⁸³

Accordingly, consistent with the proposal, the final rules incorporate a potential future exposure test that seeks to estimate how much the value of swaps or security-based swaps might change against an entity over the remaining life of the contract. Although some commenters took the view that this test should only address potential volatility during the period of time it would take for a non-defaulting party to close out positions and liquidate collateral,⁸⁸⁴ we believe that it is more appropriate for the analysis to consider the risks that swaps or security-based swap positions pose over the lives of those positions. An exclusive focus on short-term risks would fail to account for the possibility that an entity's large swap or security-based swap positions can readily produce large losses in adverse market circumstances, potentially leading either to large uncollateralized exposure (if the posting of collateral is not required), or to large collateral calls

⁸⁸¹ CFTC Regulation § 1.3(jjj)(3); Exchange Act rule 3a67-3(c).

⁸⁸² See Proposing Release, 75 FR at 80188.

⁸⁸³ See *id.* at 80191.

⁸⁸⁴ See letters from SIFMA AMG II and Vanguard.

that may lead to the entity's default (or to calls for extraordinary action) and that can threaten non-defaulting parties with significant costs and challenges in connection with liquidating and replacing those positions. The analysis should give appropriate weight to those risks.

ii. Risk multipliers

Subject to modifications addressed below, the final rules implementing the "substantial position" analysis incorporate a potential future exposure test based on the proposal's general approach of adjusting notional positions using risk multipliers.⁸⁸⁵ This approach incorporates and builds upon tests used by bank regulators for the purposes of setting prudential capital.⁸⁸⁶ Through this methodology, the final rules implement an objective approach that readily can be replicated by market participants.

Although some commenters have suggested the use of value-at-risk measures or internal models to evaluate potential future exposure,⁸⁸⁷ we do not believe that such approaches would be well tailored to be implemented by a range of market participants, or would lead to comparable results across market participants with identical swap or security-based swap portfolios.

In adopting this approach, we are mindful of the significance of commenter concerns about the adequacy of the tables that set forth the risk multipliers that would be applied to notional positions. These comments address, among other issues: discontinuities in the tables; the failure to account for whether, and how much, a swap or security-based swap is in-the-money

⁸⁸⁵ See CFTC Regulation § 1.3(jjj)(3)(ii)(A)(1); Exchange Act rule 3a67-3(c)(2)(i).

⁸⁸⁶ See 12 CFR part 3, app. C, section 32 (Office of the Comptroller of the Currency capital adequacy guidelines for banks); 12 CFR part 325, app. D, section 32 (Federal Deposit Insurance Corp. capital adequacy guidelines for banks); 12 CFR part 208, app. F, section 32 (Federal Reserve System capital adequacy guidelines for banks); 12 CFR part 225, app. G, section 32 (Federal Reserve System capital adequacy guidelines for bank holding companies).

⁸⁸⁷ See letters from Riverside Risk Advisors and Better Markets I.

or out-of-the money; the failure of the multipliers applicable to interest rate swaps to distinguish between counterparties who pay floating rates and counterparties who pay fixed rates; the failure of the multipliers in the credit category to account for the volatility of the underlying instrument or the duration of the swap or security-based swap; the failure of the multipliers for equity and commodity swaps to distinguish between high-volatility and low-volatility stocks and commodities; the adequacy of how the test addresses diversification and correlation; the fact that the approach does not provide for delta weighting of options positions; and the fact that the factors do not distinguish between index and single-name credit default swaps.⁸⁸⁸ While we acknowledge that it may be possible to develop revised risk multipliers that are more finely tuned to reflect relevant risk factors, at this time we believe that it would be most appropriate to implement the “substantial position” analysis by building upon an existing regulatory approach that is comparatively simpler to implement and leads to reproducible results, rather than seeking to develop a brand new approach.⁸⁸⁹

The final rules implementing the “major security-based swap participant” definition, however, modify the proposed risk multipliers in response to commenter concerns about how the “major” categories of security-based swaps should be applied to the risk multiplier categories. In

⁸⁸⁸ See, e.g., letters from Riverside Risk Advisors and MFA I.

⁸⁸⁹ We also are not following a commenter suggestion to incorporate the “standardized method” prescribed as part of the “Basel II” bank capital methodology. See letter from ISDA I. The standardized method relies on counterparty credit ratings provided by external credit rating agencies for purposes of calculating risk-weighted capital measurements. See “International Convergence of Capital Measurement and Capital Standards, A Revised Framework, Comprehensive Version,” the Basel Committee on Banking Supervision, June 2006. Incorporating this reliance on credit ratings provided by external credit rating agencies into these final rules would be inconsistent with Section 939A of the Dodd-Frank Act, which required all Federal agencies to review and modify existing regulations “to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations.”

particular, the final risk multiplier category for security-based swaps in the “equity and other” category encompasses all security-based swaps that are not credit derivatives, and the final rules eliminate the proposed category for “other” types of security-based swaps.⁸⁹⁰

iii. Potential future exposure measures for certain lower-risk positions

Consistent with the proposal, the potential future exposure calculation will exclude purchases of options and other positions for which a person has prepaid or otherwise satisfied its payment obligations.⁸⁹¹ Also, in response to commenter concerns, the final rules expand on the proposal with regard to capping the potential future exposure associated with certain lower-risk swap and security-based swap positions. The final rules particularly cap – at the net present value of the unpaid premiums – the potential future exposure associated with positions by which a person buys credit protection using a credit default swap, and positions by which a person purchases an option for which the person retains additional payment obligations under the position.⁸⁹² This reflects the reduced risk associated with such positions. The final rules do not prescribe a particular discount rate for purposes of this analysis, and market participants instead should use a commercially appropriate discount rate.

⁸⁹⁰ See Exchange Act rule 3a67-3(c)(2)(i). Aside from making the risk multipliers consistent with the “major” categories of security-based swaps, this change also should allow total return swaps on debt to be subject to the same risk multipliers as total return swaps on equity, rather than causing the debt swaps to be subject to higher multipliers (which may not accurately reflect the comparative risks of those instruments).

⁸⁹¹ See CFTC Regulation § 1.3(jjj)(3)(ii)(A)(3)(ii); Exchange Act rule 3a67-3(c)(2)(i)(C).

⁸⁹² See CFTC Regulation § 1.3(jjj)(3)(ii)(A)(4); Exchange Act rule 3a67-3(c)(2)(i)(D). The proposed rules would have applied this net present value caps only to the purchase of credit protection. The final rules expand this provision by also capping the potential future exposure associated with the purchases of options in which an entity retains payment obligations, to reflect the reduced risk associated with those positions.

In addition, to better align the results of the potential future exposure analysis with the risks that a person presents, the final rules have been modified from the proposal to also exclude swap or security-based swap positions for which, pursuant to regulatory requirement, a person has placed in reserve an amount of cash or Treasury securities that is sufficient to pay the person's maximum possible liability under the position, when the person is prohibited from using that cash or those securities without also liquidating the swap or security-based swap position.⁸⁹³

iv. Adjustments for netting

Consistent with the proposal, and with the bank regulator standards that form the basis for these potential future exposure measures, the final rules provide that an entity may reduce the measure of its potential future exposure in a major category by up to 60 percent to reflect the risk mitigation effects of master netting agreements. We believe that this approach appropriately reflects the risk mitigating attributes of netting on potential future exposure. Moreover, in light of commenter requests for clarification of how these netting provisions would be applied,⁸⁹⁴ the final rules have been revised from the proposal to provide that the risk reduction associated with netting should be estimated using the same pro rata allocation methodology that will be used to measure current exposure.⁸⁹⁵

⁸⁹³ CFTC Regulation § 1.3(jjj)(3)(ii)(A)(3)(iii); Exchange Act rule 3a67-3(c)(2)(i)(C)(3). This exclusion of such positions from the major participant analysis may apply, for example, to certain swap or security-based swap positions of insurers where applicable law requires an amount equal to the maximum possible exposure of the insurer be segregated.

⁸⁹⁴ See letter from SIFMA AMG II.

⁸⁹⁵ Consistent with the proposal, the effects of netting are to be estimated using the formula: $P_{Net} = 0.4 \times P_{Gross} + 0.6 \times NGR \times P_{Gross}$. Under that equation, P_{Net} is the potential exposure adjusted for bilateral netting; P_{Gross} is that potential outward exposure without adjustment for bilateral netting; and NGR is the net to gross ratio. The final rule has been revised from the proposal to clarify that the net to gross ratio equals the current exposure associated with the major category as calculated using the pro rata

v. Adjustments for cleared and margined positions

The final rules also provide for the measure of potential future exposure to be adjusted in the case of swap and security-based swap positions that are centrally cleared or that are subject to daily mark-to-market margining. This is consistent with the purpose of the potential future exposure test, which is to account for the extent to which the current outward exposure of positions (though possibly low or even zero at the time of measurement) might grow to levels that can lead to high counterparty risk to counterparties or to the markets generally. The practice of the periodic exchange of mark-to-market margin between counterparties helps to mitigate the potential for large future increases in current exposure.

Consistent with the proposal, the final rules reflect this ability to mitigate risk by providing that the potential future exposure associated with positions that are subject to daily mark-to-market margining will equal 0.2 times the amount that otherwise would be calculated. However, in response to commenters' opinions about the risk-mitigating effects of central clearing, and the additional level of rigor that clearing agencies may have with regards to the process and procedures for collecting daily margin, the final rules further provide that the potential future exposure associated with positions that are subject to central clearing will equal

methodology discussed above, divided by what the measure of current exposure in connection with those out-of-the-money positions would be in the absence of that methodology.

Accordingly, for the example set forth in note 875, *supra*, the *NGR* for "security-based credit derivatives" and "other security-based swaps" both would equal 0.48 (equal to \$19.2 million net exposure divided by \$40 million in out-of-the-money positions in the case of "security-based credit derivatives," or \$43.2 million net exposure divided by \$90 million in out-of-the-money positions in the case of "other security-based swaps"). If an entity has no current exposure to a counterparty following the application of netting arrangements and collateralization, the *NGR* for those positions would equal zero, and the potential exposure would equal 40 percent of what it would equal otherwise.

0.1 (rather than the proposed 0.2) times the potential future exposure that would otherwise be calculated.⁸⁹⁶

Although some commenters supported the complete exclusion of cleared positions from the potential future exposure analysis,⁸⁹⁷ and we are mindful of the risk mitigating attributes of central clearing, we also recognize that central clearing cannot reasonably be expected to entirely eliminate counterparty risk.⁸⁹⁸ We conclude, however, that the use of a 0.1 factor (in lieu of the proposed 0.2) would be appropriate for cleared positions, reflecting the strong risk mitigation features associated with central clearing, particularly the procedures regarding the collection of daily margin and the use of counterparty risk limits, while recognizing the presence of some remaining counterparty risk.

⁸⁹⁶ See CFTC Regulation § 1.3(jj)(3)(iii)(A); Exchange Act rule 3a67-3(c)(3)(i). The final rules further have been revised to clarify that the 0.1 factor applies to positions cleared by a registered clearing agency or by a clearing agency that has been exempted from registration.

⁸⁹⁷ See, e.g., letters from MFA I and SIFMA AMG II.

⁸⁹⁸ Central clearing helps to mitigate counterparty credit risk by improving risk management and, among other things, mutualizing the risk of counterparty failure. If multiple members of a central counterparty fail beyond the level to which such risk is managed, however, the central counterparty would also be at risk of failure. Cf. Basel Committee on Banking Supervision, Consultative Document, "Capitalisation of bank exposures to central counterparties," Nov. 25, 2011 (available at: <http://www.bis.org/publ/bcbs206.pdf>) (proposing that the capital charge for trade exposures to a qualifying central counterparty should carry a low risk weight, reflecting the relatively low risk of default of the qualifying central counterparty). In addition, as we discussed in the Proposing Release, see 75 FR at 80192 n.115, for example, central counterparties that clear credit default swaps do not necessarily become the counterparties of their members' customers (although even absent direct privity those central counterparties benefit customers by providing for protection of collateral they post as margin, and by providing procedures for the portability of customer positions in the event of a member's default). As a result, central clearing may not eliminate the counterparty risk that the customer poses to the member, although required mark-to-market margining should help control that risk, and central clearing would be expected to reduce the likelihood that an entity's default would lead to broader market impacts.

Moreover, although some commenters opposed any deduction from the measure of potential future exposure for uncleared positions that are margined on a daily basis,⁸⁹⁹ we believe that the risk-mitigating attributes of daily margining warrant an adjustment given that the goal of the potential future exposure test is to account for price movements over the remaining life of the contract.⁹⁰⁰ The use of a 0.2 factor also reflects our expectation that the risk mitigation associated with uncleared but margined positions would be less than the risk mitigation associated with cleared positions.

While higher or lower alternatives to the 0.1 and 0.2 factors may also be reasonable for positions that are cleared or margined on a daily basis, we believe that the factors of the final rules reasonably reflects the risk mitigating (but not risk eliminating) features of those practices. The final rules also retain and clarify provisions addressing when daily mark-to-market margining occurs for purposes of this discount.⁹⁰¹

⁸⁹⁹ See letter from Better Markets I; see also letter from AFR.

⁹⁰⁰ We do not believe that it is appropriate to have this type of discount when mark-to-market margining is done less than daily, however.

⁹⁰¹ We recognize that at times, market participants whose agreements provide for the daily exchange of variation margin in connection with swaps or security-based swaps in practice may not exchange collateral daily, if the amounts at issue are relatively small (such as through the use of collateral thresholds and minimum transfer amounts). We do not believe that such practices would be inconsistent with providing a discount for daily margining practices. The proposed rules sought to accommodate those practices by providing that positions would be considered to be subject to daily mark-to-market margining for purposes of the “uncollateralized outward exposure” plus “potential outward exposure” analysis, so long as the total of such thresholds, and the total of such minimum transfer amounts above \$1 million are deemed to be “uncollateralized outward exposure” for those purposes.

In light of commenter concerns, which indicated that the proposal was not fully clear about the mechanics and purpose of this approach, the relevant rule language has been revised to clarify that this attribution of thresholds and minimum transfer amounts is solely for the purpose of determining whether certain positions are subject to daily mark-to-market margining for purposes of the analysis. In addition, the final rules have been revised from the proposal to provide that the attribution of thresholds as “uncollateralized outward exposure” for these purposes will be reduced by initial margin posted, up to the amount of the threshold. See CFTC Regulation § 1.3(jjj)(iii)(B); Exchange Act rule 3a67-3(c)(3)(ii).

vi. Application of “effective notional” amounts

Consistent with the proposal (as well as the rules implementing the de minimis exception to the dealer definitions), the potential future exposure test is based on the “effective notional” amount of the swap or security-based swap when the stated notional is leveraged or enhanced by the structure of the swap or security-based swap.⁹⁰²

Moreover, as discussed in the Proposing Release,⁹⁰³ in the case of positions that represent the sale of an option on a swap or security-based swap (other than the sale of an option permitting the person exercising the option to purchase a credit default swap), we would view the effective notional amount of the option as being equal to the effective notional amount of the underlying swap or security-based swap, and in general we would view the duration used for purposes of the formula as being equal to the sum of the duration of the option and the duration of the underlying swap or security-based swap.⁹⁰⁴

vii. Treatment of initial margin or overcollateralization

The final rules retain the proposed approach of not modifying the measure of potential

⁹⁰² As discussed above, this may occur, for example, if the exchange of payments associated with an equity swap is based on a multiple of the return associated with the underlying equity. As is the case for measuring current exposure, the final rules do not prescribe any particular methodology for calculating the notional amount or effective notional amount used in the calculation of potential future exposure, but instead contemplate the use of industry standard practices.

⁹⁰³ See Proposing Release, 75 FR 80192 n.110.

⁹⁰⁴ The effective notional amount of the underlying instrument is used for these purposes because that amount fairly reflects the basis for measuring the potential counterparty risk associated with the instrument. The sum of the duration of the option and the underlying instrument is used for these purposes because that sum reflects the length of time of the potential counterparty risk associated with the instrument.

At the same time, we agree with a commenter’s view that if the underlying swap or security-based swap is cash settled, the calculation of duration will only include the duration of the option, and not the duration of the swap, because counterparty exposure would exist only until the option expiration date. See letter from MFA I.

future exposure to reflect collateral that a person has posted to its counterparty in excess of current exposure. Although we recognize that the posting of excess collateral may mitigate the future credit risk that the potential future exposure measure is intended to estimate, that mitigating effect is not certain, and any such mitigation may not reflect the full value of the excess collateral. Moreover, while we believe that the measure of potential future exposure associated with swap or security-based swap positions reasonably estimates the credit risk that may be posed by those positions for purposes of the substantial position analysis, we also recognize that particular positions may prove to pose a far higher amount of credit risk.⁹⁰⁵ Given how the credit risk associated with a swap or security-based swap position can far exceed the associated measure of potential future exposure, we do not believe that it would be appropriate to offset that measure to account for overcollateralization.⁹⁰⁶

d. Thresholds

The final rules retain the proposed thresholds for the amount of current uncollateralized exposure and potential future exposure that will cause an entity to be deemed to be a major participant. Accordingly, for a person to have a "substantial position" in a major category of swaps, it would be necessary for that person to have a daily average current uncollateralized exposure of at least \$1 billion (or \$3 billion for the rate swap category), or a daily average

⁹⁰⁵ For example, if a person writes a CDS that provides \$10 billion in protection on a reference entity, with the CDS being subject to daily mark-to-market margining, then for purposes of the substantial position analysis that CDS would be associated with a potential future exposure measure of no more than \$200 million (reflecting the 0.1 conversion factor and the additional 0.2 multiplier for margined positions), even before accounting for netting. Yet if the reference entity were to default, the writer of the CDS could pose up to \$10 billion in credit risk to its counterparty.

⁹⁰⁶ However, as discussed above, *see* note 901, *supra*, initial margin may be considered when determining if a collateral threshold is to be attributed to current uncollateralized exposure for purposes of determining whether certain positions are subject to daily mark-to-market margining for purposes of the substantial position analysis.

current uncollateralized exposure plus potential future exposure of \$2 billion (or \$6 billion for the rate swap category).⁹⁰⁷ To have a “substantial position” in a major category of security-based swaps, it would be necessary for the person to have a daily average current uncollateralized exposure of at least \$1 billion, or a daily average current uncollateralized exposure plus potential future exposure of at least \$2 billion.⁹⁰⁸

As the Proposing Release noted, the proposed thresholds sought to reflect: (i) the financial system’s ability to absorb losses of a particular size; (ii) the recognition that it would not be appropriate for the substantial position test to encompass entities only after they pose significant risks to the market through their swap or security-based swap activity; and (iii) the need to account for the possibility that multiple market participants may fail close in time.⁹⁰⁹ While some commenters took the position that the proposed thresholds were inappropriately low, those commenters did not present empirical data or analysis in support of that view. Moreover, the Commissions do not concur with the suggestion⁹¹⁰ that the major participant definitions can reasonably be read to require that we defer this rulemaking until we have gathered additional data. Instead, the definitions direct us to set a standard that is “prudent,” which is what we have sought to do.

Some commenters who supported an increase in the proposed thresholds attempted to support their positions via analogy to past events, with the most significant of these being an

⁹⁰⁷ CFTC Regulation § 1.3(jjj)(1).

⁹⁰⁸ Exchange Act rule 3a67-3(a).

⁹⁰⁹ As discussed above, we do not believe it would be prudent to presume that entity failures will be separated in time during periods of financial stress.

⁹¹⁰ See letters from BlackRock I and CCMR I.

analogy to AIG Financial Products ("AIG FP").⁹¹¹ The analogy to AIG FP⁹¹² actually argues against an increase in these thresholds, however, particularly given that the credit derivative portfolio that significantly contributed to the liquidity problems that AIG FP faced amounted to \$72 billion in notional amount.⁹¹³ Under the final rules, in the presence of central clearing or daily marking to market it would take a credit derivative portfolio in excess of that amount to trigger the potential future exposure threshold under the "substantial position" analysis.⁹¹⁴ This

⁹¹¹ See letter from ABC/CIEBA. One commenter's analogy to Enron also is unpersuasive. See letter from BG LNG I. In particular, the \$18.7 billion in Enron derivatives exposure cited by that commenter does not account for collateral posted in connection with those positions. Also, the market impact of Enron's bankruptcy was substantially mitigated by the sale of Enron's derivatives trading arm to a third party.

Moreover, although one commenter generally alluded to corporate financial losses in the derivatives markets that exceeded the proposed \$1 billion and \$2 billion thresholds, see letter from NCGA/NGSA II, the relevant question does not focus on losses that market participants have incurred, but instead focuses on what degree of credit risk to counterparties in the swap and security-based swap markets presents such a potential to cause significant market impact that it would be prudent to regulate persons who pose that degree of credit risk in connection with their swap or security-based swap positions.

⁹¹² Our discussion of how the major participant analysis may apply to an entity that has a portfolio of a size equivalent to that of AIG FP should not be read to imply that a person may engage in swap and security-based swap activities akin to those of AIG FP without registering as a swap dealer or security-based swap dealer.

⁹¹³ See, e.g., Congressional Oversight Panel, The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy 22-24 (2010) (discussing how the risk in AIG's CDS business largely was the result of a "multi-sector" CDO book that amounted to \$72 billion notional as of September 2008, and how the losses to AIG were driven by 125 of the roughly 44,000 contracts entered into by AIG FP).

⁹¹⁴ For cleared security-based credit default swaps (in which we assume daily margining requirements result in no current uncollateralized exposure) achieving \$2 billion of potential future exposure would require writing \$200 billion notional of credit default swap protection (reflecting the 0.10 multiplier in the risk adjustment tables, and the additional 0.10 multiplier for positions that are cleared). Similarly, it would take a \$100 billion notional portfolio of uncleared but marked-to-market security-based credit default swaps to meet that same threshold (reflecting the 0.20 multiplier for positions that are subject to daily mark-to-market margining). The total might be even higher if such instruments were subject to counterparty netting agreements.

Even in the absence of clearing or daily mark-to-market margining, it would take a minimum \$20 billion notional portfolio of written protection on credit (reflecting the 0.10 multiplier in the risk adjustment tables) to meet the \$2 billion potential future exposure threshold. Accounting for netting

indicates that the thresholds are not inappropriately low, particularly given our view that the major participant definition is intended to encompass entities before their swap or security-based swap positions pose significant market threats.⁹¹⁵ Conversely, while additional data and analysis may warrant a reduction of these thresholds in the future, commenters who supported a reduction in those thresholds have not persuaded us that the proposed thresholds should be lowered.

The final rules do not incorporate a mechanism for revising the thresholds over time. Instead, the Commissions intend to evaluate the operation of the major participant tests, and as appropriate, consider possible revisions to the thresholds (as well as to other aspects of the tests).

e. Additional issues

The final rules applying the “substantial position” analysis and the major participant definitions generally apply to all types of swaps or security-based swaps that a person maintains. Although one commenter suggested that swaps on government securities should be excluded from the analysis, the rules will not provide such an exclusion. To the extent that a person presents credit risk as a result of swaps referencing government securities, there is no basis for disregarding that risk when determining whether the person is a major participant.

(which can reduce potential future exposure measures by up to 60 percent) could materially increase that required amount.

⁹¹⁵ The case of Long-Term Capital Management (“LTCM”) also is instructive in connection with the current exposure thresholds of the major participant analysis. Had LTCM failed, its top 17 counterparties would have suffered estimated total losses of between \$3 and \$5 billion. See President’s Working Group on Financial Markets, Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management (April 1999) at 17 (<http://www.treasury.gov/resource-center/fin-mkts/Documents/hedgfund.pdf>). The government acted in connection with LTCM because the rushed close-out of LTCM’s positions would have affected other market participants, and the spread of losses would have led to market uncertainty, likely causing a number of credit and interest rate markets to experience extreme price moves and possibly not function for a period of time. See Statement by William J. McDonough, President Federal Reserve Bank of New York before the Committee on Banking and Financial Services U.S. House of Representatives (October 1, 1998) (http://www.newyorkfed.org/newsevents/speeches_archive/1998/mcd981001.html).

In addition, in light of one commenter's concern,⁹¹⁶ the Commissions believe that it is important to emphasize that these rules should not be interpreted to deter end-users from requesting margin from dealers or major participants who are their counterparties to swaps or security-based swaps.

Also, in light of a point raised by another commenter,⁹¹⁷ the Commissions note that these rules implementing the major participant definitions do not place any independent calculation or other obligations upon counterparties to potential major participants, and that the rules do not preclude a potential major participant from seeking the assistance of a third party to perform the relevant calculation.

C. "Hedging or Mitigating Commercial Risk"

1. Proposed approach

a. General availability of the proposed exclusion

The first test of the major participant definitions excludes positions held for "hedging or mitigating commercial risk" from the substantial position analysis.⁹¹⁸ In the Proposing Release, we preliminarily concluded that positions that hedge or mitigate a person's commercial risk may qualify for this exclusion regardless of whether the entity is financial or non-financial in nature.⁹¹⁹ That conclusion in part was prompted by the fact that the statutory major participant definitions do not explicitly make the exclusion unavailable to financial entities; in contrast to the Title VII exceptions from mandatory clearing requirements in connection with hedging

⁹¹⁶ See letter from FHLB I.

⁹¹⁷ See letter from ISDA I.

⁹¹⁸ See CEA section 1a(33)(A)(i)(I); Exchange Act section 3(a)(67)(A)(i)(I).

⁹¹⁹ See Proposing Release, 75 FR at 80194.

commercial risk,⁹²⁰ which explicitly are unavailable to financial entities.⁹²¹ The conclusion also was prompted by the presence of the third major participant test – which specifically applies the substantial position analysis to certain non-bank financial entities but (unlike the first test) does not exclude commercial risk hedging positions from the analysis.⁹²²

In the Proposing Release, we also preliminarily concluded that the question of whether an activity is commercial in nature should not be determined solely by a person's organizational status as a for-profit, non-profit or governmental entity, but instead should depend on whether the underlying activity is commercial in nature.⁹²³

The proposal did not preclude the exclusion from being available in connection with hedges of a person's "financial" or "balance sheet" risks. In addition, the proposal solicited comment as to whether the exclusion should extend to activities in which a person hedges an affiliate's risk.

b. Proposed definition under the CEA exception

The proposed interpretation of "hedging or mitigating commercial risk" for purposes of the CEA's definition of "major swap participant" premised the exclusion on the principle that

⁹²⁰ See CEA section 2(h)(7)(A); Exchange Act section 3C(g)(1)(B).

⁹²¹ As we discussed in the Proposing Release, had the Dodd-Frank Act intended the phrase "hedge or mitigate commercial risk" to apply only to activities of, or positions held by, non-financial entities, it would not have been necessary for the mandatory clearing exceptions to include additional provisions generally restricting the availability of the exceptions to non-financial entities. See Proposing Release, 75 FR at 80194.

⁹²² As we discussed in the Proposing Release, the third statutory major participant test would be redundant if the hedging exclusion in the first major participant test were entirely unavailable to financial entities. See Proposing Release, 75 FR at 80194 n.125.

⁹²³ See Proposing Release, 75 FR at 80194.

swaps necessary to the conduct or management of a person's commercial activities should not be included in the calculation of the entity's substantial position.⁹²⁴

The CFTC noted first that the phrase "hedging or mitigating commercial risk" as used with respect to the major swap participant definition is virtually identical to Dodd-Frank provisions granting an exception from the mandatory clearing requirement to non-financial entities that are using swaps to hedge or mitigate commercial risk.⁹²⁵ Also noted was that although only non-financial entities that use swaps or security-based swaps to hedge or mitigate commercial risk generally may qualify for the clearing exemption, no such statutory restriction applies with respect to the exclusion for hedging positions in the first test of a major participant. We therefore concluded that positions established to hedge or mitigate commercial risk may qualify for the exclusion, regardless of the nature of the entity – i.e., whether or not the entity is financial (including a bank) or non-financial.⁹²⁶

The CFTC preliminarily believed that whether a position hedges or mitigates commercial risk should be determined by the facts and circumstances at the time the swap is entered into, and should take into account the entity's overall hedging and risk mitigation strategies. However, the

⁹²⁴ The scope of the proposed exclusion is based on our understanding that when a swap or security-based swap is used to hedge a person's commercial activities, the gains or losses associated with the swap or security-based swap itself will generally be offset by losses or gains in the person's commercial activities, and hence the risks posed by the swap or security-based swap to counterparties or the industry will generally be mitigated.

⁹²⁵ See CEA section 2(h)(7)(A); Exchange Act section 3C(g)(1)(B) (exception from mandatory clearing requirements when one or more counterparties are not "financial entities" and are using swaps or security-based swaps to "hedge or mitigate commercial risk").

⁹²⁶ The presence of the third major participant test suggests that financial entities generally may not be precluded from taking advantage of the hedging exclusion in the first test. The third test, which does not account for hedging, specifically applies to non-bank financial entities that are highly leveraged and have a substantial position in a major category of swaps or security-based swaps. That test would be redundant if the hedging exclusion in the first major participant test were entirely unavailable to financial entities.

swap could not be held for a purpose that is in the nature of speculation, investing or trading. We anticipated that a person's overall hedging and risk management strategies would help inform whether or not a particular position is properly considered to hedge or mitigate commercial risk. Further, the exclusion under the Proposing Release included swaps hedging or mitigating any of a person's business risks, regardless of the swap's status under accounting guidelines or the bona fide hedging exemption.

c. Proposed definition under the Exchange Act exception

For purposes of the Exchange Act's "major security-based swap participant" definition, the proposed rule defining "hedging or mitigating commercial risk" would require that a security-based swap position be "economically appropriate" to the reduction of risks in the conduct and management of a commercial enterprise, where those risks arise from the potential change in the value of assets, liabilities and services connected with the ordinary course of business of the enterprise.⁹²⁷ The Proposing Release stated that the SEC preliminarily planned to interpret the concept of "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 further stated that the SEC also preliminarily believed that for a security-based swap to be deemed "economically appropriate" in this context, it should not introduce any new material quantum of risks (*i.e.*, it could not reflect over-hedging that could reasonably have a speculative effect) and it should not introduce any basis risk or other new types of risk

⁹²⁷ See proposed Exchange Act rule 3a67-4(a).

(other than the counterparty risk that is attendant to all security-based swaps) more than reasonably necessary to manage the identified risk.⁹²⁸

The proposed rules further provided that the security-based swap position could not be held for a purpose that is in the nature of speculation or trading – a limitation that would make the exclusion unavailable to security-based swap positions that are held intentionally for the short term and/or with the intent of benefiting from actual or expected short-term price movements or to lock in arbitrage profits, including security-based swap positions that hedge other positions that themselves are held for the purpose of speculation or trading.⁹²⁹ The proposal also provided that a security-based swap position could not be held to hedge or mitigate the risk of another security-based swap position or swap position unless that other position itself is held for the purpose of hedging or mitigating commercial risk.⁹³⁰ Finally, the proposal would have conditioned the entity's ability to exclude these security-based swap positions on the entity engaging in certain specified activities related to documenting the underlying risks and assessing the effectiveness of the hedge in connection with the security-based swap positions.⁹³¹

2. Commenters' views

a. In general

Several commenters generally supported the broad concepts underlying the proposed rules for identifying hedges of commercial risk, and particularly supported the proposed use of an "economically appropriate" standard instead of the "highly effective" standard that is used to

⁹²⁸ See Proposing Release, 75 FR at 80195 n.129.

⁹²⁹ See proposed Exchange Act rule 3a67-4(b)(1), and Proposing Release, 75 FR at 80195 n.131.

⁹³⁰ See proposed Exchange Act rule 3a67-4(b)(2).

⁹³¹ See proposed Exchange Act rule 3a67-4(c).

identify hedges for accounting purposes.⁹³² On the other hand, one commenter stated that the definition should incorporate all manner of risks associated with commercial operations, including interest rate and currency risks, risks from incidental activities to commercial activities and risks from financial commodities.⁹³³ One commenter further stated that the definition should encompass positions that facilitate asset optimization and dynamic hedging.⁹³⁴

Commenters further stated that the exception should include any position taken as part of a bona fide risk mitigation strategy,⁹³⁵ and that Congress included “mitigation” in the exception for the purpose of covering risk reduction strategies that may not clearly be hedges but mitigate risk.⁹³⁶ Some commenters also criticized the Proposing Release’s position equating the terms “hedging” and “mitigating.”⁹³⁷ One commenter also expressed concern that entities would find it difficult to analyze their positions with respect to the Proposing Release’s statement, in the context of the Exchange Act definition, that “economically appropriate” security-based swaps would not add a new quantum of risk.⁹³⁸

Conversely, some commenters suggested that the proposed interpretation was too broad,⁹³⁹ and that a broad interpretation could allow evasion,⁹⁴⁰ or permit corporate end users to

⁹³² See letters from ACLI, Barnard, CDEU, COPE I, EEI/EPSCA, FSR I, ISDA I, Kraft, MetLife, NAIC, Philip Morris International Inc. (“Philip Morris”) and Utility Group.

⁹³³ See letter from CDEU.

⁹³⁴ See letter from Peabody.

⁹³⁵ See letter from ISDA I.

⁹³⁶ See letter from CDEU.

⁹³⁷ See letters from APG, CDEU and ISDA I.

⁹³⁸ See letter from SIFMA AMG II.

⁹³⁹ See letters from AFR and AFSCME. The CFTC also received submissions of a substantially identical letter from approximately 193 individuals and small businesses urging the CFTC to define commercial risk narrowly to include only risks arising from physical commodity price fluctuations, and

accumulate very large positions without becoming major swap participants.⁹⁴¹ One commenter stated that to include “financial risks” within the exclusion’s scope would be improper because a “commercial risk” is one that is inherent in a person’s commercial activities, while interest rate and currency risks arise from choices about how a person structures and finances its operations.⁹⁴² Some commenters stated that the rule should not include hedging of financial risks because Congress deleted the reference in an earlier version of the Dodd-Frank Act to hedging of “balance sheet risk.”⁹⁴³ One commenter urged that we consider using accounting hedge treatment or the bona fide hedging exemption as guideposts for determining the availability of the exclusion.⁹⁴⁴ Commenters also raised concerns about differences between the proposed approaches under the CEA and Exchange Act definitions of the terms.⁹⁴⁵

One commenter suggested that the definition should be expanded to include as commercial risks the risks faced by government entities because their need to manage risk is no different than the need of commercial firms.⁹⁴⁶ Additional commenters suggested that commercial risk be interpreted to include risks faced by non-profit firms.⁹⁴⁷

not financial risks, and to construe the exception for captive finance companies narrowly. See, e.g., letter from Needham Oil & Air, LLC. In addition, the CFTC received submissions from approximately 535 individuals of a different letter, which also urged the CFTC to define commercial risk narrowly. See, e.g., letter from Christie Hakim.

⁹⁴⁰ See letters from Sen. Carl Levin (“Senator Levin”), Commodity Markets Oversight Coalition (“CMOC”) and Greenberger and meeting with MFA on February 14, 2011.

⁹⁴¹ See meeting with SIFMA AMG on February 4, 2011.

⁹⁴² See meeting with AFR and Better Markets on March 17, 2011.

⁹⁴³ See letters from AFR and CMOC, and meeting with Duffie on February 2, 2011.

⁹⁴⁴ See letter from Senator Levin.

⁹⁴⁵ See letters from Senator Levin, NAIC and SIFMA AMG II.

⁹⁴⁶ See letter from Milbank, Tweed, Hadley & McCloy LLP (“Milbank”).

⁹⁴⁷ See letters from CDEU and NFPEEU.

Some commenters also supported modification of the rule text for specific purposes such as including risks from “transmitting” to cover activities of electricity companies,⁹⁴⁸ to encompass risks “arising from” an asset rather than just risks arising from changes in value of the asset,⁹⁴⁹ and to encompass the use of swaps by structured finance special purpose vehicles to hedge interest rate risk in structured financing.⁹⁵⁰

b. Availability of exclusion to financial entities

Several commenters supported making the exclusion available to financial companies.⁹⁵¹ Some commenters further stated that there should be no special limits on financial entities with regard to the exclusion,⁹⁵² and that commercial risk should be defined broadly to include all of the commercial activities of a person, whether or not those activities relate to financial or non-financial commodities.⁹⁵³ Two commenters discussing the use of swaps by insurance companies stated that making the exclusion available to financial companies is consistent with CFTC practice in the futures markets, that there is no fundamental difference in how an insurance company or a commercial enterprise uses swaps to reduce its risk, and that commercial risk

⁹⁴⁸ See letter from Edison Int’l.

⁹⁴⁹ See letter from Milbank.

⁹⁵⁰ See letter from American Securitization Forum (“ASR”).

⁹⁵¹ See letters from ACLI, American Express Company (“Amex”), California State Teachers’ Retirement System (“CalSTRS”) dated Feb. 28, 2011 (“CalSTRS I”), ISDA I, MetLife, NAIC and Peabody.

⁹⁵² See letters from Amex, CalSTRS I and Peabody.

⁹⁵³ See letter from Amex.

encompasses financial risk.⁹⁵⁴ In addition, these commenters noted that insurance regulators allow insurance companies to use swaps to hedge risk.⁹⁵⁵

On the other hand, some commenters opposed allowing financial entities to avail themselves of the exclusion, arguing that there is no benefit from allowing a financial firm to avoid major participant regulation through the hedging exclusion,⁹⁵⁶ that the exclusion would allow financial companies to engage in risky trades,⁹⁵⁷ and that the exclusion should be narrowly interpreted to cover hedging of only risks related to products.⁹⁵⁸

c. Hedging risks of affiliates and third parties

Some commenters expressed support for allowing persons to take advantage of the hedging exclusion when they use swaps to hedge the commercial risks of affiliates or third parties. Some commenters suggested that a person that aggregates and hedges risk within a corporate group should be allowed to use the exclusion despite the fact that it is the affiliates' risks that are hedged.⁹⁵⁹ One commenter further stated that providers of risk management services should be allowed to take advantage of the exclusion because they are hedging commercial risk on behalf of their clients.⁹⁶⁰

⁹⁵⁴ See letters from ACLI and MetLife.

⁹⁵⁵ Id.

⁹⁵⁶ See letter from Senator Levin (further highlighting the need to add strict standards and controls to prevent evasion).

⁹⁵⁷ See letters cited in note 939, supra.

⁹⁵⁸ See letter from AFR.

⁹⁵⁹ See letters from CDEU, EDF Trading, Kraft, Metlife and Philip Morris.

⁹⁶⁰ See letter from EDF Trading.

One commenter, on the other hand, stated that the exclusion should be read narrowly for captive finance companies because the hedging entity may have to liquidate positions rapidly without access to affiliate's funds.⁹⁶¹

d. Hedge effectiveness and documentation

Many commenters suggested that the rule should not test hedge effectiveness, explaining that requiring demonstration of hedge effectiveness would impose a subjective standard and would not reduce systemic risk.⁹⁶² In this regard, some commenters that addressed the proposed procedural requirements in the Exchange Act definition argued that these procedures would place unnecessary regulatory burdens on entities not regulated under the Dodd-Frank Act.⁹⁶³ Conversely, one commenter that supported testing hedge effectiveness stated that the subdivided parts of a hedge should line up exactly with the subdivided parts of the risk.⁹⁶⁴

Some commenters agreed that the relationship between hedging and risk should be documented. One commenter expressed the view that documentation would facilitate audits.⁹⁶⁵ Others took the view that a person should be required to demonstrate that the hedge does not create additional risk, that the risk may be hedged by swaps, and that there is a link between the swap and the risk.⁹⁶⁶

⁹⁶¹ See meeting with Duffie on February 2, 2011.

⁹⁶² See letters from EEI/EPSC and EDF Trading; see also letters from CDEU, Kraft Metlife, NRG Energy and Philip Morris (that such a test would be overly prescriptive).

⁹⁶³ See letters from FSR I and SIFMA AMG I.

⁹⁶⁴ See letter from Better Markets I.

⁹⁶⁵ See letter from Metlife (but opposing ongoing evaluation of hedge effectiveness).

⁹⁶⁶ See letters from AFR and Senator Levin.

Several commenters suggested that once initiated, a hedge should not be retested over time, regardless of whether the position continues to serve a hedging purpose.⁹⁶⁷ Other commenters disagreed, stating that a position that is no longer a hedge should not be covered by the exclusion.⁹⁶⁸

e. Swaps that hedge positions held for speculative, investment or trading purposes

Many commenters took the view that swaps or security-based swaps used to hedge positions held for speculative, investment or trading purposes should qualify as hedges of commercial risk.⁹⁶⁹ A few commenters stated that speculation, investment and trading are fundamental to commercial activity, and thus cannot be differentiated from other types of commercial activity.⁹⁷⁰ Other commenters suggested the exclusion should cover swap positions that hedge other swap or security-based swap positions that are not themselves hedging positions.⁹⁷¹ Some commenters asserted that trading is different from speculating (taking an outright view on market direction) and investing (entering into a swap for appreciation in value of the swap position), and that swaps held for “trading” should be able to qualify for the exclusion.⁹⁷²

Some commenters requested that the definition under the CEA clarify how swaps that

⁹⁶⁷ See letters from CDEU, EDF Trading, EEI/EP SA, Kraft, Metlife, NRG Energy and Philip Morris.

⁹⁶⁸ See letters from Better Markets I and Senator Levin.

⁹⁶⁹ See letters from BG LNG II, COPE I, EP SA, FSR I, Metlife, Peabody, Vitol and WGCEF dated February 22, 2011 regarding the major swap participant definition (“WGCEF II”), and meeting with Bunge; see also letter from ISDA I (taking the view that swaps and security-based swaps used to hedge speculative positions should qualify as hedges and stating that failure to treat them as hedges would “invariably result in there being more unhedged speculative risk in the market”).

⁹⁷⁰ See letters from Vitol and WGCEF II and meeting with Bunge.

⁹⁷¹ See letters from BG LNG II, FSR I, ISDA I and Metlife.

⁹⁷² See letters from COPE I, EP SA and Peabody.

qualify as bona fide hedges are treated for the major swap participant definition if the underlying position had a speculative, investment or trading purpose,⁹⁷³ and clarify that while the hedging exclusion would not apply to swap positions that hedge other swap positions that are held for speculation or trading, the hedging provision would apply to swap positions that hedge other non-swap positions held for speculation or trading.⁹⁷⁴ Commenters also requested that the final rules provide that the hedging exclusion be available for physical positions in exempt or agricultural commodities and arbitrage positions relating to price differences between physical commodities at different locations.⁹⁷⁵ One commenter, on the other hand, suggested that even swap positions that hedge other swap positions which are not hedging positions should be treated as hedging commercial risk because they are risk reducing.⁹⁷⁶

Four commenters took the position that swaps held for a purpose that is in the nature of speculation, investing or trading should not qualify as hedges of commercial risk.⁹⁷⁷ One commenter pointed out that experience has shown that market participants sometimes inaccurately characterize positions as hedges (e.g., the inaccurate characterization occurs because the nature of positions change over time), and that excluding swap positions that hedge speculative, investment or trading positions would be especially inappropriate for financial firms that frequently use swaps to speculate, invest or trade.⁹⁷⁸ One commenter stated that any swap

⁹⁷³ See letters from Vitol and WGCEF dated June 3, 2011 regarding the major swap participant definition ("WGCEF VI").

⁹⁷⁴ See letter from BG LNG II.

⁹⁷⁵ See letters from BGLNG II and WGCEF VI.

⁹⁷⁶ See letters from MetLife.

⁹⁷⁷ See letters from AFR, Better Markets I and Senator Levin and meeting with Duffie on February 2, 2011.

⁹⁷⁸ See letter from Senator Levin.

position hedging another swap position could never be considered to be hedging commercial risk because the second swap is only adjusting the first swap position, meaning that neither swap would be congruent with risk reduction.⁹⁷⁹ Another commenter stated that the hedging exclusion should not cover any swap hedging a speculative position.⁹⁸⁰

3. Final rules – general availability of the exclusions

As with the proposed rules, the final CEA and Exchange Act rules implementing this exclusion are different in certain regards to reflect the different ways that swaps and security-based swaps may be expected to be used to hedge commercial risk, as well as differences in existing regulations under the CEA and the Exchange Act. Notwithstanding these differences, the two rules follow parallel approaches and address certain key issues in similar ways.

a. Availability to financial entities

Consistent with the position we took in the Proposing Release, the final rules with regard to both major participant definitions do not foreclose financial entities from being able to take advantage of the commercial risk hedging exclusion in the first major participant test. This conclusion in part is guided by the fact that the statutory text implementing this hedging exclusion does not explicitly foreclose financial entities from taking advantage of the exclusion – in contrast to Title VII's exceptions from mandatory clearing requirements for commercial risk

⁹⁷⁹ See letter from Better Markets I.

⁹⁸⁰ See meeting with Duffie on February 2, 2011.

hedging activities. The conclusion also results from the need to avoid an interpretation that would cause the third major participant test to be redundant.⁹⁸¹

In reaching this conclusion, we recognize that some commenters stated that there would be no benefit from allowing financial firms to avoid regulation as a major swap participant through the hedging exclusion, and that the exclusion should cover only risks related to non-financial commercial activities, or else the exclusion would allow financial companies to engage in risky transactions.⁹⁸² We believe that not allowing the exclusion to cover swaps or security-based swaps used for speculation or trading (or investments, in the case of swaps) will be sufficient to limit financial entities' ability to engage in risky transactions. We also are not persuaded that "commercial risk" should be limited to only risks related to non-financial activities.

We nonetheless recognize the significance of concerns that financial entities may seek to depict speculative positions as hedges to take advantage of the exclusion. We also are mindful of the need to give appropriate meaning to the term "commercial risk" within the exclusion. We believe that the standard set forth in the final rules, including the provisions that make the exclusions unavailable to swap or security-based swap positions of a speculative or trading nature (or investment purposes, in the case of swaps), apply the statutory test in a manner that

⁹⁸¹ While we recognize that commenters have identified policy reasons as to why financial entities should be entirely excluded from being able to take advantage of the hedging exclusion, we continue to believe the language of the major participant definitions dictates a contrary approach.

⁹⁸² See letters from AFR and Senator Levin.

appropriately addresses those other concerns. As discussed below, those standards limit the ability of financial entities to take advantage of the exclusion.⁹⁸³

b. Availability to non-profit and governmental entities

Under the final rules, a person's organizational status will not determine the availability of this hedging exclusion. The exclusion thus may be available to non-profit or governmental entities, as well as to for-profit entities, if the underlying activity to which the swap or security-based swap relates is commercial in nature.

c. Hedges of "financial" or "balance sheet" risks

Under the final rules, the exclusion is available to positions that hedge "financial" or "balance sheet" risks. While we recognize that some commenters oppose the exclusion of those positions,⁹⁸⁴ we nonetheless believe that the exclusion would be impermissibly narrow if it failed to extend to the "financial" or "balance sheet" risks that entities may face as part of their commercial operations, given that those types of risks (e.g., interest rate and foreign exchange risks) may be expected to arise from the commercial operations of non-financial end-users of swaps and security-based swaps. We do not believe the exclusion was intended to address those risks differently from other commercial risks, such as risks associated with the cost of physical inputs or the price received for selling products.⁹⁸⁵

⁹⁸³ We also do not believe that the size of an entity or an entity's position is determinative of whether a position hedges commercial risk. Moreover, given that the major participant definitions implicitly require large swap or security-based swap positions as triggers, a rule that made the hedging exclusion unavailable to entities with large positions could negate the statutory hedging exclusion.

⁹⁸⁴ See notes 942 and 943, supra.

⁹⁸⁵ Moreover, it is questionable as to what types of security-based swap positions – if any – would fall within the exclusion for purposes of the "major security-based swap participant" definition if the exclusion did not extend to hedges of "financial" or "balance sheet" risks. Security-based swaps such as

d. Hedging on behalf of an affiliate

The final rules further provide that the exclusion is not limited to the hedging of a person's own risks, but also would extend to the hedging of the risks of a person's majority-owned affiliate.⁹⁸⁶ This approach reflects the fact that a corporate group may use a single entity to face the market to engage in hedging activities on behalf of entities within the group. In our view, it would not be appropriate for the swap or security-based swap positions of the market-facing entity to be encompassed within the first major participant test if those same positions could have been excluded from the analysis if entered into directly by the affiliate.⁹⁸⁷ Of course, the exclusion will only be available to the market-facing entity if the position would have been subject to the exclusion – e.g., not for a speculative or trading purpose – had the affiliate directly entered into the position.

single-name credit default swaps and equity swaps would not appear amenable to hedging a commercial entity's non-financial risks, such as price risks associated with non-financial inputs or sales. We do not believe that it would be appropriate to interpret the exclusion in such a way as to make it a nullity in the context of the "major security-based swap participant" definition.

⁹⁸⁶ See CFTC Regulation § 1.3(kkk)(1)(i); Exchange Act rule 3a67-4(a)(1). For these purposes – consistent with the standards regarding the application of the dealer and major participant definitions to inter-affiliate swaps and security based swaps, see parts II.C and IV.G – we would view the counterparties to be majority-owned affiliates if one party directly or indirectly holds a majority ownership interest in the other, or if a third party directly or indirectly holds a majority interest in both, based on holding a majority of the equity securities of an entity, or the right to receive upon dissolution or the contribution of a majority of the capital of a partnership. See note 348, supra.

⁹⁸⁷ The exclusion, however, would not be available to the extent that a person enters into swaps or security-based swaps in connection with the hedging activities of an unaffiliated third party. Such activities, moreover, may indicate that the person is acting as a swap dealer or security-based swap dealer.

4. Final rules – “major swap participant” definition under the CEA

a. In general

The general scope of the rule regarding “hedging or mitigating risk” will be adopted substantially as proposed.⁹⁸⁸ The CFTC, however, is adopting CFTC Regulation § 1.3(kkk) with a modification to paragraph (1)(iii) to include a reference to qualified hedging treatment for positions meeting Government Accounting Standards Board (“GASB”) Statement 53, Accounting and Financial Reporting for Derivative Instruments. The CFTC believes that this minor modification to CFTC Regulation § 1.3(kkk) is necessary in order to include swaps that qualify for hedging treatment issued by GASB.⁹⁸⁹

As noted above, the CFTC will not prohibit financial companies from using the hedging exclusion because the exclusion for positions held for hedging or mitigating commercial risk set forth in CEA section 1a(33)(A)(i)(1) does not limit its application based on the characterization or status of the person or entity. Unlike the end-user clearing exemption of section 2(h)(7), the major swap participant hedging exclusion is not foreclosed to financial entities.⁹⁹⁰ In addition,

⁹⁸⁸ The final rule text of CFTC Regulation § 1.3(kkk)(2) has been revised to include the conjunction “and” between clauses (i) and (ii). In the proposed text of this rule, there was no conjunction between these two clauses, while the conjunction “and” was used in the parallel rule, § 240.3a67-4(b), under the Exchange Act. Thus, the revision of the final rule text conforms the CEA rule to the Exchange Act rule.

Also, the final rule text of CFTC Regulation § 1.3(kkk)(1)(E) has been revised to include interest and currency rates to be consistent with § 1.3(kkk)(1)(F). Both provisions address similar financial risks arising from rate “movements” and “exposures,” respectively.

⁹⁸⁹ Local government entities that use GASB accounting standards may not be able to use comparable FASB hedge accounting as a demonstration that a swap is a hedge. Although the two standards are not the same, they are similar in effect and degree in respect of determining whether a swap hedges a risk.

⁹⁹⁰ Although CEA section 1a(33)(A)(iii), 7 U.S.C. 1a(33)(A)(iii), provides that financial entities that are highly leveraged and not subject to capital requirements established by a Federal banking agency are effectively precluded from applying the hedging exclusion, other financial entities are not so precluded.

the hedging exclusion will extend to entities hedging the risks of affiliates in a corporate group, but not to third parties outside of a corporate group.

Like the proposed rule, the final rule under the CEA does not require a demonstration of hedge effectiveness, periodic retesting or specific documentation in order to apply the hedging exclusion from the definition of major swap participant.

b. Swaps that hedge positions held for speculation, investment, or trading

Swaps that hedge positions held for speculation, investment or trading will not qualify for the exclusion. In the Proposing Release, the CFTC explained that swap positions held for the purpose of speculation, investment or trading are those held primarily to take an outright view on market direction, including positions held for short term resale, or to obtain arbitrage profits.⁹⁹¹ Additionally, the Proposing Release stated that swap positions that hedge other positions that themselves are held for the purpose of speculation, investment or trading are also speculative, investment or trading positions.⁹⁹²

We note that some commenters suggested that swaps that hedge speculative, investment or trading positions should qualify for the exclusion because speculation, investment or trading are fundamental to commercial activity and cannot be differentiated from other types of commercial activity. Similarly, commenters that support allowing speculative, investment or trading positions to qualify for the exception stated that a swap hedging the risk of another swap (regardless of that swap's nature) is risk reducing and therefore hedges commercial risk. We

Thus, availability of the hedging exclusion to some financial entities for purposes of the major swap participant definition is contemplated in the statutory text.

⁹⁹¹ See 75 FR at 80195 n.128.

⁹⁹² Id.

believe that these commenters' interpretation of "commercial" is not consistent with congressional intent or the meaning of "commercial" in the Dodd-Frank Act with respect to the first test of the major participant definition or the end-user exception to the clearing mandate. We are unconvinced that allowing swap positions to qualify for the exception would be appropriate when used to hedge speculative, investment or trading positions because the swap would not hedge or mitigate the risks associated with the underlying position, or at least not in the manner intended by Congress. In addition, we believe that doing so would undermine the effectiveness of the major participant definition in that entities would be able to characterize positions for speculative, investment or trading purposes as hedges and therefore evade regulation as major participants.

Under CFTC Regulation § 1.3(kkk)(2)(i), swap positions executed for the purpose of speculating, investing, or trading are those positions executed primarily to take an outright view on market direction or to obtain an appreciation in value of the swap position itself, and not primarily for hedging or mitigating underlying commercial risks.⁹⁹³ For example, swaps positions held primarily for the purpose of generating profits directly upon closeout of the swap, and not to hedge or mitigate underlying commercial risk, are speculative or serve as investments. Further, as an alternative example, swaps executed for the purpose of offsetting potential future increases in the price of inputs that the entity reasonably expects to purchase for its commercial activities serve to hedge a commercial risk.

⁹⁹³ The Commissions note that the SEC interprets the availability of the hedging exclusion differently in the context of the "major security-based swap participant" definition, and that the SEC's guidance in this area controls for purposes of that definition.

The CFTC notes that the use of “trading” in this context is not used to mean simply buying and selling. Rather, a party is using a swap for the purpose of trading under the rule when the party is entering and exiting swap positions for purposes that have little or no connection to hedging or mitigating commercial risks incurred in the ordinary course of business. “Trading,” as used in CFTC Regulation § 1.3(kkk)(2)(i), therefore would not include simply the act of entering into or exiting swaps if the swaps are used for the purpose of hedging or mitigating commercial risks incurred in the ordinary course of business.⁹⁹⁴

The CFTC acknowledges that some swaps that may be characterized as “arbitrage” transactions in certain contexts may also reduce commercial risks enumerated in CFTC Regulation § 1.3(kkk)(1). The discussion in footnote 128 of the Proposing Release was intended to focus on clarifying that swaps are speculative for purposes of the rule if entered into principally and directly for profit and not principally to hedge or mitigate commercial risk. The reference to “arbitrage profits” in footnote 128 was intended to provide an example of what is commonly a speculative swap, not to characterize all arbitrage swaps as speculative.

c. “Economically appropriate” standard

The CFTC has determined to adopt the “economically appropriate” standard as proposed. We believe that this standard will help the CFTC and market participants distinguish which swaps are, or are not, commercial hedges thereby reducing regulatory uncertainty and helping prevent abuse of the hedging exclusion. CFTC Regulation 1.3(kkk)(1)(i) of the final rules enumerates specific risk shifting practices that are deemed to qualify for purposes of the hedging

⁹⁹⁴ The CFTC further clarifies that merchandising activity in the physical marketing channel qualifies as commercial activity, consistent with the Commission’s longstanding bona fide hedging exemption to speculative position limits. See § 1.3(kkk)(1)(ii).

exclusion.⁹⁹⁵ Whether a swap is economically appropriate to the reduction of risks will be determined by the facts and circumstances applicable to the swap at the time a swap is entered into. While we acknowledge that this standard leaves room for judgment in its application, we believe this flexibility is needed given the wide variety of swaps and hedging strategies the rule applies to. We believe the economically appropriate standard together with the identification of the six different categories of permissible commercial risks listed in final CFTC Regulation § 1.3(kkk)(1)(i) is specific enough, when reasonably applied, to distinguish whether a swap is being used to hedge or mitigate commercial risk.

The Commission has determined not to adopt a “congruence” standard because that standard may be too restrictive and difficult to use given the range of potential types of swaps and hedging strategies available.

5. Final rules – “major security-based swap participant” definition under the Exchange Act
 - a. “Economically appropriate” standard

The final rules retain the proposed “economically appropriate” standard, by which a security-based swap position that is used for hedging purposes⁹⁹⁶ would be eligible for exclusion

⁹⁹⁵ In the alternative to meeting the requirements of CFTC Regulation § 1.3(kkk)(1)(i), a swap may also be eligible for the hedging exclusion if the swap qualifies as a bona fide hedge for purposes of an exception from position limits under the CEA as provided in CFTC Regulation § 1.3(kkk)(1)(ii), or if it qualifies for hedging treatment under FASB Accounting Standards Codification Topic 815 or under GASB Statement 53 as provided in CFTC Regulation § 1.3(kkk)(1)(iii). Consequently, the universe of swaps that can qualify for the hedging exclusion is broader than the universe of swaps that qualify as bona fide hedges for purposes of an exception from position limits under the CEA as provided in CFTC Regulation § 1.3(kkk)(1)(ii).

⁹⁹⁶ In the Proposing Release we stated that we did not believe the use of the term “mitigating” in the exclusion to mean something significantly more than “hedging.” See Proposing Release, 75 FR 80194 n.127. As noted above, some commenters disagreed, and argued that “mitigating” should be interpreted more broadly to encompass general risk mitigation strategies. See, e.g., letters from ISDA and CDEU. In our view, the final rules we are adopting – including the use of “economically appropriate” standards and

from the first major participant analysis if the position is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, when those risks arise from the potential change in the value of assets, liabilities and services in connection with the ordinary course of business of the enterprise.⁹⁹⁷

Consistent with the Proposing Release, we interpret the concept of “economically appropriate” to mean that the security-based swap position cannot materially over-hedge the underlying risk such that it could reasonably have a speculative effect,⁹⁹⁸ and that the position cannot introduce any new basis risk or other type of risk (other than counterparty risk that is attendant to all security-based swaps) more than reasonably is necessary to manage the identified risks.

For example, a manufacturer that wishes to hedge the risk associated with a customer’s long-term lease of a product may purchase credit protection using a single-name credit default swap on which the customer is the reference entity. The credit default swap may be excluded from the first major participant analysis even if it is for a shorter term than the anticipated

the exclusions for certain positions – encompass positions that may reasonably be described as “hedging” or “mitigating” commercial risk.

⁹⁹⁷ Exchange Act rule 3a67-4(a)(1). Under this standard, the first major participant analysis need not account for security-based swap positions that pose limited risk to the market and to counterparties because the positions are substantially related to offsetting risks from a person’s commercial operations. These hedging positions would include activities, such as the management of receivables, that arise out of the ordinary course of a person’s commercial operations, including activities that are incidental to those operations. See Proposing Release, 75 FR at 80195.

In addition, the security-based swap positions included within the rule would not be limited to those recognized as hedges for accounting purposes. See *id.*

⁹⁹⁸ In the Proposing Release, we described the “economically appropriate” standard as excluding positions that introduce “any new material quantum of risks.” See Proposing Release, 75 FR 80194 n. 129. The interpretation in this release is consistent with that approach, but does not make use of the same “quantum of risks” terminology.

duration of the lease so long as the use of such a shorter-term instrument is reasonable as a hedge, such as due to cost or liquidity reasons.⁹⁹⁹ Also, the credit default swap may be excluded from the first major participant test if it hedges an amount of risk that is lower than the total amount of risk associated with the long-term contract.¹⁰⁰⁰

In adopting this rule, we have considered commenter views that we should consider limiting the exclusion to positions that are recognized as hedges for accounting purposes.¹⁰⁰¹ We nonetheless do not believe that the requirements that are appropriate to identifying hedging for accounting purposes are needed to limit the availability of the hedging exclusion. Moreover, linking the availability of the exclusion to accounting standards – which themselves may evolve over time – may lead the availability of the exclusion to evolve over time in unforeseen ways. We accordingly believe that the exclusion should be available if a security-based swap position is economically appropriate for hedging purposes (and not otherwise precluded from taking advantage of the exclusion).

We also have considered commenter concerns that the “economically appropriate” standard is too broad,¹⁰⁰² and the additional suggestion that the exclusion instead should be limited to circumstances in which the hedge is “congruent” to the underlying risk.¹⁰⁰³

⁹⁹⁹ In other words, the entity may determine that the use of a credit default swap for a term that is shorter than the lease is justified if that shorter-term instrument costs less or is more liquid than a bespoke instrument that matches the duration of the contract. While the shorter-term credit default swap does not eliminate the underlying commercial risk, the instrument’s use may be commercially reasonable for hedging purposes, and hence appropriately excluded from the first major participant test.

¹⁰⁰⁰ The use of a credit default swap for an amount that is smaller than the underlying risk may be justified as part of an entity’s risk management strategy. For example, an entity may choose to engage in a partial hedge because a credit default swap for a smaller amount than the underlying risk may cost less or be more liquid than a bespoke instrument that more closely matches the amount of the risk.

¹⁰⁰¹ See letter from Senator Levin.

¹⁰⁰² See letters from AFR and AFSCME.

We recognize the significance of commenters' concerns as to the practical application of the "economically appropriate" standard, particularly with regard to hedges that are not perfectly correlated with the underlying risk.¹⁰⁰⁴ The standard embeds principles of commercial reasonableness that should assuage those implementation concerns, however. These principles necessarily account for the fact that the reasonable use of security-based swaps to hedge a person's commercial risk may result in residual basis risk, and that the mere presence of this basis risk should not preclude the availability of the exclusion. Moreover, the mere presence of residual basis risk need not run afoul of the restriction against materially over-hedging the underlying risk, which is instead intended to prevent the hedging exclusion from applying to positions that are entered into for speculative purposes or that have speculative effect (such as by being based on a notional amount that is disproportionate to the underlying risk).¹⁰⁰⁵

We also acknowledge that an "economically appropriate" standard does not provide the compliance assurance that would accompany quantitative tests or safe harbors. Nonetheless, grounding the hedging exclusion in principles of commercial reasonableness permits the standard to be sufficiently flexible to appropriately address an end-user's particular circumstances and hedging needs. Use of an "economically appropriate" standard also is

¹⁰⁰³ See letter from Better Markets I. We nonetheless do not believe that such a requirement would be consistent with the exclusion's "commercial risk" terminology or underlying intent. A congruence standard particularly would not appear to adequately reflect the fact that commercially reasonable hedging activities can leave residual basis risk.

¹⁰⁰⁴ See letter from SIFMA AMG II.

¹⁰⁰⁵ For example, non-material basis risk or a non-material over-hedge may occur due to the use of a standardized instrument. A commercial entity may reasonably determine that it is cost effective to use a standardized security-based swap to hedge the underlying risk, even if use of the standardized instrument introduces non-material basis risk or reflects a non-material amount of over-hedging compared to what would be the result of using a bespoke security-based swap to hedge that risk.

consistent with the fact that entities should be expected to use their reasonable business judgment when hedging their commercial risks.

To provide additional guidance to entities hedging commercial risk, moreover, the final rule incorporates examples of security-based swap positions that, depending on the applicable facts and circumstances, may satisfy the “economically appropriate” standard.¹⁰⁰⁶ These are:

- Positions established to manage the risk posed by a customer’s, supplier’s or counterparty’s potential default in connection with: financing provided to a customer in connection with the sale of real property or a good, product or service; a customer’s lease of real property or a good, product or service; a customer’s agreement to purchase real property or a good, product or service in the future; or a supplier’s commitment to provide or sell a good, product or service in the future.¹⁰⁰⁷
- Positions established to manage the default risk posed by a financial counterparty (different from the counterparty to the hedging position at issue) in connection with a separate transaction (including a position involving a credit derivative, equity swap, other security-based swap, interest rate swap, commodity swap, foreign exchange swap or other swap, option, or future that itself is for the purpose of hedging or mitigating commercial risk pursuant to the rule or the counterpart rule under the Commodity Exchange Act);

¹⁰⁰⁶ Exchange Act rule 3a67-4(a)(2). We previously noted that the proposed definition would facilitate those types of security-based swap positions. See Proposing Release, 75 FR at 80196.

¹⁰⁰⁷ As discussed in the Proposing Release, see 75 FR at 80196 n.135, the references here to customers and counterparties do not include swap or security-based swap counterparties.

- Positions established to manage equity or market risk associated with certain employee compensation plans, including the risk associated with market price variations in connection with stock-based compensation plans, such as deferred compensation plans and stock appreciation rights;
- Positions established to manage equity market price risks connected with certain business combinations, such as a corporate merger or consolidation or similar plan or acquisition in which securities of a person are exchanged for securities of any other person (unless the sole purpose of the transaction is to change an issuer's domicile solely within the United States), or a transfer of assets of a person to another person in consideration of the issuance of securities of such other person or any of its affiliates;
- Positions established by a bank to manage counterparty risks in connection with loans the bank has made; and
- Positions to close out or reduce any of the positions addressed above.

b. Treatment of speculative or trading positions

The final rule, consistent with the proposal, provides that this hedging exclusion does not extend to security-based swap positions that are in the nature of speculation or trading.¹⁰⁰⁸ The exclusion thus does not extend to security-based swap positions that are held for short-term resale and/or with the intent of benefiting from actual or expected short-term price movements or

¹⁰⁰⁸ Exchange Act rule 3a67-4(b)(1). The commercial risk hedging exclusion for the purposes of the "major security-based swap participant" definition (in contrast to the commercial risk hedging exclusion in connection with the "security-based swap dealer" definition) does not turn upon whether a position is "primarily" for speculative or trading purposes. For the "major security-based swap participant" definition, a security-based swap position with any speculative or trading purpose cannot take advantage of the commercial risk hedging exclusion regardless of whether speculation or trading constitutes the "primary" purpose of the position.

to lock in arbitrage profits, or to security-based swap positions that hedge other positions that themselves are held for the purpose of speculation or trading.¹⁰⁰⁹

The Commissions recognize that some commenters take the position that the exclusion should extend to security-based swap positions that hedge speculative or trading positions.¹⁰¹⁰ In support, these commenters have stated that the proposed approach would lead to more unhedged risk in the market, and that the proposed approach could lead entities that use security-based swaps to hedge speculative positions to be major participants, in contrast to unhedged (and presumably riskier) entities. Commenters further requested clarification regarding how entities may distinguish speculative or trading positions from other security-based swap positions.¹⁰¹¹

The Commissions nonetheless do not believe that it would be appropriate to extend the hedging exclusion to speculative or trading positions, including security-based swap positions that themselves hedge other positions that are for speculative or trading purposes. Those limitations are appropriate to help give meaning to the concept of “commercial” risk, and to reflect the legislative intent to limit the impact of Title VII on commercial end-users of security-

¹⁰⁰⁹ See generally Basel Committee on Banking Supervision, “International Convergence of Capital Measurement and Capital Standards, A Revised Framework, Comprehensive Version” (June 2006) at ¶¶ 685-689(iii) (defining the term “trading book” for purposes of international bank capital standards, and stating that positions that are held for short-term resale and/or with the intent of benefiting from actual or expected short-term price movements or to lock in arbitrage profits are typically considered part of an entity’s trading book).

In contrast to the CEA rule implementing the commercial risk hedging definition in the context of the “major swap participant” definition, the Exchange Act rule does not explicitly exclude security-based swaps held for the purpose of investing. We note, however, that security-based swaps held for the purpose of investing (i.e., held primarily to obtain an appreciation in value of the security-based swap position) would not meet the “economically appropriate” standard set forth above, and hence would not be eligible for the exclusion.

¹⁰¹⁰ See, e.g., letters from FSR I and ISDA I.

¹⁰¹¹ See, e.g., letter from CDEU.

based swaps.¹⁰¹² Indeed, the use of security-based swap positions in connection with speculative and trading activity often may be expected either to have the purpose of locking-in arbitrage profits associated with those activities or producing an adjusted risk profile in connection with perceptions of future market behavior – neither of which would eliminate the speculative or trading purpose of the activity.¹⁰¹³ We do not believe that it would be appropriate, or consistent with the Dodd-Frank Act, to interpret the term “commercial risk” to accord the same regulatory treatment to security-based swap positions for speculative or trading purposes as is accorded to the use of security-based swap positions in connection with commercial activities such as producing goods or providing services to customers.¹⁰¹⁴

¹⁰¹² In addition, this limitation is consistent with the exclusion from the first major participant test in connection with ERISA plans. That exclusion particularly addresses security-based swap positions with the primary purpose of “hedging or mitigating any risk directly associated with the operation of the plan.” It is not clear why that scope of the ERISA exclusion would need to be incorporated into the first major participant test if the “commercial risk” exclusion already were broad enough to encompass hedges of trading or speculative positions.

¹⁰¹³ As an example, one speculative/trading strategy involving security-based swaps can be to purchase short-dated credit protection in conjunction with a long-dated bond, to reflect a view that a particular company is likely to fail in the current credit environment. Combined, those positions can produce losses if the current credit environment did not change or if spreads were to widen, but could produce profits either if the company were to default or if spreads were to narrow and funding costs were to decrease. See Morgan Stanley, *Credit Derivatives Insights* 156-58 (4th ed., 2008). In other words, under that strategy the purchase of the credit protection would offset a portion of the risks associated with the ownership of the bond, but for the purpose of taking a directional view of the market with the hope for profit if the purchaser’s view of future market dynamics is correct (and the reality of losses if the purchaser’s view of the market is wrong). It would require an extraordinarily liberal construction of “commercial risk” to subsume this type of speculative security-based swap activity.

At the same time, we recognize that an entity hedging a commercial risk (in contrast to a risk arising from a speculative or trading strategy) reasonably may choose to use a security-based swap that is shorter-dated than the underlying risk, with the security-based swap appropriately excluded from the first major participant definition.

¹⁰¹⁴ This approach does not reflect any value judgment about the role of speculation in the market for security-based swaps, or about the relative market benefits or risks associated with speculation. This position simply represents an attempt to give meaning to the statutory use of the term “commercial risk” in a way that reflects Title VII’s special treatment of commercial end-users, and (as discussed below) avoid an interpretation that effectively undermines the first major participant test.

Moreover, the Commissions believe that it would undermine the major participant definition to attribute a non-speculative or non-trading purpose to security-based swap positions that hedge speculative or trading positions. When a person uses a security-based swap position to help lock in profits or otherwise control the volatility associated with speculative or trading activity, or to cause that speculative or trading activity to reflect a particular market outlook or risk profile, the security-based swap position serves as an integral part of that speculative or trading activity. It thus would not appear appropriate or consistent with economic reality to seek to distinguish the security-based swap component from the other speculative or trading aspects of that activity. In fact, if "hedges" of speculative or trading positions were excluded from the first major participant test, entities could readily label a wide range of security-based swap positions entered into for speculative or trading purposes as being excluded hedges.¹⁰¹⁵ Taken to its natural conclusion, such an approach largely may exclude security-based swap positions from the first major participant test, effectively writing that test out of the statutory definition.

We are aware of commenters' views that regulation of major participants has the potential to create a disincentive against certain entities' use of security-based swaps to manage risk in connection with their speculative or trading activities.¹⁰¹⁶ Under this view, regulation potentially could result in those entities electing not to reduce the risks that they otherwise would

¹⁰¹⁵ As noted by one participant to the roundtable on these definitions: "[B]eing a hedge fund manager, there's nothing in my portfolio I can't claim to be hedging a risk. There's nothing. There's not a trade I do ever that I can't claim it to be a hedge against interest rates, or inflation, or against equity. You know, the fact of the matter is, if you're a capital market participant, your business is taking risks." Roundtable Transcript at 325 (remarks of Michael Masters, Better Markets).

¹⁰¹⁶ See letter from ISDA I.

seek to hedge, to avoid being regulated as major participants.¹⁰¹⁷ That potential result, however, is an unavoidable consequence of the legislative decision to regulate persons whose security-based swap positions cause them to be major participants. It would not be appropriate to use the hedging exclusion to negate part of the underlying statutory definition simply to avoid disincentives that are an unavoidable consequence of the legislative decision to regulate major participants.

At the same time, we are mindful that market participants have requested further guidance as to how to distinguish between hedging positions that are subject to this exclusion, and speculative or trading positions that fall outside the exclusion. In our view, analysis of this issue is simplified by the nature of security-based swaps, and by the limited circumstances in which a person may be expected to have a commercial risk such that the use of a security-based swap may be economically appropriate for managing that commercial risk (rather than being for speculation or trading purposes).

In the case of security-based swaps that are credit derivatives, the final rule provides examples of the use of credit default swaps to purchase credit protection that, depending on the applicable facts and circumstances, may appropriately be excluded from the first major participant test (e.g., the use of a credit default swap to purchase credit protection in connection with the potential default of a customer, supplier or counterparty, or in connection with loans made by a bank). Certain other purchases of credit protection using credit default swaps – such as the purchase of credit protection to manage the risks associated with securities that a non-financial company holds in a corporate treasury and that are not held for speculative or trading

¹⁰¹⁷ Of course, this would only be the case where the entity's hedging and speculative activities combined were at a level in excess of the major participant thresholds.

purposes – may also meet the standard under these rules.¹⁰¹⁸ The sale of offsetting credit protection may also reasonably be expected to fall within the exclusion to the extent that this sale is reasonably necessary to address changes (particularly reductions) in the amount of underlying commercial risk hedged by the initial security-based swap position.¹⁰¹⁹

As for security-based swaps that are not credit derivatives – such as equity swaps and total return swaps – the final rule provides examples of how the use of those security-based swaps in connection with certain business combinations may, depending on the applicable facts and circumstances, appropriately be excluded from the first major participant test. The use of equity swaps or total return swaps to manage the risks associated with securities that are held in a corporate treasury (and that are not held for speculative or trading purposes) may also appropriately be subject to the exclusion. Other uses of equity swaps, or total return swaps to offset risks associated with long or short positions in securities, however, may not appropriately be excluded from the first major participant test, because such positions would be expected to have an arbitrage purpose or other speculative or trading purpose, and would be inconsistent with the “commercial risk” limitation to the hedging exclusion.

¹⁰¹⁸ This is not to say that the purchase of credit protection on a security that a person owns would necessarily be entitled to the hedging exclusion. If the underlying security itself is held for speculative or trading purposes, the credit protection would not be excluded from the first major participant analysis, and in any event would not reasonably be construed as hedging “commercial risk.”

¹⁰¹⁹ Apart from that example, it is more difficult to foresee circumstances in which the sale of credit protection using a credit default swap would be expected to fall within the exclusion. We recognize, for example, that a person that has a short position in a security of a reference entity may have an incentive to sell credit protection on that reference entity to offset movements in the price or value of that short position (and/or lock in arbitrage profits in connection with that short position). While that sale of credit protection may mitigate the risks associated with that short position, or produce an arbitrage profit in connection with that short position, that security-based swap position would not appear to constitute the hedging of “commercial risk” for purposes of the exclusion.

c. Treatment of positions that hedge other swap or security-based swap positions

The final rule, consistent with the proposal, provides that the hedging exclusion does not extend to a security-based swap position that hedges another swap or security-based swap position, unless that other position itself is held for the purposing of hedging or mitigating commercial risk.¹⁰²⁰ This provision allows the first major participant analysis to exclude a person's purchase of credit protection to help address the risk of default by a counterparty in connection with an interest rate swap, foreign exchange swap or other swap or security-based swap that the person has entered into for the purpose of hedging or mitigating commercial risk.

d. Procedural conditions

In contrast to the proposal, the final rule does not incorporate procedural requirements in connection with the hedging exclusion from the first test of the major security-based swap participant definition.¹⁰²¹ In making this change, we have been mindful of concerns that have been expressed that such procedural requirements would lead to undue costs in connection with hedging activity.¹⁰²²

We understand, however, that many entities engaging in legitimate hedging of commercial risks do, as a matter of business practice, identify and document those risks and evaluate the effectiveness of the hedge from time to time. The presence of supporting documentation consistent with such procedures would help support a person's assertion that a

¹⁰²⁰ Exchange Act rule 3a67-4(b)(2).

¹⁰²¹ Those proposed provisions would have conditioned the exclusion on the person identifying and documenting the underlying risks, establishing and documenting a method of assessing the hedge effectiveness, and regularly assessing the effectiveness of the security-based swap as a hedge. See proposed Exchange Act rule 3a67-4(c).

¹⁰²² See, e.g., letter from FSR I.

security-based swap position should be excluded from the first major participant analysis, should the legitimacy of the exclusion become an issue.

Also, although we are not requiring the entity to monitor the effectiveness of the hedge over time, that absence of this requirement does not change the underlying need for a security-based swap position to be economically appropriate for the commercial risks facing the entity to be excluded from the first major participant definition. Thus, for example, if a person's underlying commercial risk materially diminishes or is eliminated over time, a security-based swap position that may have been economically appropriate to the reduction of risk at inception at a certain point in time may, depending on the facts and circumstances, no longer be reasonably included within the exclusion.¹⁰²³ As part of the reports required in connection with possible future changes to the major participant definitions,¹⁰²⁴ the staffs are directed to address whether the continued availability of the hedging exclusion should be conditioned on assessment of hedging effectiveness and related documentation.

D. Exclusion for Positions Held by Certain Plans Defined Under ERISA

1. Proposed approach

The first statutory test of the major participant definitions excludes swap and security-based swap positions that are "maintained" by any employee benefit plan as defined in sections

¹⁰²³ Factors that may be relevant to determining whether a security-based swap position is economically appropriate to the reduction of risk may include the costs associated with terminating or reducing that position.

¹⁰²⁴ See part V, infra.

3(3)¹⁰²⁵ and 3(32)¹⁰²⁶ of ERISA “for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan.”¹⁰²⁷

The proposed rules incorporated that statutory exclusion without additional interpretation or refinement.¹⁰²⁸ In the Proposing Release, moreover, the Commissions expressed the preliminary view that we did not “believe that it is necessary to propose a rule to further define the scope of this exclusion.” We further noted that the exclusion for those plans identified in the statutory definition is not strictly limited to “commercial” risk, and that this may be construed to mean that hedging by those ERISA plans should be broadly excluded. The Commissions also solicited comment as to whether this exclusion should be made available to additional types of entities.¹⁰²⁹

2. Commenters’ views

Some commenters requested clarification that the ERISA hedging exclusion is broader than the commercial risk hedging exclusion, and that the ERISA hedging exclusion can

¹⁰²⁵ Section 3(3) of Title I of ERISA defines the term “employee benefit plan” to include “an employee welfare benefit plan or an employee pension benefit plan or a plan which is both an employee welfare benefit plan and an employee pension benefit plan.” See 29 U.S.C. 1002(3). The terms “employee welfare benefit plan” and “employee pension benefit plan” are further defined in Sections 3(1) and (2) of ERISA. See 29 U.S.C. 1002(1) and (2).

¹⁰²⁶ Section 3(32) of Title I of ERISA defines the term “governmental plan” to mean a plan that the U.S. government, state or political subdivision, or agencies and instrumentalities establish or maintain for its employees, as well as plans governed by the Railroad Retirement Acts of 1935 and 1937, plans of international organizations that are exempt from taxation pursuant to the International Organizations Immunities Act, and certain plans established and maintained by a tribal governments or their subdivisions, agencies or instrumentalities. See 29 U.S.C. 1002(32).

¹⁰²⁷ CEA section 1a(33)(A)(i)(I); Exchange Act section 3(a)(67)(A)(ii)(I).

¹⁰²⁸ See proposed CFTC Regulation § 1.3(hhh)(1)(ii)(A); proposed Exchange Act rule 3a67-1(a)(2)(i).

¹⁰²⁹ See Proposing Release, 75 FR at 80201, *supra*.

encompass positions that are not solely for hedging purposes.¹⁰³⁰ One commenter cautioned against interpreting the ERISA hedging exclusion broadly.¹⁰³¹

Commenters also requested that the Commissions clarify that the ERISA hedging exclusion applies to positions maintained by trusts that hold plan assets,¹⁰³² or by pooled funds.¹⁰³³ One commenter, in contrast, stated that the exclusion should not be available to trusts holding plan assets.¹⁰³⁴

¹⁰³⁰ See letters from BlackRock I (noting that the ERISA hedging exclusion applies to positions with the "primary purpose" of hedging, "which suggests plans may exclude swap positions even if they serve a purpose in addition to hedging or mitigating"), The ERISA Industry Committee ("ERISA Industry Committee") (stating that if ERISA Title I plans are not excluded from the major participant definition, the rules should clarify that the ERISA hedging exclusion is broader than the commercial hedging exclusion and encompasses a variety of risks associated with the value of a plan's assets or the measures of its liabilities; also stating that the ERISA exclusion should not omit positions in the nature of investing, and particularly discussing the use of swaps to provide diversification), ABC/CIEBA (expressing the view that the ERISA hedging exclusion extends beyond "traditional" hedges, and stating that the exclusion should encompass swaps with purposes in addition to hedging, and that the exclusion should encompass positions for the purpose of rebalancing, diversification and gaining asset class exposure) and CalSTRS I (requesting that regulations provide for an ERISA hedging exclusion that is broader than the commercial risk hedging exclusion, and that encompasses positions for the purpose of investing).

One commenter alluded to the incorporation of efficient portfolio theory principles within the exception. See letter from Russell Investments.

¹⁰³¹ See letter from AFSCME (stating that while the statutory exclusion may encompass swaps to mitigate currency risk of cash market investments, the exclusion should not encompass swaps used for investment purposes such as to gain asset class exposure or avoid transaction costs associated with a direct investment).

¹⁰³² See letters from ERISA Industry Committee (stating that the rules should provide that the exclusion applies to positions maintained by any trust holding plan assets) and ABC/CIEBA (stating that the rules should provide the relevant entity for purposes of the exclusion is the counterparty to the swap, further stating that if a trust enters into a swap as a counterparty, it is the trust that should be tested as a possible major participant, even if the trust also holds non-ERISA assets).

¹⁰³³ See letters from BlackRock I (discussing how plan fiduciaries may invest plan assets "in pooled investment vehicles such as registered investment companies, private funds and bank maintained collective trust funds," and stating that not including pooled funds within the exclusion would limit plans' ability to avail themselves of the efficiencies associated with pooling), ERISA Industry Committee (stating that there is "no reason" why the exception should not also extend to position held by a pooled investment trust on behalf of multiple employee benefit plans) and ABC/CIEBA (stating that if a pool within a trust is the counterparty, it is that pool that should be tested as a possible major participant, and noting Department of Labor regulations providing that a collective investment vehicle would be viewed

One commenter stated that the exception should be extended to all public pension plans,¹⁰³⁵ and one commenter particularly took the view that the exclusion should be available to church plans.¹⁰³⁶ Some commenters stated that the exclusion should be available to non-U.S. plans.¹⁰³⁷

3. Final rules

Consistent with the position expressed in the Proposing Release, the Commissions interpret the ERISA hedging exclusion in the first statutory major participant test to be broader than that test's commercial risk hedging exclusion. This reflects the facts that the ERISA hedging exclusion is not limited to "commercial" risk, and that the ERISA hedging exclusion addresses positions that have a "primary" hedging purpose (which suggests that those positions may have a secondary non-hedging purpose).

a. Types of excluded hedging activities

The Commissions are mindful of commenters' request for additional clarity regarding the scope of the ERISA hedging exclusion. In that regard, we note that we generally would expect swap or security-based swap positions to have a primary purpose of hedging or mitigating risks

as holding plan assets if the vehicle is not a registered investment company, and plans hold at least 25 percent of the interests in the vehicle).

¹⁰³⁴ See letter from AFSCME (stating that "it is important to limit the exemption to plans themselves, not to entities holding 'plan assets'").

¹⁰³⁵ See letter from Russell Investments.

¹⁰³⁶ See letter from Church Alliance (stating that the exclusion also should encompass church plans defined in paragraph 3(33) of ERISA, on the grounds that Congress would not have intended to discriminate against church plans, and that church plans are considered "special entities" that should be the beneficiaries of extra protection).

¹⁰³⁷ See letters from ABC/CIEBA, APG and BTPS.

The Commissions intend to issue separate releases that address the application of the major participant definitions, and Title VII generally, to non-U.S. entities.

directly associated with the operation of the types of plans identified in the statutory definition – and hence eligible for the exclusion – when those positions are intended to reduce disruptions or costs in connection with, among others, the anticipated inflows or outflows of plan assets, interest rate risk, and changes in portfolio management or strategies.

Conversely, we believe that certain other types of positions would less likely have the primary purpose of hedging or mitigating risks directly associated with the operation of the plan, as anticipated by the statutory definition.¹⁰³⁸

b. Availability of exclusion

The Commissions recognize the significance of comments that these plans may use separate entities such as trusts or pooled vehicles to hold plan assets, and that the exclusion should not be interpreted in a way that deters the use of those vehicles. We believe that the same principles that underpin the exclusion for hedging positions directly entered into by the types of plans identified in the statutory definition also warrant making the exclusion applicable to plan hedging positions that are entered into by those other parties that hold assets of those types of plans. Otherwise, the major participant analysis would have the effect of deterring efficiencies in plan operations for no apparent regulatory purpose.

Accordingly, the Commissions interpret the meaning of the term “maintain” – in the context of the statutory provision that the swap or security-based swap position be “maintained

¹⁰³⁸ For example, we do not foresee that the use of a swap or security-based swap position to replicate exposure to a foreign market or to a particular asset class to be for the primary purpose of hedging risks directly associated with the operation of these types of plans. While we recognize that an asset manager may perceive benefits in using swaps or security-based swaps in that manner, it also is necessary to give effect to the statutory language limiting the exclusion to positions that have a “primary purpose” of hedging risks “directly associated” with the “operations” of a plan. We recognize that lack of diversification may be viewed as a risk, but it is not an “operations” risk.

by” an employee benefit plan— not only to include positions in which the plan is a counterparty, but also to include positions in which the counterparty is a trust or pooled vehicle that holds plan assets. Thus, for example, the exclusion would be available to trusts or pooled vehicles that solely hold assets of the types of plans identified in the statutory definition.¹⁰³⁹ The exclusion further may be available to entities that hold such plan assets in conjunction with other assets, but only to the extent that the entity enters into swap or security-based swap positions for the purpose of hedging risks associated with the plan assets. The exclusion does not extend to positions that hedge risks of other assets, even if those are managed in conjunction with plan assets.¹⁰⁴⁰

The Commissions also are mindful of commenter concerns that the exclusion should explicitly be made available to other plans, such as church plans and non-U.S. plans.¹⁰⁴¹ In this regard, the Commissions believe that the boundaries of the exclusion are set by the explicit statutory language, which states that it applies to any employee benefit plan as defined in paragraphs (3) and (32) of section 3 of ERISA. This reference is disjunctive – that is, a plan is eligible for the exclusion if it is within the scope of paragraph (3) (which refers to employee benefit plans) or of paragraph (32) (which applies to government plans). Accordingly, the scope

¹⁰³⁹ This interpretive guidance is intended solely in the context of the interpretation of the first test of the statutory major participant definitions. The guidance is not based on or relevant to the interpretation of other regulations relating to ERISA.

¹⁰⁴⁰ As appropriate, for purposes of the first major participant analysis an entity may need to allocate the exposure associated with swap or security-based swap positions between the amount that is attributable to plan assets (and hence eligible for exclusion) and the amount that is attributable to other assets.

¹⁰⁴¹ As previously noted, the Commissions intend to issue separate releases that address the application of the major participant definitions, and Title VII generally, to non-U.S. entities.

of the cited definitions in paragraphs (3) and (32) should be determined in accordance with all law that applies in the interpretation of ERISA.¹⁰⁴²

E. “Substantial Counterparty Exposure”

1. Proposed approach

The major participant definitions’ second statutory test encompasses persons whose outstanding swaps or security-based swaps “create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets.”¹⁰⁴³ In contrast to those definitions’ first statutory test, which relates to persons with a “substantial position” in swaps or security-based swaps in a “major” category,¹⁰⁴⁴ this second test is not limited to positions in a single category. Also, unlike the first test, the second statutory test does not explicitly exclude certain commercial risk hedging positions or ERISA hedging positions.

For the “major swap participant” definition, the Proposing Release provided that a person’s swap positions pose “substantial counterparty exposure” if those positions present a daily average current uncollateralized exposure of \$5 billion or more, or present daily average current uncollateralized exposure plus potential future exposure of \$8 billion or more.¹⁰⁴⁵ For the “major security-based swap” definition, the proposal provided that a person’s security-based swap positions pose “substantial counterparty exposure” if those positions present daily average

¹⁰⁴² We are not taking a view as to whether church plans or non-U.S. plans constitute employee benefit plans as defined by section 3(3) of ERISA.

¹⁰⁴³ CEA section 1a(33)(A)(ii); Exchange Act section 3(a)(67)(A)(ii)(II).

¹⁰⁴⁴ CEA section 1a(33)(A)(i); Exchange Act section 3(a)(67)(A)(ii)(I).

¹⁰⁴⁵ See proposed CFTC Regulation § 1.3(III).

current uncollateralized exposure of \$2 billion or more, or present daily average current uncollateralized exposure plus potential future exposure of \$4 billion or more.¹⁰⁴⁶

Under the proposal, those measures would be calculated in the same manner as would be used for the first major participant test, except that the “substantial counterparty exposure” analysis would consider all of a person’s swap or security-based swap positions rather than solely considering positions in a particular “major” category, and that the “substantial counterparty exposure” analysis would not exclude positions to hedge commercial risks or ERISA plan risks.

The proposed “substantial counterparty exposure” thresholds were set higher than the proposed “substantial position” thresholds in part to reflect the fact that the former test accounts for a person’s positions across four major swap categories or two major security-based swap categories.¹⁰⁴⁷ The proposed “substantial counterparty exposure” thresholds also reflected the fact that this second test (unlike the first major participant test) encompasses certain hedging positions that, in general, we would expect to pose a lesser degree of risk to counterparties and the markets.

2. Commenters’ views

a. General comments

In light of the similarity between the proposed tests, a number of the concerns that commenters expressed with regard to the proposed “substantial position” definition also apply to

¹⁰⁴⁶ See proposed Exchange Act rule 3a67-5.

¹⁰⁴⁷ Thus, these proposed thresholds in part would account for a person that has large positions in more than one major category of swaps or security-based swaps, but that does not meet the substantial position threshold for any single category of swaps or security-based swaps.

the proposed “substantial counterparty exposure” definition. In addition, some commenters took the view that the proposed “substantial counterparty exposure” thresholds were too low,¹⁰⁴⁸ with several of those commenters stating that the thresholds should be raised to a level that reflects systemic risk.¹⁰⁴⁹ A few commenters took the view that the proposed thresholds were too high.¹⁰⁵⁰ Some commenters generally supported the approach to the definition of “substantial counterparty exposure” proposed by the Commissions.¹⁰⁵¹

¹⁰⁴⁸ See, e.g., letters from ATAA (supporting higher thresholds to measure substantial counterparty exposure), CCMR I (suggesting that the thresholds be set high initially, capturing only a few entities until the Commissions are able to collect and analyze data that supports lowering the thresholds), BG LNG I (stating that proposed threshold should be increased substantially), WGCEF II (stating that the Commissions should adopt substantial position and substantial counterparty exposure tests that account for current conditions in swap markets), ABC/CIEBA (requesting that the Commissions raise the thresholds to better target persons creating or causing systemic risk as set forth in the a major swap participant and major security-based swap participant definitions), BlackRock I (stating that proposed thresholds for the substantial counterparty exposure test are too low so that they could encompass market participants that do not have systemically important swap positions) and ACLI (supporting increasing the thresholds under the CEA definition to \$7 billion in daily average aggregate uncollateralized outward exposure or \$14 billion in daily average aggregate uncollateralized outward exposure plus daily average aggregate potential outward exposure), and meeting with MFA on February 14, 2011 (requesting that the Commissions raise the thresholds for measuring substantial counterparty exposure until the Commissions conduct a market survey to determine how many entities would need to perform the calculations regularly and whether those entities have characteristics capable of causing systemic risk).

¹⁰⁴⁹ See letters from ABC/CIEBA, BlackRock I, ISDA I, WGCEF II, and meeting with MFA on February 14, 2011.

¹⁰⁵⁰ See letters from Greenberger (in connection with thresholds relating to substantial position) and AFR (Commissions should define a major swap participant or major security-based swap participant as any person that maintains \$500 million in daily average, uncollateralized exposure for any category of swaps other than rate swaps, for which the daily average could be up to \$1.5 billion).

¹⁰⁵¹ See, e.g., letters from ATAA (supporting the proposed definitions of “substantial position” and “substantial counterparty exposure,” with the caveat that higher thresholds be used to measure “substantial counterparty exposure”), Dominion Resources (supporting the Commissions proposed definitions of “substantial position” and “substantial counterparty exposure”), Fidelity (threshold levels set at appropriate levels but should be periodically reviewed for adjustment) and Kraft (thresholds as proposed are appropriate).

Some commenters took the view that the “substantial counterparty exposure” test should focus on the size of an entity’s exposure to specific counterparties.¹⁰⁵² Several commenters suggested that the thresholds should be adjusted over time for inflation and changes in the swap and security-based swap markets.¹⁰⁵³ One commenter urged that the analysis consider the interconnectedness of the entity.¹⁰⁵⁴

One commenter addressed the application of the second major participant test to insurance companies, arguing that substantial counterparty exposure should be decided by the FSOC in consultation with the relevant state insurance commissioner, and that hedges should be excluded from the calculation for insurers.¹⁰⁵⁵

b. Lack of exclusion for hedging positions

A number of commenters took the view that the second major participant test should exclude commercial risk hedging positions from the analysis.¹⁰⁵⁶ Some commenters also

¹⁰⁵² See letters from MFA (stating that the calculation of substantial counterparty exposure should measure the exposure that a person has to each individual counterparty that is a systemically important financial institution excluding cleared swap transactions) and CCMR I (stating that the “substantial counterparty exposure” and “substantial position” thresholds should apply to the largest exposure that a person has to another market participant, with any aggregate test being set at a higher level).

¹⁰⁵³ See letters from CDEU, COPE I, Fidelity, ISDA I and MFA I.

¹⁰⁵⁴ See letter from CDEU.

¹⁰⁵⁵ See letter from NAIC (stating that the Commissions should defer to FSOC when considering the designation of insurers under the second test, and should exclude from the analysis swaps and security-based swap positions used for hedging provided that such positions are subject to state investment laws and ongoing monitoring by a state insurance regulatory authority).

¹⁰⁵⁶ See letters from SIFMA AMG II (noting that the Commissions have suggested that hedging positions may not raise the same degree of risk as other swap positions), NAIC (supporting exclusion of commercial risk hedging positions subject to state investment laws and ongoing monitoring by state insurance regulators), AIA (supporting hedging exclusion to avoid capturing entities such as property-casualty insurers), CDEU (suggesting that inclusion of hedging positions is inconsistent with goal of mitigating systemic risk), APG (supporting exclusion of positions held by regulated foreign pension plans) and NRG Energy (suggesting that a lack of an exclusion would cause end-users to curtail hedging

supported excluding ERISA hedging positions from the analysis.¹⁰⁵⁷ One commenter opposed any such exclusions for hedging positions.¹⁰⁵⁸

3. Final rules

Consistent with the Proposing Release, the final rules defining the term “substantial counterparty exposure” generally are based on the same current uncollateralized exposure and potential future exposure tests that are used to identify a “substantial position.”¹⁰⁵⁹ As with the Proposing Release, moreover, the “substantial counterparty exposure” analysis addresses all of a person’s swap or security-based swap positions (rather than being limited to positions in a “major” category), and does not exclude hedging positions.¹⁰⁶⁰ The final rules also incorporate the quantitative thresholds that were proposed for those tests.¹⁰⁶¹

In adopting these final rules we have considered commenter views that the “substantial

activities and increase systemic risk); see also letter from AIMA I (supporting an exemption or discount if the swap transaction is cleared, an off-set for the value and quality of any collateral, and consideration of the directional moves of particular swap contracts).

¹⁰⁵⁷ See letters from ABC/CIEBA and SIFMA AMG II. One commenter further requested that ERISA Title I plans be explicitly excluded from the second test. See letter from ERISA Industry Committee. Another commenter requested an exclusion for ERISA plans generally. See letter from CalSTRS I.

¹⁰⁵⁸ See letter from Better Markets I (stating that excluding hedging positions would be inappropriate because the Dodd-Frank Act did not provide for any such exclusion in the second test, hedge positions may still contribute to counterparty exposure, and the thresholds already reflect the lower level of risk posed by hedge positions).

¹⁰⁵⁹ Accordingly, changes that the final rules made to the proposal with regard to the “substantial position” definition, see part IV.B.3, supra, also are carried over to the definition of “substantial counterparty exposure.”

¹⁰⁶⁰ See CFTC Regulation § 1.3(l)(l); Exchange Act rule 3a67-5.

¹⁰⁶¹ Accordingly, consistent with the proposal, the threshold for the “major swap participant” definition is \$5 billion or more in daily average current uncollateralized exposure, or \$8 billion or more in daily average uncollateralized exposure plus potential future exposure. The threshold for the “major security-based swap participant” is \$2 billion or more in daily average current uncollateralized exposure, or \$4 billion or more in daily average uncollateralized exposure plus potential future exposure.

counterparty exposure” analysis should exclude certain commercial risk and ERISA hedging positions. We nonetheless believe that the structure of the major participant definitions – particularly the fact that those definitions specifically exclude hedging positions from the first statutory test but not from the second test – necessitates the conclusion that the second test not exclude those hedging positions.

We also have considered commenter views that the “substantial counterparty exposure” analysis should account for the maximum exposure that a person poses to any single counterparty. We nonetheless believe that the statutory test – particularly its focus on serious adverse effects on financial stability or financial markets – more appropriately is addressed by measures of the aggregate counterparty risk that an entity poses through its swap or security-based swap positions. Also, consistent with our views regarding the “substantial position” definition, we believe that the “substantial counterparty exposure” analysis appropriately is addressed via objective and quantitative criteria (rather than a multi-tier approach), and appropriately takes into account current uncollateralized exposure and potential future exposure.

Consistent with the Proposing Release, the thresholds to implement the second major participant test are higher than the corresponding thresholds for the first major participant test. These differences reflect the fact that the second test encompasses four “major” categories of swaps or two “major” categories of security-based swaps, as well as the fact that this second test does not exclude hedging positions that would appear to pose a lesser degree of counterparty risk than non-hedging positions.

While we are mindful of commenter views that the proposed “substantial counterparty

exposure” thresholds were too low,¹⁰⁶² we believe that the same principles that support the proposed standards in the context of the “substantial position” definition also support the proposed standards for this second test. As with the “substantial position” analysis, the “substantial counterparty exposure” analysis seeks to reflect a standard that encompasses large market participants before the counterparty risk posed by their swap and security-based swap positions present too large a problem, as well as the financial system’s ability to absorb losses of a particular size, and the need to account for the possibility that multiple market participants may fail close in time.¹⁰⁶³ Commenters have not presented empirical or analytical evidence in support of a different standard. In the future, the Commissions may review and potentially adjust these thresholds to reflect evolving market structures and additional data.

F. “Highly Leveraged” and “Financial Entity”

1. Proposed approach

The third statutory test of the major participant definitions encompasses any non-dealer that: (i) is a “financial entity” (other than one that is “subject to capital requirements established by an appropriate Federal banking agency”), (ii) is “highly leveraged relative to the amount of capital it holds,” and (iii) maintains a “substantial position” in any “major” category of swaps or security-based swaps.¹⁰⁶⁴ In contrast to the first statutory test – which also encompasses persons with a “substantial position” in swaps or security-based swaps in a “major” category – this third test does not exclude positions that hedge commercial risk or ERISA risks.

¹⁰⁶² See notes 1051 and 1052, *supra*.

¹⁰⁶³ As with the “substantial position” analysis, our decision to adopt these thresholds is informed by events related to AIG Financial Products and LTCM. See part IV.B.3.d, *supra*.

¹⁰⁶⁴ CEA section 1a(33); Exchange Act section 3(a)(67).

a. "Financial entity"

The Proposing Release defined the term "financial entity" for purposes of the major participant definition in the same general manner as Title VII defines that term for purposes of the end-user exemption from mandatory clearing,¹⁰⁶⁵ but with certain technical changes to avoid circularity.¹⁰⁶⁶

b. "Highly leveraged"

The Proposing Release set forth two alternative approaches for determining whether a particular entity would be deemed "highly leveraged."¹⁰⁶⁷ Under one approach, an entity would be "highly leveraged" if the ratio of its liabilities to equity exceeded 8 to 1; this proposed alternative reflected the fact that the third statutory major participant test excludes certain types of entities.¹⁰⁶⁸ Under the alternative approach, an entity would be "highly leveraged" if the ratio

¹⁰⁶⁵ CEA section 2(h)(7); Exchange Act section 3C(g)(3)(A).

¹⁰⁶⁶ See proposed CFTC Regulation § 1.3(mmm)(1); proposed Exchange Act rule 3a67-6(a). For both sets of rules, the "financial entity" definition would include any: commodity pool (as defined in section 1a(10) of the CEA); private fund (as defined in section 202(a) of the Investment Advisers Act of 1940); employee benefit plan as defined in paragraphs (3) and (32) of section 3 of ERISA; and person predominantly engaged in activities that are in the business of banking or financial in nature (as defined in section 4(k) of the Bank Holding Company Act of 1956).

To avoid circularity, the use of the term "financial entity" in the context of the "major swap participant" definition also would encompass any "security-based swap dealer" and "major security-based swap participant," but would not include any "swap dealer" or "major swap participant" (even though the latter terms also are found in the "financial entity" definition used for purposes of the end-user clearing exception). See proposed CFTC Regulation § 1.3(mmm)(1). In the context of the "major security-based swap participant" definition, the term "financial entity" also would encompass any "swap dealer" or "major swap participant," but would not include any "security-based swap dealer" and "major security-based swap participant." See proposed Exchange Act rule 3a67-6(a).

¹⁰⁶⁷ See proposed CFTC Regulation § 1.3(mmm)(2); proposed Exchange Act rule 3a67-6(b).

¹⁰⁶⁸ The Proposing Release particularly noted that the third statutory major participant test excludes financial institutions subject to capital requirements set by Federal banking agencies, and recognized the possibility those entities were excluded based on the presumption that they generally are highly leveraged. The Proposing Release noted, based on analysis of financial statements, that it appears that those institutions generally have a leverage ratio of 10 to 1, and that this suggested that the "highly

of its liabilities to equity exceeded 15 to 1; this proposed alternative reflected standards for maximum leverage in certain circumstances found in Title I of the Dodd-Frank Act.¹⁰⁶⁹ The proposal further provided that leverage would be measured at the close of business on the last business day of the applicable fiscal quarter, and that liabilities and equity would be determined in accordance with U.S. generally accepted accounting principles ("GAAP").¹⁰⁷⁰

In proposing these alternative standards for identifying "highly leveraged" entities, the Commissions recognized that traditional balance sheet measures of leverage are limited as tools for evaluating an entity's ability to meet its obligations – in part because such measures do not directly account for potential risks posed by specific instruments held on the balance sheet, or for financial instruments held off of the balance sheet. At the same time, the Commissions preliminarily concluded that it was not necessary to use more complex measures of risk-adjusted leverage for these purposes, in part because the third test's "substantial position" analysis already

leveraged" threshold would have to be lower for those institutions to potentially be subject to the third test. See Proposing Release, 75 FR at 80199.

¹⁰⁶⁹ The Proposing Release noted that Title I provides that the Board must require a bank holding company with total consolidated assets equal to or greater than \$50 billion, or a nonbank financial company supervised by the Board, to maintain a debt to equity ratio of no more than 15 to 1 if the FSOC determines "that such company poses a grave threat to the financial stability of the United States and that the imposition of such requirement is necessary to mitigate the risk that such company poses to the financial stability of the United States." See Dodd-Frank Act section 165(j)(1). The Proposing Release further noted that this 15 to 1 ratio may represent an upper limit to acceptable leverage and that the major participant analysis should use a lower threshold, or, alternatively, that the 15 to 1 ratio provides an appropriate test of whether an entity poses the systemic risk concerns implicated by the major participant definitions. See Proposing Release, 75 FR at 80199.

¹⁰⁷⁰ The Proposing Release also stated that entities that file quarterly reports on Form 10-Q and annual reports on Form 10-K with the SEC would determine their total liabilities and equity based on the financial statements included with such filings while all other entities would calculate the value of total liabilities and equity consistent with the proper application of U.S. GAAP. See id.

accounts for such risks. The Commissions also noted the costs that would be associated with causing entities to engage in complex calculations of risk-adjusted leverage.¹⁰⁷¹

The Proposing Release solicited comment on a variety of issues related to the proposed leverage ratios, including the relative merits of the alternative 8 to 1 and 15 to 1 standards, and potential alternative standards.¹⁰⁷²

2. Commenters' views

a. "Financial entity"

Some commenters recommended that certain types of entities should be excluded from the definition of "financial entity," on the grounds that those types of entities are more appropriately treated as non-financial end users of swaps for purposes of the Dodd-Frank Act.¹⁰⁷³ Commenters specifically suggested that the "financial entity" definition exclude: (i) centralized hedging and treasury subsidiaries in corporate groups;¹⁰⁷⁴ (ii) employee benefit plans;¹⁰⁷⁵ and (iii) cooperative structures.¹⁰⁷⁶ Commenters also requested clarification as to which entities would not be "subject to capital requirements established by an appropriate Federal banking

¹⁰⁷¹ See *id.* at 80198-99.

¹⁰⁷² See *id.* at 80199-200.

¹⁰⁷³ See, e.g., letters from CalSTRS dated June 15, 2011 ("CalSTRS II"), Kraft, Newedge, NRU CFC I and Philip Morris.

¹⁰⁷⁴ See letters from Kraft and Philip Morris.

¹⁰⁷⁵ See letter from CalSTRS II (asserting that there is not a basis to treat ERISA plans as "financial entities" for purposes of the major participant definitions solely to maintain consistency with an "anomalous" statutory provision).

¹⁰⁷⁶ See letter from NRU CFC I.

agency,” and hence not subject to the third statutory test.¹⁰⁷⁷ In addition, commenters addressed the application of the “financial entity” definition to non-U.S. persons.¹⁰⁷⁸

b. “Highly leveraged”

A number of commenters supported the proposed 15 to 1 alternative leverage ratio over the 8 to 1 alternative, with some commenters further suggesting that the final rule should set a leverage ratio higher than 15 to 1, or that the ratio should be reconsidered when more information is available regarding leverage among swap users.¹⁰⁷⁹ One commenter supported the

¹⁰⁷⁷ See letters from ACLI (requesting confirmation that the exclusion from the third statutory test extends to entities subject to bank or financial holding companies, entities deemed systemically important under Title I of the Dodd-Frank Act, and any other persons subject to capital regulation established by a Federal banking regulator) and MetLife (requesting clarification that the exclusion extends to persons subject to regulation and capital requirements on a consolidated basis under federal banking law, and persons that are individually or systemically important financial institutions under Title I).

¹⁰⁷⁸ One commenter took the view that non-U.S. governments and their agencies should be excluded from the “financial entity” definition for purposes of the major participant definition and the Title VII end-user exemption from mandatory clearing. See letter from Milbank. On the other hand, one commenter favored the inclusion of non-U.S. governments in the “financial entity” definition. See meeting with Duffie on February 2, 2011 (suggesting that foreign governments and other foreign jurisdictions, such as municipalities, should be treated as “financial entities” for purposes of the major swap participant definition and other requirements under the Dodd-Frank Act on the grounds that such entities could become sources of systemic risk).

The Commissions intend to issue separate releases addressing the application of Title VII to non-U.S. persons.

¹⁰⁷⁹ See letters from ISDA I (suggesting that the wide use of leverage by financial institutions means that the definition should capture only entities with the “very highest” leverage ratios, and that the 15 to 1 ratio should be viewed as a floor for identifying highly leveraged entities given that it is used in Title I to address entities that have already been determined to pose a “grave threat” to the stability of the U.S. financial system), MFA I (stating that 15 to 1 is the more appropriate of the two choices, and that the Commissions could subsequently adjust the ratio after receiving market data on the use of leverage), AIMA I (encouraging the Commissions to adopt the 15 to 1 leverage threshold until an assessment of the impact of the major participant definitions can be completed); Amex (supporting the use of the 15 to 1 ratio, noting that it is consistent with the maximum leverage allowed to entities designated as a grave threat to financial stability under Title I of the Dodd-Frank Act) and CDEU (recommending use of the 15 to 1 standard, based on its consistency with the leverage limit in Title I of the Dodd-Frank Act for entities posing a grave threat to the United States financial system and that “it would be unreasonable to propose a stricter leverage threshold under the major participant test for nonbank financial end-users,” and expressing concern that entities comfortably falling under the 8 to 1 ratio could unexpectedly exceed this

proposed 8 to 1 alternative,¹⁰⁸⁰ and one commenter suggested that the final rule should set a leverage ratio lower than 8 to 1.¹⁰⁸¹ One commenter suggested a ratio of 12 to 1, consistent with certain capital requirements.¹⁰⁸²

Commenters also suggested a variety of methods and adjustments for calculating leverage ratios.¹⁰⁸³

Some commenters further suggested that specific leverage tests be applied to particular types of financial entities. For employee benefit plans, commenters particularly stated that a plan's obligations to pay benefits should not be considered a liability for purposes of the analysis, and the value of the plan's assets should be used as the denominator for the ratio in lieu of using the non-applicable term "equity."¹⁰⁸⁴ Another commenter – which obtains a substantial

threshold during periods of market stress and that sudden designation as a major participant "could seriously hinder a company from meeting its obligations").

¹⁰⁸⁰ See letter from Better Markets I (stating that the 8 to 1 threshold would better serve the purposes of the Dodd-Frank Act by "ensuring that more, rather than fewer, financial entities are covered by the risk mitigation and business conduct standards that Congress established" for major participants, and that use of the 15 to 1 leverage ratio from Title I of the Dodd-Frank Act is inappropriate because the Title I ratio is used for the "relatively draconian" purpose of imposing leverage limits, while this ratio would be used for "the more modest purpose of imposing registration requirements").

¹⁰⁸¹ See letter from Greenberger (suggesting that the leverage test should be set at a ratio that is lower than either of the two proposed levels).

¹⁰⁸² See meeting with MFA on February 14, 2011 (MFA representatives making point that "highly leveraged" should be defined in coordination with other regulations under the Dodd-Frank Act, and for example, a requirement that banks hold 8% capital implies a leverage ratio of approximately 12:1).

¹⁰⁸³ The suggested adjustments were: to measure the ratio of net current credit exposure to Tier I capital, in a manner similar to that used by bank regulators (see letter from Greenberger); to include as liabilities all unfunded exposures on swaps, both current and potential (see letter from Better Markets I); and to account for the different risk levels of various classes of assets and liabilities and for other factors affecting a person's riskiness (see letters from CCMR I and MFA I).

¹⁰⁸⁴ See letters from CalSTRS I (also stating that for purposes of determining leverage ratios, the value of the plan's assets should be determined as of most recent annual valuation rather than quarterly) and APG (stating that only investment-related liabilities, rather than anticipated shortfalls in benefit obligations, should be considered in the leverage calculation, and the test should be adjusted to take into

amount of funding by issuing subordinated debt, rather than equity – expressed the view that the leverage calculation should allow it to treat subordinated debt as equity.¹⁰⁸⁵

Several commenters addressed the application of the leverage ratio to insurance companies in light of the applicable regulatory regimes and their use of statutorily required accounting methods rather than GAAP.¹⁰⁸⁶ Those commenters took the view that an insurance company's leverage should be tested based on its risk-based capital ratio or on its statutory accounting statements, with certain adjustments to account for different types of liabilities,¹⁰⁸⁷ or based on whether its insurance regulator believes that it is adequately capitalized.¹⁰⁸⁸ One commenter said that the leverage ratio test should not apply to insurance companies,¹⁰⁸⁹ and another said that application of the leverage ratio test to insurance companies should be coordinated with the FSOC.¹⁰⁹⁰

3. Final rules

a. "Financial entity"

Consistent with the Proposing Release, the final rules defining "financial entity" for purposes of the third major participant test are based on the corresponding "financial entity" definition used in the Title VII exception from mandatory clearing for end users, with certain

account legally binding investment restrictions and other constraints that could be just as effective, or more effective, at reducing insolvency risk as capital requirements that would limit leverage).

¹⁰⁸⁵ See letter from NRU CFC I (stating that this application of the leverage test would be consistent with its financial statements).

¹⁰⁸⁶ See letters from ACLI, FSR I, MetLife and NAIC.

¹⁰⁸⁷ See letters from ACLI, FSR I and NAIC.

¹⁰⁸⁸ See letter from MetLife.

¹⁰⁸⁹ See letter from FSR I.

¹⁰⁹⁰ See letter from NAIC.

adjustments to avoid circularity.¹⁰⁹¹ In this regard, while we are mindful of one commenter's views that the differences between the major participant definitions and the end-user clearing exception necessitate different "financial entity" definitions,¹⁰⁹² we do not concur with the view that the term "financial entity" should be interpreted independently in these two contexts. Both sets of provisions distinguish between financial and non-financial entities in a way that limits the impact of Title VII on the latter set of entities, and we believe that the definitions should be consistent in light of those parallel purposes.

The Commissions are aware, however, that the major participant definitions differ from the mandatory clearing requirements in how they address affiliates. The mandatory clearing requirements include a provision that specifically addresses affiliates of persons that qualify for the exception from mandatory clearing for end users,¹⁰⁹³ while no such specific provision is included in the major participant definitions. Given this absence, the Commissions believe it is appropriate to modify the final rules defining "financial entity" for purposes of the major participant definitions from the proposal to exclude certain centralized hedging and treasury entities.¹⁰⁹⁴ The Commissions understand that a primary function of such centralized hedging and treasury entities is to assist in hedging or mitigating the commercial risks of other entities within their corporate groups. Although those entities' activities could constitute being "in the

¹⁰⁹¹ See CFTC Regulation § 1.3(mmm)(1); Exchange Act rule 3a67-6(a). Accordingly, this general definition encompasses commodity pools, private funds, ERISA plans, and persons predominately engaged in activities that are in the business of banking or financial in nature, as well as certain dealers or major participants. See note 1066, *supra*.

¹⁰⁹² See letter from CalSTRS II (ERISA plans should not be included in the definition of "financial entity" for purposes of the major participant definitions).

¹⁰⁹³ See CEA section 2(h)(7)(D); Exchange Act section 3C(g)(4).

¹⁰⁹⁴ See CFTC Regulation § 1.3(mmm)(2); Exchange Act rule 3a67-6(b).

business of banking or financial in nature,” we do not believe that it would be appropriate to treat a person as a “financial entity” for the purposes of the major participant definitions if the person would fall within that definition solely because it facilitates hedging activities involving swaps or security-based swaps by majority-owned affiliates that themselves are not “financial entities.”¹⁰⁹⁵ Absent this change, the major participant analysis would exclude hedging positions that do not use centralized hedging facilities, but would not exclude identical hedging positions that make use of a centralized hedging facility.¹⁰⁹⁶ Such a result would inappropriately discourage the use of centralized hedging and treasury entities.

While the Commissions also have considered the views of commenters that the “financial entity” definition should exclude certain other types of entities – such as employee benefit plans, and cooperatives – the final rules do not provide any such exclusions. As a general matter, the Commissions believe that the “financial entity” definition should be the same for purposes of the major participant definition as it is for purposes of the end-user exception from mandatory clearing.¹⁰⁹⁷

We also have considered the views of some commenters that subsidiaries of bank holding companies, financial holding companies or systemically important financial institutions should

¹⁰⁹⁵ Consistent with the general inter-affiliate exceptions from the dealer and major participant definitions, *see* parts II.C and IV.G, for purposes of these rules, the counterparties are majority-owned affiliates if one party directly or indirectly holds a majority ownership interest in the other, or if a third party directly or indirectly holds a majority interest in both, based on holding a majority of the equity securities of an entity, or the right to receive upon dissolution or the contribution of a majority of the capital of a partnership. *See* CFTC Regulation § 1.3(mmm)(1); Exchange Act rule 3a71-6(b)(2).

¹⁰⁹⁶ We also note that this result is parallel to the Title VII end-user exception from mandatory clearing, which extends to hedging activities of financial entities on behalf of non-financial affiliates. *See* CEA section 2(h)(7)(D); Exchange Act section 3C(g)(4).

¹⁰⁹⁷ Similarly, the Commissions in general are not adopting categorical requests for exclusions from the major participant definitions. *See* part IV.J, *infra*.

be considered to be “subject to capital requirements established by an appropriate Federal banking agency,” and hence not subject to the third statutory major participant test. We nonetheless interpret the term “subject to capital requirements established by an appropriate Federal banking agency” to specifically apply to persons for whom a Federal banking agency directly sets capital requirements. We do not believe that the term should be interpreted to apply to other persons by virtue of their being part of a holding company that is subject to those capital requirements, or otherwise being affiliated with persons subject to those capital requirements, because we do not believe that the mere fact of that relationship is sufficient to control or mitigate the credit risk that those persons pose to their counterparties.

b. “Highly leveraged”

i. Leverage ratio level

After considering commenters’ views, the Commissions are adopting final rules that define “highly leveraged” to generally mean a ratio of liabilities to equity in excess of 12 to 1.¹⁰⁹⁸ Our adoption of this 12 to 1 standard, rather than the proposed 8 to 1 or 15 to 1 alternatives, takes into account commenters’ views on the alternatives, as well as one commenter’s support for a 12 to 1 ratio.¹⁰⁹⁹

In general, we believe that the structure of the third statutory major participant test – which, unlike the first statutory test, does not permit the exclusion of certain hedging positions – reasonably may be interpreted as reflecting the determination that: (a) higher leverage indicates that an entity poses a heightened risk of being unable to meet its obligations; and (b) such entities

¹⁰⁹⁸ See CFTC Regulation § 1.3(mmm)(2); Exchange Act rule 3a67-7(a). The final rules defining “highly leveraged” have been renumbered from the proposal for the sake of clarity.

¹⁰⁹⁹ See note 1082, *supra*, and accompanying text.

should not be permitted to exclude hedging positions from the “substantial position” analysis in light of the counterparty risks those positions pose (even recognizing that these may be lower than counterparty risks posed by comparable non-hedging positions).

Commenters who addressed the proposed leverage ratio raised diverse points of view in support of the 8 to 1 and 15 to 1 alternatives, or other standards. A number of those commenters, however, appeared to focus on the outcome of particular leverage ratios – *i.e.*, that a lower leverage ratio likely would lead to more major participants, and that a higher leverage ratio likely would lead to fewer major participants – and to base their conclusions on their views of that outcome. In general, the comments did not reflect an attempt to identify typical leverage ratios for financial entities, or to address the link between leverage and risk.

Some commenters specifically supported the use of a 15 to 1 leverage ratio in light of Title I’s use of that ratio.¹¹⁰⁰ While considering this perspective, we believe it also is appropriate to consider the different purposes for which leverage is addressed in the Title I and major participant contexts. The 15 to 1 leverage provision in Title I reflects a maximum allowable threshold of leverage for certain bank holding companies and nonbank financial companies when a determination has been made that such entities pose a “grave threat to the financial stability of the United States” and that the imposition of this limitation is necessary to mitigate the risks posed by such entities – in essence serving as a hard leverage cap for certain entities that have been deemed risky to the U.S. financial system.¹¹⁰¹ In contrast, leverage serves a type of gatekeeper function in the major participant definitions by identifying the amount of leverage

¹¹⁰⁰ See, *e.g.*, letters from Amex and CDEU.

¹¹⁰¹ See Dodd-Frank Act section 165(j)(1).

that will require a non-bank financial entity to engage in the “substantial position” analysis without excluding hedging positions, rather than seeking to limit the maximum leverage available to those entities. Just as concepts of “maximum leverage” are distinct from concepts of “high leverage,” the use of a 15 to 1 maximum leverage ratio in Title I does not mandate the conclusion that the same 15 to 1 ratio must be used for interpreting the meaning of “highly leveraged” in the major participant definitions.¹¹⁰²

In considering the definition of the term “highly leveraged” based on the reasoning outlined above, we also are mindful that, as the Proposing Release noted,¹¹⁰³ broker-dealer capital regulations include special provisions that apply when a broker-dealer’s leverage exceeds 12 to 1.¹¹⁰⁴ While we recognize that these capital regulations have limitations as tools for defining “highly leveraged” for purposes of the major participant definitions due to differences in how leverage would be calculated,¹¹⁰⁵ we also believe that these regulations are informative regarding the use of leverage in the major participant context given that they highlight an

¹¹⁰² We also note that the use of the 15 to 1 ratio of Title I in this context could lead to potentially incongruous results. In particular, if the Commissions were to use the 15 to 1 leverage ratio for the “highly leveraged” definition, then an entity that is deemed to be such a threat to the United States financial system that its leverage has been capped pursuant to Title I also would effectively be excepted from the third statutory test of the major participant definitions due to that cap. The 12 to 1 leverage ratio that we are adopting today does not give rise to the same result and therefore does not present the same question of interpretation as to whether this result would be appropriate.

¹¹⁰³ See Proposing Release, 75 FR at 80199 n.152.

¹¹⁰⁴ Exchange Act rule 15c3-1 provides that a broker-dealer may determine its required minimum net capital, among other ways, by applying a financial ratio that provides that its aggregate indebtedness shall not exceed 1500 percent of its net capital (i.e., a 15 to 1 aggregate indebtedness to net capital ratio). In addition, Exchange Act rule 17a-11 further requires that broker-dealers that use such method to establish their required minimum net capital must provide notice to regulators if their aggregate indebtedness exceeds 1200 percent of their net capital (i.e., a 12 to 1 aggregate indebtedness to net capital ratio).

¹¹⁰⁵ The measure of aggregate indebtedness in rule 15c3-1 excludes certain secured liabilities, and the measure of net capital excludes certain illiquid assets but includes certain subordinated debt. As a result, the ratios discussed above would not necessarily be equivalent to 15:1 or 12:1 ratios when converted to a balance sheet ratio of liabilities to equity.

existing link between increased regulatory oversight and the amount of leverage an entity maintains.

In light of the reasons noted above for using a leverage ratio below 15 to 1, commenter concerns that a ratio of 8 to 1 would be too low, one commenter's suggestion of a 12 to 1 leverage ratio, and leverage tests found in broker-dealer capital regulations, the Commissions have determined that a 12 to 1 leverage ratio reflects an appropriate basis for identifying "highly leveraged" financial entities. In making this determination we recognize that other approaches also may be reasonable (e.g., lower thresholds based on the analysis of the leverage of certain financial entities also may be reasonable, as may higher thresholds based on Title I and on other aspects of broker-dealer capital rules). We also recognize, however, that the need to implement the major participant definitions requires that we draw a line. In our view, a 12 to 1 ratio reflects a reasonable location for this line that is appropriate for purposes of the third major participant test, and that reasonably accounts for commenter concerns and the other considerations discussed above.

ii. Leverage ratio calculation

Consistent with the proposal, the final rules defining "highly leveraged" generally measure leverage as a ratio of a person's liabilities to equity, as determined in accordance with GAAP.¹¹⁰⁶ Also, consistent with the proposal, these leverage ratios should be calculated as of the close of business on the last business day of the applicable fiscal quarter, as we do not

¹¹⁰⁶ See CFTC Regulation § 1.3(mmm)(2); Exchange Act rule 3a67-7(b). The accounting standard setters are currently working on a number of projects that may impact how leverage would be calculated using GAAP. The Commissions will review and potentially adjust their rules in the future to reflect changes in GAAP.

believe there is any relevant difference among financial entities that would require timing variations.

In general, moreover, the Commissions believe that all types of financial entities should be subject to the same methods of measuring leverage, to facilitate the even application of the leverage test. At the same time, we are mindful of the significance of commenter concerns that calculating leverage as a ratio of liabilities to equity consistent with GAAP would lead to inappropriate results for certain types of financial instruments or financial entities.

We believe that these concerns are significant enough to warrant one modification of the proposed approach to measuring leverage. In particular, the final rules provide that certain employee benefit plans may: (i) exclude obligations to pay benefits to plan participants from their measure of liabilities for purposes of the leverage calculation; and (ii) substitute the total value of plan assets for equity for purposes of the leverage calculation.¹¹⁰⁷ We believe that this change will allow the measure of leverage to more appropriately reflect the risk that those entities pose.

Otherwise, we do not believe that it would be appropriate to depart from GAAP measures of equity and liabilities for purposes of identifying highly leveraged entities.¹¹⁰⁸

G. Application to Inter-Affiliate Swaps and Security-Based Swaps

1. Proposed approach and commenters' views

¹¹⁰⁷ See CFTC Regulation § 1.3(mmm)(2)(ii); Exchange Act rule 3a67-7(b). These provisions specifically apply to employee benefit plans as defined by paragraph (3) and (32) of section 3 of ERISA, consistent with the ERISA exclusion from the first statutory major participant test.

¹¹⁰⁸ Although commenters raised issues with regard to the application of leverage ratios to insurers, *see, e.g.*, letter from FSR I, we do not believe that it would be appropriate to create a special leverage test for insurers. We note that insurers that are publicly traded companies already file financial statements consistent with GAAP. Also, smaller insurers that do not file GAAP-based financial statements would be able to take advantage of the safe harbor from the major participant calculations. *See* part IV.M, *infra*.

In the Proposing Release, we stated that the major participant analysis should consider the economic reality of swaps and security-based swaps between affiliates, and preliminarily concluded that swaps or security-based swaps among wholly owned affiliates “may not pose the exceptional risks to the U.S. financial system that are the basis for the major participant definitions.”¹¹⁰⁹

A number of commenters concurred that swaps among affiliates should be excluded from the major participant analysis.¹¹¹⁰ At the same time, no commenters expressed support for the Proposing Release’s suggestion that this interpretation be limited to transactions among wholly owned subsidiaries. Instead, several commenters expressed the view that the swaps or security-based swaps should not be counted for purposes of the major participant analysis when the counterparties are under common control,¹¹¹¹ or otherwise are affiliates.¹¹¹² One commenter suggested that the analysis exclude swaps or security-based swaps between entities that are under common control and whose financial statements are consolidated.¹¹¹³

2. Final rule

¹¹⁰⁹ See Proposing Release, 75 FR at 80202.

¹¹¹⁰ See, e.g., letters from COPE I, FSR I and Encana Marketing (USA) Inc. dated February 22, 2011 (“Encana I”).

Some commenters explained the widespread use of central hedging desks to allocate risk within affiliate groups or to gather risk from within a group and lay off that risk on the market. See, e.g., letters from CDEU, EEI/EPSCA, Encana I and FSR I. Also, some commenters noted that including these inter-affiliate transactions within the major participant analysis would result in many cases in double-counting of an entity’s swap or security-based swap activity. See letters from CDEU and FSR I.

¹¹¹¹ See letter from Amex and CDEU. One commenter specifically suggested that we adopt the definition of “control” found in the Bank Holding Company Act. See joint letter from The Bank of Tokyo-Mitsubishi UFJ, Ltd., Mizuho Corporate Bank, Ltd. and Sumitomo Mitsui Banking Corporation.

¹¹¹² See, e.g., letters from COPE I, EEI/EPSCA, FSR I, Encana I and Utility Group.

¹¹¹³ See joint letter from ABA Securities Association, ACLI, FSR, FIA, Institute of International Bankers, ISDA and SIFMA.

After considering commenters' views, we have concluded that the major participant definitions should not encompass a person's swaps or security-based swaps for which the counterparty is a majority-owned affiliate. As noted in our discussion of inter-affiliate activities in the context of the dealer definitions, market participants may enter into such inter-affiliate swaps or security-based swaps for a variety of purposes. When swaps and security-based swaps are entered into to allocate risk within a corporate group and do not pose a high likelihood of risk to the broader market – as we believe would be the case with majority ownership – we do not believe that their swaps and security-based swaps raise the systemic risk and other concerns that major participant regulation is intended to address. For this reason, we do not believe that this interpretation needs to be limited to swaps or security-based swaps among wholly owned affiliates, as the Proposing Release had indicated.

Accordingly, the final rules provide that a person may exclude particular swaps or security-based swaps from the analysis of whether the person is a major participant, so long as the counterparties to those swaps or security-based swaps are majority-owned affiliates.¹¹¹⁴

In taking this approach, we have also considered alternatives suggested by commenters. For example, while one commenter suggested that we allow the exclusion of all swaps or security-based swaps between entities under common control, we believe that such an approach

¹¹¹⁴ See CFTC Regulation § 1.3(hhh)(4); Exchange Act rule 3a67-3(e). A person's market-facing swap or security-based swap positions, including those taken to lay off risk assumed from a majority-owned affiliate, must still be included in the person's substantial position and counterparty exposure calculations.

For the purposes of this rule, and consistent with the general inter-affiliate exception from the dealer definitions, see part II.C, supra, counterparties are majority-owned affiliates if one party directly or indirectly owns a majority interest in the other, or if a third party directly or indirectly owns a majority interest in both, based on the right to vote or direct the vote of a majority of a class of voting securities of an entity, the power to sell or direct the sale of a majority of a class of voting securities of an entity, or the right to receive upon dissolution or the contribution of a majority of the capital of a partnership.

would be overly inclusive for the purpose of identifying transactions that should be excluded from the major participant analysis, given that common control by itself does not ensure that two entities' economic interests are sufficiently aligned.¹¹¹⁵ Also, one commenter suggested that the inter-affiliate exclusion should apply to swaps and security-based swaps between affiliates whose financial statements are consolidated, but, as we addressed in the context of the dealer definitions, we do not believe that the scope of this exclusion should be exposed to the risk of future changes in accounting standards.¹¹¹⁶

H. Application to Positions of Affiliated Entities and to Guarantees

1. Proposed approach

The Proposing Release expressed the preliminary view that when a parent is the majority owner of a subsidiary entity, the subsidiary's swap or security-based swap positions may be aggregated at the parent for purposes of the major participant analysis, on the grounds that the parent effectively is the beneficiary of the transaction. At the same time, the Proposing Release acknowledged that there could remain questions as to whether the requirements applicable to major participants – such as capital, margin and business conduct requirements – should be placed upon the parent or the subsidiary.¹¹¹⁷

The Proposing Release solicited comment on a number of aspects of these issues, including whether attribution would be appropriate when there is less than majority ownership,

¹¹¹⁵ See part II.C.2, *supra*.

¹¹¹⁶ See text accompanying note 350, *supra*.

¹¹¹⁷ The Proposing Release further recognized that it may be appropriate at times to place the requirements upon the subsidiary to the extent the subsidiary is acting on behalf of the parent. See Proposing Release, 75 FR at 80202.

or when a parent provides guarantees on behalf of its subsidiaries. The Proposing Release also solicited comment with regard to implementation issues.¹¹¹⁸

2. Commenters' views

A number of commenters expressed the view that the Commissions should not aggregate the positions of affiliates to the parent, arguing that legal separation should be respected unless there is some evidence that separate affiliates are being used to evade regulation.¹¹¹⁹ Other commenters took the view that aggregation of affiliates' positions may be appropriate in some circumstances, such as when aggregation would accurately reflect the structure of a corporate group or its participation in the derivatives market.¹¹²⁰ One commenter recommended that if the Commissions choose to require the aggregation of affiliate positions for purposes of the major participant test, the Commissions also should provide a mechanism for entities to receive "disaggregation" relief upon a showing that the affiliates are acting autonomously.¹¹²¹

¹¹¹⁸ See id.

¹¹¹⁹ See letters from FSR I, ISDA, MetLife and Newedge. Certain of those commenters also warned of problems that could arise if the positions of international affiliates were aggregated, due to conflicting regulations potentially applicable to such entities. See letters from ISDA I, MetLife and Newedge. The Commissions are addressing issues related to the application of the major participant definitions to non-U.S. persons in separate releases.

¹¹²⁰ See letters from CDEU (suggesting that control should be interpreted narrowly for purposes of the major participant test such that affiliated positions would only be aggregated if there is whole ownership or consolidation for accounting purposes, and exercise of actual control in terms of ownership and management) and ACLI (suggesting flexibility such that an entity with independent credit and no guarantee or credit support from a parent could be treated separately, but a corporate group could consolidate its affiliates' positions if that would accurately reflect its participation in the derivatives market).

¹¹²¹ See letter from Newedge.

Some commenters argued that positions should not be consolidated for purposes of the major participant analysis even when a parent guarantees the obligations of a subsidiary.¹¹²²

Other commenters, however, expressed less opposition to aggregation in the presence of a guarantee or credit support.¹¹²³

Commenters also addressed the application of these principles to particular types of entities. Some commenters took the view that positions guaranteed by financial guarantors should not be attributed to those entities for purposes of the major participant analysis.¹¹²⁴ Other commenters stated that the positions of a special purpose vehicle should not be aggregated with

¹¹²² See letters from APG (stating that the aggregation of inter-affiliate guaranteed transactions would raise costs without providing a corresponding benefit to the financial system, and that principal obligors and guarantors pose separate credit risks, which are already priced into the positions, and that guarantees are not traditionally regulated as swaps), CDEU (objecting to attributing the positions of an end-user affiliate that relies on a parent for credit support, primarily out of concern that an end-user that might otherwise avail itself of the end-user clearing exception might be forced to clear its transactions if they were attributed to the major participant parent), ISDA I and Twelve Firms (stating that the statutory major participant definitions do not indicate that they encompass contingent credit support arrangements, and that credit exposures of subsidiaries already will be addressed through regulation of the subsidiary).

¹¹²³ See letters from FSR I (suggesting that there may be some situations in which the positions of different entities in a corporate group should be aggregated, such as when "a parent entity guarantees the obligations of its subsidiaries that are engaging in swaps") and MetLife (stating that "it is not appropriate to require aggregation of subsidiaries' swaps at the parent level unless the parent is providing a guarantee or credit support for the subsidiaries' obligations"); see also letter from ACLI (stating that the positions of entities that do not have a guarantee or credit support from a parent are entitled to an individualized determination of their status under the major participant test).

¹¹²⁴ See letters from AFGI (arguing against attribution on the grounds that the guarantors are typically not exposed to a fluctuating termination value of interest rate swaps for these types of transactions due to the fact that they do not guarantee that amount, but rather only guarantee continued payments of these policies, and also that they are subject to the standard underwriting process and thus are subject to comprehensive regulation) and joint letter from MBIA Inc., MBIA Insurance Corp. and National Public Finance Guarantee Corp. ("MBIA") (arguing against attribution on the grounds that the economic exposure to the financial guarantor is the equivalent of having underwritten a fixed rate bond issued by the particular municipal entity, and such exposures are subject to the normal underwriting process and significant risk management and regulatory oversight).

its sponsor where there is no recourse to the sponsor for the vehicle's obligations.¹¹²⁵ One commenter requested clarification that positions of joint ventures would not be aggregated with those of another entity if the positions are not consolidated on the other entity's balance sheet.¹¹²⁶ Commenters further took the view that ERISA plans should not be aggregated with those of plan sponsors for purposes of the major participant tests, noting that plans and sponsors are separate legal entities, file separate financial statements, are subject to separate regulatory schemes, and that plan sponsors are prohibited from providing credit support or guarantees to ERISA Title I plans.¹¹²⁷

Two commenters addressed operational compliance issues that would be raised if positions are aggregated for purposes of the major participant analysis. One commenter suggested that a corporate group that falls within the major participant definition due to its aggregate positions should be able to designate a single entity to undertake compliance on behalf of the other affiliates.¹¹²⁸ Another commenter stated that when the aggregated positions of a corporate group results in major participant designation, the Commissions should exempt from

¹¹²⁵ See letters from American Securitization Forum (suggesting that aggregation is not appropriate when the risk is contained within the special purpose vehicle, and noting that special purpose vehicles often bear the entire economic risk of a security-based swap transaction and are bankruptcy remote, so the failure of a special purpose vehicle to meet its obligations would not have a rippling effect onto its sponsor) and FSR I (stating that the major participant determination should focus on a special purpose entity itself, and not its sponsor or transferor, in circumstances where securitization vehicles have been consolidated with sponsors or transferors for financial accounting purposes but a counterparty would have to conduct a separate credit analysis on the special purpose entity, and its obligations are nonrecourse to the sponsor or transferor).

¹¹²⁶ See letter from CDEU (noting that non-consolidated joint ventures typically enter into their own swaps and these transactions are not included on the balance sheet of a minority holder in a joint venture).

¹¹²⁷ See letters from CDEU and ERISA Industry Committee.

¹¹²⁸ See letter from FSR I (suggesting that a corporate group should be permitted to designate a single entity or a small number of entities as the registered major participant, with other entities in the group relying on that entity for compliance).

major participant regulation all affiliates in the corporate group that otherwise would qualify for the end-user clearing exception.¹¹²⁹

3. Final interpretation

After considering commenter concerns and the underlying issues, we are revising certain of the preliminary views we expressed in the Proposing Release. In particular, we no longer take the position that a subsidiary's swap or security-based swap position as a matter of course should be attributed to the subsidiary's majority-owner parent. Instead, consistent with the approach discussed below with regard to managed accounts,¹¹³⁰ an entity's swap or security-based swap positions in general would be attributed to a parent, other affiliate or guarantor for purposes of the major participant analysis to the extent that the counterparties to those positions would have recourse to that other entity in connection with the position. Positions would not be attributed in the absence of recourse.¹¹³¹ We believe this approach in general appropriately reflects the risk focus of the major participant definitions by providing that entities will be regulated as major participants when they pose a high level of risk in connection with the swap and security-based swap positions they guarantee.¹¹³² Indeed, the events surrounding the failure of AIG FP

¹¹²⁹ See letter from CDEU.

¹¹³⁰ See part IV.I, *infra*.

¹¹³¹ In taking this position, we are not suggesting that the presence of a guarantee would be determinative of other issues arising under Title VII. For example, the fact that a parent that is a "financial entity" guarantees a subsidiary's swap or security-based swap positions would not foreclose the subsidiary from taking advantage of the exception from mandatory clearing that is available to commercial end-users.

¹¹³² In reaching this conclusion, we have been mindful of views expressed by some commenters that the mere fact of a guarantee should not be enough to require the attribution of a position to a guarantor. We believe, however, that this approach is best suited to address the risk focus of the major participant definitions. We further believe that the statutory definition's language that addresses persons who

highlights how the guarantees can cause major risks to flow to the guarantor.¹¹³³

Even in the presence of a guarantee, however, we do not believe that it is necessary to attribute a person's swap or security-based swap positions to a parent or other guarantor if the person already is subject to capital regulation by the CFTC or SEC (i.e., swap dealers, security-based swap dealers, major swap participants, major security-based swap participants, FCMs and broker-dealers) or if the person is a U.S. entity regulated as a bank in the United States.

Positions of those regulated entities already will be subject to capital and other requirements, making it unnecessary to separately address, via major participant regulations, the risks associated with guarantees of those positions.¹¹³⁴

We recognize that attribution of swap or security-based swap positions to a parent or guarantor for purposes of the major participant analysis can raise special issues with regard to operational compliance. These include, for example, issues as to the application of the

"maintain" substantial positions or "whose" positions create substantial counterparty exposure is consistent with this approach.

We also have considered arguments that the major participant definition should not extend to financial guarantee insurers. We nonetheless believe that when an insurer guarantees the performance of other parties' swap or security-based swap positions, in an amount that is greater than the applicable major participant thresholds, it would be appropriate to regulate that entity as a major participant. When the guaranteed positions are large enough, the risks associated with those positions and the repercussions of the guarantor's default would appear to be within the ambit of the risks that the major participant definitions were intended to capture. In reaching this conclusion, the Commissions are not expressing a view regarding whether financial guarantee insurance is a swap or security-based swap. See Product Definitions Proposal, note 3, supra.

¹¹³³ "AIGFP's obligations were guaranteed by its highly-rated parent company . . . an arrangement that facilitated easy money via much lower interest rates from the public markets, but ultimately made it difficult to isolate AIGFP from its parent, with disastrous consequences." The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy, note 913, supra, at 20.

¹¹³⁴ As a result of this interpretation, holding companies will not be deemed to be major participants as a result of guarantees to certain U.S. entities that already are subject to capital regulation. The Commissions intend to address guarantees provided to non-U.S. entities, and guarantees by non-U.S. holding companies, in separate releases.

transaction-focused requirements applicable to registered major participants (e.g., certain requirements related to trading records and transaction confirmations), given that the entity that directly is the party to the swap or security-based swap may be better positioned to comply with those requirements. For those transaction-focused requirements, we believe that an entity that becomes a major participant by virtue of swaps or security-based swaps directly entered into by others must be responsible for compliance with all applicable major participant requirements with respect to those swaps or security-based swaps (and must be liable for failures to comply), but may delegate operational compliance with transaction-focused requirements to entities that directly are party to the transactions. The entity that is the major participant, however, cannot delegate compliance duties with the entity-level requirements applicable to major participants (e.g., requirements related to registration and capital).¹¹³⁵

I. Application to Managed Accounts

1. Proposed approach

The Proposing Release expressed the preliminary view that the major participant definitions should not be interpreted to cause asset managers or investment advisers to be major participants by virtue of the swap and security-based swap positions of the accounts that they manage.¹¹³⁶ In addition, the Proposing Release expressed the preliminary view that the managed

¹¹³⁵ This type of attribution may also be expected to raise special issues of application in the context of guarantees involving swap or security-based swap positions of non-U.S. entities. The Commissions intend to address those issues in separate releases.

¹¹³⁶ In reaching this preliminary conclusion, we considered the text of the major participant definitions, as well as a colloquy on the Senate floor that addressed the status of managed accounts for purposes of the major participant definitions. See Proposing Release, 75 FR at 80201 & n.162.

The Proposing Release also noted that the Commissions have anti-evasion authority to the extent that persons seek to allocate swaps or security-based swaps among different accounts to seek to evade the regulations applicable to major participants. See *id.* at 80201.

positions for which a person is a beneficial owner should be aggregated with the person's other positions for the purpose of determining whether the beneficial owner is a major participant.¹¹³⁷

2. Commenters' views

Numerous commenters supported the view that the major participant definitions should not be construed to aggregate the accounts managed by asset managers or investment advisers when determining whether a manager or adviser itself is a major participant.¹¹³⁸ One commenter requested that the final rules codify this principle.¹¹³⁹

Some commenters opposed the possibility that the swap or security-based swap positions of mutual funds would be attributed to fund investors for purposes of the major participant analysis, emphasizing that the fund is the entity that bears the credit exposure.¹¹⁴⁰ Some commenters also opposed the possibility that a swap or security-based swap position of a managed account may be attributed to the account's beneficial owner when the counterparty to the position does not have recourse to the beneficial owner's assets.¹¹⁴¹

¹¹³⁷ See id.

¹¹³⁸ See, e.g., letters from BlackRock I and Fidelity.

¹¹³⁹ See letter from Fidelity (particularly addressing fund managers).

¹¹⁴⁰ See letter from BlackRock and joint letter from ICI and SIFMA AMG.

¹¹⁴¹ See letters from SIFMA AMG II (stating that ISDA Master Agreements commonly provide that the counterparty to the transaction does not have recourse to the accountholder's other assets held in different accounts) and Fidelity (stating that when counterparties look solely to the credit and assets of an individual account, the actual risks to the counterparty are tied to and limited by the activities of the account; also stating that requiring aggregation of separate accounts based on beneficial ownership would be complicated, costly, and present substantial operational and legal complexities); see also letter from BlackRock I (stating the understanding that the Proposing Release's reference to beneficial ownership to require that separate account positions be attributed to the owner of the separate account, and stating that this result would be consistent with the definitions' focus on the persons whose positions create credit risk).

One commenter encouraged the Commissions to consider developing anti-evasion measures if necessary, but cautioned that the rules should recognize that there are legitimate business reasons to structure separate, individually managed funds.¹¹⁴² Another commenter dismissed concerns that entities may spread assets among many asset managers or use separate trading agreements to avoid regulation.¹¹⁴³

In addition, commenters raised related issues regarding the potential attribution of positions for purposes of the major participant analysis. Some commenters expressed the view that insurance company separate accounts should be excluded from the major participant determination for the insurer, because those separate accounts generally are segregated from the insurance company's other accounts.¹¹⁴⁴ Two commenters requested clarification as to how swap and security-based swap positions of funds with a "master-feeder" structure should be allocated for the major participant determinations.¹¹⁴⁵

Commenters also emphasized potential impracticalities of requiring asset managers to be responsible for making major participant determinations on behalf of beneficial owners. See, e.g., letter from SIFMA AMG II.

¹¹⁴² See letter from AIMA I.

¹¹⁴³ See letter from SIFMA AMG II (arguing that it would be unlikely for this sort of evasion to actually occur since such tactics would be prohibitively expensive and operationally burdensome, and further stating that the Commissions could address such concerns through their anti-evasion authority).

Also, one commenter suggested that major participant obligations should be limited in their territorial scope and should only apply to U.S. funds or those funds that are otherwise regulated in the U.S. See letter from AIMA I. The Commissions are addressing issues related to the application of the major participant definitions to non-U.S. persons in separate releases.

¹¹⁴⁴ See letters from ACLI, FSR I and MetLife.

¹¹⁴⁵ See letters from MFA I (stating that in master-feeder fund structures, money that is invested flows to the master fund for actual investing or trading, and further explaining that the master fund: is the party to the master trading agreements; negotiates the individual transactions; holds assets; receives the margin calls; is ultimately responsible for posting collateral; and is the entity to whom recourse is generally limited) and CCMR I.

3. Final interpretation

Consistent with the approach set forth in the Proposing Release, the Commissions do not believe that it is necessary to consider the swap or security-based swap positions of the client accounts managed by asset managers or investment advisers when determining whether those entities are major participants. In reaching this conclusion we particularly are influenced by the fact that the statutory definitions specifically address entities that “maintain” substantial positions or “whose” outstanding swaps and security-based swaps create substantial counterparty exposure. Our conclusion also is influenced by the fact that it would not appear appropriate to impose certain regulations applicable to major participants (e.g., capital) upon those entities.¹¹⁴⁶

Separately, after carefully considering commenters’ views and the purposes of major participant regulation, we are modifying the preliminary views expressed in the Proposing Release regarding the application of the major participant analyses to the beneficial owners of managed swap and security-based swap positions. In particular, we conclude that the major participant analysis that applies to the beneficial owners of those positions should focus on where the risk associated with those positions ultimately resides, given how the statutory major participant definitions focus on the risks posed by large swap or security-based swap positions. Thus, for example, if the counterparties to a swap or security-based swap position within a managed account have recourse only to the assets of that account in the event of default – and lack recourse to other assets of the beneficial owners – we do not believe that it would be appropriate to attribute that position to its beneficial owner.¹¹⁴⁷ Conversely, to the extent that

¹¹⁴⁶ We do not believe that it is necessary to codify this interpretation.

¹¹⁴⁷ Thus, for example, there would not be recourse to the owners of shares in a registered investment company that maintains swap or security-based swap positions.

the counterparty to that position also has recourse to the beneficial owner, it would be appropriate to attribute the positions to the beneficial owner for purposes of the major participant analysis.¹¹⁴⁸

We believe that this general approach of attributing positions when recourse is possible also is applicable with respect to related issues raised by commenters, including issues related to insurance company separate accounts and master-feeder fund arrangements. For those situations the same principle would apply – positions within an account or entity may be attributed to another entity for purposes of the major participant analysis if the counterparties to those positions can seek recourse from that other entity.

J. Requests for Exclusion of Certain Entities from the Major Participant Definitions

1. Proposed approach

In advance of the Proposing Release, a number of commenters argued that the Commissions should exclude various types of entities from the major participant definitions.¹¹⁴⁹ While the proposed rules did not incorporate any such exclusions, the Proposing Release solicited comment as to potential exclusions for: entities that maintain legacy portfolios, investment companies, ERISA plans, registered broker-dealers and/or registered FCMs, sovereign wealth funds, banks, state-regulated insurers, private and state pension plans, and registered DCOs or clearing agencies.¹¹⁵⁰

¹¹⁴⁸ For example, under some circumstances the positions within the managed account may make use of a credit support annex entered into by the beneficial owner. In that case, the counterparty to the account's swaps and security-based swaps may have legal recourse to the beneficial owner, making it appropriate to attribute the position to the beneficial owner for purposes of the major participant analysis.

¹¹⁴⁹ These comments were submitted in response to the ANPRM. See notes 4 and 5, supra.

¹¹⁵⁰ See Proposing Release, 75 FR at 80202-03.

2. Commenters' views

Several commenters supported categorical exclusions from the major participant definitions for various types of entities. Commenters particularly urged the Commissions to provide exclusions for:

- entities that maintain legacy portfolios of swaps and security-based swaps that are in run-off;¹¹⁵¹
- registered investment companies and related investment advisers;¹¹⁵²
- ERISA plans, other pension funds, and endowments;¹¹⁵³
- insurance companies;¹¹⁵⁴
- certain registered FCMs and broker-dealers.¹¹⁵⁵
- end users;¹¹⁵⁶ and

¹¹⁵¹ See, e.g., letters from Canadian MAVs, ISDA I and MBIÁ.

¹¹⁵² See letters from Fidelity and Vanguard and joint letter from ICI and SIFMA AMG.

¹¹⁵³ See letters from CDEU, ERISA Industry Committee and SIFMA AMG II (addressing ERISA plans); see also letters from ABC/CIEBA, CalSTRS I, Fidelity and SIFMA AMG II, (addressing government plans) and letter from Government of Singapore Investment Corp. ("GIC") (addressing other pension plans and endowments). But see letter from AFSCME (urging caution with respect to a full exclusion of plan swaps from major participant consideration).

¹¹⁵⁴ See letters from AFGI (supporting exclusion for state-regulated insurers), NAIC (supporting exclusion for state-regulated insurers to the extent they are using derivatives for the purpose of hedging and not engaging in systemically significant derivatives activities determined by the Financial Stability Oversight Counsel), ACLI (supporting exclusion for life insurers) and AIA (supporting exclusion for property-casualty insurers).

¹¹⁵⁵ See letter from Newedge (supporting exclusion for registered FCMs and broker-dealers that engage principally in customer swap facilitation activities but not in other activities of swap or security-based swap dealers).

¹¹⁵⁶ Commenters making this point varied in their phrasing of the requested exclusion. One request asked for the exclusion of any company (regardless of its primary business) that uses swaps predominantly to hedge business risks and that does not pose systemic risk. See letter from CDEU. Another commenter asked for the exclusion of any end user employing prudent risk management. See

- various types of non-U.S. persons, including: foreign governments and their agencies and instrumentalities (such as central banks, treasury ministries, export agencies and governmental financing authorities),¹¹⁵⁷ international organizations and multilateral development banks,¹¹⁵⁸ sovereign wealth funds,¹¹⁵⁹ and non-U.S. entities subject to comparable foreign regulation.¹¹⁶⁰

Commenters articulated a range of rationales in support of such exclusions. These included arguments that particular types of entities: (i) are unlikely to meet one or more of the major participant tests;¹¹⁶¹ (ii) already are subject to regulation (and in some cases are subject to prudential limits on their use of swaps or security-based swaps);¹¹⁶² (iii) do not pose systemic risk¹¹⁶³ and/or the type of counterparty risk contemplated by Title VII;¹¹⁶⁴ or (iv) do not raise concerns given that they would remain subject to the clearing, exchange trading, and reporting

letter from NAIC. And one commenter asked for the exclusion of energy companies that use swaps to hedge commercial risks. See letter from EDF Trading.

¹¹⁵⁷ See letters from Milbank Tweed and Norges Bank Investment Management and meeting with Kreditanstalt für Wiederaufbau (“KfW”).

¹¹⁵⁸ See letter from World Bank Group.

¹¹⁵⁹ See letters from China Investment Corporation (“CIC”) and GIC.

¹¹⁶⁰ See letters from Newedge and SIFMA AMG II.

¹¹⁶¹ See letters from AIMA I (addressing hedge fund managers registered as investment advisers); AIA (addressing property-casualty insurers) and Newedge (addressing FCMs and broker-dealers).

¹¹⁶² See letters from Fidelity and Vanguard and joint letter from ICI and SIFMA AMG (addressing registered investment companies and their advisors), ABC/CIEBA, CDEU, ERISA Industry Committee and Fidelity (addressing ERISA plans and government benefit plans), ACLI (addressing life insurers), AIA (addressing property-casualty insurers), NAIC (addressing state-regulated insurers), Newedge (addressing FCMs and broker-dealers) and GIC (addressing sovereign wealth funds).

¹¹⁶³ See letters from ABC/CIEBA and CDEU (addressing ERISA plans), ICI I and Vanguard (addressing registered investment companies), ACLI (addressing life insurers), CDEU and NAIC (addressing end users), and letter from CIC and meeting with Weil (addressing sovereign wealth funds).

¹¹⁶⁴ See letters from CDEU and ERISA Industry Committee (addressing ERISA plans) and letter from GIC and meeting with Weil (addressing sovereign wealth funds).

requirements of Title VII.¹¹⁶⁵ Also, some commenters maintained that regulating non-U.S. entities as major participants would raise issues with respect to extra-territoriality, international comity and sovereignty.¹¹⁶⁶

In contrast to these requests, one commenter urged that the benefits arising from regulation of major participants be considered in determining whether to create carve-outs from the participant definitions that are not provided in the statute.¹¹⁶⁷

3. Final rules

After considering the comments received and the underlying issues, the Commissions have determined not to provide categorical exclusions from the major participant definitions for the types of entities discussed by commenters.

a. Entities that maintain legacy portfolios

Commenters that supported the exclusion of entities with legacy portfolios of swaps or security-based swaps emphasized that those portfolios are in run-off, and that those entities generally do not engage in ongoing swap or security-based swap activity.¹¹⁶⁸ Several of those

¹¹⁶⁵ See letters from Vanguard (addressing registered investment companies), Newedge (addressing FCMs and broker-dealers), and CIC (addressing sovereign wealth funds).

¹¹⁶⁶ See letters from CIC, GIC, and Milbank Tweed and meeting with KfW (addressing foreign governments and their agencies and instrumentalities), meeting with Weil (addressing sovereign wealth funds) and letter from World Bank Group (addressing international organizations and multilateral development banks).

¹¹⁶⁷ See letter from AFSCME.

¹¹⁶⁸ See letters from AFGI, BlackRock I, Canadian MAVs, ISDA I and MBIA and meetings with Athilon Structured Investment Advisors (“Athilon”) on April 18, 2011 and with Cypress Group, Invicta Financial Group, Primus Asset Management, Inc., and Quadrant Structured Investment Advisors on April 7, 2011.

Although the Proposing Release specifically addressed granting an exclusion in connection with legacy positions entered into by monoline insurers and credit derivative product companies, commenters expressed the view that such an exclusion should apply to other types of entities that maintain legacy

commenters further expressed concerns that imposing the regulations applicable to major participants – particularly margin and capital rules – upon these entities could cause them to default on their obligations and lead to market disruption.¹¹⁶⁹

In the view of the Commissions, the fact that these entities no longer engage in new swap or security-based swap transactions does not overcome the fact that entities that are major participants will have portfolios that are quite large and could pose systemic risk to the U.S. financial system.

We are mindful of the significance of concerns that regulating entities that maintain legacy portfolios has the potential to lead to defaults and disruption. We do not believe, however, that these concerns are best addressed by excluding those entities from major participant regulation. Instead, in adopting substantive rules applicable to major participants, the Commissions intend to pay particular attention to the special issues raised by the application of those rules to legacy portfolios.¹¹⁷⁰ Moreover, to the extent that these types of concerns remain following the promulgation of those final substantive rules, the Commissions may entertain requests for relief or guidance on a case-by-case basis.

b. Other domestic entities

Commenters also raised concerns regarding duplicative regulation for entities that already are subject to other types of regulation (e.g., state-regulated insurers, SEC-regulated registered

portfolios, such as certain special purpose vehicles. See letters from BlackRock I, Canadian MAVs and ISDA.

¹¹⁶⁹ See letters from Athilon, BlackRock I, Canadian MAVs, and ISDA I.

¹¹⁷⁰ For example, in conjunction with the SEC's proposed margin and capital rules applicable to major participants, the SEC expects to request comment on how the rules should apply to entities with legacy portfolios.

investment companies and broker-dealers, and CFTC-regulated registered FCMs). The final rules nonetheless provide no such exclusion. The Dodd-Frank Act provided for the regulation of major participants against the backdrop of existing state and federal regulation, without opting to categorically exclude particular types of entities. Indeed, the definitions explicitly anticipate that pension plans¹¹⁷¹ and banks¹¹⁷² – both of which are subject to existing regulation – may be major participants. Major participant regulation provides a regulatory structure prescribed by the Dodd-Frank Act to address the risks posed by entities whose swap or security-based swap positions are large enough to satisfy the major participant definitions. Other types of regulations to which these entities may be subject serve different objectives¹¹⁷³ that are not substitutes for major participant regulation.¹¹⁷⁴

¹¹⁷¹ The first major participant test (but not the second or third tests) excludes positions maintained by certain employee benefit plans for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan. See CEA section 1a(33)(A)(i)(II); Exchange Act section 3(a)(67)(A)(ii)(I). This tailored exclusion of certain pension plan positions suggests that Congress did not intend to broadly exclude such plans from the other two prongs or from the major participant definitions as a whole. The fact that, as two commenters noted (see letters from ABC/CIEFA and CDEU), the CFTC previously has relied on the regulatory structure already governing ERISA plans as a basis to not regulate these plans in other certain unrelated contexts does not alter this conclusion.

¹¹⁷² The third major participant test excludes entities that are subject to bank capital standards, which suggests that such entities may be eligible to be major participants under the first and second tests. Also, the capital and margin requirements applicable to major swap participants and major security-based swap participants (see Dodd-Frank Act sections 731 and 764, respectively) do not apply to major participants subject to capital rules set by bank regulators, which further indicates that such entities may be major participants.

¹¹⁷³ As some commenters noted, entities excluded from the major participant definitions nonetheless may be subject to other requirements of general applicability imposed by Title VII, such as clearing, trade execution, and reporting requirements. Even where that is the case, though, these requirements serve separate and independent purposes. They do not stand as a substitute for the protections that Congress has prescribed with respect to major participants in particular.

¹¹⁷⁴ For example, as noted above, some commenters stated that the major participant definitions should not apply to investment companies registered under the ICA. See, e.g., letters from Fidelity, ICI I and Vanguard. However, we are not adopting any such exclusions in part because the major participant definitions focus on the market impacts of an entity's swap and security-based swap positions and the risk to the U.S. financial system generally, areas that are not the focus of the regulation of investment

The Commissions expect that only a very few entities within a given category may meet the test of being a major swap participant – or even be close to the various thresholds for meeting that test. Entities that do not meet the thresholds of the major participant definitions do not need an exclusion from those definitions. Further, as noted elsewhere in this Adopting Release, the Commissions are permitting entities to rely on a “safe harbor” when their positions are far below any threshold for any particular quarter. Some of the entities for which exclusion has been sought may be expected to fall within the safe harbor. Those comparatively fewer entities that will be closer to a particular threshold, by contrast, should not be excused on a per se basis from completing the calculations set forth in these rules and, if the calculations demonstrate that the entity meets the test of a major participant, from compliance with the requirements for major participants set forth by Congress.

At the same time, the Commissions recognize the benefits of efficiently regulating major participants that are separately registered with and regulated by the CFTC or SEC (such as registered FCMs or broker-dealers).¹¹⁷⁵ If any such registrants are required also to register as

companies under the ICA. Moreover, based on our understanding of the swap and security-based swap activity of registered investment companies, we believe that registered investment companies generally are not likely to meet the thresholds of the major participant definitions. We will continue to monitor the effects of the rules we are adopting today to help ensure that they do not result in any inadvertent consequences for registered investment companies, or other entities registered with the SEC or CFTC.

¹¹⁷⁵ The Commissions also sought comment as to whether the major participant definitions should apply to derivatives clearing organizations or clearing agencies, but received no comments in response to this inquiry. Nonetheless, the Commissions do not believe that Congress intended derivatives clearing organizations registered with the CFTC or clearing agencies registered with the SEC to be registered or regulated as major participants. The CFTC and the SEC already exercise substantive regulatory oversight over these clearinghouses, authority that was enhanced by Title VII. Further, Title VIII of the Dodd-Frank Act provides for the supervision of systemically important derivatives clearing organizations and clearing agencies. See Dodd-Frank Act Title VIII. We do not believe that Congress intended to place a third layer of oversight on those entities by subjecting them to additional regulation as major participants, and we do not interpret the major participant definitions to do so.

major participants, the CFTC and SEC would seek to coordinate their regulatory oversight as appropriate to achieve the independent purposes of major participant regulation and those separate regulatory requirements, while avoiding unnecessary duplication.¹¹⁷⁶

c. Foreign entities

Commenters¹¹⁷⁷ discussed the major participant definitions in the context of foreign governments and various entities related to foreign governments¹¹⁷⁸ (i.e., foreign central banks,¹¹⁷⁹ international financial institutions¹¹⁸⁰ and sovereign wealth funds). The CFTC

¹¹⁷⁶ For many years, the Commissions have coordinated their examination of dually-registered FCM/BDs through working groups including the Joint Audit Committee and the Intermarket Financial Surveillance Group. Moreover, pursuant to Title IV of the Dodd-Frank Act, the CFTC and SEC have issued joint reporting rules for advisors to private funds that are dually registered with the SEC as investment advisers and with the CFTC as commodity pool operators or commodity trading advisors. See CFTC and SEC, Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF; Final Rule, 76 FR 71127 (Nov. 16, 2011).

¹¹⁷⁷ See letters from CIC, GIC, Milbank Tweed, Norges Bank Investment Management and the World Bank, and meetings with KfW and Weil.

¹¹⁷⁸ For this purpose, we consider that the term “foreign government” includes KfW, which is a non-profit, public sector entity responsible to and owned by the federal and state authorities in Germany, mandated to serve a public purpose, and backed by an explicit, full, statutory guarantee provided by the German federal government.

¹¹⁷⁹ For this purpose, we consider the Bank for International Settlements, in which the Federal Reserve and foreign central banks are members, to be a foreign central bank. See <http://www.bis.org/about/orggov.htm>.

¹¹⁸⁰ For this purpose, we consider the “international financial institutions” to be those institutions defined as such in 22 U.S.C. 262r(c)(2) and the institutions defined as “multilateral development banks” in the Proposal for the Regulation of the European Parliament and of the Council on OTC Derivative Transactions, Central Counterparties and Trade Repositories, Council of the European Union Final Compromise Text, Article 1(4a(a)) (March 19, 2012). There is overlap between the two definitions, but together they include the following institutions: the International Monetary Fund, International Bank for Reconstruction and Development, European Bank for Reconstruction and Development, International Development Association, International Finance Corporation, Multilateral Investment Guarantee Agency, African Development Bank, African Development Fund, Asian Development Bank, Inter-American Development Bank, Bank for Economic Cooperation and Development in the Middle East and North Africa, Inter-American Investment Corporation, Council of Europe Development Bank, Nordic Investment Bank, Caribbean Development Bank, European Investment Bank and European Investment Fund. (The term international financial institution includes entities referred to as multilateral

provides the following guidance with respect to the major swap participant definition and the swap dealer definition.¹¹⁸¹

As an initial matter, foreign entities are not necessarily immune from U.S. jurisdiction for commercial activities undertaken with U.S. counterparties or in U.S. markets.¹¹⁸² In accordance with the general rule, a per se exclusion for foreign entities from the CEA's major swap participant or swap dealer definition, therefore, is inappropriate. A foreign entity's swap activity may be commercial in nature and may qualify it as a swap dealer or major swap participant. Registration and regulation as a swap dealer or major swap participant under such circumstances may be warranted.¹¹⁸³ This is particularly true for foreign corporate entities and sovereign wealth funds, which act in the market in the same manner as private asset managers.

On the other hand, the sovereign or international status of foreign governments, foreign

development banks. The International Bank for Reconstruction and Development, the International Finance Corporation and the Multilateral Investment Guarantee Agency are parts of the World Bank Group.)

¹¹⁸¹ The SEC intends to address issues related to the application of the major security-based swap participant definition to non-U.S. entities as part of a separate release that the SEC is issuing in connection with the application of Title VII to non-U.S. persons. The SEC is also able to address concerns related to the individual substantive rules applicable to major security-based swap participants on a case-by-case basis.

¹¹⁸² See Foreign Sovereign Immunities Act of 1976, 28 U.S.C. 1602 ("under international law, states are not immune from the jurisdiction of foreign courts insofar as their commercial activities are concerned . . . Claims of foreign states to immunity should henceforth be decided by courts of the United States and of the States in conformity with the principles set forth in this chapter."). See also Mendaro v. World Bank, 717 F.2d 610 (D.C. Cir. 1983) (multilateral development banks generally do not have immunity in connection with their commercial dealings in the United States); Osseiran v. International Financial Corp., 552 F.3d 836 (D.C. Cir. 2009) (same); Vila v. Inter-American Investment Corp., 570 F.3d 274 (D.C. Cir. 2009) (same).

¹¹⁸³ Such a registration requirement would have to satisfy the requirements of CEA section 2(i), 7 U.S.C. 2(i), which provides that the provisions of Title VII relating to swaps "shall not apply to activities outside the United States unless those activities—(1) have a direct and significant connection with activities in, or effect on, commerce of the United States; or (2) contravene such rules or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of [the CEA] that was enacted by" Title VII of the Dodd-Frank Act.

central banks and international financial institutions that themselves participate in the swap markets in a commercial manner is relevant in determining whether such entities are subject to registration and regulation as a major swap participant or swap dealer. Canons of statutory construction “assume that legislators take account of the legitimate sovereign interests of other nations when they write American laws.”¹¹⁸⁴ There is nothing in the text or history of the swap-related provisions of Title VII to establish that Congress intended to deviate from the traditions of the international system by including foreign governments, foreign central banks and international financial institutions within the definitions of the terms “swap dealer” or “major swap participant,” thereby requiring that they affirmatively register as swap dealers or major swap participants with the CFTC and be regulated as such.¹¹⁸⁵ The CFTC does not believe that foreign governments, foreign central banks and international financial institutions should be required to register as swap dealers or major swap participants.

K. Financing Subsidiary Exclusion from Major Swap Participant Definition

In connection with the definition of major swap participant, CEA section 1a(33)(D) excludes certain entities from the definition of a major swap participant whose primary business is providing financing and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise

¹¹⁸⁴ See F. Hoffman-LaRoche, Ltd. v. Empagran S.A., 542 U.S. 155, 164 (2004), citing Murray v. Schooner Charming Betsy, 2 Cranch 64, 118, 2 L.Ed. 208 (1804) (“[A]n act of congress ought never to be construed to violate the law of nations if any other possible construction remains”); Hartford Fire Insurance Co. v. California, 509 U.S. 764 (1993) (Scalia, J., dissenting). See also Restatement (Third) Foreign Relations Law § 403 (scope of a statutory grant of authority must be construed in the context of international law and comity including, as appropriate, the extent to which regulation is consistent with the traditions of the international system).

¹¹⁸⁵ To the contrary, section 752(a) of the Dodd-Frank Act requires the CFTC to consult and coordinate with other regulators “on the establishment of consistent international standards with respect to the regulation (including fees) of swaps [and] swap entities . . .”

from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company (the “captive finance company exception”).¹¹⁸⁶ This provision of the Dodd-Frank Act is not applicable to major security-based swap participants.

1. Proposal

The Proposing Release restated the statutory captive finance company exception but did not further define or detail its scope or parameters. Accordingly, the CFTC did not propose a specific rule excluding certain financing subsidiaries from the definition of major swap participant in the Proposing Release.

2. Commenters’ views

Commenters generally believed that the captive finance company exception should be broadly construed to cover financing of products being sold by the parent company or its authorized dealers, financing of service and labor, financing of component parts and attachments, and other general financing of the distribution network.¹¹⁸⁷ One commenter said the exception should be read narrowly, because the physical positions (in inventory, etc.) related to swaps may not be able to be liquidated to mitigate the risks of the swaps.¹¹⁸⁸

3. Final rules

The CFTC believes that the exception set forth in CEA section 1a(33)(D) should be

¹¹⁸⁶ 7 U.S.C 1a(33)(D).

¹¹⁸⁷ See letters from CDEU, U.S. Chamber of Commerce, Center for Capital Markets Competitiveness (“Chamber”) dated December 30, 2011 (“Chamber II”) and NRU CFC I.

¹¹⁸⁸ See meeting with Duffie on February 2, 2011. In addition, another commenter also suggested that the exception not be interpreted broadly due to concerns regarding potential abuse. See letter from CMOC.

construed (consistent with the statute) to provide practical relief to those captive finance companies whose “primary business” is financing and who uses swaps for the purpose of hedging named underlying commercial risks related to interest rate and foreign currency exposures. As an initial matter, the Commission notes that a captive finance subsidiary or other similar entity is required to provide financing as its primary business, i.e., this is not a supplementary or complementary activity of the entity.¹¹⁸⁹

In connection with the exception, commenters generally focused on the second part of Section 1a(33)(D) of the CEA, requesting the CFTC to interpret the phrase “90% or more of which are manufactured by the parent company or another subsidiary of the parent company” to include component parts, attachments, systems and other products that may be manufactured by others but sold together with the company’s products as well as attachments and labor costs that are incidental to the primary purchase.¹¹⁹⁰

The CFTC believes that the captive finance exception must be interpreted in a manner consistent with the intention of Congress. As a result, a person that seeks to fall within the exemption must be in the “primary business” of providing financing of purchases from its parent company. Consistent with this initial requirement, the CFTC maintains that the captive finance exception can be applied when this financing activity finances the purchase of the products sold by the parent company in a broad sense, including service, labor, component parts and

¹¹⁸⁹ Commenters generally did not focus on this initial requirement instead commenting on other issues relating to application of the exception.

¹¹⁹⁰ See letters from CDEU and Chamber II. Another commenter suggested that it should be viewed as a captive finance subsidiary of the entities that own it in a cooperative structure. See letter from NRU CFC I. This commenter also discussed whether the captive finance company exception should be available when it provides financing to its member-owners to support their general business activities, rather than to finance purchases from its member-owners. The CFTC does not believe it would be appropriate to apply the captive finance company exception in this situation.

attachments that are related to the products.

L. Implementation Standard, Re-evaluation Period and Minimum Period of Status

1. Proposed approach

The proposed rules provided that a person would be deemed to be a major participant upon the earlier of: (i) the date on which it submits a complete application for registration, or (ii) two months after the end of the quarter in which a person meets the definition of major participant.¹¹⁹¹

The proposed rules also provided that a person that has met the criteria for designation as a major participant as a result of its swap or security-based swap activities in a fiscal quarter, but without exceeding any applicable threshold by more than 20 percent, would not immediately be subject to the timing requirements discussed above. Instead, the person would be subject to the timing requirements noted above as soon as its daily average swap or security-based swap positions over any fiscal quarter exceed any of the applicable daily average thresholds.¹¹⁹²

Finally, the proposed rules provided that a person would retain the status of a major participant if its swap positions or security-based swap positions do not fall below all of the thresholds for four consecutive quarters.¹¹⁹³ At that time, such entity may de-register as a major swap participant or major security-based swap participant.

¹¹⁹¹ See proposed CFTC Regulation § 1.3(hhh)(3); proposed Exchange Act rule 3a67-7(a).

¹¹⁹² See proposed CFTC Regulation § 1.3(hhh)(4); proposed Exchange Act rule 3a67-7(b).

¹¹⁹³ See proposed CFTC Regulation § 1.3(hhh)(5); proposed Exchange Act rule 3a67-7(c).

2. Commenters' views

Some commenters took the view that the time for compliance should be more than two months.¹¹⁹⁴ One commenter suggested that entities be given the flexibility to have an additional evaluation period if abnormal market events or price movements cause the failure of the first reevaluation.¹¹⁹⁵ Some commenters further expressed the view that the minimum amount of time a person would have to be registered as a major participant would be two quarters, rather than four quarters.¹¹⁹⁶

3. Final rules

a. Timing

Consistent with the proposal, the final rules provide that a person would be deemed to be a major participant upon the earlier of the date on which it submits a complete application for registration, or two months after the end of the quarter in which it meets the criteria to be a major participant.¹¹⁹⁷ In adopting these rules, the Commissions are mindful of commenters' concerns that market entities be given an adequate amount of time to come into compliance with the requirements applicable to major participants. At the same time, it is important to recognize that

¹¹⁹⁴ See letters from BlackRock I (requesting that market participants have eight months after they have exceeded any of the applicable thresholds to complete the registration process and come into compliance with applicable rules) and MetLife (suggesting that one year would be an adequate amount of time to come into compliance with the applicable rules); see also letters from ISDA I (suggesting a grace period of three quarters following the effectiveness of the proposed rules to permit analysis of whether a person is a major participant) and Capital One (recommending establishment of an 18 month provisional registration period for major participants and for dealers, as well as a phase-in period for applicable regulatory requirements).

¹¹⁹⁵ See letter from MFA I.

¹¹⁹⁶ See, e.g., letters from ACLI, BG LNG I, MetLife and MFA I (also suggesting that there be an alternative method of termination if an entity falls below an applicable threshold by more than 20 percent).

¹¹⁹⁷ See CFTC Regulation § 1.3(hhh)(3); Exchange Act rule 3a67-8(a).

a person may submit a completed application for major participant registration prior to the time in which it must come into compliance with the requirements applicable to major participants.¹¹⁹⁸

We believe that two months provides a reasonable amount of time for a person to submit a completed application for registration as a major participant.¹¹⁹⁹

b. Re-evaluation period

Consistent with the proposal, the final rules provide that if any entity meets the criteria for qualifying as a major participant, but does not exceed any applicable threshold by more than 20 percent in that particular quarter, the entity will not immediately be subject to the timing requirements noted above, but will become subject to the timing requirements at the end of the next fiscal quarter if such entity exceeds any of the applicable daily average thresholds in that next fiscal quarter.¹²⁰⁰ We believe that this standard will appropriately help to avoid applying major participant requirements to entities that meet the major participant criteria for only a short time due to unusual activity.¹²⁰¹

¹¹⁹⁸ The proposed rules regarding the registration of major security-based swap participants would provide that a person who files a completed registration application will be conditionally registered as a major security-based swap participant for four months (unless a person files a certification with the SEC, which would extend the conditional registration for an additional 30 days). See proposed Exchange Act rules 15Fb2-1(d)(1) and 15Fb3-1(b)(2), 76 FR 65784, 65821, 65823 (Oct. 24, 2012). In other words, under this proposal, a person who meets the criteria for being a major security-based swap participant may have up to six months, or longer, to come into compliance with the requirements applicable to major security-based swap participants.

¹¹⁹⁹ The SEC has estimated that it would take an entity approximately one week to be able to complete and file Form SBSE, the most complex application form for registration as a major security-based swap participant. The other forms for application as a major security-based swap participant are simpler, and the SEC estimates that they would take less time to complete. See 76 FR at 65814 at nn.130, 131, 133.

¹²⁰⁰ See CFTC Regulation § 1.3(hhh)(4); Exchange Act rule 3a67-8(b).

¹²⁰¹ While we are mindful that one commenter suggested that this standard be extended from one quarter to four quarters, see letter from ISDA I, we do not believe that approach would be consistent with the goal of not causing persons to become major participants as a result of short-term unusual activity.

c. Minimum period of status

Consistent with the proposal, the final rules provide that a person would retain major participant status until it does not exceed any of the applicable thresholds for four consecutive quarters following registration.¹²⁰² We believe that this time period appropriately addresses the concern that persons may move in and out of major participant status on a rapid basis. While we recognize that some commenters requested that this period be reduced to two quarters, we believe that a shorter period likely would lead to administrative confusion and burdens, as a shorter time period may be expected to lead entities to move in and out of major participant status more frequently.

M. Calculation safe harbor

1. Proposed approach and commenters' views

In the Proposing Release, we expressed the understanding that only a limited number of persons currently have swap or security-based swap positions of a size that potentially could cause them to fall within the major participant definitions.¹²⁰³ Without disagreeing with that view, some commenters expressed concern about the costs and burdens associated with performing the applicable calculations on a daily basis, particularly citing the calculations' complex nature.¹²⁰⁴ Certain commenters further suggested that participants in the swap and security-based swap markets may perceive an obligation to conduct the relevant calculations on a

¹²⁰² See CFTC Regulation § 1.3 (hhh)(5); Exchange Act rule 3a67-8(c).

¹²⁰³ For example, in connection with the major security-based swap participant definition, we preliminarily estimated that no more than ten entities that would not otherwise be security-based swap dealers would have uncollateralized mark-to-market positions or combined uncollateralized exposure and potential future exposure that may rise close enough to the proposed thresholds to necessitate monitoring to determine whether they meet those thresholds. See Proposing Release, 75 FR at 80207-08.

¹²⁰⁴ See letters from MFA I and Vanguard.

daily basis even if they are not reasonably likely to be major participants. Those commenters requested that the Commission adopt a safe harbor by which persons with swap or security-based swap positions below a certain notional threshold would not have to perform the major participant calculations, or by which persons would not have to perform those calculations more than monthly when the results of those calculations are significantly below the levels required to be a major participant.¹²⁰⁵

2. Final rule

We continue to believe that under the rules we are adopting only a limited number of persons potentially may be major participants. Nonetheless, we recognize the significance of commenter concerns that some persons may perceive an obligation to conduct the major participant calculations as part of their compliance procedures even when there is not a significant likelihood that they would be major participants. We thus believe that a safe harbor can promote certainty and regulatory efficiency by helping market participants appropriately focus their compliance efforts and avoid undue compliance costs in circumstances when they would be highly unlikely to be major participants.

Accordingly, the Commissions are adopting a rule to incorporate a safe harbor into the major participant analysis. A person may take advantage of this safe harbor in any of three situations. First, a person will not be deemed to be a major participant if: (i) the express terms of the person's arrangements relating to swaps and security-based swaps with its counterparties

¹²⁰⁵ See letters from SIFMA AMG I (recommending safe harbor when the notional amount of a person's positions is less than the applicable thresholds for current uncollateralized exposure plus potential future exposure, or when a person's end-of-month analysis indicates exposures that are at least 50 percent below the definitions' applicable current exposure plus potential future exposure thresholds), Association of Institutional Investors ("AII") and Vanguard.

at no time would permit the person to maintain a total uncollateralized exposure of more than \$100 million to all such counterparties, including any exposure that may result from the application of thresholds or minimum transfer amounts established by credit support annexes or similar arrangements;¹²⁰⁶ and (ii) the person does not maintain notional swap or security-based swap positions of more than \$2 billion in any major category of swaps or security-based swaps, or more than \$4 billion in aggregate.¹²⁰⁷

Alternatively, a person will not be deemed to be a major participant if: (i) the express terms of the person's arrangements relating to swaps and security-based swaps with its counterparties at no time would permit the person to maintain a total uncollateralized exposure of more than \$200 million to all such counterparties, including any exposure that may result from thresholds or minimum transfer amounts;¹²⁰⁸ and (ii) the person performs the major participant calculations (e.g., the "substantial position" and "substantial counterparty exposure" calculations associated with the major participant tests) as of the end of every month, and the results of each of those monthly calculations indicate that the person's swap or security-based swap positions lead to no more than one-half of the level of current exposure plus potential future exposure that would cause the person to be a major participant.¹²⁰⁹

¹²⁰⁶ See CFTC Regulation § 1.3(hhh)(6)(i)(A)(1); Exchange Act rule 3a67-8(a)(1)(i).

¹²⁰⁷ See CFTC Regulation § 1.3(hhh)(6)(A)(2); Exchange Act rule 3a67-8(a)(1)(ii). For purposes of this second condition, the measure of swap or security-based swap positions in a major category shall include all positions in that major category. This measure shall not exclude the hedging or ERISA positions that are excluded from the first major participant test.

¹²⁰⁸ See CFTC Regulation § 1.3(hhh)(6)(i)(B)(1); Exchange Act rule 3a67-8(a)(2)(i).

¹²⁰⁹ See CFTC Regulation § 1.3(hhh)(6)(i)(B)(2); Exchange Act rule 3a67-8(a)(2). In the case of security-based swaps, for example, the monthly test must indicate that the person has no more than \$1 billion in aggregate uncollateralized current exposure plus potential future exposure in a major category (equal to one-half the thresholds of the first and third major participant tests). A person also must have no more than \$2 billion in aggregate uncollateralized current exposure plus potential future exposure with

Finally, a person will not be deemed to be a major participant if the person's current uncollateralized exposure is in connection with a major category of swaps or security-based swaps is less than \$500 million (or less than \$1.5 billion with regard to the rate swap category) and the person performs certain modified major participant calculations (e.g., the "substantial position" and "substantial counterparty exposure" calculations, simplified based on assumptions that are adverse to the person)¹²¹⁰ as of the end of every month, and the results of each of those monthly calculations indicate that the person's swap or security-based swap positions in each major category of swaps or security-based swaps are less than one-half of the substantial position threshold.¹²¹¹ This test addresses the commenter suggestion that a safe harbor be set at one-half of the threshold triggering major participant designation.¹²¹² In addition, we have provided a

regard to all of its security-based swap positions (equal to one-half the thresholds of the second major participant test).

For purposes of conducting this analysis with regard to positions in a major category, if the person is subject to the third major participant test (i.e., the person is a highly leveraged financial entity that is not subject to bank capital requirements), the analysis must account for all of the person's swap or security-based swap positions in that major category (without excluding hedging positions). If the person is not subject to the third major participant test (i.e., the person is not "highly leveraged" or is not a "financial entity" potentially subject to the test) the analysis may exclude those hedging positions that also are excluded from the first major participant test.

For purposes of conducting this analysis with regard to all of its swap or security-based swap positions, the analysis may not exclude hedging positions (consistent with the lack of a hedging exclusion in the second major participant test).

¹²¹⁰ See CFTC Regulation § 1.3(hhh)(6); Exchange Act rule 3a67-9(a)(3). The simplifications and assumptions applied to this portion of the safe harbor include the fact that a person must use the exposure reports of its dealer counterparties when calculating aggregate uncollateralized outward exposure to such entities, and that potential future exposure must be calculated without taking into account offsets for clearing, mark-to-market margining, or netting.

¹²¹¹ See CFTC Regulation § 1.3(hhh)(6)(i); Exchange Act rule 3a67-9(a)(3)(i)(A).

¹²¹² As identified above, three commenters requested that the Commissions provide a "safe harbor" in connection with the status of a major participant. See letters from AII, SIFMA AMG II and Vanguard. For example, one commenter stated that "market participants that are otherwise required to perform the calculations should be able to do so on a less frequent basis if the entity is below every applicable threshold by at least 50%." See letter from SIFMA AMG I at 5.

more simplified alternate version of this test whereby a person will not be deemed to be a major participant if its monthly calculations indicate that the person's swap or security-based swap positions across all major categories of swaps or security-based swaps are significantly less than the substantial counterparty exposure threshold.¹²¹³ This alternative provides a simple safe harbor for entities to apply without undertaking additional analysis to divide their swap or security-based swap positions into major categories.¹²¹⁴

In each of these circumstances, we believe that a safe harbor would be warranted because it would be sufficiently unlikely that the person's swap or security-based swap positions would cause the entity to be a major participant.¹²¹⁵ The Commissions believe that for compliance purposes, persons should be able to rely on the proposed safe harbors noted above. This would benefit the swap and security-based swap marketplace and related market participants by

¹²¹³ See CFTC Regulation § 1.3(hhh)(6)(ii); Exchange Act rule 3a67-9(a)(3)(i)(B). The thresholds for this version of the safe harbor are consistent with the thresholds for the safe harbor set forth in CFTC Regulation § 1.3(hhh)(6)(i) and Exchange Act rule 3a67-9(a)(3)(i)(A), other than with respect to interest rate swaps. We recognize that the major participant thresholds for swaps and security-based swaps across all major categories (*i.e.*, substantial counterparty exposure) are much larger than those for each individual major category (*i.e.*, substantial position). However, given the purposes of the safe harbor, we do not believe that it is appropriate to use a higher level for the test related to all major categories as compared to the test for each individual category.

¹²¹⁴ When calculating its potential future exposure across all major swap or security-based swap categories for purposes of this portion of the safe harbor, the person must use the same specified conversion factor for all swaps or security-based swaps, with such factor reflecting the highest risk weight applied to a major category of swaps or security-based swaps, as applicable. See CFTC Regulation § 1.3(hhh)(6)(iii); Exchange Act rule 3a67-9(a)(3)(i)(B)(2).

Also, for all three tests within the safe harbor, the person should use the effective notional amount of a position rather than the stated notional amount of that position if the stated notional amount is leveraged or enhanced by the structure of the position. See CFTC Regulation § 1.3(hhh)(6)(iv); Exchange Act rule 3a67-9(b).

¹²¹⁵ Although commenters suggested a safe harbor based on a notional standard or on monthly testing, the rule we are adopting also accounts for the maximum exposure that is possible under a person's counterparty arrangements (including the aggregate amount of thresholds and minimum transfer amounts provided for by the applicable credit support annexes). This is intended to better focus the application of the safe harbor toward those entities that are highly unlikely to be, or become, major participants.

avoiding unnecessary costs for various entities that, because of compliance concerns, would engage in major participant calculations even though it would be very unlikely that the major participant thresholds would be met.

The rule further provides that even if a person does not meet the conditions required to take advantage of the safe harbor, that fact by itself will not lead to a presumption that a person is required to perform the calculations required to determine if it is a major participant.¹²¹⁶ This is consistent with the safe harbor's intent to promote certainty and efficiency in compliance efforts. While we are not prescribing when a person should perform the major participant calculations, participants in the swap and security-based swap markets should be mindful that they are responsible for determining whether they meet the major participant definitions, and that they will face liability if they knowingly or unknowingly meet one of those definitions without registering as a major participant.

N. Limited Designation as a Major Swap Participant or Major Security-Based Swap Participant

1. Proposed approach

The "major swap participant" and "major security-based swap participant" definitions provide that the Commissions may designate a person as a major participant for a single category of swap or security-based swap.¹²¹⁷ Unlike the limited designation provisions of the dealer definitions, the major participant definitions do not refer to limited designations in connection with particular swap and security-based swap activities. Also, unlike the dealer definitions (which refer to limited designations in connection with a particular "type," "class" or "category")

¹²¹⁶ See CFTC Regulation § 1.3(hhh)(6)(v); Exchange Act rule 3a67-8(c).

¹²¹⁷ See CEA section 1a(33)(C); Exchange Act section 3(a)(67)(C).

of swap or security-based swap), the major participant definitions specifically state that a person may be designated as a major participant for one or more “categories” of swap or security-based swap, without being a major participant for all “classes” of swap or security-based swap.

The proposal provided that a person who is a major participant in general would be considered to be a major participant with respect to all categories of swaps or security-based swaps, unless the person’s designation is limited.¹²¹⁸ We further stated that we anticipated that a major participant could seek a limited designation at the same time as its initial registration or at a later time, and we observed the difficulty of setting out the conditions that would allow a person to receive a major participant limited designation.¹²¹⁹

2. Commenters’ views

As discussed above, commenters generally addressed concerns regarding limited purpose major participant designations in conjunction with comments regarding limited purpose dealer designations.¹²²⁰ A few comments addressed these issues specifically in the context of the major participant definitions.

One commenter recommended that persons that exceed the first major participant threshold in a major category should presumptively be considered a limited major participant only for those categories of swaps or security-based swaps for which they crossed the threshold.¹²²¹ Another suggested a similar approach when a major participant’s swaps are

¹²¹⁸ See proposed CFTC Regulation § 1.3(hhh)(2); proposed Exchange Act rule 3a71-1(c).

¹²¹⁹ See Proposing Release, 75 FR at 80200-80201.

¹²²⁰ See part II.E.2, *supra*.

¹²²¹ See letter from ICI I (recommending that entities that exceed the thresholds of the first major participant test be registered as major participants only for the relevant major category, while those

concentrated in one major category.¹²²² Two commenters suggested that limited major participant designations should not be confined to the proposed major swap categories.¹²²³

3. Final rules and general principles applicable to limited major participant designations

Consistent with the proposal, the final rules retain the presumption that a person that meets one of the major participant definitions will be deemed to be a major participant in connection with all categories of swaps or security-based swaps.¹²²⁴ As discussed in the Proposing Release, a person may apply for a limited designation when it submits a registration application, or later.¹²²⁵ The final rules also contain one change from the proposal, in that the provisions of the final rules related to limited major participant designation do not refer to the major participant's activities in connection with swaps or security-based swaps, in contrast to the proposal, because the relevant statutory provisions do not refer to limited designations related to activities.

Many of the principles discussed above in the context of limited designation of dealers also are relevant to the limited designation of major participants. Significantly, as with limited dealer designations, it is appropriate for major participants to be subject to a default presumption

entities qualifying as major participants under the other tests would be designated as major participants for all categories, but would still be able to apply for limited designations).

¹²²² See letter from BG LNG I (recommending that if 50 percent of a major participant's swaps fall within one category of swaps, and its swaps in other categories would not separately exceed any of the proposed thresholds, that should be presumed to be a major participant for only that one category of swap).

¹²²³ See letters from BG LNG I (specifically addressing energy firms); and NCGA/NGSA I (asserting that while the major participant definition is to be based on the major categories, the limited designations should be based on a finer set of categories).

¹²²⁴ See CFTC Regulation § 1.3(hhh)(2); Exchange Act rule 3a71-1(c).

¹²²⁵ See Proposing Release, 75 FR at 80200. The SEC expects to address the process for submitting an application for limited designation as a major security-based swap participant, along with principles to be used by the SEC in analyzing such applications, as part of separate rulemakings.

that they should be regulated as major participants for all of their swaps or security-based swaps.¹²²⁶

Although a commenter suggested that different principles should apply in the context of the first major participant test¹²²⁷ – which is based on an entity’s swap or security-based swap position in a single major category – we do not concur. The substantive requirements applicable to major participants do not contemplate treating entities that exceed the first and third thresholds of the major participant definition differently than those exceeding the second threshold. Instead, those requirements indicate that each entity that falls within the major participant definition must comply with registration and other substantive requirements triggered by such designation for all of its swap or security-based swap positions and activities. This conclusion also is supported by the fact that the limited designation authority provided to the Commissions is permissive rather than mandatory, and by the challenges of demonstrating compliance with the substantive requirements applicable to major participants in the context of a limited designation.

Indeed, as with limited dealer designation, one of the key requirements to overcoming the default presumption of full designation is an applicant’s ability to comply with major participant regulation in the context of a limited designation. As with limited dealer designation, the Commissions will not designate a person as a limited purpose major participant unless the person can demonstrate compliance with the statutory and regulatory requirements applicable to major participants. Accordingly, an applicant to limited purpose designations must not only demonstrate the ability to comply with the transaction-level major participant requirements (e.g.,

¹²²⁶ See part II.E.3.a, supra, discussing the statutory and policy basis for this presumption.

¹²²⁷ See letter from ICI I.

certain business conduct standards and requirements related to trading records, documentation and confirmations) in the context of a limited designation, but also to entity-level major participant requirements (e.g., requirements related to registration, capital, risk management, supervision, and chief compliance officer).

V. Commission Staff Reports

To review and evaluate the operation of the “swap dealer,” “security-based swap dealer,” “major swap participant” and “major security-based swap participant” definitions, the CFTC and SEC are directing their respective staffs to undertake future studies regarding the rules being adopted in connection with these definitions and the related interpretations. These studies will include the analysis of market data and the input of public comment.

The CFTC staff is further directed to report the results of this study to the CFTC on a date that is no later than 30 months following the date that a swap data repository first receives swap data under the CFTC’s regulations.¹²²⁸ The SEC staff is further directed to report the results of this study to the SEC no later than three years following the later of: (i) the last compliance date for the registration and regulatory requirements for security-based swap dealers and major security-based swap participants under Section 15F of the Exchange Act; and (ii) the first date on which compliance with the trade-by-trade reporting rules for credit-related and equity-related

¹²²⁸ The CFTC has designated a period of 30 months to ensure that the report reflects two years of security-based swap transaction data, and six months for the staff to analyze the data and prepare the report. The Commissions expect that swap data repositories and security-based swap data repositories will begin to receive data at different times. Currently, swap data repositories are expected to begin to receive swap data approximately 60 days after publication of the rules further defining the term “swap.” See CFTC, Final Rule: Swap Data Recordkeeping and Reporting Requirements, 77 FR 2136 (Jan. 13, 2012); CFTC, Final Rule: Swap Data Repositories: Registration Standards, Duties and Core Principles, 76 FR 54538 (Sept. 1, 2011). The SEC has not yet adopted final rules for the receipt of security-based swap data by security-based swap data repositories. Because of this difference, the timing of the changes to the de minimis thresholds for swaps and security-based swaps will be different.

security-based swaps to a registered security-based swap data repository is required.¹²²⁹ These staff reports will be made available for public comment.

A. Objectives of the CFTC Staff Report

In general, the CFTC's staff report – together with the associated public comment – is intended to help the CFTC thoroughly evaluate the practical implications and effects of the “swap dealer” and “major swap participant” definitions following the regulation of dealers and major participants under Title VII. In addition, the staff report is intended to assist the CFTC in evaluating whether new or revised tests or approaches would be appropriate for identifying swap dealers and major swap participants or for providing greater clarity as to whether particular entities do or do not fall within these definitions. The staff report is also intended to assist the CFTC more specifically in evaluating the potential implications of terminating the phase-in thresholds associated with the de minimis exception to the definition of a “swap dealer.”

To this end, the staff report generally should review each significant aspect of the rules being adopted in connection with the definitions and related interpretations. With respect to the “swap dealer” definition, such aspects include: (i) the factors associated with the definition (including the application of the dealer-trader distinction for identifying swap dealing activity); (ii) the extent of the exclusion of swaps entered into in connection with the origination of loans; (iii) the exclusion of certain swaps from the dealer analysis (i.e., swaps between affiliated parties, swaps between a cooperative and its members and swaps entered into for the purpose of hedging as defined in the rule); and (iv) the tests and thresholds used to implement the de minimis exception. With respect to the “major swap participant” definition, such aspects include: (i) the

¹²²⁹ The SEC has designated a period of three years to ensure that the report reflects two years of security-based swap transaction data, and one year for the staff to analyze the data and prepare the report.

tests and thresholds associated with the “substantial position” definition; (ii) the definition of “hedging or mitigating commercial risk”; (iii) the tests and thresholds associated with the “substantial counterparty exposure” definition; and (iv) the definition of “highly leveraged”.

To facilitate this review, the CFTC staff report should address – as may be practicable in light of the data made available under the swap regulatory reporting regime or otherwise – a range of descriptive analytics that may be helpful in characterizing the nature of the swap market, its participants, and their activities. Such descriptive analytics could help inform the CFTC as to how the definitions in the final rules are being applied in practice and whether any adjustments to such definitions should be considered. For example, these analytics could indicate whether the population of registered swap dealers and major swap participants is substantially larger or smaller than expected, and, to some extent, what elements of the definitions are responsible for any significant differences. These analytics could also illuminate dynamics in the market that may require new or different treatment in the definitions. These analytics may also assist the CFTC in considering whether it would be practical and appropriate to apply new or different objective and readily verifiable tests or standards for determining whether particular entities are or are not swap dealers or major swap participants, including through the possible use of safe harbors, presumptions, thresholds, or defaults based on these tests or standards.

Depending on the availability and reliability of data and the developments in the market and regulatory framework, among other factors, the CFTC staff report could consider: how swaps differ among registered swap dealers, registered major swap participants and unregistered entities; differences among swaps in the major swap categories; differences among swap dealing activity of entities at various levels, including around the de minimis threshold; and estimates of

quantitative information regarding use of swaps, including notional values, effective notional values, and collateralized and uncollateralized exposure.

The CFTC staff report should also address, as may be practicable, the nature and extent of the impact that the final rules and interpretations implementing the definitions have had on certain aspects of the swap market. Depending on the available information and other factors, the CFTC staff report could address the impact of these final rules and interpretations on competition in the swap market, market participants' ability to enter into swaps with various registered and unregistered entities, including IDIs, and the terms of swaps.

B. Objectives of the SEC Staff Report

In general, the report of the SEC staff – together with the associated public comment – is intended to help the SEC thoroughly evaluate the practical implications and effects of the dealer and major participant definitions following the regulation of dealers and major participants pursuant to Title VII. In addition, the staff report is intended to assist the SEC in evaluating whether new or revised tests or approaches would be appropriate for identifying dealers and major participants or for providing greater clarity as to whether particular entities do or do not fall within these definitions. The staff report also is intended to assist the SEC more specifically in evaluating whether it is necessary or appropriate to set higher or lower thresholds for the de minimis exception to the definition of “security-based swap dealer.”

To this end, the staff report generally should review each significant aspect of the rules being adopted in connection with the definitions and related interpretations. With respect to the security-based swap dealer definition, such aspects include: (i) the factors associated with the definition (including the application of the dealer-trader distinction for identifying dealing activity); (ii) the exclusion of inter-affiliate transactions from the dealer analysis (including the

provisions limiting that exclusion to transactions among majority-owned affiliates); and (iii) the tests and thresholds used to implement the de minimis exception. With respect to the major security-based swap participant definition, such aspects include: (i) the tests and thresholds associated with the “substantial position” and “substantial counterparty exposure” definitions; (ii) the definition of “hedging or mitigating commercial risk” (including whether the definition inappropriately permits the exclusion of certain positions from the first test of the major participant definitions, and whether the continued availability of the exclusion should be conditioned on assessments of hedging effectiveness and related documentation); (iii) the definition of “highly leveraged”; and (iv) the exclusion of inter-affiliate transactions from the major participant analysis (including the provision limiting that exclusion to transactions among majority-owned affiliates).

C. Descriptive Analytics in the SEC Report

To facilitate this review, the report of the SEC staff should address – as may be practicable in light of the data made available under the applicable regulatory reporting regime or otherwise¹²³⁰ – a range of descriptive analytics that may be helpful in characterizing the nature of the security-based swap market, as well as entities within that market and those entities’ activities. Such descriptive analytics could help inform the SEC as to how the definitions in the final rules are being applied in practice and whether any adjustments to such definitions should be considered. For example, these analytics could indicate whether the populations of dealers

¹²³⁰ The Dodd-Frank Act mandates that market participants publicly report certain security-based swap transaction and pricing data. See Exchange Act section 13(m). The SEC has proposed rules to implement these requirements, which will give the Commissions and the general public additional insight into the security-based swap markets. See Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information, 75 FR 75208 (Dec. 2, 2010).

and major participants are substantially larger or smaller than expected, and, to some extent, what elements of the definitions are responsible for any significant differences. These analytics could also illuminate dynamics in the security-based swap market that may require new or different treatment in the definitions. For example, the analytics could indicate that the activity in certain segments of the security-based swap market – e.g., equity swaps – has significantly increased or decreased since the adoption of the final rules. These analytics may also assist the SEC in considering whether it would be practical and appropriate to apply new or different objective and readily verifiable tests or standards for determining whether particular entities are or are not dealers or major participants, including through the possible use of safe harbors, presumptions, thresholds or defaults based on these tests or standards.

The precise nature of the descriptive analytics included in the SEC staff report of course will depend on a number of considerations, including the availability and reliability of data and the developments in the market and regulatory framework. However, some salient candidates for descriptive analysis that could be considered at the time of the staff report include:

- Characteristics of, and differences among, the security-based swap transactions and positions of three segments of participants in those respective markets – registered dealers, any registered major participants, and unregistered entities.¹²³¹

¹²³¹ Such characteristics could include: (i) the types of market participants in each segment; (ii) their activity and positions (in terms of notional value, number of transactions, average aggregate uncollateralized outward exposures, and average aggregate potential outward exposure); (iii) the type and number of their counterparties (including the registered/unregistered status of such counterparties); and (iv) a network analysis of the concentration of activity by counterparty.

- Characteristics of, and differences among, security-based swap transactions and positions connected with the broad product segments identified in the final rules (e.g., credit default swaps and other security-based swaps).¹²³²
- Characteristics of, and differences among, the apparent dealing activity of entities at various levels (including the \$3 billion and \$150 million de minimis levels established in the final rule in connection with the security-based swap dealer definition) based on their transactions and positions;¹²³³
- Characteristics of the security-based swap trading activity of “special entities”;¹²³⁴
- Characteristics of entities entering and exiting the security-based swap markets, using a variety of baselines;¹²³⁵
- Estimates of security-based swap entities’ current uncollateralized exposure and potential future exposure at various levels of security-based swap positions;¹²³⁶ and
- Estimates of security-based swap entities’ ratios of total liabilities to equity.¹²³⁷

¹²³² Such characteristics could include: (i) the types of market participants in each segment, including their registration status; (ii) the amount of their activity (in terms of notional value and number of transactions); and (iii) the type and number of their counterparties.

¹²³³ Such characteristics could include a range of quantitative criteria indicative of apparent dealing activity, similar in some respects to the approach taken in the CDS Data Analysis. Differences that could be reviewed include variations in the number and size of trades and counterparties.

¹²³⁴ Such characteristics could include: (i) the size and nature of their counterparties; (ii) the registration status of their counterparties; and (iii) the size and number of their transactions.

¹²³⁵ Such characteristics could include: (i) the extent to which those entities bear indicia of dealing activity, including those identified in the CDS Data Analysis; and (ii) the extent to which those entities have registered as security-based swap dealers. Potential baseline could include, for example: (i) the adoption of these final rules; (ii) December 31, 2011, the end of the time period considered by the CDS Data Analysis; and (iii) the last effective date of the registration and regulatory requirements for security-based swap dealers and major security-based swap participants under Section 15F of the Exchange Act.

¹²³⁶ Such estimates could be useful in ascertaining the application of the various “substantial position” thresholds used in connection with the “major security-based swap participant” definition.

D. Additional Analyses in the SEC Staff Report

To further facilitate this review, the SEC staff report should also address, as may be practicable, the nature and extent of the impact that the final rules and interpretations implementing the definitions have had on certain aspects of the security-based swap market. However, many economic, regulatory, and other factors – both related and unrelated to the implementation of Title VII – could impact the market going forward. The extent to which the staff report will be able to provide retrospective analyses regarding the effect of the definitions on the security-based swap markets (and the robustness of any such analysis) in significant part will be based on the nature and role of future exogenous factors that have also affected the market. Depending on these future factors and the potential challenges associated with addressing them in the staff reports, some salient candidates for retrospective impact analysis that could be considered at the time of the report include:

- Effects on competition. The report may be able to explore connections between the definitions and the entry and exit of various entities in the security-based swap markets. For example, to what extent is an entity's entry or exit correlated with its registration status or its approaching or crossing any of the thresholds established by the definitions (e.g., the de minimis thresholds for dealers or the "substantial position" thresholds for major participants)? Has the current concentration of the dealer market dissipated, persisted, or strengthened over time?¹²³⁸

¹²³⁷ Such estimates could be useful in connection with evaluating the operation of the third prong of the major participant definition.

¹²³⁸ See notes 478 through 485 and accompanying text, supra.

- Effects on investor protection. The report may be able to explore connections between the definitions and the nature and scope of transactions with certain classes of counterparties. For example, to what extent do unregistered entities in the security-based swap markets transact with counterparties such as “special entities,” natural persons, small businesses or commercial entities? Have the nature and scope of trades by special entities or other classes of counterparties changed since 2011? Have unregistered entities – such as dealers operating under the de minimis threshold – emerged to deal engage in transactions with special entities or other particular classes of counterparties?
- Effects on access. The report may be able to explore connections between the definitions and the ability of certain classes of counterparties to access products in the security-based swap market. For example, to what extent is an entity’s registration status or its approaching or crossing any of the thresholds established by the definitions correlated with the entity ceasing transactions with certain classes or sizes of counterparties?
- Effects of the dealer-trader distinction. The report may be able to explore connections between market dynamics and quantifiable metrics indicative of dealing activity. For example, are there identifiable, objective differences between the registered security-based swap dealers and unregistered market participant populations in terms of number of counterparties, buy/sell ratios, posting of initial margin, concentrations by counterparty or otherwise? If so, how does the amount of the activity (in terms of notional value and number of transactions) of those entities change when they move above or below the thresholds implied by those differences?

How do the characteristics of their counterparties (in terms of number and nature) change?

- Effects of de minimis thresholds. The report may be able to explore connections between market dynamics and the de minimis thresholds established by the definitions. For example, how does the amount of the activity (in terms of notional value and number of transactions) of security-based swap entities change when they move above or below the de minimis thresholds? How do the characteristics of their counterparties (in terms of number and nature) change?
- Effects of major participant thresholds. The report may be able to explore connections between market dynamics and the major participant thresholds established by the definitions. For example, how have total notional security-based swap positions changed over time for large market participants that are not registered and that do not bear any indicia of dealing activity? For those large participants, have overall notional levels moved toward, or away from, the levels required to trigger the major participant thresholds?
- Other effects of the definitions. To what extent do entities registered security-based swap dealers have overall trading characteristics suggesting that they may not be dealers? To what extent have entities not registered as dealers have trading characteristics suggesting that they may be acting as dealers? In either case, do any discrepancies between firms' registration status and their trading characteristics suggest any gaps or areas of uncertainty regarding the scope of the dealer definitions that may require potential modifications?

VI. Effective Date and Implementation

Consistent with sections 754 and 774 of the Dodd-Frank Act, these final rules will be effective on 60 days following publication in the Federal Register. The Commissions, however, are providing for a phase-in period for persons engaged in dealing activity below certain amounts.

If any provision of these joint rules, or the application thereof to any person or circumstance, is held to be invalid, such invalidity shall not affect other provisions or application of such provisions to other persons or circumstances that can be given effect without the invalid provision or application.

A. CEA Rules

As explained below and as noted elsewhere in this Adopting Release, the compliance date for various regulatory requirements is contingent upon the adoption and effectiveness of other, related, regulatory provisions and definitions. Because the CFTC believes that the suite of rules implementing the Dodd-Frank Act are complex and interconnected, it has determined that implementation in certain cases can best be accomplished through separate rulemakings. The Commissions received comments related to implementation and phase-in that largely resulted from the CFTC's re-opening of the comment period for several rulemakings, and a request for comment on the order in which it should consider final rulemakings made under the Dodd-Frank Act.¹²³⁹ The CFTC notes that swap dealers and major swap participants will require an

¹²³⁹ See CFTC, Reopening and Extension of Comment Periods for Rulemakings Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR 25274 (May 4, 2011).

implementation or compliance period based on separate registration and regulatory requirements that are the subject of separate rulemakings by the Commission.¹²⁴⁰

As the CFTC stated recently in another rulemaking related to CPOs:

[while t]he [CFTC] recognizes that entities will need time to come into compliance with the [CFTC]'s regulations . . . [b]ased on the comments received indicating that a certain portion of entities currently claiming relief [from CPO registration] under § 4.13(a)(4) already have robust controls in place independent of [CFTC] oversight, the [CFTC] believes that entities currently claiming relief under § 4.13(a)(4) should be capable of becoming registered and complying with the [CFTC]'s regulations within 12 months following the issuance of the final rule. For entities that are formed after the effective date of the rescission, the Commission expects the CPOs of such entities to comply with the Commission's regulations upon formation and commencement of operations.¹²⁴¹

The Commissions are taking the same approach with respect to implementing CFTC Regulations §§ 1.3(m)(5) and 1.3(m)(6). The loss of ECP status for Forex Pools currently operating other than pursuant to the retail forex regime of a federal regulator described in CEA

¹²⁴⁰ See CFTC, Final Rule: Registration of Swap Dealers and Major Swap Participants, 775 FR 713792613 (Jan. 19, 2012).

¹²⁴¹ CPO/CTA Compliance Release at 11265.

section 2(c)(2)(E)(i)¹²⁴² may involve significant structural and operational changes. The loss of a commodity pool's ability to rely on CEA section 1a(18)(A)(v) if it does not fall within CEA section 1a(18)(A)(iv) may require significant structural and operational changes. Because additional time may enable a Forex Pool affected by CFTC Regulation § 1.3(m)(5) to restructure to avoid being subject to the retail forex regime (e.g., by redeeming U.S. non-ECP participants) and may allow a commodity pool affected by CFTC Regulation § 1.3(m)(6) time to satisfy the terms of CEA section 1a(18)(A)(iv) (e.g., by the pool's CPO registering as such or claiming an exemption therefrom or by the pool raising its level of total assets above \$5 million), the Commissions are delaying the effective date of CFTC Regulations §§ 1.3(m)(5) and 1.3(m)(6) until December 31, 2012, which is the compliance date for commodity pools no longer permitted to claim exemption from CPO registration pursuant to recently withdrawn CFTC Regulation 4.13(a)(4).¹²⁴³

CFTC Regulation § 1.3(m)(8) conditions ECP status in part on a requirement that a commodity pool be "formed and operated" by a registered CPO or by a CPO who is exempt from registration as such pursuant to CFTC Regulation § 4.13(a)(3). Due to the revocation of CFTC Regulation § 4.13(a)(4), the Commissions anticipate that many CPOs will be registering as such in the future. However, the compliance date for registration for CPOs required to register as such due to the withdrawal of CFTC Regulation § 4.13(a)(4) is December 31, 2012. Furthermore, such CPOs may have formed the commodity pools that they currently operate when such CPOs were not registered as such.

¹²⁴² 7 U.S.C. 2(c)(2)(E)(i).

¹²⁴³ See CPO/CTA Compliance Release.

Consequently, compliance with the formation element of CFTC Regulation § 1.3(m)(8)(iii) is not required with respect to a commodity pool formed prior to December 31, 2012. To be clear, however, while pools in existence before December 31, 2012 need not have been formed by a registered CPO, or by a CPO who is exempt from registration as such pursuant to CFTC Regulation § 4.13(a)(3), in order to satisfy the formation aspect of CFTC Regulation § 1.3(m)(8)(iii), such commodity pools nevertheless must be operated by a registered CPO, or by a CPO who is exempt from registration as such pursuant to CFTC Regulation § 4.13(a)(3), on December 31, 2012 to satisfy the “operated by a registered CPO” element of CFTC Regulation § 1.3(m)(8)(iii).

B. Exchange Act Rules

Because the SEC has not yet promulgated final rules implementing the substantive requirements imposed on dealers and major participants by Title VII of the Dodd-Frank Act, persons determined to be dealers or major participants under the regulations adopted in this Adopting Release need not register as such until the dates provided in the SEC’s final rules regarding security-based swap dealer and major security-based swap participant registration requirements, and will not be subject to the requirements applicable to those dealers and major participants until the dates provided in the applicable final rules.¹²⁴⁴

Moreover, as discussed above in the context of the de minimis exception to the security-based swap dealer definition,¹²⁴⁵ the SEC is making an extended compliance period available to persons engaged in dealing activity involving credit default swaps between \$3 billion and \$8

¹²⁴⁴ See Securities Exchange Act Release No. 64678 (June 15, 2011), 76 FR 36287 (June 22, 2011) (“Effective Date Release”) (granting exemptive relief and providing guidance in connection with Exchange Act provisions concerning security-based swaps that were added or amended by Title VII).

¹²⁴⁵ See part II.D.5, supra.

billion in trailing annual notional amount, and to persons engaged in dealing activity involving other types of security-based swaps between \$150 million and \$400 million in trailing annual notional amount. Persons taking advantage of that extended compliance period will be deemed not to be security-based swap dealers during that period, and will not be subject to registration requirements and other requirements associated with status as a security-based swap dealer during that period.

The SEC previously provided limited exemptive relief in connection with Exchange Act section 6(l),¹²⁴⁶ added by the Dodd-Frank Act, which prohibits any person from effecting a security-based swap transaction with a person that is not an ECP, unless effected on a national securities exchange. That relief expires as of the effective date of final rules further defining ECP.¹²⁴⁷ Accordingly, following the effective date of these final rules, dealers and major participants – and all other persons – will be subject to the prohibition of section 6(l) under the definition of ECP as amended by Title VII and as further defined by the rules.¹²⁴⁸

VII. Administrative Law Matters – CEA Revisions (Definitions of “Swap Dealer” and “Major Swap Participant,” and Amendments to Definition of “Eligible Contract Participant”)

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (“RFA”) requires Federal agencies to consider the impact of its rules on “small entities.”¹²⁴⁹ A regulatory flexibility analysis or certification typically is

¹²⁴⁶ 15 U.S.C. 78f(l).

¹²⁴⁷ See Effective Date Release, 76 FR at 36307.

¹²⁴⁸ Because the exemptive relief that the SEC granted in connection with section 6(l) will expire as of the effectiveness of the ECP definition, the relief that that SEC provided from the rescission provisions of Exchange Act section 29(b) in connection with section 6(l) also will expire at that time. See *id.*

¹²⁴⁹ 5 U.S.C. 601 *et seq.*

required for “any rule for which the agency publishes a general notice of proposed rulemaking pursuant to” the notice-and-comment provisions of the Administrative Procedure Act, 5 U.S.C. 553(b).¹²⁵⁰ In its proposal, the CFTC stated that “[t]he rules proposed by the CFTC provide definitions that will largely be used in future rulemakings and which, by themselves, impose no significant new regulatory requirements. Accordingly, the Chairman, on behalf of the CFTC, hereby certifies pursuant to 5 U.S.C. 605(b) that the proposed rules will not have a significant economic impact on a substantial number of small entities.”¹²⁵¹

In response to the Proposing Release, one commenter stated that the CFTC’s “rulemakings [are] an accumulation of interrelated regulatory burdens and costs on non-financial small entities like the NFPEEU members, who seek to transact in energy commodity swaps only to hedge the commercial risks of their not-for-profit public service activities.”¹²⁵² In general, the commenter said that since the Small Business Administration (“SBA”) has determined that many rural electric cooperatives are “small entities” for purposes of the RFA, if the definition of swap dealer were to cover a substantial number of rural electric cooperatives the rule further defining swap dealer may have a significant economic impact on a substantial number of small entities.¹²⁵³ Thus, the commenter concluded that the CFTC should conduct a regulatory flexibility analysis for each of its rulemakings under the Dodd-Frank Act, including this rulemaking.

¹²⁵⁰ 5 U.S.C. sections 601(2), 603, 604 and 605.

¹²⁵¹ 75 FR 80203.

¹²⁵² See letter from NFPEEU.

¹²⁵³ See letter from NFPEEU and meeting with NFPEEU on January 19, 2011.

The commenter also said that the requirement in section 2(e) of the CEA, as amended by the Dodd-Frank Act, that a person who is not an ECP must execute swaps on a designated contract market would have the potential to have a significant economic impact on a substantial number of small entities if a substantial number of rural electric cooperatives were not covered by the definition of ECP.¹²⁵⁴ Another commenter said that in considering the economic impact on small entities of the swap dealer definition rules, the CFTC should consider whether the availability and cost of swaps to small entities could be affected by potential uncertainty among persons who engage in the activities covered by the definition about whether they are required to register as swap dealers.¹²⁵⁵

The commenters did not provide specific information on how the further defining swap dealer would have a significant economic effect on a substantial number of small entities. Nonetheless, the CFTC has reevaluated this rulemaking in light of the statements made to it by these commenters. After further consideration of those statements, the CFTC has again determined that this final rulemaking will not have a significant economic effect on a substantial number of small businesses. With regard to the definition of swap dealer, the CFTC expects that if any small entity were to engage in the activities covered by the definition, most such entities would be eligible for the de minimis exception from the definition.¹²⁵⁶ Additionally, the Commission does not expect that the small entities identified by NFPEEU will be subject to

¹²⁵⁴ See letter from NFPEEU.

¹²⁵⁵ See letter from Dominion Resources.

¹²⁵⁶ The number of small entities that could conceivably be covered by the definition of swap dealer is likely to be further reduced if transactions between entities described in section 201(f) of the Federal Power Act (which generally includes rural electric cooperatives) are exempted from the requirements of the CEA, as contemplated by section 4(c)(6) of the CEA.

registration with the Commission as a major swap participant, as most entities with total electric output not exceeding 4 million megawatt hours are not expected to maintain outstanding swap positions that would exceed the applicable thresholds. In general, the major swap participant definition applies only to persons with very large swap positions, and therefore the definition of major swap participant is incompatible with small entity status.

With regard to the definition of ECP, the CFTC notes that the costs of executing swaps on a designated contract market raised by the commenter arise from a requirement of the CEA, and not from any rule promulgated by the CFTC. Last, regarding the comment that there may be an economic impact on small entities in terms of the availability and cost of swaps, the definition of swap dealer is being adopted to limit uncertainty with respect to which entities will be required to register as a swap dealer. Thus, the definition of swap dealer is intended to avoid creating the substantial economic effect which concerns the commenter.

Accordingly, the Chairman, on behalf of the CFTC, certifies, pursuant to 5 U.S.C. 605(b), that the actions to be taken herein will not have a significant economic impact on a substantial number of small entities.

B. Paperwork Reduction Act

The Paperwork Reduction Act ("PRA")¹²⁵⁷ imposes certain requirements on Federal agencies in connection with their conducting or sponsoring any collection of information as defined by the PRA. The Proposing Release stated that the proposed rules would not impose any new recordkeeping or information collection requirements, or other collections of information that require approval of the Office of Management and Budget ("OMB") under the PRA, and

¹²⁵⁷ 44 U.S.C. 3501 et seq.

invited public comment on the accuracy of the CFTC's estimate that no additional recordkeeping or information collection requirements or changes to existing collection requirements would result from the proposed rules.¹²⁵⁸

One commenter said that the regulatory requirements imposed on swap dealers and major swap participants (including swap end users that may potentially be misclassified as swap dealers or major swap participants) will entail reporting and record keeping requirements.¹²⁵⁹ Specifically, the commenter noted that the CFTC stated in the Proposing Release that "any entity determined to be a swap dealer or major swap participant would be subject to registration, margin, capital, and business conduct requirements ... all activities that will have associated reporting and additional recordkeeping requirements."¹²⁶⁰ Another commenter said that the CFTC should consider the implications under the PRA of all of its rulemakings under the Dodd-Frank Act as a whole.¹²⁶¹

As with the proposed rules, these final rules will not impose any new information collection requirements that require approval of OMB under the PRA. All reporting and recordkeeping requirements applicable to swap dealers and major swap participants instead result from other rulemakings, for which the CFTC has sought OMB approval. The CFTC submitted an information collection request to OMB for each proposed rulemaking containing reporting or recordkeeping requirements, including the recordkeeping and reporting requirements

¹²⁵⁸ 75 FR 80203.

¹²⁵⁹ See letter from Dominion Resources.

¹²⁶⁰ See id. at 6.

¹²⁶¹ See letter from NFPEEU.

referenced by the first commenter,¹²⁶² which estimated the implications of the proposed collections on prospective respondents.¹²⁶³

Moreover, in appropriate rulemakings, the CFTC sought to rely upon information collections that already had been proposed, in order to avoid imposing unnecessary additional burdens upon prospective respondents.¹²⁶⁴ Parties wishing to review the CFTC's information collections on a global basis may do so at www.reginfo.gov, at which OMB maintains an inventory aggregating each of the CFTC's currently approved information collections, as well as the information collections that presently are under review.

C. Cost Benefit Considerations

CEA section 15(a) requires the CFTC to consider the costs and benefits of its action before promulgating a regulation under the CEA, specifying that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (i) protection of market participants and the public; (ii) efficiency, competitiveness and financial integrity of futures markets; (iii) price discovery; (iv) sound risk management practices; and (v) other public interest considerations.¹²⁶⁵

1. Introduction

The terms "major swap participant" and "swap dealer" are defined in CEA sections 1a(33) and 1a(49), as added by the Dodd-Frank Act, to include any person that holds swap

¹²⁶² See, e.g., 75 FR 71379, 71386 (Nov. 23, 2010) (proposed registration rules); 75 FR 70881, 70884 (Nov. 19, 2010), 75 FR 71397, 71401 (Nov. 23, 2010), 75 FR 71391, 71394 (Nov. 23, 2010), 75 FR 80638, 80656 (Dec. 22, 2010), and 76 FR 33066, 33076 (Jun. 7, 2011); and 76 FR 27802, 27819 (May 12, 2011) (collectively, the information collection requests for the proposed business conduct rules).

¹²⁶³ See 44 U.S.C. 3506 (PRA program requirements) and 3507 (PRA submission requirements).

¹²⁶⁴ See, e.g., 75 FR 80638, 80656 (Dec. 22, 2010).

¹²⁶⁵ 7 U.S.C. 19(a).

positions above a certain level (in the case of the term “major swap participant”) or that engages in certain activities (in the case of the term “swap dealer”), with certain exclusions and exceptions, all as discussed in parts II and IV of this Adopting Release. Section 712(d)(1) of the Dodd-Frank Act directs the CFTC and the SEC, in consultation with the Board, jointly to further define these and other terms. Also, CEA section 1a(49)(D) directs the CFTC to promulgate regulations to establish factors with respect to the making of the determination to apply the de minimis exception to the definition of the term “swap dealer.”

The provisions of the Dodd-Frank Act that direct the further definition of the terms “swap dealer” and “major swap participant” should be viewed in the context of Congress’ consideration of the consequences that would arise from regulating persons and activities that were previously free from regulation. The Dodd-Frank Act is, in part, a response to a financial crisis in which unregulated swaps played a major role.¹²⁶⁶ It includes provisions to regulate swap dealers and major swap participants in order to address concerns about this previously unregulated market. In this context, the Dodd-Frank Act requires that rules should “further define” the terms “swap dealer” and “major swap participant” by establishing and providing guidance with respect to the criteria for determining if a person is covered by one of the statutory definitions and therefore should be subject to certain regulatory requirements under Title VII; the Dodd-Frank Act does not direct the Commissions to define those terms in a vacuum. So, even in the absence of these rules, Title VII would require the regulation of persons that act as swap dealers or hold positions causing them to be major swap participants. Consequently, a large part of the costs and benefits

¹²⁶⁶ See, e.g., S.Rep. 111-176, The Restoring American Financial Stability Act of 2010 at 29.

resulting from the regulation of swap dealers and major swap participants result from the Dodd-Frank Act itself and not from these definitional rules.

2. General cost and benefit considerations

In considering the comments on the proposed rules and the various alternatives available for the final rules, the CFTC sought to promulgate final rules that will help swap market participants and the public to apply the statutory definitions of the terms “swap dealer” and “major swap participant” in an efficient, uniform and accurate manner. We believe that doing so will protect market participants and the public, promote the efficiency, competitiveness and financial integrity of the swap markets, facilitate price discovery, encourage sound risk management practices and advance the public interest in general. That is, by providing direction and guidance as to which factors are relevant in applying the statutory definitions, and how to apply those factors to particular situations in the swap markets, the CFTC believes the final rules will provide benefits by reducing the cost of determining whether a particular person is covered by the statutory definitions, helping to make similar determinations for persons that are similarly situated, and promoting application of the terms “swap dealer” and “major swap participant” in conformity with the statutory definitions.

The costs and benefits considered in this final rule fall in two categories: first, those an entity will experience in determining whether it is a “swap dealer” or “major swap participant” as further defined in this rulemaking; and second, those attributable to the fact that, as interpreted in this rule, a greater or fewer number of entities at the boundaries of the statutory definitions may be deemed within them.

With respect to the first category, and as discussed further in sections V.A.3.j. and V.A.4.b. below, the CFTC has endeavored to approximate the costs of making these

determinations. At the same time, the CFTC believes that the careful consideration of, and detailed response in this Adopting Release to, comments regarding the application of the statutory definitions will provide useful, practical guidance, yielding a substantial if unquantifiable benefit to entities making such determinations.

The costs and benefits in the second category – those associated with the rules being more or less inclusive – were a primary concern of the CFTC and commenters throughout this rulemaking. Commenters stated that if the CFTC's final rules were to lead to interpretations of the statutory definitions that are over-inclusive, the result would be that entities would likely incur significant, unjustifiable costs attributable to various regulatory requirements intended for actual swap dealers and major swap participants.¹²⁶⁷ Other commenters were concerned that if the rules were to lead to under-inclusive interpretations, the benefits expected from Title VII would be dampened.¹²⁶⁸

The CFTC does not dismiss these potential unintended results and we have responded to these comments in the policy determinations made above.¹²⁶⁹ We recognize that these definitional rules are “gating” rules, and that this gating function will affect whether entities at the boundaries of the statutory definitions incur costs attributable to the regulatory regime that Congress has prescribed and the CFTC has implemented through other substantive regulations. Correspondingly, these definitional rules will also affect the extent of benefits for the swap market and the public resulting from those regulations. It is important to also recognize,

¹²⁶⁷ See letters from API I, Atmos Energy, BG LNG I, Dominion Resources, Hess, NCGA/NGSA I, NFPEEU, Vitol and WGCEF VIII.

¹²⁶⁸ See letters from AFR, Better Markets I and Greenberger.

¹²⁶⁹ See, e.g., parts II.A.4.g, II.D.3.a and IV.B.3.a.

however, that as stated above, the regulation of persons acting as swap dealers or who hold positions causing them to be major swap participants is required by the Dodd-Frank Act. For entities that are not on the boundaries of the statutory definitions, but rather squarely within them or entirely outside of them, these rules will not affect the costs and benefits that result from their inclusion or exclusion. The latter group of costs and benefits are a consequence of the statutory definitions prescribed by Congress.

In this rulemaking, we considered that more inclusive rules and guidance would cause some entities at the boundaries of the definitions to be covered by one of the definitions and therefore incur both initial and recurring direct costs of complying with Dodd-Frank Act requirements, while less inclusive rules and guidance would have the opposite effect.¹²⁷⁰ Thus, as more or fewer entities are covered by the definitions, the amount of such direct compliance costs incurred by entities in the aggregate will vary. However, this variance in the aggregate compliance costs resulting from the CFTC's definitional guidance in this rulemaking must be distinguished from the compliance costs that any particular entity will incur stemming from the other rulemakings prescribing regulations applicable to swap dealers and major swap participants. Consideration of the specific costs and benefits attendant to various substantive regulations applicable to swap dealers and major swap participants is beyond the limited scope of this rulemaking.

¹²⁷⁰ For example, the final rules specify criteria related to application of the *de minimis* exception, the range of transactions that are eligible for the exclusion of swaps in connection with the origination of loans, and the requirements for limited designation as a swap dealer, each of which will impact the total number of entities that are subject to swap dealer regulation. The final rules also specify criteria related to the thresholds for major swap participant status, factors that may be considered in the major swap participant calculations, and the threshold for "highly leveraged" status, each of which will impact the number of entities that are major swap participants.

Moreover, the variance in aggregate compliance costs resulting from this rulemaking will not track, on a "one for one" basis, the number of entities included in the definitions as the rules are more or less inclusive. This is because the initial and recurring compliance costs for any particular swap dealer or major swap participant will depend on the size, existing infrastructure, level of swap activity, practices and cost structure of the entity designated as such.¹²⁷¹ Another reason that the aggregate costs resulting as more or fewer entities are included in the definitions will not precisely track the number of such entities is that indirect costs are likely to result as market participants seek to avoid the regulations attendant to swap dealer or major swap participant status by, among other things, reducing their swap activities.¹²⁷² We do not expect

¹²⁷¹ It is likely that a swap dealer or major swap participant would incur direct compliance costs related to technology, personnel and capital. See CFTC, Registration of Swap Dealers and Major Swap Participants; Final Rule, 77 FR 2613 (January 19, 2012); CFTC, Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties; Final Rule, 77 FR 9733 (February 17, 2012) and CFTC, Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants; Final Rule, 77 FR 20128 (April 3, 2012).

¹²⁷² For example, those entities would lose the profits they may have gained from those activities, and potentially from related business activities if their customers cut back their business relationships because the abstaining entities no longer engage in those swap activities.

We recognize that small entities are more likely than large entities to abstain from swap activities in order to avoid being covered by the swap dealer definition. Smaller entities are less likely to have existing technology and procedures that would comply with new regulations and therefore their initial costs of compliance with the requirements applicable to swap dealers are likely to be larger. Moreover, the same fixed costs will have a proportionally greater effect on small entities.

Other market participants may also bear some costs if entities abstain from dealing activities or if large users of swaps reduce their activities to avoid major swap participant status. These costs could include transition costs as the other market participants identify new counterparties with which to enter into the same swaps. In addition, and likely more important, as more entities abstain from swap activities, other entities that are seeking to enter into swaps may have a reduced choice of counterparties, which may lead to unfavorable financial terms for swaps and imperfect matches between risks and the swaps that are available. These factors may increase the cost of risk mitigation in general, as entities use more costly risk management strategies in place of swaps.

that the extent of these indirect costs will be directly related to the number of entities included in the definitions.

The CFTC likewise acknowledges that more or less inclusive definitions may increase or decrease the systemic benefits expected from the composite regulation of swap dealers and major swap participants. These include improved transparency and market orderliness, as well as the reduction of excess leverage and systemic risk. The CFTC believes that less inclusive final rules could negatively impact these interests in several ways: those who engage in swaps with entities that elude swap dealer or major swap participant status and the attendant regulations could be exposed to increased counterparty risk; customer protection and market orderliness benefits that the regulations are intended to provide could be muted or sacrificed, resulting in increased costs through reduced market integrity and efficiency;¹²⁷³ and entities that elude swap dealer or major

See generally letters from API I, BG LNG I, BOK dated February 22, 2011 ("BOK III"), COPE I, Midsize Banks, NEM, NCGA/NGSA I, NGFA I, Chevron Federal Credit Union, M&T I, Sidley and WGCEF I. See also Roundtable Transcript at 39 (remarks of Eric Chern, Chicago Trading Company), 133-34 (remarks of Brenda Boulwood, Constellation).

¹²⁷³ More uniform compliance with regulations leads to more uniform expectations that market participants may reasonably have about the financial integrity of various swap dealers and major swap participants. Less uniform compliance, on the other hand, could introduce additional uncertainty about the financial integrity of an individual swap dealer or major swap participant. This could result in reduced market efficiency. Moreover, foreseeable "network effects" could magnify these costs. That is, since requirements promoting transparency and orderly documentation are expected to increase market participants' general level of certainty about the swap positions held by others in the market, the wider the market application the greater the benefit. For example, in the 2008 financial crisis, uncertainty about the potential obligations of various market participants led to actions to restrict credit and reduce leverage that may not have been taken if there was greater confidence about market participants in general; this uncertainty also hampered regulatory efforts. Significant pockets of unregulated swap activity attributable to less inclusive definitions of the terms "swap dealer" and "major swap participant" may result in costs related to uncertainty and lack of information.

swap participant status may gain an unwarranted competitive advantage over other market participants.¹²⁷⁴

Generally, rules that capture more entities are likely to increase these benefits, while rules that capture fewer entities are likely to have the opposite effect, though there are several additional factors that also have a bearing on the presence and magnitude of increased or decreased benefits. These factors include the number and size of entities whose status changes under more or less inclusive rules, the number of swaps they engage in, their connectedness to other institutions and role in the financial system, and the types of financial instruments they would have utilized in the absence of swap dealer and major swap participant regulations.

At this time, it is also not possible to quantify the impact of these rules on the direct and indirect costs and benefits that result from changing the status of an entity that is on the boundaries of the Dodd-Frank Act's definitions of the terms "swap dealer" or "major swap participant." The CFTC does not have adequate information about market participants' swap activities to determine which entities will change their activities in response to the definitions, which would be necessary in order to determine the significance of the impact on costs and benefits of including or excluding those entities from the regulations pertaining to swap dealers and major swap participants. Costs may not be estimated in an accurate or meaningful way for many reasons, including because all of the regulations pertaining to swap dealers and major swap participants have not yet been issued in their final form, and because the CFTC does not have adequate information about market participants' existing technology, infrastructure, use of

¹²⁷⁴ The extent of any such competitive advantage would depend on the number of entities that are inaccurately not covered by the definitions and the extent of their swap activities relative to the market in which they are active.

swaps, or cost structure.¹²⁷⁵ Changes in the total benefits resulting from the definitional regulations are also difficult to quantify, since many of the benefits of the swap dealer and major swap participant regulations are indirect, rather than direct. As a consequence, the CFTC may recognize and describe the impact of these rules on the overall costs and benefits deriving from swap dealer and major swap participant regulations, but it is not possible to quantify them at this time.

The applicable provisions of the Dodd-Frank Act regarding the term “eligible contract participant” are somewhat different, in that the statute modifies a particular clause in the pre-existing statutory definition of the term and also provides general authority to further define the term. The final rules adopted in this regard provide guidance for the application of these provisions.

3. Comments on the discussion of costs and benefits in the Proposing Release

Some commenters suggested that the discussion in the Proposing Release of the costs and benefits of the proposed rules further defining the terms “swap dealer,” “major swap participant” and “eligible contract participant” was inaccurate or inadequate.¹²⁷⁶ For example, commenters suggested that in considering the final rules, the CFTC should consider empirical data regarding the costs and benefits flowing from the rules,¹²⁷⁷ opportunity costs associated with

¹²⁷⁵ Currently, prior to the implementation of Title VII, the U.S. swap market generally is not subject to substantive regulation, and market participants generally do not disclose detailed information about their swap activities and positions. This lack of data reduces our ability to analyze the swap activities of individual market participants, as well as the market as a whole, and thus impacts our ability to analyze the costs and benefits of these rules. Our analysis, out of necessity, is based on data that currently is available.

¹²⁷⁶ See letters from API I, NFPEEU, Regional Banks, Sidley and WGCEF I, II and VIII; see also letter from FSR III.

¹²⁷⁷ See letters from WGCEF I and II.

regulatory uncertainty,¹²⁷⁸ and alternatives that would impose fewer costs.¹²⁷⁹ One commenter suggested that the CFTC should issue a second analysis of the costs and benefits of the rules for public comment,¹²⁸⁰ while another commenter said that the consideration of cost and benefits should include the cumulative cost of interrelated regulatory burdens arising from all the rules proposed under the Dodd-Frank Act.¹²⁸¹

Another commenter said that the cost-benefit analyses in the Proposing Release may have understated the benefits of the proposed rules, because focusing on individual aspects of all the rules proposed under the Dodd-Frank Act prevents consideration of the full range of benefits that arise from the rules as a whole, in terms of providing greater financial stability, reducing systemic risk and avoiding the expense of assistance to financial institutions in the future.¹²⁸² This commenter said the consideration of benefits of the proposed rules should include the mitigated risk of a financial crisis.¹²⁸³

We have endeavored to address the commenters' concerns in this Adopting Release by undertaking careful consideration of various alternatives proposed by commenters as described in this section. With regard to the comments suggesting that we consider empirical data, the CFTC found that no comprehensive, publicly available empirical data related to the usage of

¹²⁷⁸ See letter from Dominion Resources.

¹²⁷⁹ See letters from NextEra I and NFPEEU.

¹²⁸⁰ See letters from WGCEF I and II.

¹²⁸¹ See letter from NFPEEU.

¹²⁸² See letter from Better Markets II.

¹²⁸³ Better Markets cited estimates that the worldwide cost of the 2008 financial crisis in terms of lost output was between \$60 trillion and \$200 trillion, depending primarily on the long term persistence of the effects. See *id.*

swaps in all markets is available, and commenters provided very little empirical data to aid us in this rulemaking.

4. Costs and benefits of the rules further defining "swap dealer"

The Proposing Release proposed certain factors that could be relevant to market participants when determining whether they are covered by the statutory definition of the term "swap dealer." The CFTC received comments in response to numerous issues and considered a variety of alternatives in light of those comments, weighing the costs and benefits of each. In particular, we considered alternatives with respect to the activities indicative of holding oneself out as, or being commonly known as, a dealer in swaps, making a market in swaps, entering into swaps as a "regular business," the exclusion available to IDIs for swaps offered in connection with the origination of loans, inter-affiliate swaps, swaps hedging physical positions, limited dealer status, and the possibility of providing particularized treatment under the definition for various types of entities.

As noted above, in considering these alternatives the CFTC's primary objective was to promulgate a rule under which market participants could efficiently and accurately determine whether they are engaged in any of the activities that are included in the statutory definition of swap dealer, and whether they are covered by any of the exclusions in the statutory definition. The scope of our consideration of these alternatives included the five factors specified in section 15(a) of the CEA. That is, we considered how the promulgation of final rules that would promote application of the definition of the term "swap dealer" in a manner that is consistent with the statutory definition would protect market participants and the public, promote the

efficiency, competitiveness and financial integrity of the markets,¹²⁸⁴ facilitate price discovery, encourage sound risk management practices and serve the public interest. Rather than describing in a separate section how we applied the elements of section 15(a) in the final rule further defining the term “swap dealer,” the discussion below highlights the application of those elements where appropriate.

- a. Indicia of holding oneself out as a dealer in swaps or being commonly known in the trade as a dealer in swaps

As discussed above, the Proposing Release set forth activities that could indicate that a person is holding oneself out as a dealer or is commonly known in the trade as a dealer in swaps.¹²⁸⁵ Commenters on this point said that persons who are not swap dealers also engage in some of the activities identified in the proposed rule. In other words, these commenters asserted that these activities are not accurate indicators of swap dealer status.¹²⁸⁶

Commenters were concerned that if the rule included, as bright-line tests of swap dealer status, the proposed indicators of holding oneself out as, or being commonly known as, a swap dealer, then the rule would lead to an interpretation of the statutory definition that would be more inclusive. This, in turn, would lead to the costs of a more inclusive rule, and possibly the costs of entities abstaining from swap activities to avoid being covered by the definition, as discussed above.¹²⁸⁷

¹²⁸⁴ Although by its terms, CEA section 15(a)(2)(B) applies to the futures (not swaps) markets, the CFTC finds this factor useful in analyzing the costs and benefits of these regulations further defining the terms “swap dealer,” “major swap participant” and “eligible contract participant” as well.

¹²⁸⁵ See part II.A.1, *supra*.

¹²⁸⁶ See part II.A.2.a, *supra*.

¹²⁸⁷ See part VII.C.2, *supra*.

While we are cognizant that providing no guidance about how to apply the statutory provision stating that the term “swap dealer” includes any person who holds itself out as a dealer in swaps or is commonly known in the trade as a dealer or market maker in swaps would deprive market participants of interpretive guidance — thus increasing the direct and indirect costs to apply the rule — we considered the commenters’ concern that use of the proposed characteristics as bright-line indicators of swap dealer status could potentially result in significant costs.

Therefore, to mitigate the costs of applying the rule and the costs that would result if the rule were more inclusive, the Adopting Release clarifies that the identified activities are not per se conclusive, and could be countered by other facts and circumstances indicating that an entity is not a swap dealer. The CFTC believes that providing guidance about the factors that are correlated with holding oneself out as or being commonly known as a swap dealer - even if not perfectly so - mitigates the risk that the rule would include entities that are not actually covered by the statutory definition and provides benefits in reducing the costs of application of the rule.

b. Making a market in swaps

Commenters on this point provided several perspectives on what does and does not constitute market making.¹²⁸⁸ With those comments in view, we considered a number of characteristics for potential inclusion in the rule, and evaluated potential costs and benefits of each before determining that making a market in swaps is best described as “routinely standing ready to enter into swaps at the request or demand of a counterparty.” We also further described various activities that constitute routinely standing ready, such as routinely quoting bid or offer prices for swaps, routinely responding to requests made directly by potential counterparties for

¹²⁸⁸

See part II.A.2.b, *supra*.

bid or offer prices, etc. The alternative options we considered are discussed below in light of the five broad areas specified in section 15(a) of the CEA.

Offer swaps on both sides of the market. The proposed rule stated our view that an entity may be a market maker in swaps even if the entity does not enter into swaps on both sides of the market. Several commenters suggested the rule should require that an entity enter into swaps on both sides of the market as a prerequisite to market maker status.¹²⁸⁹ We have considered these comments and concluded that an entity could be a market maker by offering swaps on one side of the market, while entering into transactions on the other side of the market using other financial instruments.

Accordingly, using presence on both sides of the market as a determinative factor in applying the definition of the term “swap dealer” could cause the final rule to be under-inclusive by excluding entities that function as market makers by entering into swaps on one side of the market. In addition, some entities may limit their swap dealing activities to one side of the market in an attempt to avoid being covered by the definition, again leading to the rule being under-inclusive.

Excluding cleared swaps from consideration. Some commenters said cleared swaps should not be considered in determining whether an entity is a swap dealer.¹²⁹⁰ Moreover, they suggested that dealers operating through clearinghouses might choose to exit the market if required to register as swap dealers, which would reduce liquidity.¹²⁹¹

¹²⁸⁹ See letters cited in notes 52 to 54, *supra*.

¹²⁹⁰ See letters from Newedge and Traders Coalition. The commenters said that considering cleared swaps in determining if an entity is a swap dealer may cause entities to reduce their use of cleared swaps, which would be contrary to the general purpose of the Dodd-Frank Act to encourage clearing.

¹²⁹¹ See letters from CMC and Traders Coalition.

It is possible that some entities whose swap dealing activities are limited to cleared swaps will abstain from those activities in order to avoid being covered by the definition, leading to costs associated with entities abstaining from the market, as described above. Other such entities may continue their swap dealing activities and incur the initial and ongoing costs of compliance with swap dealer regulations. Benefits are linked to these compliance costs, however. For example, the swap dealer business conduct requirements are expected to provide benefits in terms of protecting market participants and the public. In any case, we note that the statutory definition of the term “swap dealer” does not include any factor considering whether the swaps that an entity enters into are cleared as opposed to not cleared. Therefore, the costs raised by commenters resulting from the absence of an exclusion of cleared swaps are costs that result from the statutory definition and not the final rule.

c. Regularly entering into swaps with counterparties as an ordinary course of business

The final rule incorporates the statutory provisions that the term swap dealer includes a person that “regularly enters into swaps with counterparties as an ordinary course of business for its own account” and “does not include a person that enters into swaps for such person’s own account, either individually or in a fiduciary capacity, but not as a part of a regular business.” The CFTC believes that the determinative issue in interpreting these provisions is whether an entity’s activity of entering into swaps is part of its usual and normal course of business and is identifiable as a swap dealing business, as discussed above.¹²⁹² This Adopting Release also

¹²⁹²

See part II.A.4.c, supra.

describes certain activities that constitute both entering into swaps “as an ordinary course of business” and “as a part of a regular business.”¹²⁹³

The CFTC believes that dealers frequently engage in the activities described in this Adopting Release, while non-dealers do not.¹²⁹⁴ As a consequence, such activities are useful indicators of swap dealing activity and it is appropriate to incorporate them in the guidance interpreting the final rule in order to properly apply the statutory definition.

d. The dealer-trader distinction

The Adopting Release incorporates the dealer-trader distinction as a consideration when identifying swap dealers. While not dispositive, the CFTC anticipates that the dealer-trader distinction will be useful as a consideration, particularly in light of the degree to which it overlaps with many of the other characteristics identified in the Adopting Release that are indicative of dealing activity. The dealer-trader distinction is likely to be familiar to some market participants that must determine whether they are swap dealers, and to the extent that this is true, the CFTC believes that its incorporation as a factor in the swap dealer analysis will help to reduce uncertainty for those entities, thereby reducing their costs of determining whether they are dealers.¹²⁹⁵ By incorporating the dealer-trader distinction as one consideration within a broader facts and circumstances approach, the CFTC has minimized the costs of under inclusion

¹²⁹³ See id.

¹²⁹⁴ For example, commenters suggested that these types of activities are indicative of swap dealing. See letters from EEI/EPISA, Hess, NextEra I, Utility Group and Vitol.

¹²⁹⁵ See letters from CCMR I and MFA I.

that could arise if the distinction were used as a bright line test to exempt entities that would otherwise be subject to regulation as swap dealers.¹²⁹⁶

e. Limited designation as a swap dealer

The Proposing Release provided that "a person who is a swap dealer shall be deemed to be a swap dealer with respect to each swap it enters into" but explained that an entity could apply for limited designation. Several commenters suggested that the CFTC should allow for the possibility of "presumptive limited designation" as a swap dealer in order to reduce costs.¹²⁹⁷ We have decided, however, not to provide for a presumptive limited designation in the final rule. While a presumptive limited designation would, for the entities that seek it, mitigate the costs of applying for limited designation and any costs related to uncertainty about whether limited designation will be granted,¹²⁹⁸ it could also lead to costs arising from the rule being less inclusive. Persons engaged in a broad range of activities that are all covered by the definition of the term "swap dealer" would have a significant incentive to improperly claim eligibility for a presumptive limited designation. This would hinder the application of swap dealer regulations to

¹²⁹⁶ See letter from AFSCME.

¹²⁹⁷ See part II.E.2.a, *supra*. Several commenters stated that it is unduly burdensome to require swap dealers to apply swap dealer requirements to all of their swaps (including swaps not resulting from dealing activity) while they pursue limited designation. See, e.g., letters from Capital One, Farm Credit Council I and FHLB I. Another commenter suggested that not allowing for a presumptive limited designation could cause some community lenders to cease offering swaps. See letter from Capital One.

Another commenter suggested that to reduce costs, presumptive limited designation should be available for any formal division of an entity, to avoid the costs that would arise if any entity were to reorganize its operations without certainty that limited designation would be available to the reorganized entity. See letter from WGCEF VII.

¹²⁹⁸ Entities that apply for limited designation as a swap dealer will be required to prepare a submission to the CFTC demonstrating their compliance with swap dealer regulations in the context of limited designation.

all of their swap dealing activities and thereby increase costs in terms of lesser protection of market participants and the public, as well as impairment of sound risk management practices.

Commenters suggested that to reduce the costs of determining whether a particular person is eligible for a limited designation as a swap dealer, the CFTC should set out certain criteria that would be relevant to that determination, such as the degree of complexity of an entity's swap activities, what percentage of an entity's total swap activities are dealing activities, the relationship between the entity and its swap counterparties, and how difficult it would be to distinguish between its "designated" and "non-designated" swaps.¹²⁹⁹

Rather than setting forth specific factors to be considered with respect to limited designation as a swap dealer, this Adopting Release takes a facts and circumstances approach, stating that all relevant factors will be considered in the determination. This Adopting Release also states that an important factor in determining whether a swap dealer qualifies for a limited designation is whether the swap dealer can demonstrate that the internal structure to which the limited designation applies (e.g., a division or business unit) complies with the swap dealer requirements. If such a structure is not pre-existing, the swap dealer will incur costs in creating a structure for its swap dealing activity in a manner that would qualify for limited designation. These costs depend on the circumstances of that swap dealer and cannot be quantified at this time; however, such costs are likely to be significant for at least some swap dealers. On the other hand, swap dealers who do qualify for the limited designation will benefit from reduced ongoing compliance costs since some swap dealer requirements are expected to apply to only those

¹²⁹⁹

See letters from Capital One and FHLB I.

activities encompassed by the limited designation.¹³⁰⁰ This flexible approach will allow entities to organize themselves in a manner that allows them to maximize the value of limited designation, so long as they are able to demonstrate that they will comply with swap dealer requirements. In settling on this flexible approach, we considered how the use of a limited designation would allow entities to minimize the effect of swap dealer registration on their swap activities, which fosters efficiency while also promoting sound risk management practices through swap dealer regulation.

The facts and circumstances approach to limited designation will likely lead to some costs arising from uncertainty among market participants about whether steps they have taken or may take will permit them to qualify for a limited designation. However, we believe that market participants may mitigate such uncertainty costs by contacting staff to discuss changes under consideration, or by applying for limited designation on the basis of planned changes (rather than making the changes and then submitting the application).

f. De minimis exception

The Dodd-Frank Act requires that the CFTC exempt from designation as a swap dealer any entity “that engages in a de minimis quantity of swap dealing in connection with transactions

¹³⁰⁰ Some swap dealer regulations may be applied at the transactional level, while others may affect the operations and capital structure of the entity beyond the swaps or activities for which it has a limited designation. On this topic, some commenters suggested that limited designation should allow the swap dealer to limit operational compliance with swap dealer requirements to the portion of the business that is designated as a swap dealer. See letters from FSR I and WGCEF VII. Another commenter stated that the CFTC should not require additional reporting regarding the non-dealing activities. See letter from Cargill.

with or on behalf of customers,” and that the CFTC “promulgate regulations to establish factors with respect to the making of this determination to exempt.”¹³⁰¹

The proposed rule set out certain quantitative standards for identifying those entities whose swap activities were sufficiently small that applying swap dealer regulations to them would not be warranted.¹³⁰² Commenters raised several points regarding the potential costs and benefits of the proposed approach. We considered these points, addressed below, in preparing the final rule, which provides that an entity qualifies for the de minimis exception if the notional amount of its swap positions or security-based swap positions over the prior 12 months arising from its dealing activity is \$3 billion or less, and the notional amount of such positions with “special entities” is \$25 million or less. However, during a phase-in period following the effective date of the final rules, an entity will not be required to register as a swap dealer if the notional amount of the swap positions it enters into over the prior 12 months arising from its dealing activities is \$8 billion or less.¹³⁰³

In determining the level of the notional amount thresholds for the de minimis exception, we considered comments stating that if the thresholds were set inappropriately low, persons engaged in a smaller quantity of swap dealing would face a choice between reducing their swap dealing activities to a level below the thresholds or registering as a swap dealer and incurring the costs of compliance with swap dealer regulation.¹³⁰⁴ It follows from these comments that these entities would incur costs in making a decision about the extent to which they should engage in

¹³⁰¹ CEA section 1a(49)(D), 7 U.S.C. 1(a)(49)(D).

¹³⁰² See part II.D.1, supra.

¹³⁰³ See CFTC Regulation § 1.3(ggg)(4)(ii).

¹³⁰⁴ See, e.g., letters and meetings cited in notes 377 to 381, supra.

swap dealing, although none of the commenters specifically quantified the costs of making that decision. Commenters also expressed a concern that if many entities chose to reduce or cease their swap dealing activities in response to the de minimis thresholds, the availability of swaps may be reduced, particularly to the smaller swap users that typically engage in swaps with such entities, which could lead to costs for those smaller swap users.¹³⁰⁵ Some commenters said that the CFTC should justify the final thresholds for the de minimis exception with an economic analysis; however, these commenters did not propose specific analyses the CFTC should perform or provide specific information that should be included in the analysis.¹³⁰⁶

The CFTC evaluated data regarding index CDS that was provided by the SEC, and made that analysis available to the public.¹³⁰⁷ The data showed that 80.8% of all participants in the index CDS market entered into index CDS with an aggregate notional amount of less than \$3 billion during 2011, and 88.7% of such market participants entered into index CDS with an aggregate notional amount of less than \$8 billion during the same period of time. However, the 19.2% and 11.3% of market participants above those respective thresholds, accounted for 98.9% and 97.8% of the total notional amount of index CDS entered into during that time, which suggests that a relatively small number of entities are responsible for a large majority of activity in the index CDS market. The data also showed that 91.7% of all entities with 3 or more counterparties that are not recognized by ISDA as dealers entered into index CDS with an aggregate notional amount of \$9 billion or more during 2011, suggesting that a large majority of

¹³⁰⁵ See, e.g., letters and meetings cited in note 378, supra. See also Roundtable Transcript at 201 (remarks of John Janney, Large Public Power Council).

¹³⁰⁶ See letters from API I, FSR VI, Midsize Banks, Regional Banks and WGCEF I.

¹³⁰⁷ See memorandum to the public comment file from the CFTC Office of the Chief Economist.

dealers in index CDS likely enter into index CDS with an aggregate notional amount of \$9 billion or more per year.

These observations, and any conclusions derived from them, however, must be qualified by limitations of the data, including: (i) although we expect that the data covers a very large part of the index CDS market, we cannot verify what percentage of all index CDS are represented in the data; (ii) the data is not filtered to reflect activity that would constitute swap dealing under the Dodd-Frank Act, so it is not possible to use the data to draw conclusions regarding any specific entity's status as a swap dealer and (iii) the data does not cover other classes of swaps that are relevant to the de minimis threshold for swap dealers, such as interest rate swaps, equity swaps, foreign exchange swaps or other commodity swaps.¹³⁰⁸ In light of these limitations, any conclusions drawn from the index CDS data must be regarded as provisional.

We note that no matter the level at which the de minimis thresholds are set, there will always be some entities engaged in a quantity of swap dealing at or above the threshold level that will face the choice described by the commenters. As noted above, we considered the costs and benefits of dealer regulation in determining the notional amount standards in the final rule.¹³⁰⁹ Among the costs we considered were those that would result if entities reduce or cease their swap dealing activities in response to the de minimis threshold and swaps become less available in smaller or niche markets. We considered that this could impact the competitiveness of those markets and undermine the ability of market participants to practice sound, cost-effective risk

¹³⁰⁸ See id.

¹³⁰⁹ See part II.D.3.a, supra. In particular, we note here that the higher notional amount standard in the final rule, as compared to the proposed rule, should reduce the number entities that will face the choice described by the commenters.

management.¹³¹⁰ In principle, a higher threshold would promote a larger pool of swap-dealing entities (since entities with swap dealing activity below the threshold need not incur costs to comply with swap dealer regulations), meaning more potential counterparties available to swap users. On the other hand, a greater quantity of swap dealing would be undertaken without the customer protection, market orderliness and market transparency benefits of dealer regulation. This, in turn would impair the protection of market participants and the public, and undermine sound risk management practices, as described above.¹³¹¹ We considered these factors in determining the level of the notional amount standard in the final rule.

Some commenters advocated use of alternative measures (such as an entity's current uncollateralized exposure from swaps, or the number or frequency of swaps) as the de minimis gauge.¹³¹² Some commenters suggested that various types of entities should be subject to different de minimis thresholds,¹³¹³ or that the rule should vary the de minimis threshold by type of swap.¹³¹⁴ Some commenters suggested that the de minimis exception should take into account the purpose of an entity's swap dealing activities or the entity's general characteristics.¹³¹⁵

The CFTC believes that these proposed alternatives are unlikely to better promote the efficiency, competitiveness and financial integrity of the markets, or yield other benefits to a

¹³¹⁰ As noted above, it is not possible to quantify these potential costs with mathematical precision. See note 421, *supra*. The commenters on these points did not provide quantifications of such costs.

¹³¹¹ Commenters expressed various views as to what level of benefits flow from dealer regulation. See, e.g., Roundtable Transcript at 137-43 (remarks of John Janney, Large Public Power Council, Bella Sanevich, NISA Investment Advisors, LLC, and Brenda Boulwood, Constellation)

¹³¹² See letters cited in notes 384 and 385, *supra*.

¹³¹³ See letters from COPE I, Farm Credit Council I and MFX II and meeting with Electric Companies on April 13, 2011.

¹³¹⁴ See letters from Gavilon II and ISDA I

¹³¹⁵ See letters from Farm Credit Council I, FHLB I and MFX II.

greater extent than the approach adopted in the final rule.¹³¹⁶ On the other hand, requiring market participants to consider more variables in evaluating application of the de minimis exception would likely increase their costs to make this determination. In light of these considerations, we concluded that to establish a single notional threshold for all of an entity's swap dealing would best protect the markets and the public, foster efficiency and competitiveness and serve the public interest.

We believe that using a de minimis threshold based on current uncollateralized exposure would lead to costs of calculation, which are discussed below in connection with the definition of major swap participant. Also, while current uncollateralized exposure may be a useful measure of the risk arising from a swap position, it fails to address the significance of an entity's swap dealing activity in terms of customer protection and market orderliness, which are significant elements in the determination of whether an entity is engaged in a de minimis quantity of swap dealing.¹³¹⁷

In response to commenters' suggestions, we considered the feasibility of assessing the breakeven point at which a potential swap dealer would earn enough profit from its swap dealing to support the costs to comply with swap dealer regulation.¹³¹⁸ However, this assessment would require access to non-public, proprietary data regarding the gross margins associated with the

¹³¹⁶ We considered the proposed options in terms of whether they would promote: protection of market participants and the public; financial integrity and efficiency of swap markets; price discovery; sound risk management principles; and other public interest considerations. The commenters suggesting other measures did not offer a systematic analysis of whether the measures would lead to more accurate determinations in all or even most cases, and we do not believe such an analysis would be possible at this time due to the lack of information regarding how swaps are used in all markets. See generally part II.D.4.a, supra.

¹³¹⁷ See part II.D.3.e, supra.

¹³¹⁸ See Roundtable Transcript at 193-94 (remarks of James Cawley, Javelin Capital Markets, and Camille Rudge, The PrivateBank and Trust Company).

swap dealing activity of a wide variety of market participants. Such data is not available to the CFTC.

One commenter suggested that the de minimis threshold for swaps related to a particular physical commodity should increase if the general price of the commodity increases, so that a constant quantity of the commodity could be hedged through a particular swap dealing entity without that entity exceeding the threshold.¹³¹⁹ However, this approach, which eschews reliance on the dollar value of swaps, would raise the complex question of when the level of dealing in swaps relating to the physical quantity of various commodities becomes more than de minimis. We do not believe that this approach would provide sufficient additional benefits beyond those resulting from the final rule to justify the additional costs of application.

Commenters also suggested that, in order to simplify application of the de minimis exception and thereby reduce costs, the final rule should include an overall threshold that considers an entity's swaps and its security-based swaps.¹³²⁰ However, the statute includes two different de minimis exceptions regarding the quantity of an entity's swap dealing and its security-based swap dealing. Therefore, the suggested approach would be contrary to the statute.

The final rule provides for a lower de minimis gross notional threshold (i.e., \$25 million over the course of twelve months) for swaps in which the counterparty is a "special entity," as that term is defined in CEA section 4s(h)(2)(C) and CFTC Regulation § 23.401(c)). While it is possible that, for the reasons noted above, this lower threshold could reduce the number of potential providers of swaps to special entities, which may constrain the ability of special entities

¹³¹⁹ See letter from NCFC I.

¹³²⁰ See letter from NYCBA Committee.

to practice sound risk management strategies in a cost-effective manner, we note that the Dodd-Frank Act provides special entities with additional protections from market practices that could increase the risks they face in using swaps.¹³²¹ We believe the threshold in the final rule reflects an appropriate consideration of these potential costs and the benefits that result in terms of serving the public interest.

Several commenters responded to the proposed de minimis thresholds limiting the number of an entity's counterparties and swaps, suggesting that the factors would not be useful in identifying entities engaged in a de minimis quantity of swap dealing.¹³²² The final rule omits these factors. We believe that, in general, entities which will restrict their activities so as to remain under the de minimis notional amount threshold are likely to be those entities that are most willing to provide swaps with lower notional values. Counting an entity's number of counterparties or swaps as de minimis factors could inappropriately discourage entities from providing swaps in smaller notional amounts. This, in turn, would likely make it more difficult for persons seeking small notional amount swaps to find dealers willing to provide them, which may increase their costs of hedging and discourage sound risk management practices.

g. Exclusion of swaps entered into by IDIs in connection with the origination of loans

¹³²¹ See generally Roundtable Transcript at 210-15 (remarks of Mary-Margaret Collier, Tennessee Comptroller of the Treasury, John Janney, Large Public Power Council and Bella Sanevich, NISA Investment Advisors, LLC).

¹³²² Some commenters suggested that the number of counterparties and the number of swaps are not indicators of systemic risk. See letters cited in note 387, *supra*. Others claimed that the de minimis standard should not limit the number of an entity's counterparties for policy reasons. See letters from Chesapeake Energy and Land O'Lakes I. Commenters also suggested that using number of counterparties or number of swaps as a factor would create an uneven playing field because it would discourage provision of swaps to small end users. See letters from EEL/EPSC and NMPF.

The statutory definition of the term “swap dealer” excludes an IDI “to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer.”¹³²³ The proposed rule would implement this statutory exclusion by providing that an IDI’s swaps with a customer in connection with originating a loan to that customer are disregarded in determining if the IDI is a swap dealer. To prevent evasion, the proposed rule further provided that the statutory exclusion does not apply where the purpose of the swap is not linked to the financial terms of the loan, the IDI enters into a “sham” loan, or the purported “loan” is actually a synthetic loan such as a loan credit default swap or loan total return swap.

Commenters on the costs and benefits of the proposed approach focused on the benefits of a flexible application of the exclusion, which they asserted would promote the offering of swaps by IDIs in connection with loans and thereby more closely tailor the risks of a loan to the borrower’s and the lender’s needs, and promote the risk-mitigating effects of swaps.¹³²⁴ In terms of costs, commenters were concerned that a narrow application of the loan origination exclusion would cause IDIs to seek to avoid being covered by the definition of the term “swap dealer” by limiting their offering of swaps in connection with the origination of loans. Commenters said that the IDIs’ limitation of their swap offerings could lead borrowers to take steps with negative ramifications, such as reduced usage of swaps for risk mitigation (which could lead to costs from an increased risk of default by the borrower), shifting from the lending institution to another institution for the swap (which could lead to inefficiency costs since two different institutions would be involved), or shifting to another institution for both the loan and the swap (which could

¹³²³ See CEA section 1a(49)(A), 7 U.S.C. 1a(49)(A).

¹³²⁴ See, e.g., letter from B&F Capital I.

increase risk by increasing concentration in the markets for loans and swaps).¹³²⁵ To mitigate these costs, commenters suggested that the loan origination exclusion should be construed broadly, particularly with respect to the range of loans covered,¹³²⁶ the type of swaps covered,¹³²⁷ the required timing for entering into a swap relative the corresponding loan's origination,¹³²⁸ and which financial institutions could be eligible for this exclusion.¹³²⁹

The final rule limits the loan origination exclusion to swaps with terms that are directly related to the financial terms of the associated loan, or are required by loan underwriting criteria to be in place as a condition of the loan in order to hedge commodity price risks incidental to the borrower's business. We believe that extending the loan origination exclusion further, to encompass a broader range of swaps connected to a borrower's other business activities would expand the exclusion beyond its statutory limits. This would lead to the costs associated with the rule becoming less inclusive, such as decreased protection of market participants and the public, as well as impaired risk management practices and market efficiency, as described above.

This Adopting Release also includes guidance that the term "loan" should be construed for this purpose in accordance with the common law definition of the term, in order to efficiently

¹³²⁵ Commenters said that if, because of concern about triggering the de minimis threshold, IDIs were not willing to offer swaps at times when the borrower's hedging needs change due to loan related events, borrowers would have an incentive to seek out lenders who are not so constrained, and this incentive would be particularly strong if a borrower was not able to provide collateral to secure both a loan and a related swap from two separate counterparties. See letters from BOKIII, FSR VI and Rabobank, New York Branch. One commenter suggested that the impact of a narrow loan origination exclusion should be considered in tandem with the de minimis exception, because an expansion of one of the exceptions could offset some of the costs that result from a narrow interpretation of the other. See letter from FSR VI.

¹³²⁶ See letters cited in notes 308 to 313, supra.

¹³²⁷ See letters cited in notes 299 to 301, 313, supra.

¹³²⁸ See letters cited in notes 302 to 304, 313, supra.

¹³²⁹ See letters cited in notes 314 to 317, 304, 313, supra.

allow all interested parties to determine which transactions and instruments are eligible to be a basis for the exclusion. The CFTC believes that a detailed definition of the term “loan” covering all of the potential variations in how loans may be structured would be both costly to apply (because of the level of analysis required to determine if a particular instrument qualifies as a loan) and unnecessary (because a common law definition of the term “loan” has already been established).

We believe that extending the loan origination exclusion to cover any swap entered into by an IDI and a borrower at any point during the life of the loan would be contrary to the statutory terms of the exclusion, which focuses specifically on swaps entered into in connection with the “origination” of loans, and could lead to the costs of the rule being less inclusive described above. Rather, since a primary element of a loan is the transfer of money from the lender to the borrower, the final rule provides that the loan origination exclusion can cover an otherwise eligible swap if the swap is entered into during a specified period around either the execution of the loan agreement or any draw of principal under the loan. We believe that this aspect of the final rule accurately reflects the statutory terms of the exclusion and will serve the public interest by being neither over-inclusive nor under-inclusive.

Commenters generally agreed with the statement in the Proposing Release that the exclusion should be available to IDIs in a loan syndicate, purchasers of a loan, assignees of a loan, and participants in a loan.¹³³⁰ We believe that allowing the loan origination exclusion to extend to IDIs that participate in loans accurately reflects the statutory terms of the exclusion, so long as the IDIs’ participations are meaningful. Therefore, the rule includes a minimum

¹³³⁰ See letters cited in note 305313, supra.

participation requirement in order to avoid inappropriate exploitation of the exclusion — i.e., IDIs participating minimally in a loan syndication to gain eligibility for the exclusion — which could lead to costs of under-inclusion. The final rule allows the exclusion to be applied to a swap (which is otherwise covered by the exclusion) even if the notional amount of the swap is different from the amount of the loan tranche assigned to the IDI, so long as the IDI meets the minimum participation requirements in the loan. This provision is expected to facilitate minimization of the number of swaps borrowers enter into, and the number of counterparties they face with respect to those swaps, when entering swaps in connection with loans, thereby reducing the operational costs and risks born by borrowers.

h. Inter-Affiliate Swaps

The Proposing Release stated that the dealer analysis should consider the economic reality of swaps between affiliates, and preliminarily concluded that swaps “between persons under common control may not involve the interaction with unaffiliated persons that we believe is a hallmark of the elements of the definitions that refer to holding oneself out as a dealer or being commonly known as a dealer.” Commenters generally agreed with the proposed approach.¹³³¹ Some commenters expressed the view that the proposed approach would facilitate the use by affiliated corporate groups of centralized market-facing conduits, which would promote efficient risk management.¹³³²

The final rule interprets the dealer definition not to encompass a person’s activities with respect to swaps between legal entities that are under common majority ownership. The final

¹³³¹ See letters cited in note 341, supra.

¹³³² See letters from Kraft, ONEOK and Shell Trading II.

rule also provides that the swap dealer definition does not encompass the activities of a cooperative with respect to swaps between the cooperative and its members. We believe that such swaps generally serve to allocate or transfer risks within an affiliated group, rather than to move those risks out of the group to an unaffiliated third party, and therefore to include such swaps in the determination of whether an entity is a swap dealer would not be consistent with the statutory definition, nor would it serve the public interest or promote the protection of markets or the public. We also agree with commenters that the use of conduit structures to enter into swaps on behalf of commonly controlled entities has the potential to promote sound risk management practices and the efficiency of the swap markets. Therefore, including these swaps in the determination of whether a person is covered by the definition of "swap dealer" is not likely to provide significant benefits, but to include entities in the definition by virtue of these swaps would lead to the costs of the rule being overinclusive, as described above.

i. Exclusions of swaps entered into for hedging physical positions

Several commenters said that swaps used to hedge risks should not be considered in determining whether a person is a swap dealer. While the statutory definition of the term "swap dealer" does not specifically address hedging activity, the Commissions believe that in certain situations, entering into a swap for the purpose of hedging a physical position is not indicative of, and is not, swap dealing. An interim final rule provides that the determination of whether a person is a swap dealer will not consider a swap that the person enters into for the purpose of offsetting or mitigating certain price risks as defined in the rule, if the swap meets conditions specified in the rule.

When a person enters into a swap for the purpose of hedging the person's own risks in specified circumstances, an element of the swap dealer definition – the accommodation of the

counterparty's needs or demands – is absent. Therefore, consistent with our overall interpretive approach to the definition, the activity of entering into such swaps (in the particular circumstances defined in the rule) does not constitute swap dealing. Providing an exclusion of such swaps from the swap dealer analysis reduces costs that persons using such swaps would incur in determining if they are swap dealers.

j. Exclusions of certain swaps entered into by floor traders

The CFTC believes that it would be inappropriate to require persons who are registered with the CFTC as floor traders to include in the swap dealer analysis swaps that they enter into, using only proprietary funds, on or subject to the rules of a DCM or SEF and submit for clearing to a DCO, and that meet certain other conditions specified in the rule. The CFTC believes that a requirement that these persons register as swap dealers (if the swap dealer registration requirement were to apply) could lead to duplicative regulation, since they are already registered as floor traders.

Providing an exclusion of such swaps from the swap dealer analysis reduces costs that persons using such swaps would incur if such swap activity were to require them to register as swap dealers. Since the swaps are entered into on an exchange, by a person who is registered with the CFTC and cleared, we expect that the potential impact on the transparency, market orderliness and other goals of dealer registration from excluding these swaps from the dealer analysis would be minimal. Importantly, the rule requires that the person comply with the record keeping and risk management requirements of CFTC Regulation §§ 23.201, 23.202, 23.203, and 23.600 with respect to each such swap as if the person were a swap dealer. The requirement to comply with these important provisions reduces the potential for negative consequences from this rule.

k. Exclusions for particular types of entities

Several commenters said the CFTC should interpret the statutory definition of “swap dealer” to include per se exemptions from the definition for certain types of persons or persons who engage in certain activities.¹³³³ These commenters argued, in general, that there would be little or no benefit from construing the statute as covering these persons or activities because they did not contribute to the causes of the recent financial crisis or they do not pose systemic risk.¹³³⁴ These commenters also asserted that to interpret the statutory definition to cover these types of persons or activities would lead to the costs of the rule being more inclusive, as noted above.¹³³⁵

As stated previously, we note that the statutory definition of the term “swap dealer” applies to “any person” who engages in the activities described in the statute and who does not fall within the specific exceptions and exclusions in the statute. Therefore, the costs of applying the statutory definition to certain types of persons identified by the commenters arise from the provisions of the statute and not from the CFTC’s rulemaking. In addition, to provide the requested per se exemptions from the statutory definition could also introduce the costs of the rule being less inclusive discussed above, such as decreased protection of market participants and the public, as well as impaired risk management practices and market efficiency.

Regarding the argument that there is no or little economic benefit from interpreting the statutory definition to cover persons whose failure would not create systemic risk, the

¹³³³ See part II.A.2.f, *supra*.

¹³³⁴ See *id.*

¹³³⁵ In addition, comments along these lines asserted that to apply dealer regulation to certain persons who are already subject to different financial regulations would be duplicative and could create additional costs. See letters from Farm Credit Council I, FERC Staff, Fidelity, GIC, MFA I, and NARUC and joint letter from ICI and SIFMA AMG.

commenters making this point did not provide evidence or analysis to indicate whether there would be systemic risk concerns if they were to fail. While some of these commenters asserted that their swap activities are not comparable to the activities of the financial institutions that are generally considered to have had a significant role in the recent crisis, and some asserted that persons eligible for the claimed exemptions did not play a role in the crisis, even if these assertions are taken as true they are not determinative of whether persons of this type could in fact be a source of systemic risk. We emphasize that the relevant question in this regard would not be whether the failure of any one person within the class covered by a suggested exemption would be the source of systemic risk, but rather whether a failure of several or many such persons would impact the efficiency, competitiveness and financial integrity of the markets, impair sound risk management practices or otherwise affect the protection of markets and the public.¹³³⁶ To be clear, we do not believe and we are not asserting that any of the types of persons discussed by the commenters in this regard necessarily could be the source of systemic risk concerns, but rather we point out that the comments in this regard were general assertions rather than a presentation of specific evidence or analysis to support the claimed exemptions from the statutory definition. Thus, even if the statute allowed for such exemptions, which we do not believe it does, none of the commenters provided substantial support for their assertions. Also, as noted above we believe that the dealer definitions should be construed in the light of

¹³³⁶ This is so because the commenters requested per se exemptions for broad classes of persons and activities, rather than for specific persons. Whether a particular type of market participant, as a group, can be the source of systemic risk depends on, among other things, the financial strength of each entity in the group, the number and financial strength of their counterparties, the total amount of swap business conducted, the amount and types of margin posted by the entities in question as well as by their counterparties, what portion of their swap positions are cleared, the volatility of each swap's value as well as the covariance in value for all the swaps in their portfolio, and numerous other economic factors.

several benefits of dealer regulation (including protection of the markets and the public, encouraging the efficiency, competitiveness and financial integrity of the swap markets, and the overall public interest) and not just in terms of mitigating potential systemic risk.

In any case, we believe that the final rule and the guidance in the Adopting Release provide clarifications that in many respects mitigate the costs that were raised by some of the commenters seeking per se exemptions from the definition.

I. Other comments on the rule further defining the term “swap dealer”

Commenters cited other potential costs that could arise from the proposed approach to interpreting the statutory definition of the term “swap dealer,” suggesting that the proposed approach was not sufficiently clear, may result in multiple interpretations, and risks covering entities that would not actually be covered by the statutory definition, if it were correctly interpreted.¹³³⁷ Other commenters suggested that there could be high costs from application of the swap dealer regulations due to erroneous interpretation of the statutory definition of the term “swap dealer,” including high costs of regulatory uncertainty,¹³³⁸ and therefore it is particularly important that the final rule provide guidance on the application of the statutory definition.¹³³⁹ For example, these commenters said that if the final rule does not adequately clarify application of the statutory definition, market participants may incur unnecessary costs to avoid being

¹³³⁷ See letters from AIMA I, API I, Dominion Resources, FSR III, NRG Energy, Peabody and Utility Group.

¹³³⁸ See letters from API I, Dominion Resources, FERC Staff, NextEra I and WGCEF VIII.

¹³³⁹ See letters from API I, FSR III, M&T I, Utility Group and Vitol.

covered by the definition of "swap dealer," including by avoiding swap activities that are associated with areas of uncertainty under the rule.¹³⁴⁰

Some commenters said that the proposed rule captures too broad a range of entities in its further definition of the term "swap dealer,"¹³⁴¹ and that the asserted over-inclusiveness of the proposed rule could lead to direct costs for covered entities as well as indirect costs for covered entities, other swap market participants, and the public.¹³⁴² For example, the commenters assert that as entities change their swap activities in reaction to the rule, the objectives they previously achieved through swaps may either be compromised, accomplished through less suitable means, or both.¹³⁴³ As another example, the commenters assert that changes in swap activities may reduce the choice of counterparties available to market participants, which may lead to unfavorable financial terms for swaps and imperfect matches between risks and swaps, which

¹³⁴⁰ One area cited by commenters as a potential source of such costs is the application for limited designation as a swap dealer. Commenters were concerned that if the parameters of the limited designation were uncertain, entities may incur opportunity costs from avoiding activities that may be incompatible with a limited designation, planning and operational costs from changing corporate structure in ways that are not actually necessary to obtain a limited designation, and other costs from modifying swap activities in response to uncertainty about the steps necessary for a limited designation. See letters from API I, BG LNG I, Dominion Resources, NextEra I, Vitol and WGCEF VII.

¹³⁴¹ See letters from BG LNG I, FSR III, NCGA/NGSA I, and WGCEF I, II and VIII.

¹³⁴² See letters from API I, Atmos Energy, BG LNG I, Dominion Resources, Hess, NCGA/NGSA I and Vitol, and WGCEF VIII.

¹³⁴³ For example, an entity using swaps to hedge price risks may choose not to hedge or to use a different instrument to hedge similar positions. If it chooses not to hedge, its risk management objectives may be compromised. If it chooses to hedge using futures or some other instrument, that instrument may be less suitable for various reasons (e.g., basis risk, rollover risk, liquidity risk, less customizability, different fee structure, etc.). However, it is not possible to quantify the costs and benefits resulting from these choices without knowing the terms of the individual swaps the entities would have used and the available alternatives for each of those swaps.

could in turn lead to reduced usage of swaps and lower liquidity in the swap markets, resulting ultimately in increased costs of risk mitigation in general.¹³⁴⁴

The commenters did not quantify the extent of these costs that may arise when entities change their swap activities in reaction to the rule further defining the term “swap dealer.”

We believe that by addressing the concerns regarding the costs and benefits of specific aspects of the rule, discussed above in section V.C.5., the final rule will also mitigate the indirect costs that may arise from the rule. While it is impossible to completely eliminate the costs that entities will incur in interpreting the rule and applying it to their particular swap activities, we believe the final rule mitigates these costs by providing detailed guidance. Also, these costs may decrease over time as precedents are established to provide further guidance on the application of the statutory definition.

For example, the final rule and the guidance in this Adopting Release mitigate the costs of uncertainty in application of the statutory definition by providing more detail about the interpretation of the statute’s inclusion of any person who “makes a market in swaps” and the statute’s exclusion of a person that enters into swaps, “but not as a part of a regular business.” The guidance describes activities that are indicative of making a market in swaps and of entering into swaps as a part of a regular business. The final rule also provides details regarding the scope of the statutory exclusion of swaps in connection with the origination of loans and the de minimis exception. Also, the final rule provides that swaps between majority-owned affiliates, swaps entered into by a cooperative with its members, swaps entered into for hedging physical

¹³⁴⁴ On the other hand, entities may find that they can achieve their risk management goals using forward contracts, futures and other financial instruments, or they may determine that their financial risks can be reduced in other ways.

positions as defined in the rule, and certain swaps entered into by floor traders, are excluded from the swap dealer determination. These provisions will reduce the costs that market participants incur in determining whether they are covered by the statutory definition of the term "swap dealer."

While it is possible that some entities could choose to cease or reduce their swap dealing activities to avoid the costs of compliance with swap dealer regulations, which could impair the efficiency and competitiveness of the swap markets, there are also likely to be significant benefits derived from swap dealer regulation, including reduced counterparty risk, better protection of the markets and the public, and more assured financial integrity of the markets and improved market transparency. Moreover, whether such reductions in activity will lead to reduced liquidity in the swap markets, as some commenters assert, is not certain. For example, if such reductions in swap activity occur, new swap dealers may organize themselves or existing swap dealers may expand to accommodate the demand for swaps, although the time that would be required for this to occur and the extent to which it would occur are uncertain.

In addition, indirect costs could arise from the rule being less inclusive. For example, if the rule considered factors that are not relevant to whether an entity is actually covered by the definition, such as by providing that only entities that make a two-sided market in swaps are makers of markets in swaps, then it is possible that entities could change their behavior in response to that aspect of the rule. For example, entities that previously made a two-sided market in swaps may decide to make only a one-sided market in swaps, potentially leading to the types of costs that commenters said would arise if entities reduce their swap activities.

Last, several commenters raised questions and offered suggestions about the timeline for implementation of swap dealer requirements¹³⁴⁵ and the sequencing of the CFTC's rulemaking.¹³⁴⁶ While we understand that appropriate timing of rulemaking and the implementation of the requirements applicable to swap dealers will play a significant role in mitigating inappropriate or avoidable costs flowing from those requirements, this rulemaking is limited to the interpretation of the statutory definition of the term "swap dealer," and so these comments are beyond the scope of this rulemaking.

In sum, we are cognizant that both direct and indirect costs would arise if the rule further defining the term "swap dealer" did not appropriately reflect the statutory definition of the term. Such costs, which would arise as the rule is either more or less inclusive, are detailed above. The Adopting Release provides benefits by interpreting the term "swap dealer" in a manner that is as close as possible to the statutory definition of the term, thereby mitigating the potential costs of both over-inclusiveness and under-inclusiveness.

m. Costs of applying the rules further defining the term "swap dealer"

In order to apply the rules further defining the term "swap dealer" and determine whether or not it is covered by the definition, an entity will incur direct costs in the form of personnel hours devoted to analyzing the entity's activities with respect to swaps and determining whether the entity is covered by the definition. These costs will depend on the nature of the entity's swap activities in the relevant situation. For some entities, it will be relatively clear that they are covered by the definition and they will incur relatively few costs in confirming that. It is

¹³⁴⁵ See letters from API I, Capital One, COPE dated March 14, 2011 ("COPE II"), FSR III, Société Générale, and Vitol and WGCEF dated March 22, 2011 ("WGCEF III").

¹³⁴⁶ See letters from ABA Securities Association, BlackRock dated June 3, 2011 ("BlackRock III"), CDEU, Hess and WGCEF dated March 23, 2011 ("WGCEF IV").

expected that for many entities it will be relatively clear that they are not covered by the definition and they will incur little or no cost in confirming that determination. However, for some entities, especially those that enter into swaps in a variety of different ways and circumstances, the determination will be more complex and will require that personnel with financial and legal expertise review the circumstances of the entity's swap activities to make the determination of whether the entity is covered by the definition.

It is important to recognize that this would be the case in the absence of any rule further defining the term "swap dealer," or regardless of the terms of the rule, because entities would have to interpret the statutory definition to determine whether they are covered. Thus, at a minimum, a significant portion of the costs discussed below is attributable to the inclusion in the Dodd-Frank Act of a definition of the term "swap dealer" and not from any aspect of the final rules further defining that term. Indeed, the final rule provides benefits by minimizing these costs by providing guidance about the application of the statutory definitions in various situations.

The amount of time and resources that must be expended by an entity in order to determine whether it qualifies as a dealer will vary considerably depending on the complexity of the entity's operations. In addition, the direct costs will vary depending on the determinations the entity must make – reviewing whether or not it is covered by the definition of the term "swap dealer," whether it qualifies for the de minimis exception, or whether it seeks to obtain a limited purpose registration as a swap dealer. Depending on an entity's situation, it may incur some or all of these costs. We did not receive any comments quantifying the costs that an entity may incur in applying any aspect of the definition of "swap dealer," nor are we aware of any studies or surveys regarding this particular issue. Therefore, the CFTC staff has estimated the amount of

time that entities may require to apply the definition in various situations. These estimations are for informational purposes and require the CFTC to consider the aforementioned highly uncertain criteria.

Regarding the determination of whether an entity is covered by the definition of the term “swap dealer,” an entity with a relatively low degree of complexity in its organizational structure (*i.e.*, one legal entity) and in its swap activities (*i.e.*, little variation in the types of swaps they use and the purposes for which they use them) might expect the direct cost of such a determination to be approximately \$13,000.¹³⁴⁷ We estimate that approximately 250 entities of this type would be engaged in swap activities that create sufficient uncertainty regarding the application of the definition that they would have to incur these costs. An entity with a moderate degree of complexity in its organizational structure (*i.e.*, a few legal entities) and its swap activities (*i.e.*, some variation in the types of swaps they use and the purposes for which they use them) might

¹³⁴⁷ This estimate is based on the following staff requirements for this determination: 20 hours for a financial analyst at \$161/hour, 5 hours of a financial manager at \$325/hour, 2 hours of a controller or chief financial officer at \$722/hour, 10 hours of a compliance attorney at \$355/hour, 2 hours of a senior attorney at \$992/hour, and 2 hours of a chief compliance officer at \$664/ hour. We round to two significant digits. The multiplier of 5.35, which was used in the Proposing Release, is higher than the multiplier that the CFTC has used for similar purposes in other final rules adopted under the Dodd-Frank Act. *See, e.g.*, CFTC, Swap Data Recordkeeping and Reporting Requirements; Final Rule, 77 FR 2135, 2173 (Jan. 13, 2012) (adjustment factor of 1.3 for overhead and other benefits). The CFTC believes that use of a higher multiplier here is appropriate because some persons may retain outside advisors to assist in making the determinations under the rules.

The estimates of the hourly cost for these personnel are from SIFMA’s Management & Professional Earnings in the Securities Industry 2010, modified by CFTC staff to account for an 1800-hour work-year and multiplied by 5.35 to account for firm size, employee benefits, and overhead. These estimates are intended to reflect averages for compiling and analyzing the information necessary to apply the definition of the term “swap dealer.” We recognize that particular entities within each range of complexity may, based on their circumstances, incur costs substantially greater or less than the estimated averages.

expect the cost of such a determination to be approximately \$54,000.¹³⁴⁸ We estimate that approximately 150 entities of this type would be sufficiently uncertain regarding the application of the definition that they would have to incur these costs. An entity with a high degree of complexity in its organizational structure (*i.e.*, multiple affiliates in the corporate group) and its swap activities (*i.e.*, using diverse types of swaps for various purposes) could spend approximately \$170,000 when making a determination as to whether it is covered by the definition of swap dealer.¹³⁴⁹ We estimate that approximately 50 entities of this type would be sufficiently uncertain regarding the application of the definition that they would have to incur these costs. Thus, the total direct cost for all entities to determine the coverage of the definition of the term “swap dealer” would be approximately \$20,000,000.

As noted above, we estimate that approximately 450 entities (*i.e.*, 250 with relatively low complexity, 150 with moderate complexity and 50 with high complexity) would be sufficiently uncertain about the application of the definition of the term “swap dealer” that they would incur costs in applying the definition. This estimate includes IDIs that apply the loan origination exclusion. It is important to emphasize that since there is no definitive publicly available information about how many entities are engaged in swap activities and how they use swaps in particular situations, it is impossible to be sure how many entities may be uncertain about

¹³⁴⁸ This estimate is based on the following staff requirements for this determination: 40 hours for a financial analyst at \$161/hour, 10 hours of a financial manager at \$325/hour, 5 hours of a controller or chief financial officer at \$722/hour, 30 hours of a compliance attorney at \$355/hour, 20 hours of a mid-level attorney at \$608/hour, 15 hours of a senior attorney at \$992/hour, and 5 hours of a chief compliance officer at \$664/ hour.

¹³⁴⁹ This estimate is based on the following staff requirements for this determination: 120 hours for a financial analyst at \$161/hour, 40 hours of a financial manager at \$325/hour, 20 hours of a controller or chief financial officer at \$722/hour, 80 hours of a compliance attorney at \$355/hour, 60 hours of a mid-level attorney at \$608/hour, 50 hours of a senior attorney at \$992/hour, and 20 hours of a chief compliance officer at \$664/ hour.

whether the definition covers them to the point that they would incur such costs. However, we believe that the number of such entities may be estimated based on certain assumptions as discussed below.

In meetings with commenters since publication of the Proposing Release, the CFTC has discussed extensively the universe of potential entities that may be covered by the definition of the term “swap dealer” and gathered information on the swap market and its participants. In its FY 2012 budget drafted in February 2011, the CFTC estimated that 140 entities may be covered by the definition of “swap dealer,”¹³⁵⁰ and after receiving additional information the CFTC estimates that approximately 125 entities will be covered by the definitions of the terms “swap dealer” and “major swap participant.”¹³⁵¹ With these assumptions in mind, we believe it is reasonable to estimate that for every entity covered by the definitions, there will be about four entities (*i.e.*, approximately four times 120, or about 450) that are sufficiently uncertain about the coverage of the definitions that they would incur costs in applying the definitions.

Our estimate that there would be about 450 such entities is also in line with the number of entities that were sufficiently interested in the Proposing Release that they submitted substantive comments to the CFTC. As noted above, we received about 300 substantive comment letters in response to the proposal. Of these, some reflected more than one letter from a single commenter,

¹³⁵⁰ CFTC, President’s Budget and Performance Plan Fiscal Year 2012, p. 13-14 (Feb. 2011), available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cftcbudget2012.pdf>. The estimated 140 swap dealers includes “[a]pproximately 80 global and regional banks currently known to offer swaps in the United States;” “[a]pproximately 40 non-bank swap dealers currently offering commodity and other swaps;” and “[a]pproximately 20 new potential market makers that wish to become swap dealers.” *Id.*

¹³⁵¹ See CFTC, Registration of Swap Dealers and Major Swap Participants, 77 FR 2613, 2622 (Jan. 19, 2012). The number of persons covered by the definition of “major swap participant” is estimated to be quite small, at six or fewer.

comments from persons who did not expect to be swap dealers, or comments from persons who were not uncertain about their status under the definition. On the other hand, several letters were from multiple commenters that submitted their comments jointly. Thus, we estimate that about 225 entities were sufficiently interested in the proposed rule further defining the term “swap dealer” that they submitted a substantive comment, and for each such entity there was another entity that would also be similarly uncertain about the definition, which supports our estimate that 450 entities in total would incur costs in applying the definition.

Regarding the determination of whether an entity is eligible for the de minimis exception from the definition of the term “swap dealer,” we note that only an entity that is engaged in some swap dealing activity would be required to make this determination, but it would be required to make the determination regardless of whether it is uncertain about whether its swap activities constitute dealing (e.g., it would incur costs even if there were no doubt that it is engaged in swap dealing). We also note that the number of entities that will apply the de minimis exception is expected to be significantly greater than the number of entities that are required to register as swap dealers. Again, we believe that the entities making this determination would have situations that are highly complex (we believe approximately 25 entities would fall in this category), moderately complex (approximately 200 entities) and of low complexity (approximately 400 entities).¹³⁵² The direct cost of making the determination for these entities

¹³⁵² The estimate of approximately 625 entities that will apply the de minimis exception is based on our assumption that significantly more (i.e., five times as many) entities will apply the exception as compared to the number of entities registered as swap dealers (which we assume to be approximately 120). This estimate is also in line with information provided by commenters that approximately 100 community and regional banks would potentially apply the de minimis exception (i.e., the estimate reflects 100 such banks along with 525 other entities that are involved in the swap markets to a similar extent).

would be approximately \$42,000 in highly complex situations,¹³⁵³ \$15,000 in moderately complex situations¹³⁵⁴ and \$8,000 in situations of low complexity.¹³⁵⁵ The total direct costs for all entities would be approximately \$7,300,000.

Third, regarding the determination of whether an entity should apply for a limited purpose swap dealer registration, we believe that relatively few entities would make such an application but that the situation of each of these entities would be highly complex. We believe approximately 20 entities would fall in this category, and the direct cost of making the determination for each would be approximately \$250,000,¹³⁵⁶ resulting in a total direct cost of approximately \$5,000,000.

Thus, the total initial direct cost of applying the rules further defining the term "swap dealer" (including the de minimis exception and the possibility of limited purpose registration) for all entities would be approximately \$32,000,000.

¹³⁵³ This estimate is based on the following staff requirements for this determination: 80 hours for a financial analyst at \$161/hour, 20 hours of a financial manager at \$325/hour, 10 hours of a controller or chief financial officer at \$722/hour, 20 hours of a compliance attorney at \$355/hour, 5 hours of a senior attorney at \$992/hour, and 5 hours of a chief compliance officer at \$664/ hour.

¹³⁵⁴ This estimate is based on the following staff requirements for this determination: 20 hours for a financial analyst at \$161/hour, 5 hours of a financial manager at \$325/hour, 5 hours of a controller or chief financial officer at \$722/hour, 10 hours of a compliance attorney at \$355/hour, 2 hours of a senior attorney at \$992/hour, and 2 hours of a chief compliance officer at \$664/ hour.

¹³⁵⁵ This estimate is based on the following staff requirements for this determination: 10 hours for a financial analyst at \$161/hour, 5 hours of a financial manager at \$325/hour, 2 hours of a controller or chief financial officer at \$722/hour, 5 hours of a compliance attorney at \$355/hour, 1 hour of a senior attorney at \$992/hour, and 1 hour of a chief compliance officer at \$664/ hour.

¹³⁵⁶ This estimate is based on the following staff requirements for this determination: 200 hours for a financial analyst at \$161/hour, 120 hours of a financial manager at \$325/hour, 40 hours of a controller or chief financial officer at \$722/hour, 100 hours of a compliance attorney at \$355/hour, 60 hours of a mid-level attorney at \$608/hour, 50 hours of a senior attorney at \$992/hour, and 40 hours of a chief compliance officer at \$664/ hour. The estimate of approximately 20 entities applying the limited designation reflects an estimate that about one in six swap dealers would apply the designation.

In addition to these initial costs, we believe that entities would incur recurring costs in applying the definition. Regarding the application of the term "swap dealer," we estimate that approximately 10 percent of the entities noted above would, each year, experience significant changes in their usage of swaps (such as beginning or ending a new line of business) that would require reconsideration of the application of the definition, which would result in costs amounting to one-half of the direct cost of making the initial determination. Applying these factors to the costs noted above, the total recurring direct costs for all entities associated with the application of the term "swap dealer" are estimated to be approximately \$1,000,000 per year. Regarding the de minimis exception, we estimate that entities would have to incur ongoing costs of review to determine whether the exception applies on a yearly basis, and that the annual cost of this review would amount to one-half of the direct cost of making the initial determination. That is, the total recurring direct costs for all entities associated with the de minimis exception are estimated to be approximately \$3,700,000. Last, we estimate that entities that qualify for a limited purpose swap dealer registration would incur ongoing review costs amounting to one-quarter of the direct cost of making the initial determination, or approximately \$1,300,000 per year. Thus, the total recurring direct cost of applying the swap dealer definition (including the de minimis exception and the possibility of limited purpose registration) would be approximately \$6,000,000.

5. Costs and benefits of the rules further defining "major swap participant"

This Adopting Release further defines a "major swap participant" by setting out quantitative thresholds against which a market participant can compare its swaps activities to determine whether it is encompassed by the definition. The rule requires potential major swap participants to analyze their swaps in detail to determine, for example, which of their swaps are

subject to netting agreements or mark-to-market collateralization, and the amount of collateral posted with respect to the swaps. The rule includes a general, qualitative definition of the swaps that may be excluded from the calculation because they are used to “hedge or mitigate commercial risk.” Like the swap dealer definition, there is a voluntary process by which a person may request that the CFTC limit the major swap participant designation to certain categories of swaps.

a. Background

The definition set forth in CEA section 1a(33) provides that the term “major swap participant” means any person who is not a swap dealer and (i) maintains a substantial position in swaps for any of the major swap categories as determined by the CFTC; (ii) whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or (iii) is a financial entity that is highly leveraged relative to the amount of capital it holds, is not subject to capital requirements established by an appropriate Federal banking agency, and maintains a substantial position in outstanding swaps in any major swap category as determined by the CFTC. In connection with the calculation of “substantial position” noted above, the statutory definition specifically excludes positions held for hedging or mitigating commercial risk, and positions maintained by any employee benefit plan as defined in sections 3(3) and (32) of ERISA for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan. The statutory definition also provides that major swap participant designations may be limited in scope so that a person may be designated as a major swap participant in certain, but not all, swap categories.

CEA section 1a(33)(D) excludes from the definition of the term “major swap participant” certain entities whose primary business is providing financing and who use derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company. There is no analogous statutory provision applicable to major security-based swap participants.

As detailed in this Adopting Release, the definition of the term “major swap participant” focuses on the market impacts and risks associated with a person’s swap positions. This contrasts to the definition of the term “swap dealer,” which focuses on a person’s activities and accounts for the amount or significance of those activities only in the context of the de minimis exception. Persons that meet the major swap participant definition would, in large part, follow the same statutory requirements applicable to swap dealers.¹³⁵⁷ In this manner, the Dodd-Frank Act regulates entities whose swap activities do not cause them to be swap dealers, but nonetheless could pose a high degree of risk to the U.S. financial system. This regulation of major swap participants is intended to facilitate financial stability by reducing risk, increasing transparency, and promoting market integrity.

b. Costs of applying the rules further defining the term “major swap participant”

The actual cost of applying the rule further defining the term “major swap participant” to determine if a person is covered by the definition will depend, in large part, on the nature of the

¹³⁵⁷ The Dodd-Frank Act provides for the registration and regulation of major swap participants under CEA section 4s. The particular requirements applicable to major swap participants will be established in separate rulemakings. See notes 1240 and 425, supra.

person's swap activities as well as the infrastructure such person already has in place for the analysis and reporting of its swap activities. Many persons will be clearly outside the definition (and a few persons may be clearly covered by the definition) and will incur little cost to confirm that status. However, it is reasonable to expect that a few persons that are not swap dealers but nonetheless engage in significant swap activity will be required to incur costs to determine whether they are covered by the definition. The direct costs such a person would incur would result from the incremental expense of personnel with financial and accounting expertise who would be required to devote time to the review of the size and nature of the person's swap positions to determine whether the person is covered by the definition. Moreover, there will also be technology and legal review costs related to the determination of whether a person is a major swap participant. As is the case for the definition of the term "swap dealer," it is important to recognize that even in the absence of any rule further defining the term "major swap participant," or regardless of the terms of the rule, entities would incur costs in interpreting the statutory definition to determine whether they are covered. Thus, at a minimum, a significant portion of the costs discussed below is attributable to the inclusion in the Dodd-Frank Act of a definition of the term "major swap participant" and not from any aspect of the final rules further defining that term. Indeed, the final rules provide benefits by mitigating these costs by providing guidance about the application of the statutory definitions in different situations.

The amount of time and resources that must be expended by a person in order to determine whether it qualifies as a major swap participant may vary considerably depending on the complexity of such person's operations. In addition, direct costs will vary depending on the determinations the person must make relating to the definition, including, but not limited to, whether it engages in swap activity near the thresholds for "substantial position" and "substantial

counterparty exposure,” and whether it is subject to a “safe harbor” provision as set forth in the definition. The CFTC did not receive any comments quantifying the costs that a person may incur in applying any aspect of the definition of the term “major swap participant,” nor are we aware of any studies or surveys regarding this particular issue. Therefore, the CFTC staff has estimated, based on its experience, the amount of time that a person may require to determine whether it meets the definition. These estimations are for informational purposes and require the CFTC to consider the aforementioned highly uncertain criteria.

The CFTC estimates that approximately 20 persons that are not swap dealers will initially be engaged in swap activity to such an extent that they would be required to apply the calculations in the final rule in determining whether they are covered by the definition.¹³⁵⁸ The direct cost of making such determination for each such person is estimated to be approximately \$260,000,¹³⁵⁹ resulting in an initial aggregate direct cost of approximately \$5,200,000. We note

¹³⁵⁸ As is the case with respect to the definition of the term “swap dealer,” we believe that the number of persons that may incur costs in reviewing their activities and the rules will be significantly greater than the number of entities that actually are covered by the definition and will be required to register as major swap participants. Similarly, since there is no definitive publicly available information about how many entities are engaged in swap activities and how they use swaps in particular situations, it is impossible to be sure how many entities may be uncertain about whether the definition covers them to the point that they would incur such costs. Our estimate that approximately 20 entities would be sufficiently uncertain about the application of the definition of the term “major swap participant” that they would incur costs in applying the definition is based on our assumption that about six entities would be covered by the definition, and that for each such entity there will be about four entities that will be uncertain about the coverage of the definition. See note 1351, *supra*.

¹³⁵⁹ This estimate is based on the following staff requirements for this determination: 200 hours for a financial analyst at \$161/hour, 80 hours for a programmer analyst at \$196/hour; 120 hours of a financial manager at \$325/hour, 40 hours of a controller or chief financial officer at \$722/hour, 100 hours of a compliance attorney at \$355/hour, 60 hours of a mid-level attorney at \$608/hour, 50 hours of a senior attorney at \$992/hour, and 40 hours of a chief compliance officer at \$664/ hour.

The estimates of the hourly cost for these personnel are from SIFMA’s Management & Professional Earnings in the Securities Industry 2010, modified by CFTC staff to account for an 1800-hour work-year and multiplied by 5.35 to account for firm size, employee benefits, and overhead. As is the case for the application of the definition of the term “swap dealer,” we believe that that use of a higher

that the relatively low estimate of only 20 persons that would be required to incur costs at this level, as compared to the many thousands of swap market participants, reflects the relatively high thresholds for major swap participant status. As noted above, the large majority of market participants will be able to readily conclude that they are not covered by the definition.

In addition to these initial costs, we believe that approximately 20 entities would incur recurring direct costs in applying the definition of major swap participant on a daily basis, and such costs would amount to one-third of the direct cost of making the initial determination. Thus, the total recurring direct costs for all entities associated with the application of the term “major swap participant” are estimated to be approximately \$1,700,000 per year or approximately \$83,000 per year for each person.

Although the CFTC believes there will only be a limited number of persons that potentially may be major participants, we recognize the concerns raised by several commenters that major swap participant calculations will be conducted as part of the person’s overall compliance function even when there is not a significant likelihood that such person would be a major swap participant. As a result of the potential expense and effort that a person would be required to incur in connection with determining whether it meets the definition of major swap participant, the final rule includes three alternative “safe harbor” provisions.¹³⁶⁰ These safe harbor provisions relieve persons that are clearly not major swap participants from incurring the expense of the calculations otherwise required under the final rule.

multiplier here is appropriate because some persons may retain outside advisors to assist in making the determinations under the rules. These estimates are intended to reflect averages for compiling and analyzing the information necessary to apply the definition of the term “major swap participant.” We recognize that particular entities within each range of complexity may, based on their circumstances, incur costs substantially greater or less than the estimated averages. We round to two significant digits.

¹³⁶⁰

See part IV.M, supra.

To apply the safe harbor provisions of the rule, the CFTC estimates that a person would have to incur initial direct costs of approximately \$2,900 to determine whether its swap positions are within the safe harbor.¹³⁶¹ In addition, a person would incur costs of reviewing its swap positions on a monthly basis to monitor whether the safe harbor continues to apply, at an annual cost equal to one-third of the direct cost of making the initial determination, or \$960. Our assumption that approximately 1,200 entities would apply the safe harbor provisions of the rule yields an aggregate direct initial cost of approximately \$3,500,000 and aggregate annual costs of approximately \$1,200,000.¹³⁶²

c. Major swap participant thresholds

The final rule adopts the general approach in the proposed rule of determining whether a person is a major swap participant by comparing the exposure resulting from a person's swap positions to specific, quantitative thresholds. The proposed thresholds for substantial position were \$3 billion in current uncollateralized exposure or \$6 billion in current uncollateralized exposure plus potential future exposure for rate swaps, and \$1 billion in current uncollateralized exposure or \$2 billion in current uncollateralized exposure plus potential future exposure for each of the other categories of swaps. The proposed thresholds for substantial counterparty exposure are \$5 billion in current uncollateralized exposure across all categories or \$8 billion in

¹³⁶¹ This estimate is based on the following staff requirements for this determination: 5 hours for a financial analyst at \$161/hour, 2 hours for a financial manager at \$325/hour, 1 hour for a comptroller or chief financial officer at \$722/hour, 2 hours for a compliance attorney at \$355/hour.

¹³⁶² Our estimate of the number of entities that will make the safe harbor calculation includes the following: one-half of the approximately 700 investment company sponsors that are active in the U.S. (see the 2011 Investment Company Factbook published by the ICI, page 14, available at http://www.ici.org/pdf/2011_factbook.pdf), a similar number of entities (i.e., 350) that have large positions in swaps as part of other investment management activities, one half of the corporate entities in the "Fortune 500" (representing corporate entities that have large positions in swaps) and an additional 250 entities representing other holders of large positions in swaps.

current uncollateralized exposure plus potential future exposure across all categories.¹³⁶³

However, there is a change for the weight in the PFE calculations from the proposal to the final rule of 0.2 to 0.1 for cleared swaps.

Commenters generally did not oppose the proposed thresholds although several thought the thresholds should be raised.¹³⁶⁴ Two commenters supported the adoption of the thresholds as proposed.¹³⁶⁵ In addition, a few other commenters thought that the thresholds were set too high.¹³⁶⁶ Other commenters suggested that the thresholds be raised to a level that reflects systemic risk without suggesting a specific numerical threshold.¹³⁶⁷ One commenter, however, suggested that the threshold be increased to \$10 billion.¹³⁶⁸ Several commenters also said that the thresholds should be adjusted for inflation and other changes over time in the swap market.¹³⁶⁹

As discussed in part IV.B.3.d., the CFTC is adopting the thresholds as proposed. We recognize that the level of the thresholds will have a significant effect on whether the rules further defining the term “major swap participant” are applied in a manner that is more or less inclusive, and that in setting the thresholds it is possible that we may err on the side of over- or

¹³⁶³ See parts IV.B.3.d. and IV.E.3.

¹³⁶⁴ See, e.g., letters cited in notes 796 and 798, *supra*.

¹³⁶⁵ See letters from Dominion Resources and Fidelity.

¹³⁶⁶ See letters from AFR and Greenberger.

¹³⁶⁷ See letters from BlackRock I, ISDA I, MFA I and WGCEF II.

¹³⁶⁸ See letter from CCMR I. In addition, ACLI commented that thresholds for rate swaps should be increased to \$4 billion for current uncollateralized exposure and \$8 billion for current uncollateralized exposure plus potential future exposure, with corresponding increases to substantial counterparty exposure thresholds to \$7 billion for current uncollateralized exposure and \$14 billion for current uncollateralized exposure plus potential future exposure. See letter from ACLI.

¹³⁶⁹ See letters from CDEU, COPE I, Fidelity, ISDA I, and MFA I.

under-inclusion. As noted above in part V.C.2., if the rule were more inclusive, costs could arise when the persons that are classified as major swap participants incur compliance costs, while if the rule is less inclusive the benefits of regulating major swap participants (in terms of reduced risk, increased transparency and market integrity) could be reduced. We also recognize that a more inclusive rule could lead to costs if it causes persons to make changes to their use of swaps in order to avoid being covered by the rule.

One commenter said that the CFTC should conduct an empirical analysis of the proposed thresholds and whether they are suitable for identifying persons whose swap positions entail the risks enumerated in the statutory definition of the term "major swap participant."¹³⁷⁰ However, the CFTC believes it is not feasible to perform such an analysis because the comprehensive and detailed information about how very active swap market participants use swaps that it would require is not available.

The CFTC believes that the threshold levels in the final rule are appropriate to effectively monitor and oversee entities that are systemically important or could significantly impact the U.S. financial system. The CFTC and SEC are consistent in their approach to thresholds. As more data regarding the use of swaps and the importance of very large swap positions in the swap markets become available, the CFTC may consider adjusting the thresholds.

The final rules also provide for the measure of potential future exposure to be adjusted in the case of swap and security-based swap positions that are centrally cleared or that are subject to daily mark-to market margining. This is consistent with the purpose of the potential future exposure test, which is to account for the extent to which the current outward exposure of

¹³⁷⁰

See letter from WGCEF II.

positions (though possibly low or even zero at the time of measurement) might grow to levels that can lead to high counterparty risk to counterparties or to the markets generally. The practice of the periodic exchange of mark-to-market margin between counterparties helps to mitigate the potential for large future increases in current exposure.

Consistent with the proposal, the final rules reflect this ability to mitigate risk by providing that the potential future exposure associated with positions that are subject to daily mark-to-market margining will equal 0.2 times the amount that otherwise would be calculated. However, in response to commenters' assertions about the risk-mitigating effects of central clearing, and the additional level of rigor that clearing agencies may have with regards to the process and procedures for collecting daily margin, the final rules further provide that the potential future exposure associated with positions that are subject to central clearing will equal 0.1 (rather than the proposed 0.2) times the potential future exposure that would otherwise be calculated.¹³⁷¹

Although some commenters supported the complete exclusion of cleared positions from the potential future exposure analysis,¹³⁷² the CFTC recognizes that central clearing cannot reasonably be expected to entirely eliminate counterparty risk.¹³⁷³ Accordingly, the CFTC

¹³⁷¹ See CFTC Regulation § 1.3(jjj)(3)(iii)(A); Exchange Act rule 3a67-3(c)(3)(i). The final rules further have been revised to clarify that the 0.1 factor applies to positions cleared by a registered clearing agency or by a clearing agency that has been exempted from registration.

¹³⁷² See, e.g., letters from MFA I and SIFMA AMG II.

¹³⁷³ Central clearing helps to mitigate counterparty credit risk by improving risk management and, among other things, mutualizing the risk of counterparty failure. If multiple members of a central counterparty fail beyond the level to which such risk is managed, however, the central counterparty would also be at risk of failure. Cf. Basel Committee on Banking Supervision, Consultative Document, "Capitalisation of bank exposures to central counterparties," Nov. 25, 2011 (available at: <http://www.bis.org/publ/bcbs206.pdf>) (proposing that the capital charge for trade exposures to a qualifying central counterparty should carry a low risk weight, reflecting the relatively low risk of default

concluded that the use of a 0.1 factor (in lieu of the proposed 0.2) is appropriate for cleared positions, reflecting the strong risk mitigation features associated with central clearing, particularly the procedures regarding the collection of daily margin and the use of counterparty risk limits, while recognizing the presence of some remaining counterparty risk.

Moreover, although some commenters opposed any deduction from the measure of potential future exposure for uncleared positions that are margined on a daily basis,¹³⁷⁴ the CFTC believes that the risk-mitigating attributes of daily margining warrant an adjustment given that the goal of the potential future exposure test is to account for price movements over the remaining life of the contract.¹³⁷⁵ The use of a 0.2 factor also reflects the CFTC's expectation that the risk mitigation associated with uncleared but margined positions would be less than the risk mitigation associated with cleared positions.

While higher or lower alternatives to the 0.1 and 0.2 factors may also be reasonable for positions that are cleared or margined on a daily basis, the CFTC believes that the factors of the final rules reasonably reflects the risk mitigating (but not risk eliminating) features of those

of the qualifying central counterparty). In addition, as the CFTC and SEC discussed in the Proposing Release, see 75 FR at 80192 n.115, for example, central counterparties that clear credit default swaps do not necessarily become the counterparties of their members' customers (although even absent direct privity those central counterparties benefit customers by providing for protection of collateral they post as margin, and by providing procedures for the portability of customer positions in the event of a member's default). As a result, central clearing may not eliminate the counterparty risk that the customer poses to the member, although required mark-to-market margining should help control that risk, and central clearing would be expected to reduce the likelihood that an entity's default would lead to broader market impacts.

¹³⁷⁴ See letter from Better Markets I; see also letter from AFR.

¹³⁷⁵ The CFTC does not believe that it is appropriate to have this type of discount when mark-to-market margining is done less than daily, however.

practices. The final rules also retain and clarify provisions addressing when daily mark-to-market margining occurs for purposes of this discount.¹³⁷⁶

d. Difficulty in applying the major swap participant calculations

While commenters generally acknowledged that the proposed quantitative threshold tests are objective, some said that the proposed tests are difficult to understand and hard to apply.¹³⁷⁷

Another commenter submitted that “[the CFTC] should solicit feedback from market participants prior to final rule given the complexity of tests and likely interpretive issues; proposed tests are highly technical, and more challenging to use than may appear at first glance; could also request volunteers to walk-through the tests to ensure they actually function in practice.”¹³⁷⁸ Several commenters suggested means of reducing the costs of applying the proposed tests. Some commenters requested that the CFTC adopt a “safe harbor” provision in

¹³⁷⁶ The CFTC recognizes that at times, market participants whose agreements provide for the daily exchange of variation margin in connection with swaps in practice may not exchange collateral daily, if the amounts at issue are relatively small (such through the use of collateral thresholds and minimum transfer amounts). We do not believe that such practices would be inconsistent with providing a discount for daily margining practices. The proposed rules sought to accommodate those practices by providing that positions would be considered to be subject to daily mark-to-market margining for purposes of the “uncollateralized outward exposure” plus “potential outward exposure” analysis, so long as the total of such thresholds, and the total of such minimum transfer amounts above \$1 million are deemed to be “uncollateralized outward exposure” for those purposes.

In light of commenter concerns, which indicated that the proposal was not fully clear about the mechanics and purpose of this approach, the relevant rule language has been revised to clarify that this attribution of thresholds and minimum transfer amounts is solely for the purpose of determining whether certain positions are subject to daily mark-to-market margining for purposes of the analysis. In addition, the final rules have been revised from the proposal to provide that the attribution of thresholds as “uncollateralized outward exposure” for these purposes will be reduced by initial margin posted, up to the amount of the threshold. See CFTC Regulation § 1.3(jjj)(iii)(B); Exchange Act rule 3a67-3(c)(3)(ii).

¹³⁷⁷ See, e.g., letters from Fidelity, Freddie Mac, ISDA I and SIFMA AMG II.

¹³⁷⁸ See letter from WGCEF II at 11.

the final rules for swap users with positions that are substantially below the thresholds.¹³⁷⁹

Another commenter opined that the rule should allow persons to rely on third-party service providers to conduct the required calculations.¹³⁸⁰ In addition, a commenter said the rule should allow swap users to apply standard industry practices in valuing their positions.¹³⁸¹

We believe that the guidance in this Adopting Release reduces the costs of determining if a person is covered by the definition. For example, in response to commenters' concerns we clarify that a person may determine the value of its exposure using industry standard practices.¹³⁸² Also, we believe that the daily calculation burdens associated with the proposed thresholds will be addressed by safe harbors that are available if a simplified calculation shows that a person's exposure from its swap position is far below any threshold for any particular month. The final rule includes safe harbors to reduce unnecessary costs for entities that, because of compliance concerns, would engage in major swap participant calculations even though it would be very unlikely that the major swap participant thresholds would be met.¹³⁸³ Also, the CFTC will permit third-party service providers to perform major swap participant calculations, although a person that may be a major swap participant is not relieved of potential liability for violations of the CEA if there is a calculation or other error by the third-party.¹³⁸⁴

¹³⁷⁹ See letters from AII, Vanguard and SIFMA AMG II. Another commenter submitted that swap dealers will require counterparties to run the major swap participant calculations in order to certify that they are not major swap participants, even in cases where it is readily evident that they are not major swap participants. See meeting with CalSTRS on April 15, 2011.

¹³⁸⁰ See letter from ISDA I.

¹³⁸¹ See *id.*

¹³⁸² See part IV.B.3.b, *supra*.

¹³⁸³ See part IV.M.2, *supra*.

¹³⁸⁴ See part IV.B.3.e, *supra*.

e. Exclusions for particular types of entities

Commenters said that exclusions from the major swap participant definition should be available for certain entities including insurance companies, registered investment companies, entities that maintain legacy portfolios of swaps, ERISA plans, and sovereign wealth funds.¹³⁸⁵ Some commenters cited, as the underlying basis for excluding these entities, the existing regulatory regime to which these entities are subject and the potential for dual regulation if they were covered by the definition of the term “major swap participant.”¹³⁸⁶ One commenter asserted that a lack of clarity with respect to proposed exemptive relief will impose additional costs on market participants due to the uncertainty in determining major swap participant status.¹³⁸⁷

Several commenters said that sovereign wealth funds should be excluded from the definition of major swap participant based on international principles of comity and sovereign immunity.¹³⁸⁸ These commenters asserted that sovereign wealth funds are regulated in their home country and do not represent the type of counterparty risk contemplated by the Dodd-Frank Act. A commenter asserted that special purpose vehicles for structured finance or securitization should be exempted from the definition of major swap participant so as to not harm liquidity in

¹³⁸⁵ See part IV.J.2, *supra*.

¹³⁸⁶ See *id.* For example, commenters said that registered investment companies and corresponding registered investment advisers should be excluded from the definition of major swap participant because they are highly regulated by the SEC pursuant to the ICA and the Investment Advisers Act of 1940, and therefore major swap participant regulation would be duplicative. See joint letter from ICI and SIFMA AMG.

¹³⁸⁷ See letter from MetLife.

¹³⁸⁸ See letters from CIC and GIC and meeting with Weil.

asset securitizations.¹³⁸⁹ That commenter based its recommendation on the understanding that special purpose vehicles have limited functionality and resources and would accordingly be unable to comply with the burden of regulation as a major swap participant.¹³⁹⁰

The final rule does not have specific exclusions for certain types of entities. The CFTC believes that a more level playing field is desirable to ensure no particular type of entity gains an unfair competitive advantage in the market.

The appropriate treatment of “legacy portfolios” (e.g., the monoline insurers or their special purpose vehicles) will be determined on a case-by-case basis by the CFTC. Legacy portfolio operators specifically commented that they are in “run-off”/wind down mode, thereby undertaking no new swaps that would increase their risk, with an expectation to shut down or cease operations once their portfolio expires.¹³⁹¹ As a result, these commenters maintain that margin or capital requirements would likely lead to their insolvency because they do not have the assets to satisfy the proposed requirements. The CFTC notes that many of the compliance obligations imposed by the Dodd-Frank Act and/or the business conduct rules promulgated thereunder will not apply to operators of legacy portfolios because such obligations will not be applicable to swaps executed prior to the enactment of the Dodd-Frank Act such as the swaps in

¹³⁸⁹ See letter from ISDA I.

¹³⁹⁰ See *id.*

¹³⁹¹ See letters from Athilon, Berkshire Hathaway, ISDA I, MBIA and Newedge. As noted in part IV.J.3.a, *supra*, the CFTC understands that legacy portfolios are no longer entering into new transactions other than to novate, amend and hedge their existing positions. In connection with any potential exclusion, however, legacy portfolios would still be required to report to SDRs information about their swap transactions and positions. See letters from BlackRock I and Canadian MAVs.

legacy portfolios.¹³⁹² Consequently, the CFTC expects legacy portfolio operators' primary compliance obligation to be related to reporting and risk management.

f. CEA Section 15(a) Discussion

The costs and benefits of the rule further defining the term "major swap participant" are evaluated in light of the section 15(a) five broad areas of market and public concern.

Protection of market participants and the public. The rule helps parties to identify when they have substantial positions or substantial counterparty exposures in swap markets that would cause them to be covered by the definition of major swap participant. Under the Dodd-Frank Act, major swap participants are subject to regulations enacted to protect market participants and the public. The costs and benefits of the statutory and regulatory requirements for major swap participants are addressed in the various rulemakings in which they are promulgated.¹³⁹³

Efficiency, competitiveness, and financial integrity of markets. To date, potential major swap participants have engaged in swaps in an off-exchange marketplace that has been largely unregulated. Once the regulations required under the Dodd-Frank Act are adopted and effective, major swap participants will be subject to CFTC oversight and comprehensive regulation. The CFTC believes these regulations will improve the financial integrity of swap markets and the U.S. financial system generally. Since the number of persons that are expected to be major swap participants is small, the CFTC believes that these regulations will not have a significant effect on the efficiency or competitiveness of the markets.

¹³⁹² See CFTC, Swap Data Recordkeeping and Reporting Requirements: Pre-Enactment and Transition Swaps; Final Rule, 77 FR 2136 (Jan. 13, 2012).

¹³⁹³ See part VII.C.2, supra.

Price discovery. The CFTC does not perceive any direct effect on price discovery from the rule further defining the term “major swap participant.”

Sound risk management practices. The level of the major swap participant thresholds may discourage persons from engaging in swap activities that might cause them to exceed the major swap participant thresholds. This reduction in the use of swaps could be costly if other alternatives are not as suitable for the underlying risks (e.g., futures might have different contract sizes or expiration, and forward contracts introduce physical risks not present in cash settled transactions). The CFTC notes that this concern is mitigated by the relatively high threshold levels for major swap participant status.

Other public interest considerations. The specific quantitative thresholds in the rule set forth definitive tests for determining if a person is covered by the definition of the term “major swap participant.” This specific, quantitative threshold serves the public interest by promoting efficient application of the rule. Also, as noted above, major swap participants will be subject to CFTC oversight and comprehensive regulation, which we believe will improve the financial integrity of swap markets and the U.S. financial system generally.

6. Costs and benefits of the rules relating to the definition of “eligible contract participant”

a. Background

The ECP regulations and interpretation fall within the following six categories:

- CFTC Regulation § 1.3(m)(5)(i) prevents a commodity pool (i) in which any of the pool’s direct participants is not an ECP in its own right and (ii) that directly enters into retail forex transactions from being an ECP under CEA section 1a(18)(A)(iv) or (v), for purposes of retail forex transactions only. CFTC Regulation § 1.3(m)(5)(ii) provides that the CFTC would look through a commodity pool participant that directly participates in a transaction-level

commodity pool only if such direct commodity pool participant, any entity holding an interest in such direct commodity pool participant, or any entity in which such direct commodity pool participant holds an interest were structured to evade subtitle A of Title VII of the Dodd-Frank Act by permitting persons that are not ECPs to participate in retail forex transactions. The look-through in CFTC Regulation § 1.3(m)(5)(ii) does not apply to a non-commodity pool participant in a commodity pool.

- CFTC Regulation § 1.3(m)(6) excludes a commodity pool from ECP status if it does not have total assets exceeding \$5,000,000 or is not operated by a person described in CEA section 1a(18)(A)(iv)(II).¹³⁹⁴

- CFTC Regulations § 1.3(m)(1)-(4) define major swap participants, swap dealers, major security-based swap participants and security-based swap dealers, respectively, as ECPs.

- CFTC Regulation § 1.3(m)(7) permits an otherwise non-ECP to qualify as an ECP, with respect to certain swaps, based on the collective net worth of its owners, subject to several conditions, including that the owners are ECPs.

- CFTC Regulation § 1.3(m)(8) permits a Forex Pool to qualify as an ECP notwithstanding that it has one or more direct participants that are not ECPs if the Forex Pool (a) is not formed for the purpose of evading regulation under CEA sections 2(c)(2)(B) or (C) or related rules, regulations or orders, (b) has total assets exceeding \$10 million and (c) is formed and operated by a registered CPO or by a CPO who is exempt from registration as such pursuant to CFTC Regulation § 4.13(a)(3).

¹³⁹⁴

7 U.S.C. 1a(18)(A)(iv)(II).

- Finally, the Commissions have provided an interpretation to address an incorrect statutory cross-reference preventing certain government entities from qualifying as ECPs under CEA section 1a(18)(A)(vii).¹³⁹⁵

b. Summary of comments

Commenters stated that commodity pools will incur costs to comply with statutory and regulatory requirements made applicable as a result of the Commissions' narrowing of the ECP definition.¹³⁹⁶ Commenters argued that to apply the look-through at any investment level would be unnecessarily burdensome and disruptive to how commodity pools are structured, with resulting costs.¹³⁹⁷ One commenter advised that, if a trading advisor cannot be sure that all pool participants are ECPs, then it must be cautious and either register as a CPO or decide not to engage in Retail Forex Transactions on behalf of its advised pools.¹³⁹⁸ Another commenter stated that while many existing commodity pools have already obtained accredited investor and QEP representations from participants, virtually none currently obtain ECP representations from their investors.¹³⁹⁹ This commenter argued that obtaining such a representation would impose an operational burden and additional costs, as well as require commodity pools to redeem non-ECPs. The commenter further points out that, given the estimated \$1.9 trillion of assets invested in hedge funds, the portion of those assets that use OTC forex is likely to be substantial, and

¹³⁹⁵ 7 U.S.C. 1a(18)(A)(vii).

¹³⁹⁶ See letters from AIMA I, Akin Gump, Sidley, and Willkie Farr.

¹³⁹⁷ See *id.*

¹³⁹⁸ See letter from AIMA I.

¹³⁹⁹ See letter from Sidley.

therefore substantial time and expense would be expended in determining eligibility requirements for the thousands of investors in funds that use OTC forex.¹⁴⁰⁰

Commenters explained that there are costs to losing ECP status and that the enumerated counterparty list is unclear and subject to uncertainty because it relies on other regulators.¹⁴⁰¹

One commenter argues that funds would incur compliance and transaction costs if categorized as non-ECPs because they would have to enter into forex transactions through a DCM and their operators would have to register as CPOs.¹⁴⁰² That commenter also states that the markets for exchange-traded futures are less liquid than OTC forex markets, and that posting initial margin on a DCM is costly, since it cannot be used to invest in riskier assets and a FOF would have to invest in liquid and low risk (and, commensurately, lower yielding) assets necessary to post variation margin. As another commenter points out, the resulting increased expenses from the requirement to trade on a DCM and comply with retail forex rules may result in higher expenses for hedge and private equity funds, which they would likely pass along to their investors.¹⁴⁰³

A commenter asserted that the characteristics necessary to avoid non-ECP status may prevent free investment and could reduce liquidity and create volatility in these markets.¹⁴⁰⁴

With respect to CFTC Regulation § 1.3(m)(6), a commenter expressed concerns with the expected costs associated with the proposal that commodity pools that do not qualify as ECPs

¹⁴⁰⁰ See id.

¹⁴⁰¹ See letters from AIMA I, Akin Gump, and Sidley.

¹⁴⁰² See letter from Sidley.

¹⁴⁰³ See letter for Akin Gump. This commenter also said that these increased expenses could cause funds to terminate their foreign currency hedging, which would increase their investors' currency risk, causing higher volatility in the investment industry.

¹⁴⁰⁴ See letter from AIMA I. See generally part III.B.3, supra.

under clause (A)(iv) should not be able to qualify under clause (A)(v), stating that the proposal would be difficult to comply with and would adversely impact investment.¹⁴⁰⁵

Two commenters agreed that the proposed addition of swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants to the ECP definition provided a benefit with little or no costs.¹⁴⁰⁶ No commenter objected.

With respect to CFTC Regulation § 1.3(m)(7), commenters said that non-ECPs have entered into swaps in reliance on the Swap Policy Statement.¹⁴⁰⁷ Commenters emphasized the importance of the Swap Policy Statement to pass-through entities used by farmers,¹⁴⁰⁸ operating companies¹⁴⁰⁹ and commercial property developers,¹⁴¹⁰ noting that such entities may not meet the ECP criteria. According to these commenters, these pass-through entities often are small and medium-sized businesses that enter into interest rate swaps with lending financial institutions in

¹⁴⁰⁵ See letter from AIMA I.

¹⁴⁰⁶ See letters from Greenberger and Sidley.

¹⁴⁰⁷ See letters from B&F I, CDEU and Capstar. One element of the Swap Policy Statement required that the swap be entered into in connection with each swap counterparty's line of business. See Swap Policy Statement at 30697. The CFTC stated when issuing the Swap Policy Statement that it "reflects the [CFTC]'s view that at this time most swap transactions, although possessing elements of futures or options contracts, are not appropriately regulated as such under the [CEA] and [CFTC] regulations." Swap Policy Statement at 30694.

¹⁴⁰⁸ See, e.g., letter from Rabobank, New York Branch (relating that "[f]or a variety of estate planning and regulatory purposes, farmers commonly hold their ownership interests in land, buildings and farm equipment indirectly, through a network of legal entities").

¹⁴⁰⁹ See, e.g., letter from Fifth Third Bank and Union Bank, N.A. (advising that "[i]t is common for an operating business to organize a separate limited liability company (for tax and legal reasons) to acquire . . . assets . . . and to lease these assets to the operating company[, which] becomes the borrow[er] . . . for the loan used to acquire those assets" and that "[t]he limited liability company often does not maintain sufficient capital to qualify as an ECP").

¹⁴¹⁰ See, e.g., letters from BB&T I, B&F I and Midsized Banks.

reliance on the Swap Policy Statement.¹⁴¹¹ The commenters explained that the loans usually are guaranteed by the principals of the entity entering into the swap, and that the borrower would qualify as an ECP if structured as a single-level corporate entity or sole proprietorship.¹⁴¹²

Commenters said that if these non-ECP entities were limited to swaps that are available on or subject to the rules of a DCM, many regional bank borrowers would lose the ability to use swaps, real estate companies would have less flexibility in risk management, and smaller lenders would be at a competitive disadvantage.¹⁴¹³ Another commenter said that Dodd-Frank Act provisions such as the end-user clearing exception indicate that Congress intended to preserve the availability of swaps used for managing risks rather than for investment or speculation.¹⁴¹⁴

To mitigate the impact of restricting non-ECPs to swaps that are available on or subject to the rules of DCMs, some commenters said that an entity should be able to qualify as an ECP based on the financial qualifications of related entities, so long as various conditions proposed by the commenters are satisfied. Some commenters said that an entity should be eligible to be an ECP if its swap obligations are guaranteed by an ECP,¹⁴¹⁵ or if its controlling entity qualifies as an ECP under clause (A)(v) of the statutory definition.¹⁴¹⁶ Another commenter suggested

¹⁴¹¹ See letters from BB&T I and B&F I. Commenters said that these businesses may intentionally maintain less than \$1 million in equity primarily for tax and legal reasons. See letters from Capital One and Columbia State Bank (stating that over 65% of its borrowers are structured as limited liability companies or S corporations and intentionally maintain less than \$1 million in equity at the entity entering into the swap).

¹⁴¹² See letter from Columbia State Bank. See also letter from BB&T I.

¹⁴¹³ See letters from BB&T I, Capital One, Capstar, Columbia State Bank, Midsize Banks, NAREIT and Wells Fargo II.

¹⁴¹⁴ See letter from FSR I.

¹⁴¹⁵ See letters from BB&T I, Midsize Banks and Wells Fargo II.

¹⁴¹⁶ See letters from CDEU and Regional Banks.

revisions to the ECP definition that included looking to the ECP status or sophistication of the majority owner of an entity in determining if the entity itself is an ECP.¹⁴¹⁷ Other commenters suggested other provisions to allow non-ECPs to enter into swaps other than on or subject to the rules of a DCM, so long as the non-ECP meets various conditions indicating that the swap is used in connection with its line of business.¹⁴¹⁸

With respect to CFTC Regulation § 1.3(m)(8), several commenters asserted that many Forex Pools are operated by sophisticated, professional managers that do not need the protections of a retail forex regime designed to protect non-ECPs that are engaging in retail forex transactions.¹⁴¹⁹ More specifically, some commenters, based on CFTC enforcement actions involving Forex Pools, suggested that commodity pools of a sufficient size, and/or operated by a registered or exempt CPO, do not pose the risks of fraud and abuse of non-ECP customers that the statutory look-through provision is intended to address.¹⁴²⁰

As a result, commenters suggested that the look-through provision should not apply in determining ECP status of commodity pools that meet certain conditions. For example, commenters suggested that the look-through not be applied to a commodity pool with \$10 million in total assets if other factors were present—e.g., not structured to evade,¹⁴²¹ subject to regulation under the CEA¹⁴²² and/or operation by a registered CPO.¹⁴²³ Another commenter

¹⁴¹⁷ See letter from NAREIT.

¹⁴¹⁸ See letters from APGA, Capital One and Gavilon dated October 28, 2010.

¹⁴¹⁹ See letters from Millburn and Sidley.

¹⁴²⁰ See letters from GFXD I and Sidley.

¹⁴²¹ See letter from GFXD II.

¹⁴²² See letters from GFXD II and Skadden.

¹⁴²³ See meeting with SIFMA on January 20, 2012.

suggested requiring the total assets or minimum initial investment of a Forex Pool to be sufficiently large that, in general, only legitimate pools would exceed such thresholds.¹⁴²⁴ This commenter suggested a total asset threshold of \$50 million.¹⁴²⁵

Separately, one commenter also claimed that the statutory look-through, if strictly implemented, might inappropriately preclude Forex Pools and their CPOs, many of whom are registered, from engaging in retail forex transactions with swap dealers because swap dealers are not Enumerated Counterparties (and some swap dealers also may not be Enumerated Counterparties in a different capacity, such as being a U.S. financial institution).¹⁴²⁶ This commenter stated that such a result could reduce close out netting opportunities in the event of the insolvency of a counterparty.

Finally, to reduce the adverse effects on government entities that may need to qualify as ECPs based on their swap counterparties but that would be foreclosed from doing so due to an erroneous reference in the definition of ECP, a commenter requested the correction of that erroneous reference.¹⁴²⁷

c. Response to comments and consideration of costs and benefits in the final rule

CFTC Regulation § 1.3(m)(5)(i) reduces the number of pools that need to determine the ECP status of their natural person participants, and thus reduces related costs, because it limits, absent evasion, the pools the CFTC considers for look-through purposes to transaction-level retail forex pools. The guidance the Commissions provide in the preamble also reduces the

¹⁴²⁴ See letter from Sidley.

¹⁴²⁵ See *id.*

¹⁴²⁶ See letter from GFXD I.

¹⁴²⁷ See letter from Wells Fargo I.

scope of the potential look-through, with attendant cost-reductions, by stating expressly that a Retail Forex Pool using retail forex transactions solely to hedge or mitigate currency risk would not be considered structured to evade. Thus, such hedging or mitigation would not be the basis of a look-through. In particular, because, according to a commenter, the typical FOF uses retail forex transactions solely to hedge currency risk related to fluctuations in the exchange rate between non-U.S. dollar subscription currencies and the U.S. dollar, most, if not all, FOFs would not be covered by the look-through. To the extent other commodity pools use retail forex transactions solely to hedge or mitigate their currency risk, such pools also would not be subject to the CFTC Regulation § 1.3(m)(5)(ii) look-through provision. Because Regulation § 1.3(m)(5)(ii) provides a look through only in cases of evasion and the Commissions' guidance narrows considerably the scope of what might otherwise be considered evasion, the CFTC expects the CPO of the typical pool to be able to determine at little or no cost the ECP status of their direct participant commodity pools; such status will be based on CEA section 1a(18)(iv), an analysis with which such CPOs are familiar.¹⁴²⁸

While the CFTC has provided guidance to reduce the costs of applying the rule, it estimates that each affected CPO may have to spend between 5 and 20 hours of legal time, representing a cost between \$1,800 and \$7,100,¹⁴²⁹ initially to determine the ECP status of the

¹⁴²⁸ While the Commissions are adding additional detail explaining the scope of CEA section 1a(18)(A)(iv)(II), the Commissions also provide guidance on that explanation. As a result, the CFTC does not believe that the upfront costs of determining ECP status under CEA section 1a(18)(A)(iv) will significantly increase.

¹⁴²⁹ The CFTC computed these totals by assuming from 5 to 20 hours of legal review by a compliance attorney at \$355/hour based on the 2010 SIFMA survey. See SIFMA, Report on Management and Professional Earnings in the Securities Industry—2010. If we assume that 5,000 potential commodity pools need to make this determination and round to two significant digits, this results in a total approximate cost of \$8.9 million to \$36 million. As is the case for the application of the definitions of the

pools that they operate, and up to 5 hours (\$1,800) of additional legal time to determine such status upon each change to the fund's structure, operating guidelines, etc. that might implicate ECP status. Commenters noted that drafting ECP representations and contacting existing participants are part of the costs of determining ECP status. While the CFTC acknowledges such costs, CFTC Regulation § 1.3(m)(5) also provides investor protection benefits to non-ECP participants in pools that are not ECPs by requiring such pools to enter into retail forex transactions with an Enumerated Counterparty. This provides non-ECP participants in such pools the protections of the retail forex regime imposed by such counterparty's federal regulator.

The CFTC also notes that the number of categories of enumerated counterparties available as counterparties to non-ECP commodity pools has increased since the Commissions proposed the regulations, because other regulators have finalized their retail forex regimes, as discussed in greater detail above. While trading with Enumerated Counterparties will entail doing so pursuant to the retail forex regulations of the relevant federal regulator, such regulations will apply to the counterparties, not the CPO. While CPOs of Retail Forex Pools generally must register as such with the CFTC, to the extent an exemption from registration is available under the CFTC's rules, such CPOs need not register as a result of their retail forex transactions, further reducing the potential costs of Regulations §§ 1.3(m)(5)(i) and (ii). Further, commodity pools will not incur any costs to change counterparties (with the accompanying costs of, for example, putting in place new trading documentation) to the extent they already trade with Enumerated Counterparties. Commenters noted that non-ECP pools would incur costs to negotiate new trading documentation with Enumerated Counterparties to the extent that such

terms "swap dealer" and "major swap participant," these costs reflect a higher multiplier because some persons may retain outside advisors to assist in making the determinations under the rules.

pools do not currently enter into retail forex transactions with Enumerated Counterparties and wish to continue to engage in retail forex transactions other than on or subject to the rules of a DCM. However, Regulation § 1.3(m)(5) also provides investor protection benefits to non-ECP participants in pools that enter into retail forex transactions by requiring such pools to trade with Enumerated Counterparties and to be operated by registered CPOs, absent an applicable exemption.

To the extent that a commodity pool is precluded by CFTC Regulation § 1.3(m)(6) from achieving ECP status based on prong (A)(v) of the ECP definition, the pool will be limited to trading swaps, if at all, on or subject to the rules of a DCM. This could result in costs to affected commodity pools, including margin, the costs of establishing relationships with future commission merchants (e.g., reviewing new account opening documentation) and opportunity costs from losing the ability to trade swaps customized to pools' needs. Preventing commodity pools that do not qualify under clause (A)(iv) from qualifying pursuant to clause (v), however, closes a loophole that would allow smaller commodity pools that are not able to satisfy the requirements of clause (A)(iv) of the ECP definition to qualify as ECPs. Moreover, by providing additional clarification in the preamble regarding the meaning of CEA section 1a(18)(A)(iv)(II), the Commissions substantially reduced the potential number of commodity pools affected by CFTC Regulation § 1.3(m)(6).

CFTC Regulations §§ 1.3(m)(1)-(4) define major swap participants, swap dealers, major security-based swap participants and security-based swap dealers, respectively, as ECPs. Stating explicitly in regulations that these entities are ECPs avoids the potentially anomalous result of such entities, which are some of the largest and/or most active swap market participants, not being ECPs and is in line with expectations in the market that these entities may engage in a full

range of swap and security-based swap activities. The CFTC believes that these regulations will not result in any significant economic costs or benefits.

The CFTC is persuaded by commenters that allowing participants to continue to rely on the line of business element of the Swaps Policy Statement will mitigate unnecessary costs from the regulation but is adding various conditions to retain adequate protection for market participants and the public. As noted above, CFTC Regulation § 1.3(m)(7) permits an entity, in determining its net worth for purposes of subclause (A)(v)(III) of the ECP definition,¹⁴³⁰ to include the net worth of its owners, solely for purposes of determining its ECP status for swaps used to hedge or mitigate commercial risk, provided that all of its owners are themselves ECPs (disregarding shell companies, as defined above). Under CFTC Regulation § 1.3(m)(7) as adopted, an entity seeking to qualify under subclause (A)(v)(III) of the ECP definition in order to enter into a swap used to hedge or mitigate commercial risk is permitted to count the net worth of its owners in determining its own net worth, so long as all its owners are ECPs. Accordingly, CFTC Regulation § 1.3(m)(7) will allow qualified participants the flexibility to enter into customized swaps.

By limiting the line of business ECP prong to entities owned solely by ECPs, the CFTC is preserving the intent behind the ECP requirement, which is to limit the availability of customized swaps to market participants of sufficient financial sophistication and with sufficient assets or net worth to assess, appreciate and bear the implications and risks of swap transactions.

¹⁴³⁰ CEA section 1a(18)(A)(v)(III) provides that “a corporation, partnership, proprietorship, organization, trust, or other entity . . . that (aa) has a net worth exceeding \$1,000,000; and (bb) enters into an agreement, contract, or transaction in connection with the conduct of the entity’s business or to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by the entity in the conduct of the entity’s business” is an ECP. 7 U.S.C. 1a(18)(A)(v)(III).

Although commenters proposed various solutions to address the loss of the Swap Policy Statement, the CFTC believes the approach adopted is the best approach; it substantively preserves the ECP requirement and protects the real parties in interest (i.e., the owners).

Although banks and non-ECP borrowers might be able to restructure or more highly capitalize borrowing entities or borrow at a higher level in the ownership structure, this regulation will allow banks and qualified businesses to continue to conduct their loan arrangements as usual without incurring the costs, which could include undesirable tax treatment, of such operational changes. Further, because commenters focused on swap related risks, the Commissions limited this regulation's application narrowly, i.e., it does not apply for purposes of determining ECP status for: swaps not meeting the conditions set forth in Regulation § 1.3(m)(7); security-based swaps; security-based swap agreements; mixed swaps; or agreements, contracts or transactions that are not swaps (regardless of the purpose for which they are used).

CFTC Regulation § 1.3(m)(8) permits a Forex Pool to qualify as an ECP notwithstanding that it has one or more direct participants that are not ECPs if the Forex Pool (a) is not formed for the purpose of evading regulation under CEA sections 2(c)(2)(B) or (C) or related rules, regulations or orders, (b) has total assets exceeding \$10 million and (c) is formed and operated by a registered CPO or by a CPO who is exempt from registration as such pursuant to CFTC Regulation § 4.13(a)(3). The data presented by commenters, discussed above, demonstrate that registered CPOs¹⁴³¹ of commodity pools over a certain size (\$10 million in total assets) historically have engaged in retail forex misconduct to a much less significant degree than other

¹⁴³¹ CFTC Regulation § 1.3(m)(8) as adopted requires that the CPO of the Forex Pool be registered as a CPO with the CFTC. The Commissions believe that this condition is appropriate because it will ensure that the NFA oversees compliance by those CPOs relying on this new regulation.

CPOs. Only one of the 45 unique cases presented by commenters involved a pool with more than \$10 million in total assets and a registered CPO. Only two of those cases involved a pool operated by CPOs exempt from registration: in both of those cases, however, the CPO raised less than \$10 million.¹⁴³² The CFTC also recognizes that subjecting such commodity pools to the statutory look-through provision to protect non-ECP customers from fraud and abuse would cause them to incur higher costs (e.g., CPO compliance costs for those CPOs required to register as such, and redocumenting trading relationships with new counterparties who are Enumerated Counterparties), for intangible pool participant protections. To further protect pool participants, the Commissions added a requirement that, to be an ECP under the line of business prong, the Forex Pool must not be formed for the purpose of evading CFTC regulation of Retail Forex Pools and retail forex transactions under CEA Section 2(c)(2)(B) or (C). Accordingly, the Commissions have tailored CFTC Regulation § 1.3(m)(8) in a manner they believe preserves its ability to effectively protect market participants and the public, while avoiding significant costs.

As noted above, CEA section 1a(18)(A)(vii)(cc) contains a statutory cross-reference rendered incorrect due to a legislative drafting oversight. Failing to address such error would inappropriately deprive such entities of ECP status, imposing undue costs (e.g., the opportunity costs of being unable to execute a desired hedge or trading strategy using standardized exchange-traded swaps) on such entities. Allowing a government entity the ability to qualify as an ECP based on its counterparty's status will provide, at little or no cost, the benefit of effectuating Congressional intent that government entities satisfying the conditions of CEA section 1a(18)(A)(vii)(cc) be ECPs. Therefore, the CFTC included in the preamble an interpretation

¹⁴³² In addition, one of those CPOs relied on the CFTC Regulation § 4.13(a)(4) CPO registration exemption. As discussed above, the CFTC has withdrawn that exemption.

treating as an ECP government entities satisfying the conditions of CEA section 1a(18)(A)(vii)(cc) as if such section incorporated the correct cross-reference. The CFTC believes that correcting this incorrect cross-reference will not result in any significant economic costs or benefits.

d. CEA Section 15(a) Discussion

Protection of market participants and the public. Congress determined to protect retail foreign exchange investors from fraudsters by amending the ECP definition to require a pool's participants to qualify as ECPs for the pool to be an ECP under subsection (A)(iv).¹⁴³³ As discussed above, this protection, as implemented by CFTC Regulation § 1.3(m)(5) may raise the costs of legitimate foreign exchange transactions. To mitigate these potential increased costs, CFTC Regulations § 1.3(m)(5)(i) limits the look-through to the level of the commodity pool structure that engages in retail forex transactions, subject to CFTC Regulation § 1.3(m)(5)(ii). This limitation provides that, if any level of the pool has been structured to evade, the CFTC would look through the transaction-level commodity pool's direct commodity pool participants indefinitely until reaching non-commodity pool participants. CFTC Regulation § 1.3(m)(5), therefore, protects non-ECP members of the public in appropriate instances.

By limiting the line of business ECP prong to entities owned solely by ECPs, the CFTC is preserving the intent behind the ECP requirement, which is to limit the availability of customized swaps to market participants of sufficient financial sophistication to assess and appreciate the risk and implications of the transactions. Although commenters proposed various solutions to address the loss of the Swap Policy Statement, the CFTC believes the approach

¹⁴³³ Accord letter from AIMA I.

adopted is the best approach because it preserves the substance of the ECP requirement and protects the real parties in interest (i.e., the owners).

Because registered CPOs,¹⁴³⁴ and CPOs exempt from registration, who operate commodity pools over a certain size (\$10 million in total assets) historically have engaged in retail forex misconduct to a much less significant degree than CPOs of commodity pools below that threshold, the CFTC believes that imposing this size threshold requirement as a condition of ECP status pursuant to Regulation § 1.3(m)(8) provides some protection to pool participants. The additional requirement that to be an ECP under the line of business prong the Forex Pool must not be formed for the purpose of evading CFTC regulation of Retail Forex Pools and retail forex transactions under CEA Section 2(c)(2)(B) or (C) will further protect pool participants.

Efficiency, competitiveness, and the financial integrity of the market. With respect to CFTC Regulation §§ 1.3(m)(5) and (6), commodity pools that do not qualify as ECPs may have to use products listed on or subject to the rules of a DCM that might not precisely (or at all) match such parties' needs. This may reduce or eliminate a commodity pool's ability to engage in some transactions, but these regulations also seek to prevent unsophisticated parties from entering into certain transactions to prevent repeated abuses and protect members of the public. We believe CFTC Regulations §§ 1.3(m)(1)-(8) do not significantly impact competitiveness or the financial integrity of markets.

Price discovery. CFTC Regulations §§ 1.3(m)(1)-(8) only clarify the status of entities. They do not affect price discovery.

¹⁴³⁴ CFTC Regulation § 1.3(m)(8) as adopted requires that the CPO of the Forex Pool be registered as a CPO with the CFTC. This condition is appropriate because it will ensure that the NFA oversees compliance by those CPOs relying on this new regulation.

Sound risk management practices. CFTC Regulations §§ 1.3(m)(5) and (6) may restrict investment opportunities for certain non-ECPs that might have otherwise qualified as ECPs.¹⁴³⁵ This may discourage the use of some sound risk management practices and/or investment strategies. For instance, it may become more expensive for CPOs operating non-ECP pools to use such practices and/or strategies if such pools must enter into swaps on or subject to the rules of a DCM or come into compliance with a retail forex regime or choose to redeem non-ECPs to avoid such results. On the other hand, CPOs may not incur the increased expense of such sound risk management practices and/or investment strategies if they are able to pass such costs on to the participants in the pools. Also, with respect to swaps, pools that are not ECPs due to CFTC Regulation §1.3(m)(6) can enter swaps on or subject to the rules of a DCM to the extent an appropriate swap is listed by such DCM.

In contrast, CFTC Regulations §§ 1.3(m)(7) and (8) allow qualified participants to engage in swaps that are not on a DCM. This gives qualified participants more choices for their hedges, and may provide an opportunity for better risk management.

Other public interest considerations. CFTC Regulations §§ 1.3(m)(1)-(4) state that major swap participants, swap dealers, major security-based swap participants, and security-based swap dealers, respectively, are ECPs. The interpretive guidance regarding certain governmental ECPs remedies an incorrect statutory cross-reference with respect to the ability of a subset of governmental entities to qualify as ECPs under CEA section 1a(18)(A)(vii).¹⁴³⁶

¹⁴³⁵ CFTC Regulations § 1.3(m)(1)-(4) and the interpretive guidance regarding certain governmental ECPs have the opposite effect, making investment opportunities available to certain ECPs that might otherwise not have qualified as ECPs.

¹⁴³⁶ 7 U.S.C. 1a(18)(A)(vii).

VIII. Administrative Law Matters – Exchange Act Revisions (Definitions of “Security-Based Swap Dealer” and “Major Security-Based Swap Participant”)

A. Economic Analysis

1. Overview

The SEC is sensitive to the costs and benefits of our rules. Some of these costs and benefits stem from statutory mandates, while others are affected by the discretion we exercise in implementing the mandates. We have requested comment on all aspects of the costs and benefits of the proposal, including any effect our proposed rules may have on efficiency, competition, and capital formation. In considering the economic consequences of these final rules, moreover, we have been mindful of the link between the scope of the persons who are deemed to be dealers or major participants pursuant to these rules and the costs and benefits associated with the regulatory requirements that are applicable to dealers and major participants, as well as the direct assessment costs (as defined below) these rules will impose on certain market participants.

As the SEC noted in the Proposing Release, the definitions of “security-based swap dealer” and “major security-based swap participant” implicate two categories of potential costs. First, there are costs that arise from the regulatory requirements that will apply to those types of entities (e.g., the registration, margin, capital and business conduct requirements that would apply to dealers and major participants).¹⁴³⁷ The Proposing Release also noted that there are costs that entities will incur in determining whether they fall within the definitions of “security-based swap dealer” and “major security-based swap participant.”¹⁴³⁸ Commenters that addressed

¹⁴³⁷ See Proposing Release, 75 FR at 80206.

¹⁴³⁸ See Proposing Release, 75 FR at 80206-07.

these issues discussed both types of costs.¹⁴³⁹ Our consideration of these issues has been informed by the comments we received.

In adopting these final rules, we have sought to take into account the broader costs and benefits associated with the regulation of security-based swap dealers and major security-based swap participants, which we refer to in this section as “programmatic” costs and benefits. We have also considered the direct costs that persons would incur to assess whether they fall within the dealer or major participant definitions or to assess the potential availability of limited registration as a dealer or major participant. We refer to these costs as “assessment” costs.¹⁴⁴⁰ The programmatic costs and benefits and the assessment costs raise distinct analytic issues.

We discuss below certain of the costs and benefits – both programmatic and assessment-related – that we have considered in adopting these rules. These costs and benefits have informed the policy choices described above. Accordingly, the analysis below includes references throughout to the earlier discussions of the policy decisions taken by the Commissions.

¹⁴³⁹ See, e.g., letters from Representatives Bachus and Lucas (“Casting an overly-broad net in defining these terms could force some smaller participants to leave the marketplace as a result of increased costs, or eliminate certain types of contracts used for hedging. If either occurs, businesses will be left exposed to market volatility and the consequences will ultimately be felt by Americans in the forms of increased consumer costs.”); ISDA (suggesting that imposing dealer regulation beyond persons whose business is to make markets would be inconsistent with the Dodd-Frank Act’s intent to preserve growth and innovation in the swap markets); ABC/CIEBA (stating that major participant thresholds will cause persons who pose no systemic risk to incur substantial costs associated with major participant registration and regulation); SIFMA-AMG (addressing complexity and burden of analyzing potential status as a major participant, and urging implementation of a calculation safe harbor).

¹⁴⁴⁰ We expect that the benefits resulting from the identification and registration of dealers and major security-based participants will likely accrue primarily at the programmatic level. To the extent appropriate given the purposes of Title VII, we have sought to mitigate the costs entities will incur in connection with such identification and registration.

In considering the costs and benefits of these rules, we are mindful of the various considerations that must be taken into account in establishing the baseline against which those costs and benefits may be evaluated. A key consideration is that the definitions, while integral to the regulatory requirements that will be imposed on dealers and major participants pursuant to Title VII, do not themselves establish the scope or nature of those substantive requirements or their related costs and benefits. In light of this consideration associated with definitional rulemaking, the baseline we are using to consider the costs and benefits associated with the definitions presumes that the other Title VII rules that implement the statutory requirements applicable to security-based swap dealers and major security-based swap participants will be adopted (and will be the subject of their own economic analysis), but as yet there are no dealers or major participants subject to any of these requirements. The costs and benefits described below are therefore those that may arise in connection with (1) identifying a subset of current and future market participants as either security-based swap dealers or major security-based swap participants (i.e., the assessment costs) and (2) subjecting that subset, through the definitional lines we are drawing, to a complete, fully effective complement of Title VII statutory and regulatory requirements (i.e., the programmatic costs and benefits).

Accordingly, in determining the appropriate scope of the definitions being adopted in these rules, we considered what type of persons should be regulated as dealers and major participants under Title VII, in light of the purposes of the statute, the overall regulatory framework, and the data currently available to us. We thus have sought to adopt regulations that would include entities within the scope of the dealer and major participant definitions to the extent that encompassing persons with their level of security-based swap activities or positions would be necessary and appropriate given the purposes of the statute (for example, because the

institution may pose market or other risks of the type addressed by Title VII). Conversely, to the extent that we expect that the regulation of certain types of market participants would not serve the statutory purposes, we have sought to exclude them from the scope of the definitions, thereby reducing unnecessary burdens on entities whose regulation may not be necessary or appropriate to further the purposes of the statute.

We recognize that the costs and benefits arising from these rules will affect competition, efficiency, and capital formation in the security-based swap market broadly, with the impact not being limited to the specific entities that fall within the meaning of the terms “security-based swap dealer” and “major security-based swap participant.” In the sections that follow we begin with a consideration of the costs and benefits of the rule that affect the regulated market participants that fall within the meaning of these terms, and conclude with a consideration of the potential effects of this rule on competition, efficiency, and capital formation.

2. Programmatic costs and benefits associated with these definitions’ scope

a. Programmatic costs

The scope of these definitions will directly affect the number of market participants subject to Title VII and the rules thereunder and thus will directly affect the overall costs associated with the regulation of dealers and major participants pursuant to Title VII. Persons who fall within the statutory definitions of security-based swap dealer and major security-based swap participant, as further defined by these rules, will incur a number of upfront costs and ongoing costs in connection with their status as dealers or major participants. Those include, but are not limited to, costs of complying with requirements related to: registration; reporting, recordkeeping, confirmation and documentation; sales practices; margin, capital and segregation

of customer collateral; and maintaining a chief compliance officer.¹⁴⁴¹ We expect that the significance of those programmatic costs will outstrip the more discrete and entity-specific assessment costs (discussed in more detail below) that individual entities will incur in determining whether they fall within the dealer and major participant definitions.

The programmatic costs linked to compliance by regulated entities with specific requirements are not the only overall costs associated with the regulation of dealers and major participants. Other potential costs associated with the establishment of a new regulatory structure over dealers and major participants, such as costs related to the potential reduction of competition in the market, the deterrence of new entrants, or reductions in capital formation, are discussed more fully below.¹⁴⁴²

b. Programmatic benefits

The regulation of dealers and major participants also will provide a number of programmatic benefits to the security-based swap market and to market participants. As discussed above,¹⁴⁴³ registered security-based swap dealers and major participants will be subject

¹⁴⁴¹ For example, dealers and major participants will be subject to business conduct requirements of section 15F of the Exchange Act, and thus will be required, among other things, to determine that their counterparty meets certain eligibility standards before entering into security-based swaps with them and to disclose information about material risks and characteristics, material incentives, conflicts of interest, the daily mark, and clearing rights. See Securities Exchange Act Release No. 64766 (June 29, 2011), 76 FR 42396, 42406, 42410 (July 18, 2011). Also, for example, in connection with registration requirements we expect security-based swap dealers and major security-based swap participants to incur costs in connection with completing and filing forms, providing related certifications, addressing additional requirements in connection with associated persons, as well as certain additional costs. See Securities Exchange Act Release No. 65543 (Oct. 12, 2011), 76 FR 65784, 65813-18 (Oct. 24, 2011). The costs associated with these and other substantive rules applicable to dealers and major participants are being addressed in more detail in connection with the applicable rulemakings.

¹⁴⁴² See part VIII.A.4, infra.

¹⁴⁴³ See part II.D.3.a, supra.

to a number of entity-level and transaction-level requirements that we expect to produce a broad array of benefits consistent with the purposes of Title VII.¹⁴⁴⁴

For example, section 15F(e) of the Exchange Act and related rules impose capital and margin requirements on dealers and major participants,¹⁴⁴⁵ which will reduce the financial risks of these institutions and contribute to the stability of the security-based swap market in particular and the U.S. financial system more generally. Section 3E of the Exchange Act, among other things, requires security-based swap dealers that collect margin from counterparties to cleared security-based swap transactions to maintain that collateral in segregated accounts, as well as providing counterparties to uncleared security-based swap transactions with security-based swap dealers and major security-based swap participants with the right to require the segregation of assets held as collateral with an independent third-party custodian. These protections provide market participants who enter into transactions with these entities confidence that their collateral accounts will remain separate from the dealer or major participant's assets in the event of bankruptcy.¹⁴⁴⁶ Title VII also requires registered entities to implement risk management policies and procedures that should allow them to avoid taking on excessive risk and to better deal with market fluctuations that might otherwise endanger the financial health of the entity.¹⁴⁴⁷

¹⁴⁴⁴ In application, the programmatic requirements applicable to security-based swap dealers may differ from the programmatic requirements applicable to major security-based swap participants. For example, the proposed business conduct rules applicable to dealers include "know your customer," suitability and "pay to play" requirements that would not also apply to major participants. See Exchange Act Release No. 64766 (June 29, 2011), 76 FR 42396, 42399-401 (July 18, 2011).

¹⁴⁴⁵ See Exchange Act section 15F(e).

¹⁴⁴⁶ See Exchange Act section 3E.

¹⁴⁴⁷ See Exchange Act section 15F(j)(2).

Title VII further imposes a range of business conduct requirements upon these registered entities, which should deter fraudulent or deceptive conduct and increase information transparency for customers and counterparties seeking to access the security-based swap market. For example, section 15F(h)(3)(B) of the Exchange Act and related rules establish certain disclosure requirements for dealers and major participants,¹⁴⁴⁸ while section 15F(h)(3)(C) of the Act and related rules require that communications by these entities meet certain standards of fairness and balance.¹⁴⁴⁹ Section 15F(j)(5) of the Act and related rules introduce requirements intended to address potential conflicts of interest that may arise in transactions between a dealer or major participant and its counterparty.¹⁴⁵⁰ Title VII also establishes higher levels of protection for special entities entering into transactions with dealers or major participants.¹⁴⁵¹ As we discuss in more detail in our analysis of the competitive effects of these rules, these protections, and the related increase in transparency in dealings with registered entities may be expected to improve the competitiveness and efficiency of the market.

Finally, Title VII also imposes requirements that are designed to promote effective market operation and transparency. Sections 15F(f), (g), and (j)(3) of the Exchange Act and related rules impose certain reporting, recordkeeping, and regulatory disclosure requirements upon registered entities, which should enhance the volume and quality of information available

¹⁴⁴⁸ See Exchange Act section 15F(h)(3)(B).

¹⁴⁴⁹ See Exchange Act section 15F(h)(3)(C).

¹⁴⁵⁰ See Exchange Act section 15F(j)(5).

¹⁴⁵¹ See Exchange Act sections 15F(h)(2), (h)(4), (h)(5).

in the market and facilitate effective oversight by the Commission.¹⁴⁵² Section 15F(i) establishes regulatory standards related to the confirmation, processing, netting, documentation and valuation of security-based swaps, which should enhance the efficiency of the procedures surrounding the execution of security-based swap transactions.¹⁴⁵³

We expect that the regulation of security-based swap dealers and major participants through these provisions will advance the transparency, risk reduction and counterparty protection purposes of Title VII.¹⁴⁵⁴ While these benefits will be significant, they will not be entirely measurable, as it is not possible to quantify the benefits of mitigating or avoiding a future financial crisis, or the benefits of avoiding an unsuitable security-based swap transaction.¹⁴⁵⁵ Those benefits, moreover, can be expected to manifest themselves over the long-term and be distributed over the market as a whole.

c. The relation between these rules and the programmatic costs and benefits

¹⁴⁵² See Exchange Act section 15F(f) (reporting and recordkeeping requirements); Exchange Act section 15F(g) (daily trading records requirements); and Exchange Act section 15F(j)(3) (requirements related to the disclosure of information to regulators).

¹⁴⁵³ See Exchange Act section 15F(i).

¹⁴⁵⁴ Prior to the enactment of the Dodd-Frank Act, a Treasury Department blueprint for financial reform articulated benefits of comprehensive regulation of derivatives: “OTC derivatives markets, including CDS markets, should be subject to comprehensive regulation that addresses relevant public policy objectives: (1) preventing activities in those markets from posing risk to the financial system; (2) promoting the efficiency and transparency of those markets; (3) preventing market manipulation, fraud, and other market abuses; and (4) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties.” Department of the Treasury, Financial Regulatory Reform – A New Foundation 46-47 (2009).

¹⁴⁵⁵ See note 421, *supra*. The significance of these potential benefits is suggested by the 2008 financial crisis. Better Markets cited estimates that the worldwide cost of the 2008 financial crisis in terms of lost output was between \$60 trillion and \$200 trillion, depending primarily on the long-term persistence of the effects. See letter from Better Markets. We recognize, however, that this estimate addresses the aggregate cost of the financial crisis, and that Title VII is directed to only one aspect of the factors that contributed to the crisis.

In adopting these final rules, we recognize that: (a) the choices reflected by these rules will affect how many persons and which persons ultimately will be deemed to be dealers or major participants; and (b) those results, combined with the substantive requirements that are to be adopted in connection with the dealer and major participant regulatory regime, ultimately will determine the programmatic costs and benefits that will be associated with the substantive regulation of dealers and major participants.

This is not to say that there would be a one-to-one correlation between the regulation (or non-regulation) of any particular entity as a dealer or major participant and the additional (or reduced) programmatic costs and benefits that would be associated with the regulation (or non-regulation) of that entity. Some of the costs of regulating a particular person as a dealer or major participant, such as costs of registration, may largely be fixed. At the same time, other costs associated with regulating that person as a dealer or major participant (e.g., costs associated with margin and capital requirements) may be variable, reflecting the level of the person's security-based swap activity. Similarly, the regulatory benefits that would arise from deeming that person to be a dealer or major participant (e.g., benefits associated with increased transparency and efficiency, and reduced risks faced by customers and counterparties), although not quantifiable, may be expected to be variable in a way that reflects the person's security-based swap activity. In addition, it is reasonable to believe that the implementation of Title VII itself will change the security-based swap market, and, with the full implementation of Title VII – which in part is conditioned on these definitions – more information will be available for this analysis.¹⁴⁵⁶

¹⁴⁵⁶ The lack of market data is particularly significant in the context of total return swaps on equity and debt. We do not have the same amount of information regarding those products as we have in connection with the present market for single-name credit default swaps.

Given these limitations on our ability to conduct a quantitative assessment of the programmatic costs and benefits associated with these definitional terms, we have considered these costs and benefits primarily in qualitative terms. In that framework it is possible to identify a subset of such entities that, because of the volume of their dealing activity or the size of their security-based swap exposure, appear to be the types of entities for which the other statutory requirements of Title VII were created. We have therefore sought to adopt definitions that would capture these entities, as the statute requires us to do, without imposing the costs of Title VII on those entities for which regulation currently may not be justified in light of those purposes. We believe that this approach will maximize the benefits provided by Title VII while minimizing costs to the extent consistent with the purposes of the statute.

Moreover, as discussed above, the SEC has directed the staff to report to the Commission on all aspects of the dealer and major participant definitions no later than three years following the later of: (i) the last compliance date for the registration and regulatory requirements for security-based swap dealers and major security-based swap participants under Section 15F of the Exchange Act; and (ii) the first date on which compliance with the trade-by-trade reporting rules for credit-related and equity-related security-based swaps to a registered security-based swap data repository is required. This report will provide the SEC and market participants with more information about the security-based swap market following the implementation of Title VII – including information regarding the business of dealers and major participants, the characteristics of positions they and other market participants hold, the structure of the market, and how Title VII has affected those aspects of the market. This report, which will take into account the additional data from our observations of the security-based swap market and the functioning of the associated regulatory requirements, is intended to help the SEC assess whether to make

changes to the scope of the dealer and major participant definitions (as well as to assess future actions related to the extended compliance period in connection to the de minimis exception to the security-based swap dealer definition).

d. Analysis of the effect of specific rules on programmatic costs and benefits

We have sought to establish definitions that capture the types of entities whose security-based swap activity or whose security-based swap positions warrant regulation under Title VII as dealers or major participants, and to exclude the types of entities whose activity or positions may not warrant such regulation. The relationship between a given rule and the scope of the persons that ultimately will fall within the dealer or major participant definitions – along with the related costs and benefits – manifests itself in different ways depending on the rule at issue. Some of these rules may be expected to have a close link to the overall programmatic costs and benefits associated with dealer and major participant regulation because they play a significant role in determining the overall scope of the definitions (for example, because they are relevant to the status of relatively more entities). Other rules may be expected to affect the status of relatively fewer entities and thus have a smaller effect on those programmatic costs and benefits.

We anticipate that the report that the SEC staff will make to the Commission following the full implementation of Title VII with regard to these definitions will help us more fully evaluate the programmatic impact of all of these rules, both in terms of the number of potential major participants and dealers that would result from the definition we are adopting as well as potential alternatives, and in terms of the associated programmatic costs and benefits.

i. Core rules that implicate programmatic costs and benefits

The core definitional terms with respect to establishing the scope of the dealer and major participant definitions are those relating to: (i) the core dealer definition, (ii) the dealer de

de minimis exception, and (iii) the definitions of “substantial position” and “substantial counterparty exposure” within the major participant definition.

A. Dealer definition

Exchange Act rule 3a71-1 defines “security-based swap dealer” and thus plays a central role in determining the scope of the Title VII regulatory regime going forward. Based on the available data regarding activity in the market for single-name credit default swaps, including the application of various criteria that may be indicative of dealing activity in that market, and taking into account the availability of the de minimis exception to the dealer definition, we estimate that 50 or fewer entities ultimately may have to register with the SEC as security-based swap dealers.¹⁴⁵⁷ This is consistent with the estimate that accompanied the proposal.¹⁴⁵⁸

¹⁴⁵⁷ This estimate – which potentially overstates the number of potential dealers – is consistent with the data considered in the CDS Data Analysis. That analysis implied a range of alternative estimates – from 16 possible dealers to 93 possible dealers – based on currently available data and reflecting a \$3 billion de minimis level. Compare CDS Data Analysis at table 2a (identifying 16 potential dealers above the \$3 billion level based on the criterion of having 20 or more unique counterparties) with CDS Data Analysis at table 2c (identifying 93 potential dealers above that level based on the criterion of having 10 or more unique counterparties). However, most of the criteria applied by the CDS Data Analysis as potentially indicative of dealer activity suggested estimates of fewer than 50 possible dealers after accounting for the \$3 billion de minimis level. See id. at table 2b (identifying 32 possible dealers based on the criterion of having 15 or more unique counterparties); id. at table 3 (identifying 16, 19, or 25 possible dealers based on the criterion of having a certain number of counterparties not identified as dealers by ISDA); id. at table 4 (identifying 32 possible dealers based on the criterion of having a “flat notional book”); id. at table 5 (identifying 33 possible dealers based on the criterion of having “flat transaction volume”); id. at table 7 (identifying 40 possible dealers that meet two or more of the other criteria cited in the analysis); id. at table 8 (identifying 27 possible dealers that meet three or more of the other criteria cited in the analysis). Only two criteria suggested estimates in excess of 50 possible dealers above the \$3 billion level. See id. at table 2c (identifying 93 possible dealers based on the criterion of having 10 or more unique counterparties, which may also be explained by the fact that non-dealers may maintain trading relations with multiple dealers); id. at table 6 (identifying 52 possible dealers based on the criterion of posting initial margin with low frequency, which may also be explained by underreporting of margin due to the fact that such reporting was voluntary with respect to the data underlying the CDS Data Analysis).

While recognizing that alternative criteria for identifying possible dealing activity produced varied results, we believe that the results largely are consistent with the estimate of 50 or fewer security-based swap dealer registrants. We further believe that it is appropriate to place particular weight on one

Alternative approaches to identifying dealer activity, including those suggested by commenters, may have led to a lower or higher number of potential dealers out of the over 1,000 total participants in the security-based swap market. For example, commenters variously suggested, among other approaches, that the dealer definition should be interpreted to be coextensive with the concept of market making activity, that dealer status should be limited to persons available to take either side of the market at any time, or that dealer status should be limited to transactions arising from a “customer” relationship.¹⁴⁵⁹ Following those alternative

criterion that identified possible dealing activity based on whether an entity engaged in security-based swap transactions with three or more counterparties that themselves were not identified as dealers by ISDA. That analysis identified 28 entities possibly engaged in dealing activity (with 25 of those with trailing notional transactions that exceed the \$3 billion de minimis threshold we are adopting). See CDS Data Analysis at table 3c. We believe that this metric serves as a useful proxy for the application of the dealer-trader distinction, given that persons with the business model of seeking to profit by providing liquidity in general may reasonably be expected to engage in transactions with persons who are not themselves recognized as dealers.

In estimating that 50 or fewer entities ultimately may have to register as dealers, we are seeking to take a conservative approach that recognizes both the limitations on the conclusions that may be drawn from available data and the potential for changes in the security-based swap market. We recognize that the criteria applied in the CDS Data Analysis are imperfect in that they do not directly apply the dealer-trader distinction, and that some alternative criteria may prove to be superior predictors of actual dealing activity. We also recognize that the estimate may overstate the number of possible registered dealers insofar as not all of the activity of persons identified as potential dealers based on the CDS Data Analysis necessarily reflects dealing activity, meaning that in practice a greater number of entities may be able to take advantage of the de minimis exception, and fewer entities would have to register as dealers, than estimates implied by that analysis may suggest. This estimate of 50 potential dealers further seeks to reflect the potential for growth in the size of the security-based swap market, as well as growth in the number of registered dealers as a result of competition promoted by the policies contemplated by the Dodd-Frank Act, and the possibility that some business groups that are identified as a single entity for purposes of this data ultimately may register multiple legal entities as security-based swap dealers.

¹⁴⁵⁸ The proposal estimated approximately 50 entities would be required to register as security-based swap dealers, based on discussions with industry. See Proposing Release, 75 FR at 80209, n.188. Commenters did not contradict this estimate. To the extent that the actual number of registrants differs from this estimate, it is reasonable to assume that the actual number will be lower than the estimate in the proposal because the de minimis level established by the final rules for credit default swaps that are security-based swaps – as described above, by far the overwhelming majority of the security-based swap market – is higher than the level that was proposed (i.e., \$3 billion vs. \$100 million).

¹⁴⁵⁹ See part II.A.2, supra.

approaches potentially would reduce the ultimate number of persons required to register as dealers.

In adopting the final rules and providing interpretive guidance that adapts our traditional dealer-trader analysis for the security-based swap market, we have sought to capture those entities whose security-based swap activity is warranted due to the nature of their interactions with counterparties, or is warranted to promote market stability and transparency. In this respect, we have sought to limit the costs imposed by regulation under Title VII to those entities whose regulation would serve the transparency, customer protection, and market stability purposes of the statute while not imposing those costs on entities whose regulation may not produce sufficient benefit in terms of those purposes. The core dealer analysis that we have adopted here focuses on activity that characterizes dealers, as the statutory text requires, and does so while drawing on a well-established approach used in an analogous securities dealer context by a wide range of financial intermediaries.¹⁴⁶⁰

B. De minimis exception to the dealer definition

Exchange Act rule 3a71-2 implements the de minimis exception to the dealer definition. This rule will directly affect the scope of the dealer definition by excepting certain entities that otherwise would be encompassed by the dealer definition but whose security-based swap dealing activities fall below a specified notional threshold. As above, we believe that the application of the final rule implementing the de minimis exception, in combination with application of the

¹⁴⁶⁰ See part II.A.5, *supra* (discussing the application of the dealer-trader distinction to the security-based swap market).

dealer-trader distinction, reasonably may be expected to result in 50 or fewer entities ultimately registering with the SEC as security-based swap dealers.¹⁴⁶¹

As discussed above, the final rule implementing the de minimis exception reflects our attempt to focus the application of dealer regulation onto those entities for which that regulation would be appropriate, taking into account the comparative costs and benefits of dealer regulation, and the high degree of concentration of dealing activity in the security-based swap market.¹⁴⁶² The final rule particularly provides that a dealer may take advantage of the exception if the notional amount of its dealing activity involving security-based swaps that are credit default swaps over the trailing 12 months is no more than \$3 billion. For other types of swaps, a dealer may take advantage of the exception if the notional amount of its dealing activity is no more than \$150 million. The threshold for dealing activity with counterparties that are “special entities,” regardless of the type of security-based swap, is \$25 million. The final rule also eliminates proposed tests based on the number of an entity’s dealing counterparties and on the number of its dealing security-based swaps. This approach also mitigates concerns raised by some commenters about the exception being overly narrow.¹⁴⁶³

¹⁴⁶¹ See note 1457, *supra*.

¹⁴⁶² See parts II.D, *supra*. Regardless of the criterion used for identifying entities engaged in dealing activity, analysis of 2011 transaction data for single-name credit default swaps indicates that possible dealers with \$3 billion or more in trailing notional activity account for over 98 percent of all the trailing notional activity by such entities. See CDS Data Analysis at 8-17.

¹⁴⁶³ See part II.D.2, *supra*. Conversely, some commenters suggested lower thresholds than those provided in the final rule, an approach that reasonably would be expected to lead more entities to have to register as security-based swap dealers. We did not adopt these lower thresholds because we determined that, given our understanding of the current structure of the market, it was unnecessary to do so to achieve the purposes of Title VII. Under any of the metrics used in the CDS Data Analysis (with the exception of the metrics relying on the posting of margin, which are, for reasons provided in the analysis, particularly unreliable), for example, retaining the proposed de minimis threshold of \$100 million would have

We have concluded that a \$3 billion threshold for security-based swaps that are credit default swaps would appropriately apply dealer regulatory requirements to entities that comprise the vast majority of domestic dealing activities in these products, while not imposing the fixed costs of dealer regulation upon those entities responsible for only a small portion of total dealing activity, and avoiding the threat of leaving an excessive amount of dealing activity outside the ambit of dealer regulation.¹⁴⁶⁴ We believe that this approach strikes a balance that appropriately maximizes the benefits of dealer regulation while avoiding the application of the fixed costs of dealer regulation onto those entities for which dealer regulation may not significantly contribute to those benefits and avoiding the threat of allowing an excessive volume of unregulated dealing activity.¹⁴⁶⁵

Similar considerations influenced our determination that a \$3 billion de minimis threshold would be inappropriate for persons engaged in dealing activity involving other types of

captured at most an additional 0.75 percent of transaction activity engaged in by entities captured by the respective analysis. See CDS Data Analysis at 8-17.

In adopting this rule we also considered alternative approaches and thresholds suggested by some commenters that potentially may lead fewer entities to have to register as security-based swap dealers. For example, while some commenters supported the use of an exposure-based threshold rather than a notional threshold, we declined to adopt this approach because the use of an exposure threshold could permit a virtually unlimited amount of dealing activity within the de minimis exception so long as exposures are collateralized (or offset, as generally occurs with dealing activity), a result inconsistent with the purposes of Title VII.

¹⁴⁶⁴ As noted above, a sufficiently high de minimis threshold could allow a significant amount of unregulated security-based swap dealing activity to develop among entities whose dealing activity does not exceed the de minimis threshold. See part II.D.5.b, supra.

¹⁴⁶⁵ As noted above, an extended compliance period will be available to entities that engage in \$8 billion or less in annual notional dealing activity in security-based swaps that are credit default swaps (or \$400 million in dealing activity in other types of security-based swaps), to help facilitate the orderly implementation of Title VII and to afford the SEC additional time to study the security-based swap market as it evolves in the new regulatory framework. See part II.D.5.c.ii, supra.

security-based swaps, given the comparatively smaller size of that market.¹⁴⁶⁶ We instead have set the threshold at a level that reflects the relative volume in the security-based swap market of security-based swaps that are not credit default swaps.¹⁴⁶⁷

The final rule implementing the de minimis exception also sets forth a lower notional threshold for dealing activities involving “special entities,” consistent with the special protections that Title VII affords those entities. While we recognize that this lower threshold may deter certain entities that are not registered as dealers from entering into security-based swap transactions with special entities, and hence may have the effect of reducing the availability of security-based swaps to those entities or increasing their costs,¹⁴⁶⁸ we believe that this lower threshold is appropriate to avoid undermining those separate Title VII protections.¹⁴⁶⁹

The final rule implementing the de minimis exception further provides that security-based swap activities of affiliates under common control with an entity should be considered when determining whether the entity can avail itself of the de minimis exception. That is intended to avoid evasion of the dealer registration requirement; thus, while a contrary approach

¹⁴⁶⁶ See part II.D.5.d, supra.

¹⁴⁶⁷ See id. (discussing rationale for use of \$150 million threshold and \$400 million phase-in level in connection with those types of security-based swaps).

¹⁴⁶⁸ We expect any such effect will likely be minimal. An analysis of 2011 transaction data regarding single-name credit default swap transactions involving special entities shows that 16 counterparties account for all transactions with special entities. Although all but one of these entities engaged in more than \$25 million in transactions with such entities in 2011, all of these entities engaged in total single-name credit default swap activity well in excess of the \$3 billion de minimis threshold that applies to dealers generally. See CDS Data Analysis, Table 9 and note 8. Consequently, it is possible that all 16 entities would have been required to register as dealers under the standard de minimis threshold of \$3 billion, regardless of the lower de minimis threshold for special entities.

¹⁴⁶⁹ See note 179, supra (discussing business conduct requirements applicable to dealing activities involving special entities).

might be expected to reduce the number of registered dealers, such an approach would not be consistent with the purposes of Title VII.¹⁴⁷⁰

C. “Substantial position” and “substantial counterparty exposure” definitions

Exchange Act rules 3a67-3 and 3a67-5 define “substantial position” and “substantial counterparty exposure,” which constitute key terms within the major participant definition. The rules defining these thresholds – including the use of current exposure and potential future exposure tests, the specific features of those tests, and the thresholds associated with those tests¹⁴⁷¹ – can be expected to directly influence the overall number of persons who may fall with the major participant definition.

These tests seek to capture persons whose security-based swap positions pose sufficient risk to counterparties and the markets generally that regulation as a major participant is warranted.¹⁴⁷² Based on available data regarding the single-name credit default swap market – which we believe will comprise the majority of security-based swaps – we estimate that the number of major security-based swap participants likely will be fewer than five and, in actuality, may be zero. As discussed above, an entity that posts daily variation margin in connection with those positions generally would need to have security-based swap positions approaching \$100

¹⁴⁷⁰ See note 437, *supra* (discussing use of common control standard in this anti-evasion context, rather than the majority ownership standard used in connection with the inter-affiliate exclusions from the dealer and major participant definitions).

¹⁴⁷¹ As detailed above in part IV.B.3, an entity will generally be required to register as a major security-based swap participant if its current security-based swap exposure exceeds \$1 billion in a single major category of security-based swaps or to a single counterparty or if its current security-based swap exposure plus its potential future exposure exceeds \$2 billion in a single major category of security-based swaps or to a single counterparty. The current exposure test looks to an entity’s current uncollateralized exposure posed by its security-based swap positions in a given category; the potential future exposure test looks to the effective notional exposure represented by an entity’s security-based swap positions, with certain adjustments for cleared or margined positions and netting.

¹⁴⁷² See parts IV.C.3 and IV.E.3, *supra*.

billion to reach the levels of potential future exposure required to meet the substantial position threshold, even before accounting for the impact of netting, while an entity that clears its security-based swaps generally would need to have positions approaching \$200 billion.¹⁴⁷³ The available data shows that as of December 2011 a single entity had aggregate gross notional positions (i.e., aggregate buy and sell notional positions) in single-name credit default swaps exceeding \$100 billion, and three others had aggregate gross notional positions between \$50 and \$100 billion.¹⁴⁷⁴ However, as discussed above, the purchase of credit protection is weighed less heavily than the sale of credit protection for purposes of the analysis,¹⁴⁷⁵ meaning that an entity's positions reflecting single-name credit protection sold to its counterparties may be expected to be more of a key determinant of the entity's potential future exposure level under the rules we are adopting. The data shows that no entities have more than \$100 billion in positions arising from selling single-name credit protection and that only two have between \$50 and \$100 billion in positions arising from such transactions.¹⁴⁷⁶

¹⁴⁷³ See note 914, *supra*. Although it is possible that a notional position of \$20 billion could cause an entity to be a major participant in the absence of central clearing or mark-to-market margining (and assuming that there is no risk reduction associated with netting or with certain positions that pose lower credit risk), we expect that those entities (such as hedge funds) that may be expected to have large positions would, as a matter of course, post mark-to-market margin in connection with positions that are not cleared. See Proposing Release, 75 FR 80207-08 n.181 (stating our understanding that banks, securities firms, and hedge funds typically collateralize most or all of their mark-to-market exposure to U.S. banks as a matter of practice). Accordingly, we believe that \$100 billion provides a reasonable focus for the analysis.

¹⁴⁷⁴ See CDS Data Analysis at table 10.

¹⁴⁷⁵ See part IV.B.3.c.iii, *supra*.

¹⁴⁷⁶ See *id.* Although this data describes aggregate notional positions only for single-name credit default swaps and does not include analysis of positions in other types of security-based swaps, as noted above, credit default swaps appear to account for approximately 95 percent of the security-based swap market. That fact reduces the likelihood that positions involving security-based swaps that are not credit-related would cause a person to be a major security-based swap participant, or lead any entity to find it necessary to perform the major participant analysis in connection with those instruments.

While a “substantial position” or “substantial counterparty exposure” also can be established by a sufficiently high amount of current uncollateralized exposure, the available data does not provide information about individual entities’ uncollateralized exposure in connection with security-based swap positions. We note, however, our understanding that certain of the financial entities that may have large security-based swap positions, such as hedge funds, tend to collateralize their security-based swap exposures as a matter of course, which would reduce the potential impact of this aspect of the test.

As noted above, commenters suggested both higher and lower thresholds, as well as different discounts or risk multipliers for certain positions.¹⁴⁷⁷ If the final rules defining “substantial position” and “substantial counterparty exposure” incorporated higher major participant thresholds, potentially fewer entities may be major participants. Conversely, lower thresholds may have led to a higher number of major participants, with the upper bound being represented by the over 1,000 non-dealer entities that participate in the security-based swap market.¹⁴⁷⁸

By potentially capturing more or fewer major participants, such alternatives would have correspondingly increased or decreased the programmatic costs and benefits associated with Title VII regulation of major participants. As discussed above, however, the tests incorporated into the final rules, and the thresholds associated with those tests, are in our view tailored to capture only those entities that pose the risks that major participant regulation in Title VII seeks to address; in other words, these thresholds and related calculations incorporate the risk criteria

¹⁴⁷⁷ See part IV.B.2, *supra*.

¹⁴⁷⁸ See CDS Analysis at tables 10 through 12.

embedded in the major participant definition.¹⁴⁷⁹ For example, we have declined to exclude centrally cleared positions from the potential future exposure test, instead permitting entities to discount those positions for purposes of the analysis, because central clearing cannot reasonably be expected to fully eliminate all counterparty risk that may affect the broader markets. Based on this fact, we conclude that it would be inappropriate, given the purposes of Title VII, to exclude an entity from the major participant definition simply because all of its security-based swap positions arise from cleared transactions.¹⁴⁸⁰ Similar considerations informed our approach to other aspects of the substantial position and substantial counterparty position tests, as discussed more fully above.¹⁴⁸¹

ii. Rules that may be expected to have a lesser effect on programmatic costs and benefits

Several of the final rules may be expected to have relatively smaller effects on the scope of the major participant and dealer definitions because they are likely to affect relatively fewer entities. By extension, they will also have a smaller effect on the programmatic costs and benefits arising from these definitions.

¹⁴⁷⁹ See part IV.B.3, supra (discussing the decisions made regarding the substantial position definition and the reasoning behind the adopted approach). For example, we have concluded that the proposed thresholds are set prudently in a manner that takes into account the financial system's ability to absorb losses of a particular size, the need for major participant regulation not to encompass entities only after they pose significant risks to the market, and the need to account for the possibility that multiple market participants may fail close in time. In addition, as discussed above, we believe that this threshold is tailored to address the types of events associated with the failure of AIG FP. See part IV.B.3.d, supra.

¹⁴⁸⁰ Central clearing helps to mitigate counterparty credit risk by improving risk management and, among other things, mutualizing the risk of counterparty failure. If multiple members of a central counterparty fail beyond the level to which such risk is managed, however, the central counterparty would also be at risk of failure. Cf. Basel Committee on Banking Supervision, Consultative Document, "Capitalisation of bank exposures to central counterparties," Nov. 25, 2011 (available at: <http://www.bis.org/publ/bcbs206.pdf>) (proposing that the capital charge for trade exposures to a qualifying central counterparty should carry a low risk weight, reflecting the relatively low risk of default of the qualifying central counterparty).

¹⁴⁸¹ See part IV.B.3, supra.

A. Limited purpose dealer and major participant designations

Exchange Act rules 3a67-1 and 3a71-1 retain the presumption that a person that is encompassed within the major participant or dealer definitions will be deemed to be a dealer or major participant with respect to all of its security-based swap activities or positions, unless the SEC exercises its authority to limit the person's designation as a dealer to specified categories of swaps or security-based swaps, or to specified activities. This presumption may affect programmatic costs in at least two ways.

First, by not providing for registration as a limited purpose major participant or dealer as a matter of course, the final rules may be expected to increase the costs associated with the registration of those entities that seek designation as dealers or major participants or dealers. Aside from the costs of registration described in the SEC's proposal related to the registration of dealers and major participants,¹⁴⁸² we expect that entities seeking to register as a limited purpose major participant or dealer would incur some additional marginal costs associated with making applications for limited designation.¹⁴⁸³

In addition, the presumption against limited purpose designation may be expected to reduce the number of limited purpose major participants and dealers below the number that would otherwise register as limited purpose entities absent the presumption. In concept, broader availability of limited purpose registration of major participants or dealers may be expected to

¹⁴⁸² See "Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants," Exchange Act Rel. No. 34-65543 ("Registration Proposing Release"), 76 FR 65784, 65814-65818 (describing various costs associated with registration, including \$11,800 per entity to complete and file form SBSE and between approximately \$94,000 and \$610,000 per entity to certify to the capabilities of the entity seeking registration).

¹⁴⁸³ These costs may include the costs of identifying how the entity would be able, as a limited designation entity, to comply with the various entity-level requirements of Title VII.

reduce the programmatic costs associated with regulation under Title VII, without necessarily reducing certain programmatic benefits if appropriately crafted. In particular, any programmatic effects of an appropriately scoped limited designation likely would affect only the transaction-level requirements applicable to dealers and major participants (e.g., certain business conduct standards and requirements related to trading records, documentation and confirmations), potentially reducing costs and benefits that would otherwise arise from such requirements with respect to transactions that occur outside the limited designation. At the same time, certain of the entity-level regulatory requirements applicable to dealers and major participants as a whole (such as requirements related to capital) would continue to apply in the context of limited designation, ensuring that a limited purpose designation would not undermine the counterparty protection and systemic risk concerns of Title VII.

Notwithstanding these effects, we believe that the presumption against limited purpose designations is appropriate. This conclusion reflects the statutory language, the difficulty of separating a dealer's activities from its non-dealing activities (or a major participant's security-based swap positions taken under its limited purpose designation from other of its security-based swap positions) for compliance purposes, and the challenges of applying dealer or major participant regulatory requirements to only a portion of the entity's security-based swap business. Instead, we will consider limited purpose applications on an individual basis through analysis of the unique circumstances of each applicant.¹⁴⁸⁴

¹⁴⁸⁴ We will consider applications for limited purpose designation in the context of the registration requirements for major participants and dealers. In that context, we could consider applications on a case-by-case basis, pursuant to requests by specific major participants or dealers. This could help to ensure that any person that is designated as a limited purpose major participant or dealer is able to comply with the regulatory requirements applicable to major participants or dealers. Accordingly, we intend to further consider issues regarding limited designations, including associated costs, in a release relating to the

We note that the available data does not indicate how many, or which, entities may have business models that conceivably could make limited purposed designations appropriate (e.g., large positions in one major category of security-based swaps accompanied by minor positions in the other).¹⁴⁸⁵

B. Inter-affiliate exclusions from dealer and major participant definitions

Exchange Act rules 3a67-3 and 3a71-1 respectively exclude inter-affiliate security-based swaps from the calculation of substantial position and substantial counterparty position thresholds under the major participant definition, and from the de minimis calculation under the dealer definition. The inter-affiliate exclusion from the major participant and dealer definitions has the potential to affect the scope of these definitions for those entities that engage in inter-affiliate transactions by leading some entities not to meet the major participant or dealer de minimis thresholds when they otherwise would have met those thresholds (or by allowing certain centralized hedging facilities to look only at their market-facing activities in conducting the dealer-trader analysis). The exclusion or inclusion of certain inter-affiliate transactions thus may have some impact on the programmatic costs and benefits associated with dealer and major participant regulation.

We are adopting a majority-ownership standard for determining whether transactions between affiliates can be excluded from these threshold calculations because such transactions

specific registration requirements (for example, the form used for registration) for major participants and dealers. Furthermore, as noted above, the SEC is directing the staff to prepare a report on all aspects of the dealer and major participant definitions. Upon completion of this report, the SEC may further assess whether changes to the presumption against limited designation are warranted in light of the then-current state of the security-based swap market and the types of business in which security-based swap dealers are engaged.

¹⁴⁸⁵ The study that will be conducted in connection with the dealer and major participant definitions may also provide relevant information regarding limited designations of dealers and major participants.

between entities whose economic interests are aligned to a degree represented by majority ownership do not appear to pose the kinds of counterparty and market risks that Title VII addresses.¹⁴⁸⁶ Some commenters suggested lower levels of control (such as common control) that may be expected to lead to fewer entities being registered as dealers or major participants, with associated impacts on programmatic costs and benefits. In our view, however, such alternative standards would not be consistent with the scope of the interactions to which dealer regulation is intended to apply, or with an alignment of economic interests consistent with an exclusion from the major participant definitions.

We also note that the data upon which the staff assessment of credit default swap transactions and positions is based excludes certain inter-affiliate credit default swap transactions. As a result, estimates of market concentration and the distribution of dealing activity or credit default swap positions derived from this data should reflect to some extent the effect of the inter-affiliate exclusions we are adopting in this rule.

C. Commercial risk hedging exclusion

Exchange Act rule 3a67-4 defines “hedging or mitigating commercial risk” as that term is used in the major participant definition. The scope of this definition has the potential to determine whether certain market participants will be major participants by virtue of the first statutory major participant test, and will therefore affect the scope of the programmatic costs and benefits associated with major participant regulation. In application, this effect may be limited in light of the fact that we estimate that, as discussed above, only five or fewer entities – perhaps as few as zero – may have to register as major security-based swap participants.

¹⁴⁸⁶ See parts II.C.2.b and IV.G.2, supra (discussing nature of inter-affiliate security-based swap transactions).

The final rule adopts an “economically appropriate” standard for determining whether a security-based swap position hedges or mitigates commercial risk, and sets forth exclusions for security-based swap positions that have a speculative or trading purpose. As we discuss above, we carefully considered the alternative approaches suggested by some commenters, including the suggestion that the definition should encompass positions that hedge speculative or trading positions and the suggestion that the definition should incorporate a “congruence” standard. We concluded, however, that these approaches are inconsistent with the focus of the statutory text, which is on “commercial risk.”¹⁴⁸⁷ We also concluded that broadening the exclusion as some commenters suggested could largely exclude security-based swap positions from the first major participant test. This would produce a result that we believe to be contrary to the purposes of that part of the statutory definition, which envisions that entities might be required to register as major participants by virtue of their security-based swap positions.

D. “Financial entity” definition

Exchange Act rule 3a67-6 defines “financial entity” for purposes of the third test of the major participant definition, which applies to certain highly leveraged non-bank financial entities and does not prevent them from excluding commercial risk hedging positions when conducting the substantial position analysis (in contrast to the first test within the major participant definition, which permits exclusion of those hedging positions).

Although the scope of the financial entity definition has the potential to affect the number of persons who are captured by the third test of the statutory major participant definition (and thus, by extension, the programmatic costs and benefits associated with major participant

¹⁴⁸⁷ See parts IV.C.5.a and IV.C.5.b, *supra* (discussing rationale for excluding hedges of speculative and trading positions from the definition).

regulation), we believe that as a practical matter such an effect would be minimal. This is based on our view that persons that have security-based swap positions large enough and risky enough to potentially lead to major participant status to be financial in nature and thus would likely fall within any reasonable interpretation of the term “financial entity,”¹⁴⁸⁸ thus making such entities potentially subject to the third major participant test (to the extent that such entities are subject to bank capital requirements).

E. “Highly leveraged” definition

Exchange Act rule 3a67-7 defines “highly leveraged” for purposes of the third prong of the major participant definition, which applies to certain non-banks as described above. In adopting the final rule, we have considered alternative approaches suggested by commenters. For example, a number of commenters favored the use of a 15 to 1 leverage ratio, which may be expected to reduce the number of persons who are deemed to be “highly leveraged” and thus subject to the third test. Conversely, some commenters favored a ratio that is lower than the one found in the final rule, which may be expected to increase the number of entities deemed to be highly leveraged.¹⁴⁸⁹

The final rule defines “highly leveraged” as a leverage ratio of 12 to 1 or higher. In our view, this ratio reasonably sets forth objective criteria for identifying entities that pose a heightened risk of being unable to meet their obligations through their use of leverage. This 12 to 1 ratio reflects a number of factors, including the use of a 12 to 1 ratio in connection with

¹⁴⁸⁸ See Federal Reserve Bank of New York staff reports, “An Analysis of CDS Transactions: Implications for Public Reporting” (2011) at table 3 (“NY Fed analysis”) (available at http://www.newyorkfed.org/research/staff_reports/sr517.pdf) (discussing credit default swap trade frequency by market type, and indicating that most activity is done by entities of a financial nature).

¹⁴⁸⁹ See part IV.F.2.b, *supra*.

certain broker-dealer capital rules, as well as reasons to distinguish the use of a 15 to 1 ratio in Title I of the Dodd-Frank Act.¹⁴⁹⁰

As with the financial entity definition in rule 3a67-6, as a practical matter we do not believe that expanding or narrowing the leverage ratio within any reasonable definition of “highly leveraged” for purposes of the third major participant test will have a significant impact on the programmatic costs and benefits of major participant regulation. In part, this is because we believe that in many circumstances the sales of credit protection cannot reasonably be interpreted to constitute the hedging of commercial risk,¹⁴⁹¹ meaning that such positions in any event may be expected to be considered as part of the analysis of the first major participant test. The programmatic impact of this definition further is mitigated by the fact that we believe that there will be relatively few entities whose security-based swap positions would cause them to be major participants.

E. “Major” categories of security-based swaps

Exchange Act rule 3a67-2 defines “major” categories of security-based swaps, a term that plays a role in the two statutory major participant tests that turn upon the presence of a substantial position in a “major” category of security-based swaps. The final rule retains the proposal’s division of those instruments into debt-based and other categories. As discussed above, these major categories are broadly consistent with market usage and statistics, and we

¹⁴⁹⁰ See part IV.F.3.b, supra (discussing the rationale for using a 12 to 1 ratio for purposes of defining the term “highly leveraged” in the context of the major participant definitions).

¹⁴⁹¹ See note 1019, supra.

believe that it is reasonable for entities undertaking this analysis to use these categories in calculating whether they have a substantial position.¹⁴⁹²

In theory, it is possible that the categorization of security-based swaps for these purposes could result in a particular entity exceeding the applicable thresholds in a major category, causing it to be a major security-based swap participant and triggering the Title VII registration and regulatory requirements.¹⁴⁹³ The relationship between the major security-based swap categories as we have defined them in this rule and the programmatic costs and benefits associated with major participant regulation will depend largely on how the security-based swap positions of entities with security-based swap exposures approaching these thresholds are distributed between these categories.

The available data suggests that the debt-based major category (i.e., credit default swaps) accounts for the vast majority of security-based swap positions.¹⁴⁹⁴ Absent an approach that breaks single-name credit default swaps in to multiple “major” categories – which itself would not appear to be justified based on current information – this suggests that this categorization as a practical matter will not have a significant effect on the programmatic costs and benefits of major participant regulation.¹⁴⁹⁵

¹⁴⁹² See part IV.A.3 (discussing rationale for final “major” categories).

¹⁴⁹³ In other words, the dividing line that the rule sets between the major category of debt-based security-based swaps and the major category for other security-based swaps (or other dividing lines based on different or additional major categories) could determine whether an entity’s security-based swap positions exceed or fall below the major participant thresholds for a particular major category, and hence whether the entity will be deemed to be a major participant.

¹⁴⁹⁴ See note 476, *supra*.

¹⁴⁹⁵ For example, an alternative approach might divide narrow-based index CDS and single-name CDS into separate major categories. We believe, however, that single-name CDS account for the large majority of debt-based security-based swaps, see *id.*, suggesting that most entities’ status as major participants would turn on their single-name CDS exposures under any reasonable approach to defining

G. Registration period

Exchange Act rules 3a67-8 and 3a71-2 establish periods for registration as a dealer and major participant, as well as periods for reevaluating or terminating one's status as a registered entity. As such, these provisions may affect the length of time that particular entities may be deemed to be major participants or dealers, and hence subject to the requirements applicable to those entities. However, any effect of delaying or accelerating dealer or major participant status on the programmatic costs and benefits associated with major participant or dealer status likely will be negligible compared to the overall programmatic costs and benefits associated with major participant or dealer regulation.

H. Calculation safe harbor

Exchange Act rule 3a67-9 establishes a calculation safe harbor for the major participant threshold tests. We do not believe that this safe harbor changes the scope of the major participant definition, as it should not exclude from the major participant definition any entity that would otherwise fall within the definition if that entity performed the substantial position calculations.¹⁴⁹⁶ Accordingly, we do not believe that the safe harbor would have a material effect on the programmatic costs and benefits associated with major participant regulation.

I. Interpretation related to guarantees

major categories and that the subtraction of narrow-based index CDS exposures in the calculation of substantial exposure would, given their relatively small market volume, have little effect on whether most entities meet the substantial exposure threshold. Thus, we believe that the decision to classify all debt-based security-based swaps in a single category will likely have minimal effect, if any, on any entity's status as a major participant, as compared to dividing debt-based security-based swaps into two categories.

¹⁴⁹⁶ See part IV.M.2, supra.

In adopting these final rules, we also have finalized an interpretation regarding when a person will have security-based swap positions attributed to it by virtue of having guaranteed the positions of another party. In general, we have clarified that an entity's security-based swap positions need not be attributed to its parent unless the counterparty has recourse to the parent. We also clarified that, even in the presence of a guarantee, positions of certain regulated entities – including swap dealers, security-based swap dealers, major participants, broker-dealers, FCMs and certain entities subject to U.S. bank capital requirements – will not be attributed to the guarantor.¹⁴⁹⁷

We recognize that attributing security-based swap positions to the entity guaranteeing another entity's security-based swap transactions may increase the number of major participants. At the same time, excluding certain regulated entities from the attribution requirement even in the presence of a guarantee may help prevent a guarantor, such as a holding company, from being deemed to be a major participant when the risks associated with those positions already are subject to regulation.

We do not currently possess data relating to the existence of guarantees of the security-based swap positions of other parties and thus cannot reasonably estimate the number of additional entities that may be brought within the ambit of major participant regulation by virtue of this interpretation. However, we note that, to the extent that guarantees of another entity's security-based swap positions creates the level of exposure—and corresponding risk to the market and to counterparties—that warrants regulation under Title VII, it would appear

¹⁴⁹⁷

See part IV.H.3, supra.

inconsistent with the purposes of the statute not to subject that entity to major participant regulation.

J. Other interpretations

Finally, in this release we also have provided a number of additional interpretations and discussions in connection with the dealer and major participant definitions. These include, among others: the rejection of requests for entity-specific exclusions from the dealer and major participant definitions;¹⁴⁹⁸ interpretations regarding the application of the ERISA exclusion from the first major participant test,¹⁴⁹⁹ and interpretations regarding the application of the major participant analysis to managed accounts.¹⁵⁰⁰ In theory, each of these interpretations potentially has a programmatic impact.¹⁵⁰¹ For the reasons discussed above, we believe that these interpretations reflect reasonable choices.

¹⁴⁹⁸ See parts II.A.6 and IV.J, *supra* (stating that such exclusions from the dealer definition would have no basis in the statutory text and would be inconsistent with the activity focus of the dealer definition, and not providing entity exclusions from the major participant definition because entities that meet the thresholds of the rules may pose high risk to the U.S. financial system regardless of how they are organized).

¹⁴⁹⁹ See part IV.D; *supra* (interpreting the provision to exclude security-based swap positions entered into for the primary purpose of hedging or mitigating risks associated with operation of the plan, consistent with the statutory language that does not limit the hedging exclusion for ERISA plans to commercial risk; also clarifying that such positions may be eligible for exclusion even if they are held by a non-plan entity that holds plan assets).

¹⁵⁰⁰ See part IV.I, *supra* (clarifying that the position will be attributed to the client account rather than to the investment advisers or asset managers and that a beneficial owner should be required to treat the positions of such an account as its own only if the security-based swap counterparty has recourse to the beneficial owner).

¹⁵⁰¹ For example, attributing security-based swap positions to investment advisers would have increased the likelihood of advisers being deemed to be major participants. Our interpretations do not take that approach, however, as we believe that it would be inconsistent with the focus of the statutory definition.

3. Analysis of Assessment Costs

Certain persons engaged in security-based swap activity are likely to incur costs in connection with evaluating whether they fall within the dealer or major participant definitions.¹⁵⁰² As detailed below, we have considered these assessment costs in adopting definitional rules and interpretations that seek to capture entities whose security-based swap activity or whose security-based swap positions warrant regulation under Title VII as dealers or major participants, while excluding entities whose activity or positions do not warrant such regulation.

a. Assessment costs associated with the “security-based swap dealer” definition

i. Core dealer analysis and de minimis exception

A. Overview

Exchange Act rule 3a71-1 in part restates the statutory definition of “security-based swap dealer” to consolidate the definition and related interpretations for market participants’ ease of reference. In conjunction with these final rules the SEC has set forth interpretations to provide additional guidance to implement the statutory approach of capturing persons that engage in certain security-based swap activities while excluding persons that do not engage in those activities as part of a “regular business.”¹⁵⁰³ We believe that this guidance – including its reliance on the distinction between dealing activity and non-dealing activity such as hedging or trading – will allow a number of market participants to readily conclude that their security-based swap activities will not cause them to be security-based swap dealers. In adopting this approach,

¹⁵⁰² These costs are distinguishable from the costs associated with registration as a dealer or major participant (which for purposes of this analysis we treat programmatic costs) and the other programmatic costs discussed above.

¹⁵⁰³ See part II.A.5, supra.

we have considered alternative views, expressed by some commenters, that would have had the effect of narrowing the statutory definition's scope.¹⁵⁰⁴

Exchange Act rule 3a71-2 specifies when a person that otherwise would be a security-based swap dealer can take advantage of the de minimis exception. In adopting the rule's tests and thresholds – including the use of a \$3 billion notional threshold in connection with dealing activity involving credit default swaps that are security-based swaps, a \$150 million notional threshold in connection with other types of security-based swaps, higher phase-in levels in connection with those thresholds, and a separate \$25 million threshold in connection with dealing activity involving “special entities” – we have considered a range of alternative approaches and thresholds suggested by commenters.¹⁵⁰⁵

In application, the assessment costs associated with the core dealer test and de minimis exception are linked.

B. Assessment costs associated with the final rules and interpretations

We recognize that certain participants in the security-based swap market may incur costs in connection with the facts-and-circumstances analysis of whether they are security-based swap

¹⁵⁰⁴ These include suggestions that: the dealer definition should be interpreted to be coextensive with the concept of market making activity; the dealer definition requires that a person be available to take either side of the market at any time; the dealer definition should not extend to persons solely engaged in security-based swap activity on swap execution facilities; the dealer definition should exclude persons whose security-based swap dealing activity is relatively small compared to its other activities; and dealing activity requires the presence of a “customer” relationship. See id. (discussing interpretive approach to “security-based swap dealer” definition). Conversely, a few commenters suggested rejection of the dealer-trader distinction, and implied that the dealer definition should be applied more broadly. See id.

These also include suggestions that the dealer analysis incorporate particular per se exclusions. Although we recognize that such approaches may be simpler for market participants to implement, we nonetheless do not believe that such per se exclusions would be consistent with the statutory definition, which identifies dealers based on their security-based swap activities. See part II.A.6, supra (discussing reasons not to include per se exclusions from the dealer definitions).

¹⁵⁰⁵ See parts II.D.3 and II.D.5, supra.

dealers as defined in the statute and in the final rules, particularly with regard to the application of the dealer-trader distinction and the de minimis exception.

As noted above, analysis of market data indicates that the overwhelming number of participants in the single-name credit default swap market in 2011 had total activities (dealing or non-dealing) of significantly less than \$3 billion notional amount over the prior 12 months.¹⁵⁰⁶ In general – aside from potential dealing activity involving other types of security-based swaps and dealing activity involving “special entities” – such persons likely would not be deemed to be security-based swap dealers regardless of whether their current level of security-based swap activities constitutes dealing (apart from those entities that increase their dealing activity following the implementation of Title VII).

On the other hand, some market participants whose security-based swap activities exceed, or are not materially below, the \$3 billion de minimis threshold may be expected to incur costs in connection with the dealer analysis. Those entities reasonably may conclude that they need to incur costs to analyze their security-based swap activities to determine whether those activities are non-dealing in nature (e.g., hedging or trading), or whether those activities instead are dealing in nature (e.g., part of a business purpose of providing liquidity in connection with security-based swaps), consistent with the statute and the rules and guidance provided in this release.¹⁵⁰⁷

¹⁵⁰⁶ Of 1,084 entities with single-name credit default swap transaction activity over the 12 months ending in December 2011, 961 entities, or 88.7 percent, engaged in less than \$3 billion notional in such activity. These 961 entities were responsible for approximately 3.2 percent of the notional value of all single-name credit default swap transactions during that period. See CDS Data Analysis, table 1.

¹⁵⁰⁷ The use of the \$8 billion phase-in level in connection with these activities may also be expected to temporarily mitigate such costs.

There are over 1,000 entities (U.S. and non-U.S.) that from time to time may engage in single-name credit default swap transactions.¹⁵⁰⁸ Of this number, however, only 123 entities engaged in more than \$3 billion in single-name credit default swap transactions over the previous 12 months. For purposes of analyzing the assessment costs of this rule, we have assumed that all of these entities would perform the dealer analysis.¹⁵⁰⁹ We also recognize that some entities whose activities fall below the de minimis threshold may opt to engage in this analysis out of an abundance of caution or to meet internal compliance requirements, and for purposes of this analysis have assumed that the 43 entities whose activity during the trailing 12 month period fell between \$2 and \$3 billion also would engage in the dealer analysis, leading to a total of 166.¹⁵¹⁰

¹⁵⁰⁸ See CDS Data Analysis, table 1. The Federal Reserve Bank of New York has published data that is consistent with this analysis. See NY Fed analysis at 10 (noting that for a three month period spanning from May through July of 2010, there were 933 unique market participants in the credit default swap market).

As noted above, see note 148, *supra*, in relying on the available data we are not indicating our views as to the application of Title VII to non-U.S. persons. Issues regarding the extraterritorial application of Title VII instead will be addressed in a separate release.

¹⁵⁰⁹ See CDS Data Analysis, table 1. This approach potentially overstates the number of entities that would need to engage in the analysis. Of entities with more than \$3 billion in activity over the trailing 12 month period, some number can be expected to determine, given the nature of their business, that they are (or are not) dealers under the definition without having to engage in this analysis. For example, the NY Fed analysis discussed above found that so-called G14 dealers were responsible for roughly 78 percent of CDS transactions as buyer and 85 percent of CDS transactions as sellers, and that so-called "other dealers" were responsible for approximately an additional seven percent of CDS transactions as sellers and six percent as buyers. See NY Fed analysis at 9, table 3. Many of these entities would likely determine that performing this analysis was unnecessary.

¹⁵¹⁰ For the reasons stated above, we also believe that this number potentially overstates the number of entities with less than \$3 billion in activity over the trailing 12 month period that would be likely to engage in this analysis. Because it appears that all entities engaged in security-based swap transactions with special entities engaged in more than \$8 billion in security-based swap transactions in 2011, see CDS Data Analysis at 21 n.8, we do not expect that the de minimis threshold for dealing activity involving special entities to cause market participants to incur costs independent of those associated with the general de minimis threshold.

This estimate of 166 entities, although derived from data about total (dealing and non-dealing) transactions,¹⁵¹¹ illustrates a potential upper bound for the total costs arising from security-based swap dealer determinations, to the extent that all market participants whose security-based swap activity approaches or exceeds the \$3 billion de minimis threshold identify a need to retain outside counsel to analyze their status under the security-based swap dealer definition. In that context, this estimate suggests that the costs of analysis may approach \$4.2 million.¹⁵¹²

In accounting for the de minimis exception in estimating these costs, we note our expectation that market participants generally would be aware of the notional amount of their

¹⁵¹¹ The CDS Data Analysis uses criteria that screen for likely characteristics of entities engaged in dealing activity. See CDS Data Analysis at 2. However, the available data does not permit identification of which of these entities' transactions arise from dealing activity and which arise from non-dealing activity (such as proprietary trading or hedging). It is therefore likely that the notional amounts provided in each table of the data analysis include both dealing and non-dealing activity. For purposes of the economic analysis of our rules further defining "security-based swap dealer," we have assumed that the entire notional amount for each entity appearing in Tables 2-9 represents dealing activity. Although this potentially results in an overestimate of dealing activity for these entities—and thus in an overestimate of the costs associated with conducting the dealer analysis—we believe that this represents a conservative approach to evaluating the assessment costs of these rules.

¹⁵¹² This total is based on the assumption that 166 market participants would seek outside legal counsel to determine their status under the security-based swap dealer definition, with such analysis costing an average of \$25,000 per entity.

The average cost incurred by such entities in connection with outside counsel is based on staff experience in undertaking legal analysis of status under federal securities laws, and assumes that the legal analysis for a complex entity on average may cost \$30,000, and that the legal analysis for a less complex entity on average may cost \$20,000. The use of inside counsel in lieu of outside counsel would reduce this upper bound.

We recognize that the complexity of market participants may vary greatly, and that we do not have insight into market participants such that we could reasonably determine how many entities may be considered more or less complex for these purposes. Thus, based on our understanding of the market we believe that an average of the costs associated with more complex and less complex entities equaling \$25,000 would reasonably approximate the average costs for entities across the credit default swap market, assuming that all such participants perceive a need to retain outside counsel for purposes of the analysis.

activity involving security-based swaps as a matter of good business practice. Consequently, we would not expect market participants to incur costs in determining the availability of the de minimis exception significantly in excess of the costs associated with the general dealer determination.¹⁵¹³

We recognize that additional market participants may be expected to incur these types of assessment costs to the extent that they engage in activity involving other types of security-based swaps in an amount close to, or in excess of, \$150 million annually. Because the market for these other types of security-based swaps appears to be highly concentrated (like the single-name credit default swap market) and to involve many of the same entities,¹⁵¹⁴ we expect the number of entities that will incur assessment costs solely by virtue of this lower threshold also to be small.

¹⁵¹³ We note that different cost estimates have been used for purposes of the “swap dealer” definition under the CEA. We do not believe that the estimate of the number of persons who would have to engage in a dealer analysis under the CEA would be germane to the analysis of the costs associated with the Exchange Act’s “security-based swap dealer” definition, given the wide range of markets that are exclusive to the “swap” definition. We also do not believe that the basis that underpins the CFTC’s estimate of the cost of performing the dealer analysis under the definition of swap as set forth in the CEA would be relevant to the Exchange Act definition. In part, this is because we believe that the entities whose security-based swap activities may cause them to be dealers likely would have businesses that are financial in nature. We thus expect that those entities would be particularly sensitive to the link between the business purpose of their activities and the dealer definition. In many cases those entities also should be familiar with the use of the dealer-trader distinction in connection with their activities involving other types of securities.

We also note that different cost estimates have been used for purposes of the de minimis exception under the CEA. We expect, however, that entities whose security-based swap activities may cause them to be dealers likely would have businesses that are financial in nature. We thus expect that those entities would: (a) be well placed to distinguish their security-based swap dealing activities from their non-dealing activities under the dealer-trader distinction; and (b) would be familiar with the notional amount of their security-based swap activities over the prior year.

¹⁵¹⁴ See, e.g., OCC Quarterly Report at tables 1 and 10 (listing notional credit and equity derivatives for largest U.S. banks and trust companies). See also note 429, supra.

In addition, we recognize that some market participants potentially may incur these types of assessment costs to the extent they engage in security-based swap activities in an amount close to, or in excess of, \$25 million annually.¹⁵¹⁵

For the reasons discussed above we believe that the approach we are adopting in the final rules is necessary and appropriate given the goals of Title VII and the statute's express requirement that we implement a de minimis exception to the dealer definition.

ii. Additional issues related to the dealer analysis

A. Limited designation of dealers

Exchange Act rule 3a71-1(c) implements the portion of the "security-based swap dealer" definition that provides for limited purpose registration of dealers. The rule provides for a presumption that a person that acts as a security-based swap dealer is a dealer with regard to all of its security-based swaps or security-based swap activities, unless the SEC limits its designation. While we recognize that permitting persons to more broadly take advantage of limited dealer designations potentially would lower the cumulative costs that individual dealers otherwise would incur to determine whether to seek a limited designation,¹⁵¹⁶ after careful

¹⁵¹⁵ We believe that any such costs would be modest, in light of data indicating that persons who are counterparties to special entities in the single-name credit default swap market may otherwise have to register as dealers notwithstanding the lower threshold connected with special entities. See note 1510, supra.

¹⁵¹⁶ A default presumption in favor of the availability of limited designations may be expected to reduce the costs associated with an entity determining whether it qualifies for such relief, such as the costs of hiring outside legal counsel to undertake this analysis to determine that they could take advantage a limited designation relief.

consideration of commenter concerns we have determined that it is appropriate to adopt a presumption against limited designation.¹⁵¹⁷

Certain persons who satisfy the dealer definition may incur costs in determining whether to seek a limited designation. We believe that such costs would affect no more than the 166 entities that potentially may be expected to engage in the dealer analysis,¹⁵¹⁸ and expect these costs to be included in the estimated costs of seeking outside legal counsel described above.

B. Exclusion of inter-affiliate security-based swaps

Exchange Act rule 3a71-1 also provides that security-based swaps between majority-owned affiliates will be excluded for purposes of the dealer analysis. After consideration of commenter views, we are adopting this standard, rather than potential alternatives such as a common control test, because we believe that it is appropriate, in light of the goals of Title VII, that the dealer definition not capture entities by virtue of security-based swap transactions with affiliated entities that have a sufficient alignment of economic interests to avoid raising systemic

¹⁵¹⁷ In this regard we note the relative lack of data about the types of security-based swap positions held by particular entities that will fall within the dealer definition. Our decision takes into account the difficulty of separating a dealer's activities from its non-dealing activities for compliance purposes, and the challenges of applying dealer requirements to only a portion of the entity's security-based swap activities. In reaching our decision, we have especially been influenced by the statutory definition's discretionary language in connection with the potential for limited designations, and by the need for persons subject to limited designations to be able to comply with the statutory and regulatory requirements applicable to major participants. See part II.E.3, supra (discussing limited designation principles applicable to dealers).

We note that the discussion of limited designation of "swap dealers" under the CEA generally seeks to quantify the costs associated with applications for limited designations. However, we believe that the costs of applying for a limited designation are dependent upon the application process for this type of registration category. As noted previously, the SEC expects to address the limited designation application process for security-based swap dealers in separate rulemakings. See id. As such, we believe that the costs associated with security-based swap dealer limited designation applications under the Exchange Act are more appropriately addressed in the context of those separate rulemakings.

¹⁵¹⁸ As discussed above, see note 1457, supra, we have estimated that 50 or fewer entities ultimately may have to register as security-based swap dealers.

risk, customer protection, and other concerns that dealer regulation is intended to address.¹⁵¹⁹

Moreover, we note that a majority-ownership test should, given its objective nature, impose fewer assessment costs on market participants than a more subjective common control test.

Some market entities may need to incur costs in connection with determining whether particular security-based swap positions may be excluded from the dealer analysis by virtue of the inter-affiliate exclusion. Such costs potentially could be incurred by any of the approximately 166 entities that we believe may engage in the dealer analysis. The costs specifically associated with that assessment may vary depending on factors including the extent to which those entities engage in inter-affiliate security-based swaps, but we expect these costs to be included in the estimated costs of seeking outside legal counsel described above.

C. Timing issues connected to the de minimis exception

In response to commenter concerns, Exchange Act rule 3a71-2 specifies that an entity that no longer may rely on the de minimis exception, because its dealing activity has exceeded the exception's thresholds, has two months to submit a completed application to register as a dealer.¹⁵²⁰ The final rule also specifies that a person who has been registered as a dealer for at least 12 months may withdraw from registration while continuing to engage in a limited amount of dealing activity under the exception.

In adopting these rules we have carefully considered alternatives that would lead to slower entry and faster exit from dealer status, and we recognize that providing particular entities with additional time to register as a dealer may have the potential to reduce the costs associated

¹⁵¹⁹ See part II.C.2, *supra*.

¹⁵²⁰ See part II.D.6, *supra* (discussing rationale for final rule addressing registration period for entities that exceed the de minimis threshold).

with the registration process.¹⁵²¹ We believe, however, that a two-month period for registration should provide entities with sufficient time to register without incurring additional expenses – both for large firms with security-based swap businesses well above the \$3 billion threshold, and for mid-sized firms that fluctuate near the \$3 billion threshold amount. We also conclude that this approach will appropriately help to avoid applying dealer requirements to entities that no longer meet the dealer criteria, and will avoid the prospect of persons moving in and out of dealer status overly frequently.

b. Assessment costs associated with the “major security-based swap participant” definition

i. “Substantial position” and “substantial counterparty exposure” definitions

A. Overview of “substantial position” and “substantial counterparty exposure” definitions

Exchange Act rule 3a67-3 defines the term “substantial position” for purposes of the first and third tests of the statutory major participant definition (which address whether a person has a “substantial position” in a major category of security-based swaps). The final rule sets forth two tests for identifying the presence of a substantial position – one test based on a \$1 billion daily average measure of uncollateralized mark-to-market exposure, and one based on a \$2 billion daily average measure of combined uncollateralized mark-to-market exposure and potential future exposure. Both of those daily measures would be calculated and averaged over a calendar quarter. In developing the “substantial position” tests and their associated thresholds, we have sought to capture those entities whose security-based swap positions have the potential to pose

¹⁵²¹ For example, a shorter period for registration might be expected to cause some entities to incur over-time costs arising from the need to complete the registration process within a short time frame, whereas a longer time period could have enabled such an entity to avoid those costs.

significant risks to financial markets, while not capturing other entities for which major participant regulation and its associated costs would be unwarranted.¹⁵²²

Exchange Act rule 3a67-5 defines “substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets,” a phrase that comprises part of the second test of the “major security-based swap participant” definition. The analysis set forth in this rule parallels the “substantial position” analysis, but: (i) contains higher thresholds; (ii) examines an entity’s security-based swap positions as a whole (rather than focusing on a particular “major” category); and (iii) would not exclude certain hedging positions.¹⁵²³

In adopting these definitions, we carefully considered alternative approaches suggested by commenters, including suggestions that the thresholds should be raised or lowered, and that certain positions should be excluded from the potential future exposure test, or that the test should discount certain positions differently.¹⁵²⁴ We have retained the tests largely as proposed, however, as we believe that the tests appropriately address the risk criteria embedded in the major participant definition.¹⁵²⁵ We also believe that the tests minimize the assessment costs to

¹⁵²² See part IV.B.3, supra (discussing basis for the substantial position analysis we are adopting).

¹⁵²³ See part IV.E.3, supra (discussing basis for the substantial counterparty exposure analysis we are adopting).

¹⁵²⁴ See parts IV.B.2 and IV.E.2, supra.

¹⁵²⁵ See part IV.B.3, supra (discussing the decisions made regarding the substantial position definition and the reasoning behind the adopted approach). For example, we have concluded that the proposed thresholds are set prudently in a manner that takes into account the financial system’s ability to absorb losses of a particular size, the need for major participant regulation not to encompass entities only after they pose significant risks to the market, and the need to account for the possibility that multiple market participants may fail close in time. In addition, as discussed above, we believe that this threshold is tailored to address the types of events associated with the failure of AIG FP. See part IV.B.3.d, supra.

these entities in a manner consistent with the statutory definition. For example, the decision to base the potential future exposure analysis on tests used by bank regulators for purposes of setting prudential capital reflects our view that it would be appropriate to implement the analysis by building upon an existing regulatory approach that is less subjective – and thus less costly – for market participants to utilize (as compared to, for example, a VaR approach¹⁵²⁶) and would lead to reproducible results, rather than seeking to develop a brand new approach.¹⁵²⁷

B. Assessment costs associated with the final rules defining “substantial position” and “substantial counterparty exposure”

Certain market participants may be expected to incur costs in connection with the determination of whether they have a “substantial position” in security-based swaps or pose “substantial counterparty exposure” in connection with security-based swaps.

Based on a review of notional positions maintained in 2011 by entities with single-name credit default swap positions, we estimate that approximately 12 entities have security-based swap positions of such an amount that, as a matter of prudence, they may reasonably find it

As discussed above, for an entity with no current uncollateralized exposure – and before accounting for netting – it would take a \$100 billion notional portfolio of marked-to-market security-based swaps that reflect written protection on credit to meet the \$2 billion potential future exposure threshold for security-based credit derivatives, and it would take a \$200 billion notional portfolio of cleared positions to meet that threshold. Even in the absence of clearing or daily mark-to-market margining, it would take a minimum \$20 billion notional portfolio of written protection on credit (reflecting the 0.10 multiplier in the risk adjustment tables) to meet the \$2 billion potential future exposure threshold. Accounting for netting (which can reduce potential future exposure measures by up to 60 percent) could materially increase that required amount. See note 914, *supra*.

¹⁵²⁶ For example, because value-at-risk measures typically account only for market risk and not for other types of risk, an approach based on such measures would likely require separate calculations for these other risks, as well as calculations to account for possible losses in the event of a severe market downturn; such an approach would also require the selection of appropriate parameters for the test. See Concept Release: Net Capital, Exchange Act Rel. No. 39456, at 13-19 (comparing value-at-risk and haircut approaches to net capital calculations).

¹⁵²⁷ See part IV.B.3.c, *supra*.

necessary to engage in the requisite calculations, particularly given the additional availability of the calculation safe harbor.¹⁵²⁸ In our view, the data indicates that other than approximately 12 entities, the non-dealer market participants in the security-based swap market use these products in such limited amounts that they reasonably would conclude that they do not need to undertake the calculations used to determine whether they have a “substantial position.”¹⁵²⁹

¹⁵²⁸ In the Proposing Release, we stated that based on our understanding of the market, we concluded that only 10 entities had security-based swap positions of a size to necessitate performing the calculations to determine whether they meet those thresholds. See Proposing Release, 75 FR at 80207-08. Some commenters challenged the assumption that only approximately 10 entities would engage in the requisite calculations. Those commenters took the view that certain entities with smaller security-based swap positions would perceive a need to conduct the relevant calculations on a daily basis even if they are not reasonably likely to be major participants, and, to address that concern, requested a safe harbor from having to perform the major participant calculations. See letters from SIFMA AMG I and Vanguard.

¹⁵²⁹ As discussed above, an entity that margins its positions daily generally would need to have security-based swap positions approaching \$100 billion notional to meet the substantial position threshold, assuming no current uncollateralized exposure, while an entity that clears those positions generally would need positions approaching \$200 billion notional to meet the threshold. See note 914, supra. We believe that it is reasonable to assume that most entities that will have security-based swap positions large enough to potentially cause them to be major participants in practice will post variation margin in connection with those positions that they do not clear, making \$100 billion the relevant measure. The available data shows that as of December 2011 a single entity had aggregate gross notional positions from bought and sold credit protection exceeding \$100 billion, four had aggregate gross notional single-name credit default swap positions exceeding \$50 billion, and 12 had aggregate gross notional single-name credit default swap positions exceeding \$25 billion. See CDS Data Analysis at table 10. Making allowances for certain entities that may determine, due to internal policies or other reasons, that they need to conduct this analysis and cannot rely on the calculation safe harbor we also are adopting, we believe that it is reasonable to assume that entities with aggregate gross notional single-name credit default swap positions exceeding \$25 billion may identify a need to perform the major participant analysis. (In the Proposing Release, we stated that based on our understanding of the market, we thought that fewer than ten entities had security-based swap positions of a size to necessitate performing the calculations to determine whether they meet those thresholds. See Proposing Release, 75 FR at 80207-08.)

We believe, moreover, that the estimate that 12 entities will perceive a need to perform this analysis in practice may overstate the number of entities that reasonably will find it necessary to perform the major participant analysis, given that only four entities had \$25 billion or more of aggregate gross notional single-name credit default swap positions arising from the selling of credit protection. See id. As discussed above, moreover, we believe that fewer than five entities ultimately may be required to register as major security-based swap participants. See part VIII.A.2.d.i.C, supra.

Finally, we note that this estimate may also overstate the size of positions held by individual legal entities; thus further overstating the number of legal entities that have security-based swap positions of

Although some commenters noted concerns about the complexity of the major participant calculation,¹⁵³⁰ commenters did not appear to directly question the Proposing Release's per-entity cost estimates.¹⁵³¹ After further consideration, however, we are modifying that estimate, in that we believe that the annual per-entity costs associated with the assessment will amount to \$15,268, and the annual one-time per-entity costs associated with the assessment will amount to

such a size as to potentially trigger major participant status. This is because the data in the analysis at times aggregates multiple affiliated accounts – which may reflect the legal entities that are counterparties to the security-based swap – at the parent level. While such aggregation is appropriate for these purposes given that parents may be deemed to be major participants by virtue of security-based swap positions that they guarantee, the aggregation in fact may tend to overstate the extent to which a legal entity bears credit risk in connection with security-based swaps.

To the extent that an entity's security-based swap transactions are not cleared or associated with the posting of variation margin, security-based swap positions of \$20 billion may lead to sufficient potential future exposure to cause the entity to be a major participant. As we have noted, we believe that few if any entities with significant security-based swap positions will have a significant number of such transactions. Even then, the data indicates that only a total of 32 entities have notional credit default swap positions in excess of \$10 billion. See CDS Data Analysis at table 10 (showing that 32 entities have aggregate gross single-name credit default swap positions of \$10 billion or greater).

¹⁵³⁰ E.g., letter from WGCEF II (addressing technical complexity of the proposed major participant calculations).

¹⁵³¹ Based on industry discussions, in the Proposing Release we estimated that those 10 entities would incur one-time programming costs of approximately \$13,444 per entity, or \$134,440 in total, and that these entities would incur annual ongoing costs of \$7,260 per entity, or \$72,600 in total. See Proposing Release, 75 FR at 80207-08, nn.183-86 and accompanying text (providing a summary of the methodology used to estimate these costs). The hourly cost figures in the Proposing Release for the positions of Compliance Attorney, Compliance Manager, Programmer Analyst, and Senior Internal Auditor were based on data from SIFMA's Management & Professional Earnings in the Securities Industry 2009. For purposes of the cost estimates in this release, we have updated these figures with more recent data as follows: the figure for a Compliance Attorney is \$322/hour, the figure for a Compliance Manager is \$279/hour, the figure for a Programmer Analyst is \$196/hour, and the figure for a Senior Internal Auditor is \$198/hour, each from SIFMA's Management & Professional Earnings in the Securities Industry 2011, modified by SEC staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead. We have also updated the Proposing Release's \$450/hour figure for a Chief Financial Officer, which was based on data from 2010. Using the consumer price index to make an inflation adjustment to this figure, we have multiplied the 2010 estimate by 1.03 and arrived at a figure of \$464/hour for a Chief Financial Officer in 2011. Incorporating these new cost figures, the updated one-time programming costs based upon our assumptions regarding the number of hours required in the proposing release would be \$13,692 per entity, or \$136,920 in total, and the annual ongoing costs would be \$7,428 per entity, or \$74,280 in total.

approximately \$13,692.¹⁵³² The total industry-wide assessment costs associated with the major participant definition, given our expectation that 12 entities will need to engage in this analysis, is \$183,216 for annual costs and \$164,304 for annual one-time costs.¹⁵³³

We believe that these estimates also address the assessment costs under the “substantial counterparty exposure” test. Because credit default swaps may be expected to constitute the bulk of the likely security-based swap market, it is possible that participants in the market may be more likely to have a “substantial position” in debt-related security-based swaps than they would

¹⁵³² This revision in part is based on the addition of an ongoing cost of a Programmer Analyst who we estimate would spend an additional 40 hours annually on software maintenance attributable to the modifications made to an automated system to undertake these tests. We further estimate that the hourly wage of a Programmer Analyst would be approximately \$196. The \$196/hour figure for a Programmer Analyst is from SIFMA’s Management & Professional Earnings in the Securities Industry 2011, modified by SEC staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead. Based on these assumptions, we estimate these additional costs as \$7,840 per year per entity and \$94,080 per year for all entities as follows: (Programmer Analyst at \$196 per hour for 40 hours) x (12 entities) = \$94,080.

¹⁵³³ These adjustments do not materially change the estimated costs associated with performing these calculations.

To the extent that additional entities perceive a need to perform the major participant calculations provided by the rules, notwithstanding a relatively low position in security-based swaps, these costs would differ. For example, if we assume that 32 entities will perceive the need to conduct the major participant analysis, see note 1529, supra, initial legal costs will total approximately \$960,000 (based on the per-entity cost estimate of \$30,000); one-time industry-wide costs would total approximately \$440,000 (based on the per-entity cost estimate of \$13,692); and annual industry-wide costs would total approximately \$490,000 (based on the per-entity cost estimate of \$15,268 addressed below).

At the extreme, available data indicates that 1,188 participants have single-name credit default swap positions in the security-based swap market (excluding ISDA-recognized dealers and ICE Trust). See CDS Data Analysis at table 10. To the extent that none of these 1,188 entities avail themselves of the calculation safe harbor we are adopting, and that all of them engage in the full major participant analysis, then there potentially will be initial legal costs of approximately \$35.6 million (based on the per-entity cost estimate of \$30,000), one-time industry-wide costs of approximately \$16.3 million (based on the per-entity cost estimate of \$13,692), and annual industry-wide costs of approximately \$18.1 million (based on the per-entity cost estimate of \$15,268 addressed below).

In practice, however, we think that the estimates for 12 entities more fairly assesses the relevant costs for the reasons discussed above. See note 1529, supra. In our view, a large number of participants in the market have notional security-based swap positions low enough to permit them to conclude that they do not have to engage in the relevant calculations. See id.

be to meet this second test. Nonetheless, we conservatively estimate that the same approximately 12 entities would engage in the “substantial counterparty exposure” calculation as would undertake the “substantial position” calculation.¹⁵³⁴ Given the link between this rule and the “substantial position” calculations, however, we do not anticipate that the “substantial counterparty exposure” test would create incremental costs additional to those associated with the definition of “substantial position.”¹⁵³⁵ We thus believe that the estimate of assessment costs in connection with the “substantial position” analysis (consisting of one-time programming costs of approximately \$13,692 per entity, and annual costs of \$15,268 per entity) also adequately addresses the costs of assessment under this statutory test.¹⁵³⁶

¹⁵³⁴ See part VIII.A.3.b.i.A, *supra*. These costs would differ if additional entities perceive a need to perform the major participant calculations provided by the rules, notwithstanding a relatively low position in security-based swaps. Commenters have taken the view that more than 10 entities may identify a need to perform the requisite calculations. As already noted, based on the analysis of 2011 transaction data, we have revised this estimate upward to 12 entities, though we believe that the actual number is likely to be smaller. In any event, these concerns should be addressed by the calculation safe harbor that we are adopting as part of these final rules.

¹⁵³⁵ See *Proposing Release*, 75 FR at 80209.

¹⁵³⁶ We note that higher cost estimates have been used for purposes of the “major swap participant” definition under the CEA. We expect, however, that the entities that may have security-based swap positions of a size that could lead them to be major participants likely would have businesses that are financial in nature (rather than being non-financial entities that use security-based swaps as part of their commercial activities). As such, we would expect those entities to generally be cognizant of, or in a good position to obtain information about: their uncollateralized exposure with counterparties (to the extent that those financial entities have any material amount of uncollateralized exposure); the total notional amount of their security-based swap positions; the notional amount of those positions that are subject to central clearing or daily mark-to-market margining; and the extent to which those positions are in-the-money or out-of-the-money (for purposes of calculating the netting discount to the potential future exposure calculation). We also expect that security-based swaps will be used less frequently for hedging purposes than swaps. See, e.g., Bernadette A. Minton, René Stulz & Rohan Williamson, “How Much Do Banks Use Credit Derivatives to Hedge Loans?,” 35 J. Fin. Serv. Res. 1 (2008) (noting that the “net notional amount of credit derivatives used for hedging of loans in 2005 represents less than 2% of the total notional amount of credit derivatives held by banks”). Accordingly, there is reason to believe that the costs of calculation associated with the “major security-based swap participant” assessment will be lower than the costs associated with the “major swap participant” assessment.

At the same time, upon further consideration we believe these rules also may impose certain interpretive costs, including those related to obtaining legal counsel, on market participants. Given the size and complexity of the entities that may find it necessary to analyze their status under the major participant definition, we believe that it is reasonable to conclude that at least some entities with security-based swap positions that approach the major participant thresholds are likely to seek legal counsel for interpretation of various aspects of the rules pertaining to the major participant definition. The costs associated with obtaining such legal services would vary depending on the relevant facts and circumstances, including the size and complexity of the person's security-based swap positions, and the extent to which these interpretations may be germane to whether the entity ultimately is deemed to be a major participant. We believe, however, that \$30,000 represents a reasonable estimate of the upper end of the range of the costs of obtaining the services of outside counsel in undertaking the legal analysis of the entity's status as a major participant.¹⁵³⁷ Based on the conclusion that no more

¹⁵³⁷ The average cost incurred by such entities in connection with outside counsel is based on staff experience in undertaking legal analysis of status under federal securities laws. The staff believes that costs associated with obtaining outside legal counsel relating to such determinations range from \$20,000 to \$30,000 depending on the complexity of the entity. We believe that an entity that maintains security-based swap exposures of the size that would necessitate undergoing this analysis will generally be large, complex financial organizations. We also recognize that, while the major participant test may be more objective and quantitative than the dealer test (and therefore require a less involved legal analysis), the test is novel (unlike the core dealer test, which draws on the dealer-trader distinction familiar to many market participants) and, as such, may cause entities to incur additional costs in interpreting and applying the test. Together, these factors lead us to estimate that entities undertaking this analysis will incur legal costs at the upper end of our estimated range. The use of inside counsel in lieu of outside counsel would reduce this upper bound.

The legal costs associated with the major participant analysis may include, among other things, legal advice with respect to whether an affiliate with which the entity enters into security-based swap transactions qualifies as an "affiliate" under rule 3a67-3, whether particular transactions fall within the definition of security-based swap, whether certain types of security-based swap transactions fall within the debt-based security-based swap or other security-based swap category, whether the entity falls within the definition of "financial entity," and whether certain types of security-based swap transactions qualify

than 12 entities have security-based swap positions that they would face enough of a possibility of being a major participant that they would need to engage in such analysis,¹⁵³⁸ we estimate that the total legal costs associated with evaluating the various elements of this definition may approach \$360,000.¹⁵³⁹

ii. Calculation safe harbor

We also are adopting Exchange Act rule 3a67-9, which provides a safe harbor from the definition of “major security-based swap participant” for market participants whose security-based swap positions fall below certain thresholds. This safe harbor responds to concerns raised by commenters that – based on internal compliance policies and procedures, out of an abundance of caution, or for other reasons – certain entities may feel compelled to perform the full major participant calculations even if their security-based swap positions did not rise to a level near the thresholds in the “substantial position” or “substantial counterparty exposure” definitions.¹⁵⁴⁰

for the hedging exclusion under the substantial exposure tests. We recognize that the complexity of the analysis required for any of these issues may vary considerably across entities, depending on each entity’s individual business model.

The major participant test is based on daily average exposures over the course of the previous quarter, and, as discussed further below, some number of entities may decide to establish a system that will monitor their exposure on an ongoing basis. To the extent that the entity does so, we expect that any initial legal analysis should permit the entity to make determinations about these calculations on an ongoing basis. As such, we assume that any additional costs associated with outside counsel with respect to ongoing monitoring of positions would be negligible.

¹⁵³⁸ See note 1529, *supra*.

¹⁵³⁹ If 32 entities were to perform this analysis, as discussed above, the market-wide legal costs associated with the analysis would total \$960,000.

¹⁵⁴⁰ In particular, some commenters challenged the assumption in the Proposing Release that only approximately 10 entities had security-based swap positions large enough to lead them to engage in the major participant calculations. Those commenters took the view that certain entities with smaller security-based swap positions would perceive a need to conduct the relevant calculations on a daily basis even if they are not reasonably likely to be major participants, and, to address that concern, requested a safe harbor from having to perform the major participant calculations. See letters from SIFMA AMG I and Vanguard.

The safe harbor makes use of three alternative tests. The first of these is based on the maximum possible uncollateralized exposure under the applicable credit support arrangements, and on the notional amount of a participant's security-based swap positions. The two other alternatives entail monthly calculations, with the second alternative using calculations based on the maximum possible uncollateralized exposure under the applicable credit support arrangements and monthly adaptations of the substantial position and substantial counterparty exposure calculations, and the third alternative using calculations based on uncollateralized exposure and a modified version of the potential future exposure calculation.

Although the provisions of the safe harbor we are adopting do not mirror the safe harbors suggested by commenters,¹⁵⁴¹ the inclusion of this safe harbor should help address commenter concerns regarding entities with small positions that would nonetheless feel compelled (due to their own internal compliance programs, or otherwise) to undertake the major participant calculations. While recognizing that more liberal standards for this safe harbor¹⁵⁴² could further mitigate costs of assessing major participant status, the safe harbor may be expected to help some entities avoid the costs associated with assessing if they are major participants.

It is not clear how many firms may ultimately seek to rely on the calculation safe harbor.¹⁵⁴³ Participants in the security-based swap market vary greatly in the size of their

¹⁵⁴¹ See part IV.M, supra (discussing rationale for safe harbor).

¹⁵⁴² See part IV.M.2, supra (discussing rationale for final rule implementing safe harbor).

¹⁵⁴³ As noted previously in part VIII.A.3.b.i.B, supra, we expect that approximately 12 entities may have security-based swap positions in an amount such that it may be reasonably necessary for them to undertake the major participant calculations. To the extent, however, that entities with smaller positions nonetheless identify a reason to perform a major participant analysis, the safe harbor would permit those entities to conclude that they are not major participants without the need to engage in the full set of calculations otherwise anticipated by the rules.

positions, and may be expected to vary greatly in the complexity of their operations, and in the requirements of their internal compliance and risk management policies. As a result, it is possible that some firms with relatively small positions may choose to undertake the safe harbor analysis while significantly larger firms may determine that such analysis is unnecessary.

The first of the three alternatives within the safe harbor would be based on the maximum possible uncollateralized exposure under the applicable credit support arrangements, and on the notional amount of a participant's security-based swap positions. We believe that as a matter of good business practice large participants in the security-based swap market already would be aware of that information, making the test relatively simple to implement. We also note that available data indicates that 1,073 of the 1,188 entities with single-name credit default swap positions (other than ISDA-recognized dealers and ICE Trust), have notional positions less than \$2 billion, potentially making the first test of the safe harbor available to them.¹⁵⁴⁴

The other alternatives within the safe harbor would also entail monthly calculations, with such calculations for the second alternative based on the maximum possible uncollateralized exposure under the applicable credit support arrangements and monthly adaptations of the substantial position and substantial counterparty exposure calculations, while the monthly calculation for the third alternative is based on uncollateralized exposure and a modified version of the potential future exposure calculation. Both of these would entail additional analysis beyond current industry practices, causing entities to incur higher costs than the first alternative, but no more than would be required to complete the full major participant test.¹⁵⁴⁵

¹⁵⁴⁴ See CDS Data Analysis at table 10.

¹⁵⁴⁵ We expect that the outer bounds of the assessment costs associated with this safe harbor will be no higher than the one-time costs associated with conducting the major participant analysis, given that, to

iii. Additional issues related to the major participant analysis

A. “Major” categories of security-based swaps

Exchange Act rule 3a67-2 sets forth two “major” categories of security-based swaps for purposes of the first and third tests of the major participant definitions – one consisting of debt-based security-based swaps and the other consisting of other security-based swaps (including equity swaps). These categories are consistent with our understanding of the ways in which

the extent that an entity determines that performing the safe harbor analysis is more expensive, it would likely choose to perform the less-costly major participant analysis. As such, the upper bound of costs associated with the safe harbor is not likely to exceed our estimates of the costs associated with the full major participant analysis, and should in fact be considerably lower.

We estimate that one-time costs associated with establishing a system to identify and monitor security-based swap positions, as may be necessary to perform the monthly assessments anticipated by two of the three alternative tests that comprise the safe harbor, would be similar to the one-time costs associated with the major participant analysis, and that, therefore, up to 1,188 entities may incur one-time industry-wide costs of approximately \$16.3 million. See note 1533 and accompanying text, supra. The annual costs associated with monthly assessment would be expected to be less than the costs of daily assessment, and \$9.1 million—approximately half of the estimated \$18.1 million estimated annual costs if all 1,188 entities found it necessary to perform the daily assessment required by the substantial position test (see id.)—may be a reasonable estimate of that amount, given the relative simplicity of the test and the less frequent assessments that it requires. In practice, however, we believe that the costs associated with this safe harbor will be less because we expect that far fewer entities would perceive a need to rely on these aspects of the safe harbor, particular given that, as noted above, approximately 1,073 entities have aggregate gross notional single-name credit default swap positions under \$2 billion. See note 1544 and accompanying discussion, supra.

We note that our analysis of the safe harbor in connection with the “major security-based swap participant” definition differs from that of the CFTC with regard to the “major swap participant” safe harbor. This, in part, reflects the differences between the markets for swaps and security-based swaps. We also note our expectation that many of the entities that may opt to avail themselves of the safe harbor likely would have businesses that are financial in nature (rather than being non-financial entities that use security-based swaps as part of their commercial activities). As such, we would expect those entities to generally be cognizant of, or in a good position to obtain information about: their maximum potential uncollateralized exposure with security-based swap counterparties; the total notional amount of their security-based swap positions; the notional amount of those positions that are subject to central clearing or daily mark-to-market margining; and the extent to which those positions are in-the-money or out-of-the-money (for purposes of calculating the netting discount to the potential future exposure calculation). Other non-financial entities seeking to take advantage of the safe harbor may minimize their costs by utilizing whichever safe harbor option may be expected to most closely align with the security-based swap information that readily is available to such entities.

those products are used, as well as market statistics and current market infrastructures,¹⁵⁴⁶ and we believe it is appropriate that those market categories be reflected in the major participant definition.

The consistency of the rule with current market practices should help mitigate any assessment costs incurred by market participants. Moreover, we do not expect that market participants will be required to incur costs to determine the major category with respect to a large majority of their security-based swap positions, given that the vast majority of security-based swaps likely fall within the debt-based security-based swap major category. Also, in adopting the final rules we also have provided additional guidance related to the categorization of certain types of instruments in response to commenter concerns. Nonetheless, given the fact-specific nature of any such assessment, we recognize that some entities may seek the opinion of legal counsel as to how specific security-based swap transactions should be categorized for purposes of this rule (such as legal costs associated with having counsel analyze a particular security-based swap to determine its status under these rules, to the extent that certain types of security-based swaps with complex, novel or bespoke structures are not readily categorized within one of the two identified major categories). We expect that these costs would be included in the estimated costs of seeking outside legal counsel in connection with the major participant analysis, as described above.¹⁵⁴⁷

¹⁵⁴⁶ In particular, the major categories of security-based swaps adopted in these final rules are consistent with how bank derivatives data is presented by the Office of the Comptroller of the Currency, as well as with categories used by derivatives market infrastructure such as The Depository Trust & Clearing Corporation. See part IV.A.3, *supra*.

¹⁵⁴⁷ Entities may also incur programming and other costs related to recording the classification of their security-based swap transactions in systems designed to monitor current exposure and potential future exposure, but we expect these costs to be one component of entities' overall system costs relating

B. Definition of “hedging or mitigating commercial risk”

Exchange Act rule 3a67-4 defines the term “hedging or mitigating commercial risk” for purposes of the exclusion from the first major participant test. Among other aspects, this rule makes use of an “economically appropriate” standard, and sets forth exclusions for security-based swap positions that have a speculative or trading purpose.

As discussed above, we carefully consider alternative approaches suggested by some commenters, including the suggestion that the definition should encompass positions that hedge speculative or trading positions and the suggestion that the definition should incorporate a “congruence” standard.¹⁵⁴⁸ We concluded, however, that these approaches are inconsistent with the focus of the statutory text, which is on “commercial risk,” and in adopting this definition we have sought to set forth criteria that reasonably distinguish hedging positions from other positions. We believe that the approach we are adopting, which seeks to exclude positions that hedge commercial risk without also excluding other types of positions, is necessary and appropriate in light of the statute.¹⁵⁴⁹

Some market participants may be expected to incur costs in connection with determining whether certain security-based swap positions fall within this hedging exclusion.¹⁵⁵⁰ Any such costs of analyzing the status of particular security-based swaps as a hedge of commercial risk

to its substantial position calculations, which we discuss in further detail above. See part VIII.A.3.b.i.B, supra.

¹⁵⁴⁸ See parts IV.C.5.a and IV.C.5.b, supra (discussing rationale for excluding positions hedging speculative and trading positions from the definition).

¹⁵⁴⁹ See parts IV.C.3 and IV.C.5, supra.

¹⁵⁵⁰ We have incorporated provisions into the final rule designed to provide guidance to market participants as to which types of security-based swap positions could be expected to fall within this exclusion. This release also provides further guidance as to the scope of the exclusion.

would reflect the unique character of individual positions and the business purpose associated with the position. Such costs may be particularly relevant for security-based swaps of a more complex nature, or for security-based swaps that introduce some degree of basis risk in connection with the hedge. Because of the facts-and-circumstances nature of this analysis,¹⁵⁵¹ we believe that some entities may seek the opinion of legal counsel as to whether certain transactions qualify for the commercial hedging exclusion at the time they conduct their initial analysis, and these costs would likely be encompassed within the estimated costs of legal services related to the major participant definition.¹⁵⁵²

C. Definitions of “financial entity” and “highly leveraged”

Exchange Act rule 3a67-6 defines the term “financial entity” for purposes of the third major participant test. This definition is largely consistent with the statutory “financial entity” definition used in Title VII’s exception from mandatory clearing for commercial end-users.¹⁵⁵³ However, in response to commenter concerns, the final rules exclude centralized hedging facilities from the “financial entity” definition (in a way that itself is consistent with that Title VII hedging exception).¹⁵⁵⁴ Although particular market participants may incur costs in

¹⁵⁵¹ The transaction-related costs of making a hedging determination would apply only to entities with security-based swap positions that are near to or exceed the substantial position threshold prior to taking advantage of the hedging exclusion. This may be expected to mitigate costs associated with making this determination.

¹⁵⁵² Separately, the proposed rule defining this term would have included certain documentation and assessment conditions that commenters stated could lead to significant costs. Commenters expressed concerns regarding the application of these conditions and the associated costs. As discussed previously in this release, we have determined not to include these conditions in the final rule. See part IV.C.5.d, supra.

¹⁵⁵³ See Exchange Act section 3C(g).

¹⁵⁵⁴ In addition, we considered, but do not incorporate, some commenters’ suggestion that “financial entity” be defined more narrowly, such as by excluding employee benefit plans. See part IV.F.3.a, supra, (discussing rationale for final rule defining “financial entity”).

connection with determining whether they fall within the “financial entity” definition, we believe that such costs would be minimal in light of the objective nature of the definition, and its consistency with the use of the term elsewhere in Title VII. We also recognize that entities may seek the opinion of legal counsel as to whether the entity falls within the scope of this “financial entity” definition, but believe that these costs would likely be encompassed within the estimated costs of legal services related to the major participant definition.

Exchange Act rule 3a67-7 defines the term “highly leveraged,” also for purposes of the third statutory major participant test. After considering commenters’ views, the final rule defines that term based on a 12 to 1 leverage ratio, as discussed in greater detail above. In adopting this leverage ratio, we also modify the proposed method of calculating leverage in certain respects,¹⁵⁵⁵ but conclude that it would not be appropriate to provide special methodologies for insurers to measure leverage.¹⁵⁵⁶ It is possible that certain market participants will incur costs in connection with determining whether they are “highly leveraged” for purposes of the major participant definitions. In part, we believe that those costs are mitigated by the fact that the final rules identify “highly leveraged” entities based on a ratio of liabilities to equity, which we expect are simpler for entities to implement than alternative methods for measuring leverage, such as risk-adjusted methods.

We recognize that the unavailability of an alternative method of calculation for insurers may have the effect of increasing certain insurers’ cost of calculating leverage for purposes of determining whether they fall within the major participant definition, to the extent that insurers

¹⁵⁵⁵ See part IV.F.3.b, supra (addressing leverage ratio calculation for certain employee benefit plans).

¹⁵⁵⁶ See note 1107, supra (providing special rules related to the calculation of leverage for certain employee benefit plans).

have security-based swap positions that are close enough to the relevant thresholds that they have to perform the required calculations.¹⁵⁵⁷ We believe, however, that a uniform approach to defining “highly leveraged” is appropriate here given that the large insurance firms that are most likely to meet the major participant definition would be expected already to use GAAP in preparing their financial statements. This should mitigate any additional costs arising from the absence of an alternative calculation method for insurers.

D. Limited designations of major participants

Exchange Act rule 3a67-1 in part implements the portion of the “major security-based swap participant” definition that provides for limited purpose registration of major participants. The rule sets forth a presumption that a person that acts as a major security-based swap participant in general will be deemed to be a major participant with regard to all of its security-based swaps, unless the SEC limits its designation.

¹⁵⁵⁷ We note that many large insurers of the type that maintain security-based swap positions in an amount that would require them to perform the major participant calculations may be publicly traded companies, in which case they would already calculate their financial statements according to GAAP for purposes of public disclosure, and thus would not incur additional costs due to our decision not provide special methodologies for insurers to calculate their leverage. We also expect that the concerns of many smaller insurers that are not publicly traded and thus may not use GAAP will be addressed by our inclusion of the safe harbor for major participant calculations.

In addition, publicly available information regarding insurer use of derivatives suggests that the potential costs to insurers arising from the definition of “major security-based swap participant” may be negligible. As of the end of 2010, U.S. insurers as a whole had entered into roughly \$33.5 billion in notional amount of credit default swaps (not distinguishing between credit default swaps that fall within the “security-based swap” definition and those that are “swaps”). See National Association of Insurance Commissioners, “Insights into the Insurance Industry’s Derivatives Exposure” (available at http://www.naic.org/capital_markets_archive/110610.htm) (stating that life insurers had entered into roughly \$27.1 billion of that amount, and that property and casualty insurers had entered into roughly \$6.4 billion of that amount). Even if those positions were concentrated within single entity, they would not necessarily lead that entity to exceed the thresholds that could cause it to be a major participant, see note 914, *supra*, suggesting that, given the likely distribution of these positions across a significant number of insurers, few or no insurers may have exposures that approach the thresholds.

In adopting this rule we have considered the alternative, suggested by some commenters, of permitting persons to more broadly take advantage of limited major participant designations.¹⁵⁵⁸ Our decision to use this presumption takes into account the difficulty of separating a major participant's positions taken under its limited purpose designation from other of its positions for purposes of compliance, and the challenges of applying major participant regulatory requirements to only a portion of the entity's security-based swap activities. The presumption further reflects the statutory definition's discretionary language in connection with the potential for limited designations, and the need for persons subject to limited designations to be able to comply with the statutory and regulatory requirements applicable to major participants.¹⁵⁵⁹

Certain persons who satisfy the major participant definition may incur costs in determining whether to seek a limited designation. Consistent with the discussion above, in

¹⁵⁵⁸ Such an approach may be expected to lower the cumulative costs that major participants would incur in determining whether to seek a limited designation. For example, a default presumption in favor of the availability of limited designations may be expected to reduce the costs that certain entities would incur to determine that they could take advantage of limited designation relief, and thus reduce the costs associated with an entity determining whether it qualifies for such relief, such as the costs of hiring outside legal counsel to undertake this analysis to determine that they could take advantage a limited designation relief. A default presumption in favor of limited designations also would be expected to reduce costs in connection with the registration process for entities seeking limited designation status, as discussed above. See part VIII.A.2.d.ii.A, supra.

¹⁵⁵⁹ See part IV.N.3, supra (discussing limited designation principles applicable to major participants). We note that the discussion of limited designation of "swap dealers" under the CEA generally seeks to quantify the costs associated with applications for limited designations. However, we believe that the costs of applying for a limited designation are dependent upon the application process for this type of registration category. As noted previously, the SEC expects to address the limited designation application process for major security-based swap participants in separate rulemakings. See id. As such, we believe that the costs associated with major security-based swap participant limited designation applications under the Exchange Act are more appropriately addressed in the context of that separate rulemaking.

general we believe that such costs would affect no more than 12 entities.¹⁵⁶⁰ These costs could, however, vary significantly depending on the structure or other characteristics of an entity's business.

E. Exclusion of inter-affiliate security-based swaps

Exchange Act rule 3a67-3 provides that security-based swap transactions between majority-owned affiliates will be excluded for purposes of the substantial position test.¹⁵⁶¹ We have concluded that majority ownership represents an alignment of interests appropriate to justify an inter-affiliate exclusion.¹⁵⁶² Moreover, we note that a majority-ownership test should, given its objective nature, impose fewer assessment costs on market participants than a more subjective common control test.

Some market entities may incur costs in connection with determining whether particular security-based swap positions may be excluded from the major participant analysis by virtue of the inter-affiliate exclusion. It is possible that such costs could be incurred by any of the approximately 12 entities that we believe reasonably may have to engage in the major participant calculations.¹⁵⁶³ We believe that any costs arising out of such an analysis would be encompassed within the \$30,000 estimated for legal services related to the major participant definition as a whole.

F. Timing requirements, reevaluation period and termination of status

¹⁵⁶⁰ See note 1529, *supra*.

¹⁵⁶¹ This exclusion also applies to the "substantial counterparty exposure" analysis.

¹⁵⁶² See part IV.G.2, *supra* (discussing rationale for the approach we are adopting, and considering alternative approaches).

¹⁵⁶³ The data underlying this assessment already excludes certain inter-affiliate credit default swaps.

Exchange Act rule 3a67-8 specifies the time at which an entity that satisfies the major participant tests would be deemed to be a “major security-based swap participant,” and also addresses the time at which an entity’s status as a major security-based swap participant would be terminated. In adopting this rule we have considered alternatives that would lead to slower entry and faster exit from major participant status, and we believe that the approach that we are adopting provides a reasonable amount of time for registration based on the proposed registration process, will appropriately help to avoid applying major participant requirements to entities that meet the major participant criteria for only a short time due to unusual activity, and will avoid the prospect of persons moving in and out of major participant status overly frequently.¹⁵⁶⁴

Persons falling within the major participant definitions will incur costs in connection with the registration process,¹⁵⁶⁵ and it is possible that alternative timing approaches could allow such persons to register at a more deliberate pace, potentially reducing the associated costs.¹⁵⁶⁶ Such cost differences may affect the up-to-twelve entities that we believe reasonably may have to engage in the major participant calculations. Moreover, altering the timing requirements may not significantly decrease costs associated with registration because in all cases we would expect the same preparatory actions to be taken, and we believe that the final rules provide sufficient time for entities to perform the activities necessary for compliance.¹⁵⁶⁷

¹⁵⁶⁴ See part IV.L.3, supra (discussing rationale for the final rules addressing timing, reevaluation and termination).

¹⁵⁶⁵ Registration Proposing Release, 76 FR at 65814-65818.

¹⁵⁶⁶ For example, it is possible that an entity may perceive the steps associated with the registration process as requiring it to take additional steps to complete the registration process within the time frame we are adopting, whereas a longer time period could have enabled such an entity to avoid those costs.

¹⁵⁶⁷ Specific costs associated with the registration process will be addressed by the SEC in final rules related to the registration of major security-based swap participants that have not yet been adopted.

4. Consideration of Burden on Competition, and Promotion of Efficiency, Competition and Capital Formation

Section 3(f) of the Exchange Act requires the SEC, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action would promote efficiency, competition, and capital formation.¹⁵⁶⁸ In addition, section 23(a)(2) of the Exchange Act¹⁵⁶⁹ requires the SEC, when adopting rules under the Exchange Act, to consider the impact such rules would have on competition. Section 23(a)(2) of the Exchange Act also prohibits the SEC from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

We are adopting these rules and interpretive guidance pursuant to authority under section 712(d) of the Dodd-Frank Act, which requires the Commissions to further define several terms, including “security-based swap dealer” and “major security-based swap participant.”¹⁵⁷⁰ In the Proposing Release, we stated that we preliminarily believed that the proposed Exchange Act rules would not result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, that they would not significantly affect capital formation, and that they would improve efficiency. We requested comment on each of these issues, and

However, we expect any additional costs arising from the timing provisions of this rule to be insignificant.

¹⁵⁶⁸ 15 U.S.C. 78c(f).

¹⁵⁶⁹ 15 U.S.C. 78w(a)(2).

¹⁵⁷⁰ The SEC is also acting pursuant to its rulemaking authority provided by Exchange Act sections 3 and 23(a).

certain commenters raised concerns that overbroad definitions would lead to undue competitive impacts.¹⁵⁷¹

In adopting these final rules, we recognize that the most significant impact of the dealer and major participant definitions will derive from those definitions' role in implementing Title VII, particularly given the significant impacts that Title VII will have on the security-based swap market. Many of these impacts may be expected to be positive, because Title VII imposes, among other measures, requirements that may be expected to promote safety and soundness, transparency, and competition within the security-based swap market. We recognize, however, that regulation also can pose costs that have negative impacts on the markets.

In adopting these definitional rules and interpretations, moreover, we have sought to fairly reflect the statutory definitions and their underlying intent. Given the link between these definitional rules and interpretations and the Title VII framework, the scope of the definitions will affect the ultimate regulatory benefits and costs that will accompany the full implementation of Title VII. Definitions that capture more entities will tend to promote the Title VII benefits, but will also risk increasing the accompanying costs. Definitions that capture fewer entities may be expected to lead to the converse result.

a. Competitive impacts

¹⁵⁷¹ See, e.g., letters from Representatives Bachus and Lucas ("Casting an overly-broad net in defining these terms could force some smaller participants to leave the marketplace as a result of increased costs, or eliminate certain types of contracts used for hedging."), SIFMA – Regional Dealers (stating that the proposed *de minimis* exception "is unnecessarily narrow, will discourage smaller dealers from competing in the market and will limit the availability of efficient and cost-effective intermediation services to small- and medium-sized organizations") and Midsize Banks (stating that a reduction in small dealers due to an overly narrow *de minimis* exception would "curtail economic development going forward and would leave end-users less options for hedging risks with community and smaller regional dealers").

As noted above, the SEC is required to consider the effect of these rules and interpretations on competition. The SEC also is prohibited from adopting any rule that would impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. Because these definitional rules and interpretations will help determine which entities within the market are subject to the Title VII requirements that govern dealers and major participants, they may also affect competition within the security-based swap market.

In enacting Title VII, Congress set forth a regulatory framework for OTC derivatives; security-based swaps represent one segment of the overall OTC derivatives market. Within the security-based swap market, dealers compete for business from counterparties, while non-dealers that participate in the market use security-based swaps for purposes that can include speculation and hedging. To date, security-based swaps primarily have traded in the over-the-counter market, and have not been subject to comprehensive regulation in the U.S. We understand that entities engaged in dealing activity within this market facilitate the vast majority of security-based swap transactions.¹⁵⁷² Dealing activity within the market also is highly concentrated.¹⁵⁷³

¹⁵⁷² Data from the credit default swap trade information warehouse operated by DTCC indicates that as of the week ending October 7, 2011, single-name credit default swaps involving two counterparties that are not dealers (as identified by DTCC) constitutes roughly 0.2 percent of the notional amount of all open positions involving single-name credit default swaps (amounting to \$24.6 billion gross notional out of a total of \$15.2 trillion gross notional). Conversely, single-name credit default swaps involving two dealers (as identified by DTCC) constitute roughly 74.2 percent of the total notional amount (amounting to \$11.3 trillion gross notional out of the \$15.2 trillion total). See <http://www.dtcc.com/products/derivserv/data/index.php> (as of October 7, 2011). We have no reason to believe that the market for other types of security-based swaps exhibits different amounts of concentration with regard to dealer activity.

¹⁵⁷³ As discussed above in the context of the de minimis exception to the security-based swap dealer definition, analysis of available data shows that, under any metric used to screen for dealers in our CDS Data Analysis, over 90 percent of activity in single-name credit default swaps among entities identified as dealers is attributable to the fourteen or fifteen largest of those entities. We have no reason to believe that

This concentration in large part appears to reflect the fact that larger entities possess competitive advantages in engaging in over-the-counter security-based swap dealing activities, particularly with regard to having sufficient financial resources to provide potential counterparties with adequate assurances of financial performance.¹⁵⁷⁴ As such, it is reasonable to conclude that there are high barriers to entry in connection with security-based swap dealing activity.¹⁵⁷⁵

At the same time, commenters have noted that some entities engage in smaller volumes of security-based swap dealing activity. Some small and mid-size banks, for example, routinely provide such services involving relatively small notional amounts to their customers.¹⁵⁷⁶ Although these relatively smaller dealers in general may not compete directly with the largest dealers (because they service a different segment of the market), they may be expected to play a role in helping certain types of customers (such as customers with a relatively smaller need for security-based swaps) enter into security-based swaps, thus promoting the availability of these products.

Fundamentally, in considering the competitive impacts associated with Title VII regulation of dealers and major participants – and hence the competitive impacts associated with the dealer and major participant definitions – we recognize that one consequence of the current

the concentration of dealing activity involving other types of security-based swaps significantly differs from the concentration of dealers in the single-name credit default swap market.

¹⁵⁷⁴ See Pirrong, note 487, *supra*, at 17-18 (noting that counterparties seek to reduce risk of default by engaging in credit derivative transactions with well capitalized firms).

¹⁵⁷⁵ See *id.*, at 18-19 (noting lack of success among new entrants into derivatives dealing market due to perception that AAA rating for subsidiary is less desirable than a slightly lower rating for a larger entity, and suggesting that there are “economies of scale in bearing default risk” that may induce “substantial concentration in dealer activities”).

¹⁵⁷⁶ See letter from FSR I.

concentrated market structure¹⁵⁷⁷ is the potential for risk spillovers and systemic risk, which can occur when the financial sector as a whole (or certain key segments) becomes undercapitalized. Risk spillovers emerge when losses and financial distress at one firm lead to losses and financial distress for the financial sector as a whole, either through direct counterparty relationships or the deterioration of asset values. As financial distress spreads, the aggregate financial system may become undercapitalized, hindering its ability to provide financial intermediation services. If firms do not internalize this aggregate cost, the financial system may end up holding more risk than its aggregate capital can manage.

In enacting Title VII, Congress set forth a framework that will impose new costs and regulatory burdens, including capital, margin, and registration requirements, on persons who act as security-based swap dealers, and on persons whose security-based swap positions are large enough to cause them to be major security-based swap participants. While the substantive rules associated with capital, margin, and registration requirements have yet to be finalized, we have sought to set the dealer and major participant definitions in such a way as to impose the substantive rules on those entities most likely to contribute to an aggregate capital shortfall without imposing unnecessary burdens on those who do not pose similar risks to the market.¹⁵⁷⁸ It is reasonable to expect that it is the largest security-based swap entities that are more likely to

¹⁵⁷⁷ See, e.g., notes 478 and 485, *supra*, and accompanying text.

¹⁵⁷⁸ We expect that implementation of Title VII will provide both the SEC and market participants with more information about the business of dealers and major participants, the characteristics of positions they and other market participants hold, the structure of the market, and how each of these have changed under the Title VII framework. For that reason the SEC has directed the staff to report to the Commission on all aspects of the dealer and major participant definitions. See part V, *supra*.

contribute to an aggregate capital shortfall than smaller participants, as more risk is likely to be concentrated within these entities.¹⁵⁷⁹

As discussed above, persons who fall within the statutory definitions of security-based swap dealer and major security-based swap participant will incur a range of one-time costs and ongoing costs by virtue of that status.¹⁵⁸⁰ Also, as discussed above, market participants may incur costs in connection with determining whether their security-based swap activities or positions will cause them to be dealers or major participants.¹⁵⁸¹ To the extent the costs associated with these statutorily mandated requirements are relatively fixed or large enough, they may negatively affect competition within the market. This may, for example, lead smaller dealers or entities for whom dealing is not a core business to exit the market, which could cause smaller customers to have less access to the market or to incur higher costs in accessing the market. Such costs might also deter the entry of new firms into the market. If sufficiently high, these costs of compliance may increase concentration among dealers. We also recognize that some market participants may be expected to incur costs in connection with determining their status as a dealer or major participant, but such costs can be expected to be significantly less than the costs associated with the various rules applicable to dealers or major participants.

¹⁵⁷⁹ See Acharya, Pedersen, Philippon, and Richardson, Measuring Systemic Risk (May 2010) (available at <http://vlab.stern.nyu.edu/public/static/SR-v3.pdf>) (working paper that derives an empirical measure of a financial entity's expected contribution to an aggregate capital shortfall that scales with the size of the institution, and that shows using historical data that their measure predicted the risks that emerged during the recent financial crisis).

¹⁵⁸⁰ As discussed above, for example, security-based swap dealers and major security-based swap participants will have to meet minimum capital and margin requirements, maintain specified business and transaction records and adhere to certain standards of business conduct, along with other obligations. See, e.g., notes 178 to 180, *supra*.

¹⁵⁸¹ See part VIII.A.3, *supra*.

Conversely, certain aspects of Title VII may enhance competition in the market. For example, the business conduct and other requirements of Title VII may enhance the availability of information to market participants. Measures designed to equalize access to information through disclosure requirements should promote participation, which may intensify price competition among dealers, and thus may increase participation in the security-based swap market. Other aspects of Title VII, such as rules promoting access of dealers to central clearing facilities, also may be expected to enhance competition in the market.

i. Security-based swap dealer definition

Persons who are deemed to be dealers may be expected to incur costs in connection with the substantive rules applicable to dealers, and to incur comparatively smaller costs in connection with determining whether they fall within the dealer definition. We cannot rule out the possibility that the prospects of these aggregate costs might deter new entrants from engaging in security-based swap activity that potentially could lead them to be dealers.¹⁵⁸² We also cannot rule out the possibility that the imposition of those costs could lead some persons who currently engage in dealing activity involving security-based swaps to lessen or cease that activity. Those effects – if they were to occur – would be expected to reduce competition in the market.

Conversely, the application of the Title VII requirements applicable to dealers, such as, for example, the business conduct requirements related to disclosures to counterparties, may be expected to enhance the availability of information to market participants. The resulting

¹⁵⁸² We do think it unlikely that the costs associated with determining an entity's status, considered on their own, would have any measurable effect on competition. As noted above, we estimate that the cost of making this determination to be \$30,000 at most, and likely significantly less for most entities. See note 1537, *supra*. In other words, the costs would amount to, at most, 0.1 percent of the de minimis threshold, and it is likely that few firms would feel compelled to conduct this analysis until their dealing volume approached the de minimis threshold.

reduction in information asymmetries may be expected to promote participation, and therefore competition, in the market. Accordingly, the scope of the rules and interpretations defining security-based swap dealer, including the scope of the de minimis exception to the dealer definition, can be expected to affect competition in the market in a variety of ways.¹⁵⁸³

As discussed above, in rule 3a71-1 we have codified the statutory definition of security-based swap dealer and provided guidance to interpret the contours of this definition in the context of the dealer-trader distinction. After considering commenters' views, we believe that this guidance interprets the statute to give effect to the four dealer tests and the "regular business" exclusion in a way that reflects the features of the security-based swap market. This use of the dealer-trader distinction – which parallels the analysis that securities market participants currently use in the context of the Exchange Act's "dealer" definition – also should help reduce the potential competitive effects associated with the costs that market participants incur to analyze their possible status as a dealer by imposing fewer costs than a more novel approach.¹⁵⁸⁴

Moreover, as discussed above, in rule 3a71-2 we have adopted a de minimis test and thresholds that will impose the costs associated with dealer regulation upon entities that engage

¹⁵⁸³ At the same time, it is possible that these additional costs associated with dealer regulation will be comparatively small compared to the existing barriers to entry in the market (particularly the need for resources to provide counterparties with sufficient assurance of performance). Cf. Pirrong, note 487, *supra*, at 18-19 (noting that firms with smaller balance sheets, relative to largest dealers, "have largely failed to make major inroads as derivatives dealers despite concerted efforts to do so"). It thus is possible the incremental costs associated with dealer regulation may not be of the magnitude to cause persons who currently engage in security-based swap dealing activity to exit the market.

¹⁵⁸⁴ As noted above, we have declined to adopt per se exclusions or overly simple tests, even though they might impose fewer assessment costs on market participants conducting the dealer analysis because we do not believe that such exclusions or tests would capture the full range of entities that should be regulated as dealers under Title VII. Moreover, the nature of the tests being adopted are straightforward to implement and rely on information that already should be readily available to market participants.

in the bulk of dealing activity in the market, without imposing those costs upon persons who account for a small portion of dealing activity (and for which dealer regulation may be accompanied by comparatively modest benefits). We believe this will mitigate some of the potential competitive burdens associated with dealer status that could fall on entities engaged in a smaller amount of dealing activity, without leaving an undue amount of dealing activity outside of the ambit of dealer regulation. As discussed in detail above, we believe we have set the threshold in a way that appropriately considers this risk along with the benefits afforded to smaller entities by a higher threshold. Furthermore, after considering commenters' views, we believe that this approach strikes a balance that appropriately will implement the transparency, risk and customer and counterparty protection goals of Title VII. This approach, including the general use of a \$3 billion threshold, also can facilitate the initial entrance of dealers into the market, and permit persons to engage in limited dealing activity that helps smaller entities participate in the market. While we recognize that the lower threshold associated with dealing activity involving "special entities" has the potential to reduce competition to provide dealing services to those entities, we believe that this lower threshold is appropriate to preserve the protections that Title VII affords to those entities.

In rule 3a71-1, we also have set forth a presumption that a person that acts as a dealer in the security-based swap market will be a dealer with regard to all of its security-based swaps. We recognize that this presumption may have competitive impacts: on the one hand, by imposing regulatory costs on a wider range of activities, certain entities concentrated in discrete security-based swap segments may face higher costs than they might without the presumption; on the other hand, the presumption suggests a single, uniform baseline for competition across dealers. While these impacts may bear out in a number of ways, we believe that the presumption

is appropriate in light of the statutory language and the need to help ensure that security-based swap dealers comply with all applicable legal requirements.

In rule 3a71-1, we also have provided an exclusion from dealer status in connection with security-based swaps involving majority-owned affiliated counterparties. To the extent that the scope of this exclusion may have competitive impacts – such as in connection with dealing activity involving affiliates that are not majority-owned, and that hence cannot take advantage of the exclusion – we believe that the exclusion appropriately applies the Title VII dealer requirements in a way that reflects the economic reality of swaps among affiliates, which generally does not raise the customer protection or market risk concerns addressed by Title VII.

In sum, to the extent that the application of Title VII dealer requirements to certain persons were to pose a net burden on competition in the security-based swap market, we believe those effects would be a necessary or appropriate consequence of implementing the statutory definitions consistent with the purposes of the Title VII amendments to the Exchange Act.

ii. Major security-based swap participant definition

As we discuss above, we have estimated that entities approaching the level of exposure required to be a major participant may incur certain costs in connection with analyzing their status.¹⁵⁸⁵ Given the size of the exposures and notional amounts required to trigger the major participant test (e.g., \$1 billion in daily average current uncollateralized exposure in a major category), we do not believe that these costs of assessment would materially impact the

¹⁵⁸⁵ See text accompanying note 1532, *supra* (estimating assessment costs as roughly \$44,000 in the first year, and \$15,268 in subsequent years).

competitive role played in the security-based swap market by persons who have positions large enough that they potentially may be major participants.

We expect that the programmatic costs associated with the rules applicable to major participants will be more significant. Presumably, a market participant will weigh the costs of complying with the rules against the benefit it expects from maintaining security-based swap positions of a magnitude that would require registration as a major participant, in deciding whether to continue to maintain such positions. We cannot rule out the possibility that the prospect of those costs could deter persons from maintaining security-based swap positions of such a magnitude, and that this may reduce competition in the market.¹⁵⁸⁶

As discussed above, Exchange Act rules 3a67-1 through 3a67-9 and the accompanying interpretations reflect choices that we believe are reasonably designed to satisfy the risk criteria set forth in the major participant definition.¹⁵⁸⁷ In reaching these conclusions we considered commenters' views on a variety of issues, including suggested alternative approaches that would lessen the likelihood of particular entities being deemed to be major participants (e.g., alternative tests, higher thresholds, a broader hedging exclusion, and a higher leverage test). We believe that the choices reflected in the final rules and interpretations are necessary or appropriate in furtherance of the purposes of the Exchange Act and reasonably reflect the criteria set forth by the statutory definition.

¹⁵⁸⁶ The extent of such possible deterrence is mitigated by the fact that major participant status is a prospect only for those persons with very large security-based swap positions.

¹⁵⁸⁷ See part VIII.A.2, *supra*.

b. Efficiency and capital formation

As noted above, in adopting these final rules and interpretations we also are required to consider whether these actions would promote efficiency and capital formation.

In significant part, the effect of these rules on efficiency and capital formation are linked to the effect of these rules on competition. For example, markets that are competitive, with fair and transparent pricing and equal access to security-based swaps, may be expected to promote the efficient allocation of capital. Similarly, definitional rules that promote, or do not unduly restrict, competition can be accompanied by regulatory benefits that minimize the risk of market failure and thus promote efficiency within the market. Such competitive markets would increase the efficiency by which market participants could transact in security-based swaps for speculative, trading, hedging and other purposes.

Definitional rules and interpretations of an appropriate scope also can be expected to promote capital formation by facilitating the appropriate use of security-based swaps for hedging purposes, and thus by contributing to liquidity and reducing costs in connection with the issuance of equity and debt securities. In the context of credit default swaps based on loans, moreover, definitional rules and interpretations of an appropriate scope can be expected to promote capital formation by facilitating loans to businesses that may not otherwise be made absent such a swap. Since credit risk is correlated, lenders may find it desirable to hedge credit risks on their loan portfolios by purchasing protection through single-name or index credit default swaps. Even though there is basis risk in this type of trade, it should be particularly effective at reducing exposure to systemic credit events. More generally, security-based swaps can be expected to promote risk transfer to persons better positioned and more willing to bear certain risks (e.g., the transfer of risks from hedgers to speculators).

Conversely, definitional rules that are accompanied by too many competitive burdens pose the risk of imposing excessive costs of regulation that could deter the efficient allocation of capital to security-based swaps. Such rules also may be expected to reduce the capital formation benefits that otherwise would be associated with security-based swaps. Definitional rules of an inappropriate scope further may reduce the availability of security-based swaps and thus direct market participants not to seek to address certain business needs, or to use less effective financial instruments to meet their business needs. For example, major participant thresholds that broadly capture much of the security-based swap market would discourage certain entities from participating in the market, particularly if the regulatory costs for major participants are high. This could make it difficult for hedgers to find a counterparty, which would make it more expensive to hedge risks and hinder efficient risk-sharing in the broader economy. In addition, definitional rules that pose the risk of creating a market that contains an undue amount of unregulated dealing activity – as may be the result of a de minimis threshold that is too high – would lead to disparate treatment of dealers and could undermine the benefits of Title VII.

The rules and interpretations that we are adopting in connection with the dealer and major participant definitions are designed to apply the statutory definitions in a way that reasonably effects the goals of Title VII. For example, the rule implementing the de minimis exception to the dealer definition is designed to focus the application of the dealer definition in a way that implements the benefits associated with the regulation of security-based swap dealers under Title VII, without imposing the costs associated with those regulations on those entities responsible for only a small portion of total dealing activity. In addition, the rules and interpretations in connection with the major participant definition are geared to focus major participant regulation

on entities whose security-based swap positions pose a particularly high degree of credit risk to the market, without applying those regulations on persons who pose a lesser degree of risk.

In conclusion, we believe that the rules and interpretations may be expected to promote efficiency in the allocation of capital to security-based swaps, and to promote the capital formation benefits of security-based swaps, by helping to focus the costs and burdens of the regulation of dealers and major participants under Title VII upon those persons for whom the imposition of those costs are most appropriate given their overall activity and positions in the security-based swap market. The rules and interpretations similarly may be expected to apply certain Title VII requirements (e.g., counterparty disclosure requirements that can be expected to reduce information asymmetries) to those entities that engage in activities or maintain positions in the security-based swap market such that their compliance with these requirements may promote the efficiency and capital allocation benefits associated with such regulation.

B. Paperwork Reduction Act Analysis

The Proposing Release addressed a potential new “collection of information” requirement, within the meaning of the Paperwork Reduction Act of 1995,¹⁵⁸⁸ because the proposed definition of the term “hedging or mitigating commercial risk” included documentation and assessment conditions.

As discussed above, final rule defining “hedging or mitigating commercial risk” does not contain those proposed documentation and assessment conditions. Accordingly, the Paperwork Reduction Act does not apply to these definitions.¹⁵⁸⁹

¹⁵⁸⁸ 44 U.S.C. 3501.

¹⁵⁸⁹ Consistent with the discussion above, we recognize that the substantive rules applicable to dealers and major participants may contain collections of information, and that these definitions will affect which

C. Regulatory Flexibility Act Certification

The Regulatory Flexibility Act ("RFA")¹⁵⁹⁰ requires Federal agencies, in promulgating rules, to consider the impact of those rules on small entities. Section 603(a)¹⁵⁹¹ of the Administrative Procedure Act,¹⁵⁹² as amended by the RFA, generally requires the SEC to undertake a regulatory flexibility analysis of all proposed rules, or proposed rule amendments, to determine the impact of such rulemaking on "small entities."¹⁵⁹³ Section 605(b) of the RFA provides that this requirement shall not apply to any proposed rule or proposed rule amendment, which if adopted, would not have a significant economic impact on a substantial number of small entities.¹⁵⁹⁴

For purposes of SEC rulemaking in connection with the RFA, a small entity includes: (i) when used with reference to an "issuer" or a "person," other than an investment company, an "issuer" or "person" that, on the last day of its most recent fiscal year, had total assets of \$5 million or less,¹⁵⁹⁵ or (ii) a broker-dealer with total capital (net worth plus subordinated liabilities) of less than \$500,000 on the date in the prior fiscal year as of which its audited

entities are subject to those collections of information. We believe that these Paperwork Reduction Act issues are more appropriately addressed in connection with the substantive rules applicable to dealers and major participants.

¹⁵⁹⁰ 5 U.S.C. 601 *et seq.*

¹⁵⁹¹ 5 U.S.C. 603(a).

¹⁵⁹² 5 U.S.C. 551 *et seq.*

¹⁵⁹³ Although Section 601(b) of the RFA defines the term "small entity," the statute permits the Commissions to formulate their own definitions. The SEC has adopted definitions for the term small entity for the purposes of SEC rulemaking in accordance with the RFA. Those definitions, as relevant to this proposed rulemaking, are set forth in Rule 0-10, 17 CFR 240.0-10. See Securities Exchange Act Release No. 18451 (Jan. 28, 1982), 47 FR 5215 (Feb. 4, 1982) (File No. AS-305).

¹⁵⁹⁴ See 5 U.S.C. 605(b).

¹⁵⁹⁵ See 17 CFR 240.0-10(a).

financial statements were prepared pursuant to Rule 17a-5(d) under the Exchange Act,¹⁵⁹⁶ or, if not required to file such statements, a broker-dealer with total capital (net worth plus subordinated liabilities) of less than \$500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and is not affiliated with any person (other than a natural person) that is not a small business or small organization.¹⁵⁹⁷ Under the standards adopted by the Small Business Administration, small entities in the finance and insurance industry include the following: (i) for entities engaged in credit intermediation and related activities, entities with \$175 million or less in assets;¹⁵⁹⁸ (ii) for entities engaged in non-depository credit intermediation and certain other activities, entities with \$7 million or less in annual receipts;¹⁵⁹⁹ (iii) for entities engaged in financial investments and related activities, entities with \$7 million or less in annual receipts;¹⁶⁰⁰ (iv) for insurance carriers and entities engaged in related activities, entities with \$7 million or less in annual receipts;¹⁶⁰¹ and (v) for funds, trusts, and other financial vehicles, entities with \$7 million or less in annual receipts.¹⁶⁰²

The Proposing Release stated that based on feedback from industry participants about the security-based swap markets, the SEC preliminarily believes that any entities that would qualify as security-based swap dealers and major security-based swap market participants would exceed the thresholds defining “small entities,” and that the SEC believes it is unlikely that the proposed

¹⁵⁹⁶ See 17 CFR 240.17a-5(d).

¹⁵⁹⁷ See 17 CFR 240.0-10(c).

¹⁵⁹⁸ See 13 CFR 121.201 (Subsector 522).

¹⁵⁹⁹ See *id.* at Subsector 522.

¹⁶⁰⁰ See *id.* at Subsector 523.

¹⁶⁰¹ See *id.* at Subsector 524.

¹⁶⁰² See *id.* at Subsector 525.

rules would have a significant economic impact any small entity. As a result, the SEC certified that the proposed rules would not have a significant economic impact on a substantial number of small entities for purposes of the RFA, and requested written comments regarding this certification.¹⁶⁰³

While we received comment letters that addressed cost issues in connection with the proposed rules, we did not receive any comments that specifically addressed whether the rules defining “security-based swap dealer” or “major security-based swap participant” would have a significant economic impact on small entities.

The SEC continues to believe that the types of entities that would engage in more than a de minimis amount of dealing activity involving security-based swaps – which generally would be major banks – would not be “small entities” for purposes of the RFA. Similarly, the SEC continues to believe that the types of entities that may have security-based swap positions above the level required to be a “major security-based swap participant” would not be a “small entity” for purposes of the RFA. Accordingly, the SEC certifies that the final rules defining “security-based swap dealer” or “major security-based swap participant” would not have a significant economic impact on a substantial number of small entities for purposes of the RFA.

IX. Statutory Basis and Text of the Amendments

List of Subjects in 17 CFR Part 1

Definitions

Commodity Futures Trading Commission

Text of Rules

¹⁶⁰³

See Proposing Release, 75 FR at 80211.

For the reasons stated in the preamble, the CFTC is adopting the amendments to 17 CFR part 1 as follows:

PART 1—GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE
ACT

1. The authority citation for part 1 is revised to read as follows:

Authority: 7 U.S.C. 1a, 2, 5, 6, 6a, 6b, 6c, 6d, 6e, 6f, 6g, 6h, 6i, 6j, 6k, 6l, 6m, 6n, 6o, 6p, 7, 7a, 7b, 8, 9, 12, 12a, 12c, 13a, 13a-1, 16, 16a, 19, 21, 23, and 24, as amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

2. Amend §1.3 to revise paragraph (m) to read as follows:

§ 1.3 Definitions

* * * * *

(m) Eligible contract participant. This term has the meaning set forth in Section 1a(18) of the Act, except that:

- (1) A major swap participant, as defined in Section 1a(33) of the Act and § 1.3(hhh), is an eligible contract participant;
- (2) A swap dealer, as defined in Section 1a(49) of the Act and § 1.3(ggg), is an eligible contract participant;
- (3) A major security-based swap participant, as defined in Section 3(a)(67) of the Securities Exchange Act of 1934 and § 240.3a67-1 of this title, is an eligible contract participant;
- (4) A security-based swap dealer, as defined in Section 3(a)(71) of the Securities Exchange Act of 1934 and § 240.3a71-1 of this title, is an eligible contract participant;

(5) (i) A transaction-level commodity pool with one or more direct participants that is not an eligible contract participant is not itself an eligible contract participant under either Section 1a(18)(A)(iv) or Section 1a(18)(A)(v) of the Act for purposes of entering into transactions described in Sections 2(c)(2)(B)(vi) and 2(c)(2)(C)(vii) of the Act; and

(ii) In determining whether a commodity pool that is a direct participant in a transaction-level commodity pool is an eligible contract participant for purposes of paragraph (i), the participants in the commodity pool that is a direct participant in the transaction-level commodity pool shall not be considered unless the transaction-level commodity pool, any commodity pool holding a direct or indirect interest in such transaction-level commodity pool, or any commodity pool in which such transaction-level commodity pool holds a direct or indirect interest, has been structured to evade subtitle A of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act by permitting persons that are not eligible contract participants to participate in agreements, contracts, or transactions described in Section 2(c)(2)(B)(i) or Section 2(c)(2)(C)(i) of the Act;

(6) A commodity pool that does not have total assets exceeding \$5,000,000 or that is not operated by a person described in subclause (A)(iv)(II) of Section 1a(18) of the Act is not an eligible contract participant pursuant to clause (A)(v) of such Section;

(7)(i) For purposes of a swap (but not a security-based swap, security-based swap agreement or mixed swap) used to hedge or mitigate commercial risk, an entity may, in determining its net worth for purposes of Section 1a(18)(A)(v)(III) of the Act, include the net worth of any owner of such entity, provided that all the owners of such entity are eligible contract participants;

(ii)(A) For purposes of identifying the owners of an entity under §1.3(m)(7)(i), any person holding a direct ownership interest in such entity shall be considered to be an owner of such

entity; provided, however, that any shell company shall be disregarded, and the owners of such shell company shall be considered to be the owners of any entity owned by such shell company;

(B) For purposes of § 1.3(m)(7)(ii)(A), the term shell company means any entity that limits its holdings to direct or indirect interests in entities that are relying on § 1.3(m)(7); and

(C) In determining whether an owner of an entity is an eligible contract participant for purposes of § 1.3(m)(7)(i), an individual may be considered to be a proprietorship eligible contract participant only if the individual (I) has an active role in operating a business other than an entity, (II) directly owns all of the assets of the business, (III) directly is responsible for all of the liabilities of the business and (IV) acquires its interest in the entity seeking to qualify as an eligible contract participant under § 1.3(m)(7)(i) in connection with the operation of the individual's proprietorship or to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by the individual in the operation of the individual's proprietorship; and

(iii) For purposes of § 1.3(m)(7)(i), a swap is used to hedge or mitigate commercial risk if the swap complies with the conditions in § 1.3(kkk); and

(8) Notwithstanding Section 1a(18)(A)(iv) of the Act and § 1.3(m)(5), a commodity pool that enters into an agreement, contract, or transaction described in Section 2(c)(2)(B)(i) or Section 2(c)(2)(C)(i)(I) of the Act is an eligible contract participant with respect to such agreement, contract, or transaction, regardless of whether each participant in such commodity pool is an eligible contract participant, if all of the following conditions are satisfied:

- (i) the commodity pool is not formed for the purpose of evading regulation under Section 2(c)(2)(B) or Section 2(c)(2)(C) of the Act or related Commission rules, regulations or orders;
- (ii) the commodity pool has total assets exceeding \$10,000,000; and

(iii) the commodity pool is formed and operated by a registered commodity pool operator or by a commodity pool operator who is exempt from registration as such pursuant to § 4.13(a)(3).

* * * * *

3. Amend § 1.3 to add paragraphs (ggg) to (mmm) to read as follows:

§ 1.3 Definitions

* * * * *

(ggg) Swap Dealer. (1) In general. The term swap dealer means any person who:

(i) Holds itself out as a dealer in swaps;

(ii) Makes a market in swaps;

(iii) Regularly enters into swaps with counterparties as an ordinary course of business for its own account; or

(iv) Engages in any activity causing it to be commonly known in the trade as a dealer or market maker in swaps.

(2) Exception. The term swap dealer does not include a person that enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of regular business.

(3) Scope of designation. A person who is a swap dealer shall be deemed to be a swap dealer with respect to each swap it enters into, regardless of the category of the swap or the person's activities in connection with the swap. However, if a person makes an application to limit its designation as a swap dealer to specified categories of swaps or specified activities of the person in connection with swaps, the Commission shall determine whether the person's designation as a swap dealer shall be so limited. If the Commission grants such limited designation, such limited designation swap dealer shall be deemed to be a swap dealer with respect to each swap it enters

into in the swap category or categories for which it is so designated, regardless of the person's activities in connection with such category or categories of swaps. A person may make such application to limit the categories of swaps or activities of the person that are subject to its swap dealer designation at the same time as, or after, the person's initial registration as a swap dealer.

(4) De minimis exception. (i) Except as provided in paragraph (vi), a person that is not currently registered as a swap dealer shall be deemed not to be a swap dealer as a result of its swap dealing activity involving counterparties, so long as the swap positions connected with those dealing activities into which the person – or any other entity controlling, controlled by or under common control with the person – enters over the course of the immediately preceding 12 months (or following the effective date of final rules implementing Section 1a(47) of the Act, 7 U.S.C. 1a(47), if that period is less than 12 months) have an aggregate gross notional amount of no more than \$3 billion, subject to a phase in level of an aggregate gross notional amount of no more than \$8 billion applied in accordance with paragraph (ii), and an aggregate gross notional amount of no more than \$25 million with regard to swaps in which the counterparty is a “special entity” (as that term is defined in Section 4s(h)(2)(C) of the Act, 7 U.S.C. 6s(h)(2)(C), and § 23.401(c) of this chapter). For purposes of this paragraph, if the stated notional amount of a swap is leveraged or enhanced by the structure of the swap, the calculation shall be based on the effective notional amount of the swap rather than on the stated notional amount.

(ii) Phase-in procedure and staff report.

(A) Phase-in period. For purposes of paragraph (i), except as provided in paragraph (vi), a person that engages in swap dealing activity that does not exceed the phase-in level set forth in paragraph (i) shall be deemed not to be a swap dealer as a result of its swap dealing activity until the “phase-in termination date” established as provided in paragraph (ii)(C) or (ii)(D) below.

The Commission shall announce the phase-in termination date on the Commission website and publish such date in the Federal Register.

(B) Staff report. No later than 30 months following the date that a swap data repository first receives swap data in accordance with part 45 of this chapter, the staff of the Commission shall complete and publish for public comment a report on topics relating to the definition of the term "swap dealer" and the de minimis threshold. The report should address the following topics, as appropriate, based on the availability of data and information: the potential impact of modifying the de minimis threshold, and whether the de minimis threshold should be increased or decreased; the factors that are useful for identifying swap dealing activity, including the application of the dealer-trader distinction for that purpose, and the potential use of objective tests or safe harbors as part of the analysis; the impact of provisions in §§1.3(ggg)(5) and (6) excluding certain swaps from the dealer analysis, and potential alternative approaches for such exclusions; and any other analysis of swap data and information relating to swaps that the Commission or staff deem relevant to this rule.

(C) Nine months after publication of the report required by paragraph (ii)(B), and after giving due consideration to that report and any associated public comment, the Commission may either:

(1) Terminate the phase-in period set forth in paragraph (ii)(A), in which case the phase-in termination date shall be established by the Commission by order published in the Federal Register; or

(2) Determine that it is necessary or appropriate in the public interest to propose through rulemaking an alternative to the \$3 billion amount set forth in paragraph (i) that would constitute a de minimis quantity of swap dealing in connection with transactions with or on behalf of customers within the meaning of section 1(a)(47)(D) of the Act, 7 U.S.C. 1(a)(47)(D), in which

case the Commission shall by order published in the Federal Register provide notice of such determination, which order shall also establish the phase-in termination date.

(D) If the phase-in termination date has not been previously established pursuant to paragraph (ii)(C), then in any event the phase-in termination date shall occur five years after the date that a swap repository first receives swap data in accordance with part 45 of this chapter.

(iii) Registration period for persons that can no longer take advantage of the exception. A person that has not registered as a swap dealer by virtue of satisfying the requirements of this § 1.3(ggg)(4), but that no longer can take advantage of that de minimis exception, will be deemed not to be a swap dealer until the earlier of the date on which it submits a complete application for registration pursuant to Section 4s(b) of the Act, 7 U.S.C. 6s(b), or two months after the end of the month in which that person becomes no longer able to take advantage of the exception.

(iv) Applicability to registered swap dealers. A person who currently is registered as a swap dealer may apply to withdraw that registration, while continuing to engage in swap dealing activity in reliance on this section, so long as that person has been registered as a swap dealer for at least 12 months and satisfies the conditions of § 1.3(ggg)(4)(i).

(v) Future adjustments to scope of the de minimis exception. The Commission may by rule or regulation change the requirements of the de minimis exception described in § 1.3(ggg)(4)(i)-(iv).

(vi) Voluntary registration. Notwithstanding paragraph (i), a person that chooses to register with the Commission as a swap dealer shall be deemed to be a swap dealer.

(5) Insured depository institution swaps in connection with originating loans to customers. Swaps entered into by an insured depository institution with a customer in connection with originating a loan with that customer shall not be considered in determining whether the insured

depository institution is a swap dealer.

(i) An insured depository institution shall be considered to have entered into a swap with a customer in connection with originating a loan, as defined in paragraphs (ii) and (iii), with that customer only if:

(A) The insured depository institution enters into the swap with the customer no earlier than 90 days before and no later than 180 days after the date of execution of the applicable loan agreement, or no earlier than 90 days before and no later than 180 days after any transfer of principal to the customer by the insured depository institution pursuant to the loan;

(B)(1) The rate, asset, liability or other notional item underlying such swap is, or is directly related to, a financial term of such loan, which includes, without limitation, the loan's duration, rate of interest, the currency or currencies in which it is made and its principal amount;

(2) Such swap is required, as a condition of the loan under the insured depository institution's loan underwriting criteria, to be in place in order to hedge price risks incidental to the borrower's business and arising from potential changes in the price of a commodity (other than an excluded commodity);

(C) The duration of the swap does not extend beyond termination of the loan;

(D) The insured depository institution is:

(1) The sole source of funds to the customer under the loan;

(2) Committed to be, under the terms of the agreements related to the loan, the source of at least 10 percent of the maximum principal amount under the loan; or

(3) Committed to be, under the terms of the agreements related to the loan, the source of a principal amount that is greater than or equal to the aggregate notional amount of all swaps

entered into by the insured depository institution with the customer in connection with the financial terms of the loan;

(E) The aggregate notional amount of all swaps entered into by the customer in connection with the financial terms of the loan is, at any time, not more than the aggregate principal amount outstanding under the loan at that time; and

(F) If the swap is not accepted for clearing by a derivatives clearing organization, the insured depository institution reports the swap as required by section 4r of the Act (except as otherwise provided in section 4r(a)(3)(A) or section 4r(a)(3)(B) of the Act).

(ii) An insured depository institution shall be considered to have originated a loan with a customer if the insured depository institution:

(A) Directly transfers the loan amount to the customer;

(B) Is a part of a syndicate of lenders that is the source of the loan amount that is transferred to the customer;

(C) Purchases or receives a participation in the loan; or

(D) Otherwise is the source of funds that are transferred to the customer pursuant to the loan or any refinancing of the loan.

(iii) The term loan shall not include:

(A) Any transaction that is a sham, whether or not intended to qualify for the exclusion from the definition of the term swap dealer in this rule; or

(B) Any synthetic loan, including, without limitation, a loan credit default swap or loan total return swap.

(6) Swaps that are not considered in determining whether a person is a swap dealer.

(i) Inter-affiliate activities. In determining whether a person is a swap dealer, that person's

swaps with majority-owned affiliates shall not be considered. For these purposes the counterparties to a swap are majority-owned affiliates if one counterparty directly or indirectly owns a majority interest in the other, or if a third party directly or indirectly owns a majority interest in both counterparties to the swap, where "majority interest" is the right to vote or direct the vote of a majority of a class of voting securities of an entity, the power to sell or direct the sale of a majority of a class of voting securities of an entity, or the right to receive upon dissolution or the contribution of a majority of the capital of a partnership.

(ii) Activities of a cooperative. (A) Any swap that is entered into by a cooperative with a member of such cooperative shall not be considered in determining whether the cooperative is a swap dealer, provided that (1) the swap is subject to policies and procedures of the cooperative requiring that the cooperative monitors and manages the risk of such swap, (2) the cooperative reports the swap as required by Section 4r of the Act, 7 U.S.C. 6r (except as otherwise provided in Section 4r(a)(3)(A) of the Act, 7 U.S.C. 6r (a)(3)(A) or Section 4r(a)(3)(B) of the Act, 7 U.S.C. 6r (a)(3)(B)) and (3) if the cooperative is a cooperative association of producers, the swap is primarily based on a commodity that is not an excluded commodity.

(B) For purposes of this § 1.3(ggg)(6)(ii), the term cooperative shall mean:

(1) a cooperative association of producers as defined in section 1a(14) of the Act, 7 U.S.C. 1a(14), or

(2) a person chartered under Federal law as a cooperative and predominantly engaged in activities that are financial in nature as defined in section 4(k) of the Bank Holding Company Act of 1956.

(C) For purposes of this § 1.3(ggg)(6)(ii), a swap shall be deemed to be entered into by a cooperative association of producers with a member of such cooperative association of producers

when the swap is between a cooperative association of producers and a person that is a member of a cooperative association of producers that is itself a member of the first cooperative association of producers.

(iii) Swaps entered into for the purpose of hedging physical positions. In determining whether a person is a swap dealer, a swap that the person enters into shall not be considered, if:

(A) The person enters into the swap 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 (1) assets that the person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising; (2) liabilities that the person owns or anticipates incurring; or (3) services that the person provides, purchases, or anticipates providing or purchasing;

(B) The swap represents 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;

(C) The swap is economically appropriate to the reduction of the person's risks in the conduct and management of a commercial enterprise;

(D) The swap is entered into in accordance with sound commercial practices; and

(E) The person does not enter into the swap in connection with activity structured to evade designation as a swap dealer.

(iv) Swaps entered into by floor traders. In determining whether a person is a swap dealer, each swap that the person enters into in its capacity as a floor trader as defined by section 1a(23) of the Act or on or subject to the rules of a swap execution facility shall not be considered for the purpose of determining whether the person is a swap dealer if the person:

(A) Is registered with the Commission as a floor trader pursuant to § 3.11 of this chapter;

(B) Enters into swaps with proprietary funds for that trader's own account solely on or subject to the rules of a designated contract market or swap execution facility and submits each such swap for clearing to a derivatives clearing organization;

(C) Is not an affiliated person of a registered swap dealer;

(D) Does not directly, or through an affiliated person, negotiate the terms of swap agreements, other than price and quantity or to participate in a request for quote process subject to the rules of a designated contract market or a swap execution facility;

(E) Does not directly or through an affiliated person offer or provide swap clearing services to third parties;

(F) Does not directly or through an affiliated person enter into swaps that would qualify as hedging physical positions pursuant to § 1.3(ggg)(6)(iii) or hedging or mitigating commercial risk pursuant to § 1.3(kkk) (except for any such swap executed opposite a counterparty for which the transaction would qualify as a bona fide hedging transaction);

(G) Does not participate in any market making program offered by a designated contract market or swap execution facility; and

(H) Notwithstanding the fact such person is not registered as a swap dealer, such person complies with §§ 23.201, 23.202, 23.203, and 23.600 of this chapter with respect to each such swap as if it were a swap dealer.

(hhh) Major Swap Participant. (1) In general. The term major swap participant means any person:

(i) That is not a swap dealer; and

(ii)(A) That maintains a substantial position in swaps for any of the major swap categories, excluding both positions held for hedging or mitigating commercial risk, and positions

maintained by any employee benefit plan (or any contract held by such a plan) as defined in paragraphs (3) and (32) of Section 3 of the Employee Retirement Income Security Act of 1974, 29 U.S.C. 1002, for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;

(B) 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; or

(C) That is a financial entity that:

(1) Is highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking agency (as defined in Section 1a(2) of the Act, 7 U.S.C. 1a(2)); and

(2) Maintains a substantial position in outstanding swaps in any major swap category.

(2) Scope of designation. A person that is a major swap participant shall be deemed to be a major swap participant with respect to each swap it enters into, regardless of the category of the swap or the person's activities in connection with the swap. However, if a person makes an application to limit its designation as a major swap participant to specified categories of swaps, the Commission shall determine whether the person's designation as a major swap participant shall be so limited. If the Commission grants such limited designation, such limited designation major swap participant shall be deemed to be a major swap participant with respect to each swap it enters into in the swap category or categories for which it is so designated, regardless of the person's activities in connection with such category or categories of swaps. A person may make such application to limit its designation at the same time as, or after, the person's initial registration as a major swap participant.

(3) Timing requirements. A person that is not registered as a major swap participant, but that meets the criteria in this rule to be a major swap participant as a result of its swap activities in a fiscal quarter, will not be deemed to be a major swap participant until the earlier of the date on which it submits a complete application for registration as a major swap participant pursuant to Section 4s(a)(2) of the Act, 7 U.S.C. 6s(a)(2), or two months after the end of that quarter.

(4) Reevaluation period. Notwithstanding paragraph (3), if a person that is not registered as a major swap participant meets the criteria in this rule to be a major swap participant in a fiscal quarter, but does not exceed any applicable threshold by more than twenty percent in that quarter:

(i) That person will not be deemed a major swap participant pursuant to the timing requirements specified in paragraph (3); but

(ii) That person will be deemed a major swap participant pursuant to the timing requirements specified in paragraph (3) at the end of the next fiscal quarter if the person exceeds any of the applicable daily average thresholds in that next fiscal quarter.

(5) Termination of status. A person that is deemed to be a major swap participant shall continue to be deemed a major swap participant until such time that its swap activities do not exceed any of the daily average thresholds set forth within this rule for four consecutive fiscal quarters after the date on which the person becomes registered as a major swap participant.

(6) Calculation of status. A person shall not be deemed to be a "major swap participant," regardless of whether the criteria paragraph (hhh)(1) of this part otherwise would cause the person to be a major swap participant, provided the person meets the conditions set forth in paragraphs (6)(i) or 6(ii) or 6(iii) below.

(i) Caps on uncollateralized exposure and notional positions.

(A) Maximum potential uncollateralized exposure. The express terms of the person's agreements or arrangements relating to swaps with its counterparties at no time would permit the person to maintain a total uncollateralized exposure of more than \$100 million to all such counterparties, including any exposure that may result from thresholds or minimum transfer amounts established by credit support annexes or similar arrangements; and

(B) Maximum notional amount of swap positions. The person does not maintain swap positions in a notional amount of more than \$2 billion in any major category of swaps, or more than \$4 billion in the aggregate across all major categories; or

(ii) Caps on uncollateralized exposure plus monthly calculation.

(A) Maximum potential uncollateralized exposure. The express terms of the person's agreements or arrangements relating to swaps with its counterparties at no time would permit the person to maintain a total uncollateralized exposure of more than \$200 million to all such counterparties (with regard to swaps and any other instruments by which the person may have exposure to those counterparties), including any exposure that may result from thresholds or minimum transfer amounts established by credit support annexes or similar arrangements; and

(B) Calculation of positions.

(1) At the end of each month, the person performs the calculations prescribed by §1.3(jjj) of this chapter with regard to whether the aggregate uncollateralized outward exposure plus aggregate potential outward exposure as of that day constitute a "substantial position" in a major category of swaps, or pose "substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets"; these calculations shall disregard provisions of those rules that provide for the analyses to be determined based on a daily average over a calendar quarter; and

(2) Each such analysis produces thresholds of no more than:

(A) \$1 billion in aggregate uncollateralized outward exposure plus aggregate potential outward exposure in any major category of swaps; if the person is subject to §1.3(jjj), by virtue of being a highly leveraged financial entity that is not subject to capital requirements established by an appropriate Federal banking agency, this analysis shall account for all of the person's swap positions in that major category (without excluding hedging positions), otherwise this analysis shall exclude the same hedging and related positions that are excluded from consideration pursuant to §1.3(jjj)(1)(i); or

(B) \$2 billion in aggregate uncollateralized outward exposure plus aggregate potential outward exposure (without any positions excluded from the analysis) with regard to all of the person's swap positions.

(iii) Calculations based on certain information.

(A) (1) At the end of each month, the person's aggregate uncollateralized outward exposure with respect to its swap positions in each major swap category is less than \$1.5 billion with respect to the rate swap category and less than \$500 million with respect to each of the other major swap categories; and

(2) At the end of each month, the sum of the amount calculated under paragraph (A)(1) of this section with respect to each major swap category and the total notional principal amount of the person's swap positions in each such major swap category, adjusted by the multipliers set forth in § 1.3(jjj)(3)(ii)(1) on a position-by-position basis reflecting the type of swap, is less than \$3 billion with respect to the rate swap category and less than \$1 billion with respect to each of the other major swap categories.

(B)(1) At the end of each month, the person's aggregate uncollateralized outward exposure with respect to its swap positions across all major swap categories is less than \$500 million; and

(2) The sum of the amount calculated under paragraph (A)(1) of this section and the product of the total effective notional principal amount of the person's swap positions in all major security-based swap categories multiplied by 0.15 is less than \$1 billion; or

(C) For purposes of the calculations set forth in this paragraph (6)(iii),

(1) The person's aggregate uncollateralized outward exposure for positions held with swap dealers shall be equal to such exposure reported on the most recent reports of such exposure received from such swap dealers; and

(2) The person's aggregate uncollateralized outward exposure for positions that are not reflected in any report of exposure from a swap dealer (including all swap positions it holds with persons other than swap dealers) shall be calculated in accordance with § 1.3(jjj)(2).

(iv) For purposes of the calculations set forth in this paragraph (6), the person shall use the effective notional amount of a position rather than the stated notional amount of the position if the stated notional amount is leveraged or enhanced by the structure of the position.

(v) No presumption shall arise that a person is required to perform the calculations needed to determine if it is a major swap participant, solely by reason that the person does not meet the conditions specified in paragraphs (6)(i) or 6(ii) or 6(iii) of this section.

(7) Exclusions. A person who is registered as a derivatives clearing organization with the Commission pursuant to section 5b of the Act and regulations thereunder, shall not be deemed to be a major swap participant, regardless of whether the criteria in § 1.3(hhh) of this chapter otherwise would cause the person to be a major swap participant.

(iii) Category of swaps; major swap category. For purposes of Section 1a(33) the Act, 7 U.S.C.

1a(33), and § 1.3(hhh), the terms major swap category, category of swaps and any similar terms mean any of the categories of swaps listed below. For the avoidance of doubt, the term swap as it is used in this § 1.3(iii) has the meaning set forth in Section 1a(47) of the Act, 7 U.S.C. 1a(47), and the rules thereunder.

(1) Rate swaps. Any swap which is primarily based on one or more reference rates, including but not limited to any swap of payments determined by fixed and floating interest rates, currency exchange rates, inflation rates or other monetary rates, any foreign exchange swap, as defined in Section 1a(25) of the Act, 7 U.S.C. 1a(25), and any foreign exchange option other than an option to deliver currency.

(2) Credit swaps. Any swap that is primarily based on instruments of indebtedness, including but not limited to any swap primarily based on one or more broad-based indices related to debt instruments or loans, and any swap that is an index credit default swap or total return swap on one or more indices of debt instruments.

(3) Equity swaps. Any swap that is primarily based on equity securities, including but not limited to any swap based on one or more broad-based indices of equity securities and any total return swap on one or more equity indices.

(4) Other commodity swaps. Any swap that is not included in the rate swap, credit swap or equity swap categories.

(jjj) Substantial position. (1) In general. For purposes of Section 1a(33) of the Act, 7 U.S.C. 1a(33), and § 1.3(hhh), the term "substantial position" means swap positions that equal or exceed any of the following thresholds in the specified major category of swaps:

(i) For rate swaps:

(A) \$3 billion in daily average aggregate uncollateralized outward exposure; or

(B) \$6 billion in:

(1) Daily average aggregate uncollateralized outward exposure plus

(2) Daily average aggregate potential outward exposure.

(ii) For credit swaps:

(A) \$1 billion in daily average aggregate uncollateralized outward exposure; or

(B) \$2 billion in:

(1) Daily average aggregate uncollateralized outward exposure plus

(2) Daily average aggregate potential outward exposure.

(iii) For equity swaps:

(A) \$1 billion in daily average aggregate uncollateralized outward exposure; or

(B) \$2 billion in:

(1) Daily average aggregate uncollateralized outward exposure plus

(2) Daily average aggregate potential outward exposure.

(iv) For other commodity swaps:

(A) \$1 billion in daily average aggregate uncollateralized outward exposure; or

(B) \$2 billion in:

(1) Daily average aggregate uncollateralized outward exposure plus

(2) Daily average aggregate potential outward exposure.

(2) Aggregate uncollateralized outward exposure. (i) In general. Aggregate uncollateralized outward exposure in general means the sum of the current exposure, obtained by marking-to-market using industry standard practices, of each of the person's swap positions with negative value in a major swap category, less the value of the collateral the person has posted in connection with those positions.

(ii) Calculation of aggregate uncollateralized outward exposure. In calculating this amount the person shall, with respect to each of its swap counterparties in a given major swap category, (A) determine the dollar value of the aggregate current exposure arising from each of its swap positions with negative value (subject to the netting provisions described below) in that major category by marking-to-market using industry standard practices; and (B) deduct from that dollar amount the aggregate value of the collateral the person has posted with respect to the swap positions. The aggregate uncollateralized outward exposure shall be the sum of those uncollateralized amounts across all of the person's swap counterparties in the applicable major category.

(iii) Relevance of netting agreements. (A) If the person has one or more master netting agreement in effect with a particular counterparty, the person may measure the current exposure arising from its swaps in any major category on a net basis, applying the terms of those agreements. Calculation of net current exposure may take into account offsetting positions entered into with that particular counterparty involving swaps (in any swap category) as well as security-based swaps and securities financing transactions (consisting of securities lending and borrowing, securities margin lending and repurchase and reverse repurchase agreements), and other financial instruments that are subject to netting offsets for purposes of applicable bankruptcy law, to the extent these are consistent with the offsets permitted by the master netting agreements.

(B) Such adjustments may not take into account any offset associated with positions that the person has with separate counterparties.

(iv) Allocation of uncollateralized outward exposure. If a person calculates current exposure with a particular counterparty on a net basis, as provided by paragraph (2)(iii), the portion of that

current exposure that should be attributed to each “major” category of swaps for purposes of the substantial position analysis should be calculated according to the formula:

$$ES(MC) = E_{net\ total} \cdot \frac{OTM_{S(MC)}}{OTM_{S(MC)} + OTM_{S(O)} + OTM_{non-S}}$$

Where: $E_{S(MC)}$ equals the amount of aggregate current exposure attributable to the entity’s swap positions in the “major” swap category at issue; $E_{net\ total}$ equals the entity’s aggregate current exposure to the counterparty at issue, after accounting for the netting of positions and the posting of collateral; $OTM_{S(MC)}$ equals the exposure associated with the entity’s out-of-the-money positions in swaps in the “major” category at issue, subject to those netting arrangements; and $OTM_{S(O)}$ equals the exposure associated with the entity’s out-of-the-money positions in the other “major” categories of swaps, subject to those netting arrangements; and OTM_{non-S} equals the exposure associated with the entity’s out-of-the-money positions associated with instruments, other than swaps, that are subject to those netting arrangements.

(3) Aggregate potential outward exposure. (i) In general. Aggregate potential outward exposure in any major swap category means the sum of:

(A) The aggregate potential outward exposure for each of the person’s swap positions in a major swap category that are not subject to daily mark-to-market margining and are not cleared by a registered or exempt clearing agency or derivatives clearing organization, as calculated in accordance with paragraph (3)(ii); and

(B) The aggregate potential outward exposure for each of the person’s swap positions in such major swap category that are either subject to daily mark-to-market margining or are cleared by a registered or exempt clearing agency or derivatives clearing organization, as calculated in accordance with paragraph (3)(iii).

(ii) Calculation of potential outward exposure for swaps that are not subject to daily mark-to-market margining and are not cleared by a registered or exempt clearing agency or derivatives clearing organization. (A) In general. (1) For positions in swaps that are not subject to daily mark-to-market margining and are not cleared by a registered or exempt clearing agency or a derivatives clearing organization, potential outward exposure equals the total notional principal amount of those positions, multiplied by the following factors on a position-by-position basis reflecting the type of swap. For any swap that does not appropriately fall within any of the specified categories, the "other commodities" conversion factors are to be used:

Table 1—Conversion Factor Matrix for Swaps

Residual maturity	Interest rate	Foreign exchange rate and gold	Precious metals (except gold)	Other commodities
One year or less	0.00	0.01	0.07	0.10
Over one to five years	0.005	0.05	0.07	0.12
Over five years	0.015	0.075	0.08	0.15

Residual maturity	Credit	Equity
One year or less	0.10	0.06
Over one to five years	0.10	0.08
Over five years	0.10	0.10

If a swap is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the market value of the swap is zero, the remaining maturity equals the time until the next reset date.

(2) Use of effective notional amounts. If the stated notional amount on a position is leveraged or enhanced by the structure of the position, the calculation in paragraph (3)(ii)(A)(1) shall be based on the effective notional amount of the position rather than on the stated notional amount.

(3) Exclusion of certain positions. The calculation in paragraph (3)(ii)(A)(1) shall exclude:

(i) Positions that constitute the purchase of an option, if the purchaser has no additional payment obligations under the position;

(ii) Other positions for which the person has prepaid or otherwise satisfied all of its payment obligations; and

(iii) Positions for which, pursuant to law or a regulatory requirement, the person has assigned an amount of cash or U.S. Treasury securities that is sufficient at all times to pay the person's maximum possible liability under the position, and the person may not use that cash or those Treasury securities for other purposes.

(4) Adjustment for certain positions. Notwithstanding paragraph (3)(ii)(A)(1), the potential outward exposure associated with a position by which a person buys credit protection using a credit default swap or index credit default swap, or associated with a position by which a person purchases an option for which the person retains additional payment obligations under the position, is capped at the net present value of the unpaid premiums.

(B) Adjustment for netting agreements. Notwithstanding paragraph (3)(ii)(A), for positions subject to master netting agreements the potential outward exposure associated with the person's swaps with each counterparty equals a weighted average of the potential outward exposure for the person's swaps with that counterparty as calculated under paragraph (3)(ii)(A), and that amount reduced by the ratio of net current exposure to gross current exposure, consistent with the following equation as calculated on a counterparty-by-counterparty basis:

$$P_{Net} = 0.4 * P_{Gross} + 0.6 * NGR * P_{Gross}$$

Where: P_{Net} is the potential outward exposure, adjusted for bilateral netting, of the person's swaps with a particular counterparty; P_{Gross} is the potential outward exposure without adjustment for bilateral netting as calculated pursuant to paragraph (3)(ii)(A); and NGR is the ratio of (i) the

current exposure arising from its swaps in the major category as calculated on a net basis according to paragraphs (2)(iii) and (2)(iv) of this section, divided by (ii) the current exposure arising from its swaps in the major category as calculated in the absence of those netting procedures.

(iii) Calculation of potential outward exposure for swaps that are either subject to daily mark-to-market margining or are cleared by a registered or exempt clearing agency or derivatives clearing organization. For positions in swaps that are subject to daily mark-to-market margining or that are cleared by a registered or exempt clearing agency or derivatives clearing organization:

(A) Potential outward exposure equals the potential exposure that would be attributed to such positions using the procedures in paragraph (3)(ii) multiplied by:

- (1) 0.1, in the case of positions cleared by a registered or exempt clearing agency; or
- (2) 0.2, in the case of positions that are subject to daily mark-to-market margining but that are not cleared by a registered or exempt clearing agency.

(B) Solely for purposes of calculating potential outward exposure

(1) A swap shall be considered to be subject to daily mark-to-market margining if, and for so long as, the counterparties follow the daily practice of exchanging collateral to reflect changes in the current exposure arising from the swap (after taking into account any other financial positions addressed by a netting agreement between the counterparties).

(2) If the person is permitted by agreement to maintain a threshold for which it is not required to post collateral, the position still will be considered to be subject to daily mark-to-market margining for purposes of calculating potential outward exposure, but the total amount of that threshold (regardless of the actual exposure at any time), less any initial margin posted up to the amount of that threshold, shall be added to the person's aggregate uncollateralized outward

exposure for purposes of paragraph (1)(i)(B), (1)(ii)(B), (1)(iii)(B) or (1)(iv)(B), as applicable.

(3) If the minimum transfer amount under the agreement is in excess of \$1 million, the position still will be considered to be subject to daily mark-to-market margining for purposes of calculating potential outward exposure, but the entirety of the minimum transfer amount shall be added to the person's aggregate uncollateralized outward exposure for purposes of paragraph (1)(i)(B), (1)(ii)(B), (1)(iii)(B) or (1)(iv)(B), as applicable.

(4) A person may, at its discretion, calculate the potential outward exposure of positions in swaps that are subject to daily mark-to-market margining in accordance with paragraph 3(ii) in lieu of calculating the potential outward exposure of such swap positions in accordance with this paragraph 3(iii).

(4) Calculation of daily average. Measures of daily average aggregate uncollateralized outward exposure and daily average aggregate potential outward exposure shall equal the arithmetic mean of the applicable measure of exposure at the close of each business day, beginning the first business day of each calendar quarter and continuing through the last business day of that quarter.

(5) Inter-affiliate activities. In calculating its aggregate uncollateralized outward exposure and its aggregate potential outward exposure, the person shall not consider its swap positions with counterparties that are majority-owned affiliates. For these purposes the counterparties to a swap are majority-owned affiliates if one counterparty directly or indirectly owns a majority interest in the other, or if a third party directly or indirectly owns a majority interest in both counterparties to the swap, where "majority interest" is the right to vote or direct the vote of a majority of a class of voting securities of an entity, the power to sell or direct the sale of a majority of a class of voting securities of an entity, or the right to receive upon dissolution or the contribution of a

majority of the capital of a partnership.

(kkk) Hedging or mitigating commercial risk. For purposes of Section 1a(33) of the Act, 7 U.S.C. 1a(33) and § 1.3(hhh), a swap position is held for the purpose of hedging or mitigating commercial risk when:

(1) Such position:

(i) Is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise (or of a majority-owned affiliate of the enterprise), where the risks arise from:

(A) The potential change in the value of assets that a person owns, produces, manufactures, processes, or merchandises or reasonably anticipates owning, producing, manufacturing, processing, or merchandising in the ordinary course of business of the enterprise;

(B) The potential change in the value of liabilities that a person has incurred or reasonably anticipates incurring in the ordinary course of business of the enterprise; or

(C) The potential change in the value of services that a person provides, purchases, or reasonably anticipates providing or purchasing in the ordinary course of business of the enterprise;

(D) The potential change in the value of assets, services, inputs, products, or commodities that a person owns, produces, manufactures, processes, merchandises, leases, or sells, or reasonably anticipates owning, producing, manufacturing, processing, merchandising, leasing, or selling in the ordinary course of business of the enterprise;

(E) Any potential change in value related to any of the foregoing arising from interest, currency, or foreign exchange rate movements associated with such assets, liabilities, services, inputs, products, or commodities; or

(F) Any fluctuation in interest, currency, or foreign exchange rate exposures arising from a person's current or anticipated assets or liabilities; or

(ii) Qualifies as bona fide hedging for purposes of an exemption from position limits under the Act; or

(iii) Qualifies for hedging treatment under (A) Financial Accounting Standards Board Accounting Standards Codification Topic 815, Derivatives and Hedging (formerly known as Statement No. 133) or (B) Governmental Accounting Standards Board Statement 53, Accounting and Financial Reporting for Derivative Instruments; and

(2) Such position is:

(i) Not held for a purpose that is in the nature of speculation, investing or trading; and

(ii) Not held to hedge or mitigate the risk of another swap or security-based swap position, unless that other position itself is held for the purpose of hedging or mitigating commercial risk as defined by this rule or § 240.3a67-4 of this title.

(III) Substantial counterparty exposure. (1) In general. For purposes of Section 1a(33) of the Act, 7 U.S.C. 1a(33), and § 1.3(hhh), the term substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets means a swap position that satisfies either of the following thresholds:

(i) \$5 billion in daily average aggregate uncollateralized outward exposure; or

(ii) \$8 billion in:

(A) Daily average aggregate uncollateralized outward exposure plus

(B) Daily average aggregate potential outward exposure.

(2) Calculation methodology. For these purposes, the terms daily average aggregate uncollateralized outward exposure and daily average aggregate potential outward exposure shall

be calculated the same way as is prescribed in § 1.3(jjj), except that these amounts shall be calculated by reference to all of the person's swap positions, rather than by reference to a specific major swap category.

(mmm) Financial entity; highly leveraged. (1) For purposes of Section 1a(33) of the Act, 7 U.S.C. 1a(33), and § 1.3(hhh), the term financial entity means:

- (i) A security-based swap dealer;
- (ii) A major security-based swap participant;
- (iii) A commodity pool as defined in Section 1a(10) of the Act, 7 U.S.C. 1a(10);
- (iv) A private fund as defined in Section 202(a) of the Investment Advisers Act of 1940, 15 U.S.C. 80b-2(a);
- (v) An employee benefit plan as defined in paragraphs (3) and (32) of Section 3 of the Employee Retirement Income Security Act of 1974, 29 U.S.C. 1002; and
- (vi) A person predominantly engaged in activities that are in the business of banking or financial in nature, as defined in Section 4(k) of the Bank Holding Company Act of 1956, 12 U.S.C. 1843(k).

(2) For purposes of Section 1a(33) of the Act, 7 U.S.C. 1a(33), and § 1.3(hhh), the term highly leveraged means the existence of a ratio of an entity's total liabilities to equity in excess of 12 to 1 as measured at the close of business on the last business day of the applicable fiscal quarter. For this purpose, liabilities and equity should each be determined in accordance with U.S. generally accepted accounting principles; provided, however, that a person that is an employee benefit plan, as defined in paragraphs (3) and (32) of Section 3 of the Employee Retirement Income Security Act of 1974, 29 U.S.C. 1002, may exclude obligations to pay benefits to plan participants from the calculation of liabilities and substitute the total value of plan assets for

equity.

Securities and Exchange Commission

Pursuant to the Exchange Act, 15 U.S.C. 78a et seq., and particularly, Sections 3 and 23 thereof, and Sections 712 and 761(b) of the Dodd-Frank Act, the SEC is adopting Rules 3a67-1, 3a67-2, 3a67-3, 3a67-4, 3a67-5, 3a67-6, 3a67-7, 3a71-1, and 3a71-2 under the Exchange Act.

Text of Rules

For the reasons stated in the preamble, the SEC is amending Title 17, Chapter II of the Code of the Federal Regulations is amended as follows:

PART 240 –GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for Part 240 is amended by adding the following citation in numerical order:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77jjj, 77kkk, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78n-1, 78o, 78o-4, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 *et seq.*, 18 U.S.C. 1350; 12 U.S.C. 5221(e)(3), and Pub.L. 111-203, §939A, 124 Stat. 1376, (2010), unless otherwise noted.

* * * * *

Sections 3a67-1 through 3a67-9 and 3a71-1 and 3a71-2 are also issued under Pub. L. 111-203, §§712, 761(b), 124 Stat. 1841 (2010).

* * * * *

2. Add an undesignated center heading and §§ 240.3a67-1 through 240.3a67-9 and

§§ 240.3a71-1 and 240.3a71-2 to read as follows:

Security-Based Swap Dealer and Participant Definitions

Sec.

240.3a67	1— Definition of “major security-based swap participant.”
240.3a67	2— Categories of security-based swaps.
240.3a67	3— Definition of “substantial position.”
240.3a67	4— Definition of “hedging or mitigating commercial risk.”
240.3a67	5— Definition of “substantial counterparty exposure.”
240.3a67	6— Definition of “financial entity.”
240.3a67	7— Definition of “highly leveraged.”
240.3a67	8— Timing requirements, reevaluation period and termination of status.
240.3a67	9— Calculation of major participant status by certain persons.
240.3a71	1— Definition of “security-based swap dealer.”
240.3a71	2— <u>De minimis</u> exception.

* * * * *

§ 240.3a67-1 Definition of “major security-based swap participant.”

(a) General. Major security-based swap participant means any person:

(1) That is not a security-based swap dealer; and

(2)(i) That maintains a substantial position in security-based swaps for any of the major security-based swap categories, excluding both positions held for hedging or mitigating commercial risk, and positions maintained by any employee benefit plan (or any contract held by such a plan) as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;

(ii) Whose outstanding security-based swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or

(iii) That is a financial entity that:

(A) Is highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking agency (as defined in 15 U.S.C. 78c(a)(72)); and

(B) Maintains a substantial position in outstanding security-based swaps in any major security-based swap category.

(b) Scope of designation. A person that is a major security-based swap participant in general shall be deemed to be a major security-based swap participant with respect to each security-based swap it enters into, regardless of the category of the security-based swap or the person's activities in connection with the security-based swap, unless the Commission limits the person's designation as a major security-based swap participant to specified categories of security-based swaps.

§ 240.3a67-2 Categories of security-based swaps.

For purposes of section 3(a)(67) of the Act, 15 U.S.C. 78c(a)(67), and the rules thereunder, the terms major security-based swap category, category of security-based swaps and any similar terms mean either of the following categories of security-based swaps:

(a) Debt security-based swaps. Any security-based swap that is based, in whole or in part, on one or more instruments of indebtedness (including loans), or on a credit event relating to one or more issuers or securities, including but not limited to any security-based swap that is a credit default swap, total return swap on one or more debt instruments, debt swap, debt index swap, or credit spread.

(b) Other security-based swaps. Any security-based swap not described in paragraph (a) of this section.

§ 240.3a67-3 Definition of "substantial position."

(a) General. For purposes of section 3(a)(67) of the Act, 15 U.S.C. 78c(a)(67), and § 3a67-1, the term substantial position means security-based swap positions that equal or exceed either of the following thresholds in any major category of security-based swaps:

(1) \$1 billion in daily average aggregate uncollateralized outward exposure; or

(2) \$2 billion in:

(i) Daily average aggregate uncollateralized outward exposure; plus

(ii) Daily average aggregate potential outward exposure.

(b) Aggregate uncollateralized outward exposure.

(1) General. Aggregate uncollateralized outward exposure in general means the sum of the current exposure, obtained by marking-to-market using industry standard practices, of each of the person's security-based swap positions with negative value in a major security-based swap category, less the value of the collateral the person has posted in connection with those positions.

(2) Calculation of aggregate uncollateralized outward exposure. In calculating this amount the person shall, with respect to each of its security-based swap counterparties in a given major security-based swap category:

(i) Determine the dollar value of the aggregate current exposure arising from each of its security-based swap positions with negative value (subject to the netting provisions described below) in that major category by marking-to-market using industry standard practices; and

(ii) Deduct from that dollar amount the aggregate value of the collateral the person has posted with respect to the security-based swap positions.

(iii) The aggregate uncollateralized outward exposure shall be the sum of those uncollateralized amounts across all of the person's security-based swap counterparties in the applicable major category.

(3) Relevance of netting agreements.

(i) If a person has one or more master netting agreements with a counterparty, the person may measure the current exposure arising from its security-based swaps in any major category on a net basis, applying the terms of those agreements. Calculation of current exposure may take into account offsetting positions entered into with that particular counterparty involving security-based swaps (in any security-based swap category) as well as swaps and securities financing transactions (consisting of securities lending and borrowing, securities margin lending and repurchase and reverse repurchase agreements), and other financial instruments that are subject to netting offsets for purposes of applicable bankruptcy law, to the extent these are consistent with the offsets permitted by the master netting agreements.

(ii) Such adjustments may not take into account any offset associated with positions that the person has with separate counterparties.

(4) Allocation of uncollateralized outward exposure. If a person calculates current exposure with a particular counterparty on a net basis, as provided by paragraph (b)(3) of this section, the amount of current uncollateralized exposure attributable to each "major" category of security-based swaps should be calculated according to the following formula:

$$E_{SBS(MC)} = E_{net\ total} \cdot \frac{OTM_{SBS(MC)}}{OTM_{SBS(MC)} + OTM_{SBS(O)} + OTM_{non-SBS}}$$

Note to paragraph (b)(4). Where: $E_{SBS(MC)}$ equals the amount of aggregate current exposure attributable to the entity's security-based swap positions in the "major" category at issue (either security-based credit derivatives or other security-based swaps); $E_{net\ total}$ equals the

entity's aggregate current exposure to the counterparty at issue, after accounting for the netting of positions and the posting of collateral; $OTM_{SBS(MC)}$ equals the current exposure associated with the entity's out-of-the-money positions in security-based swaps in the "major" category at issue, subject to those netting arrangements; and $OTM_{SBS(O)}$ equals the current exposure associated with the entity's out-of-the-money positions in the other "major" category of security-based swaps, subject to those netting arrangements; and $OTM_{non-SBS}$ equals the current exposure associated with the entity's out-of-the-money positions associated with instruments, other than security-based swaps, that are subject to those netting arrangements.

(c) Aggregate potential outward exposure.

(1) General. Aggregate potential outward exposure means the sum of:

(i) The aggregate potential outward exposure for each of the person's security-based swap positions in a major security-based swap category that are neither cleared by a registered or exempt clearing agency nor subject to daily mark-to-market margining, as calculated in accordance with paragraph (c)(2) of this section; and

(ii) The aggregate potential outward exposure for each of the person's security-based swap positions in a major security-based swap category that are either cleared by a registered or exempt clearing agency or subject to daily mark-to-market margining, as calculated in accordance with paragraph (c)(3) of this section.

(2) Calculation of potential outward exposure for security-based swaps that are not cleared by a registered or exempt clearing agency or subject to daily mark-to-market margining.

(i) General.

(A) For positions in security-based swaps that are not cleared by a registered or exempt clearing agency or subject to daily mark-to-market margining, potential outward exposure equals

the total notional principal amount of those positions, multiplied by the following factors on a position-by-position basis reflecting the type of security-based swap. For any security-based swap that is not of the "debt" type, the "equity and other" conversion factors are to be used:

Residual maturity	Debt	Equity and other
One year or less	0.10	0.06
Over one to five years	0.10	0.08
Over five years	0.10	0.10

If a security-based swap is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the market value of the security-based swap is zero, the remaining maturity equals the time until the next reset date.

(B) Use of effective notional amounts. If the stated notional amount on a position is leveraged or enhanced by the structure of the position, the calculation in paragraph (c)(2)(i)(A) of this section shall be based on the effective notional amount of the position rather than on the stated notional amount.

(C) Exclusion of certain positions. The calculation in paragraph (c)(2)(i)(A) of this section shall exclude:

(1) Positions that constitute the purchase of an option, such that the person has no additional payment obligations under the position;

(2) Other positions for which the person has prepaid or otherwise satisfied all of its payment obligations; and

(3) Positions for which, pursuant to regulatory requirement, the person has assigned an amount of cash or U.S. Treasury securities that is sufficient to pay the person's maximum possible liability under the position, and the person may not use that cash or those Treasury securities for other purposes.

(D) Adjustment for certain positions. Notwithstanding paragraph (c)(2)(i)(A) of this section, the potential outward exposure associated with a position by which a person buys credit protection using a credit default swap, or associated with a position by which a person purchases an option for which the person retains additional payment obligations under the position, is capped at the net present value of the unpaid premiums.

(ii) Adjustment for netting agreements. Notwithstanding paragraph (c)(2)(i) of this section, for positions subject to master netting agreements the potential outward exposure associated with the person's security-based swaps with each counterparty equals a weighted average of the potential outward exposure for the person's security-based swaps with that counterparty as calculated under paragraph (c)(2)(i) of this section, and that amount reduced by the ratio of net current exposure to gross current exposure, consistent with the following equation as calculated on a counterparty-by-counterparty basis:

$$P_{Net} = 0.4 \times P_{Gross} + 0.6 \times NGR \times P_{Gross}$$

Note to paragraph (c)(2)(ii). Where: P_{Net} is the potential outward exposure, adjusted for bilateral netting, of the person's security-based swaps with a particular counterparty; P_{Gross} is the potential outward exposure without adjustment for bilateral netting, as calculated pursuant to paragraph (c)(2)(i) of this section; and NGR is the ratio of:

(a) the current exposure arising from its security-based swaps in the major category as calculated on a net basis according to paragraphs (b)(3) and (b)(4) of this section, divided by

(b) the current exposure arising from its security-based swaps in the major category as calculated in the absence of those netting procedures.

(3) Calculation of potential outward exposure for security-based swaps that are either cleared by a registered or exempt clearing agency or subject to daily mark-to-market margining.

For positions in security-based swaps that are cleared by a registered or exempt clearing agency or subject to daily mark-to-market margining:

(i) Potential outward exposure equals the potential outward exposure that would be attributed to such positions using the procedures in paragraph (c)(2) of this section, multiplied by:

(A) 0.1, in the case of positions cleared by a registered or exempt clearing agency; or
(B) 0.2, in the case of positions that are subject to daily mark-to-market margining but that are not cleared by a registered or exempt clearing agency.

(ii) Solely for purposes of calculating potential outward exposure:

(A) A security-based swap shall be considered to be subject to daily mark-to-market margining if, and for as long as, the counterparties follow the daily practice of exchanging collateral to reflect changes in the current exposure arising from the security-based swap (after taking into account any other financial positions addressed by a netting agreement between the counterparties).

(B) If the person is permitted by agreement to maintain a threshold for which it is not required to post collateral, the position still will be considered to be subject to daily mark-to-market margining for purposes of calculating potential outward exposure, but the total amount of that threshold (regardless of the actual exposure at any time) less any initial margin posted up to the amount of that threshold, shall be added to the person's aggregate uncollateralized outward exposure for purposes of paragraph (a)(2) of this section.

(C) If the minimum transfer amount under the agreement is in excess of \$1 million, the position still will be considered to be subject to daily mark-to-market margining for purposes of calculating potential outward exposure, but the entirety of the minimum transfer amount shall be

added to the person's aggregate uncollateralized outward exposure for purposes of paragraph (a)(2) of this section.

(D) A person may, at its discretion, calculate the potential outward exposure of positions in security-based swaps that are subject to daily mark-to-market margining in accordance with paragraph (c)(2) of this section in lieu of calculating the potential outward exposure of such positions in accordance with this paragraph (c)(3).

(d) Calculation of daily average. Measures of daily average aggregate uncollateralized outward exposure and daily average aggregate potential outward exposure shall equal the arithmetic mean of the applicable measure of exposure at the close of each business day, beginning the first business day of each calendar quarter and continuing through the last business day of that quarter.

(e) Inter-affiliate activities. In calculating its aggregate uncollateralized outward exposure and its aggregate potential outward exposure, a person shall not consider its security-based swap positions with counterparties that are majority-owned affiliates. For these purposes the parties are majority-owned affiliates if one party directly or indirectly owns a majority interest in the other, or if a third party directly or indirectly owns a majority interest in both counterparties to the security-based swap, where "majority interest" is the right to vote or direct the vote of a majority of a class of voting securities of an entity, the power to sell or direct the sale of a majority of a class of voting securities of an entity, or the right to receive upon dissolution or the contribution of a majority of the capital of a partnership.

§ 240.3a67-4 Definition of "hedging or mitigating commercial risk."

For purposes of section 3(a)(67) of the Act, 15 U.S.C. 78c(a)(67), and § 3a67-1, a security-based swap position shall be deemed to be held for the purpose of hedging or mitigating commercial risk when:

(a)(1) Such position is economically appropriate to the reduction of risks that are associated with the present conduct and management of a commercial enterprise (or of a majority owned affiliate of the enterprise), or are reasonably expected to arise in the future conduct and management of the commercial enterprise, where such risks arise from:

(i) The potential change in the value of assets that a person owns, produces, manufactures, processes, or merchandises or reasonably anticipates owning, producing, manufacturing, processing, or merchandising in the ordinary course of business of the enterprise (or of an affiliate under common control with the enterprise);

(ii) The potential change in the value of liabilities that a person has incurred or reasonably anticipates incurring in the ordinary course of business of the enterprise (or of an affiliate under common control with the enterprise); or

(iii) The potential change in the value of services that a person provides, purchases, or reasonably anticipates providing or purchasing in the ordinary course of business of the enterprise (or of an affiliate under common control with the enterprise);

(2) Depending on the applicable facts and circumstances, the security-based swap positions described in paragraph (a)(1) of this section may be expected to encompass, among other positions:

(i) Positions established to manage the risk posed by a customer's, supplier's or counterparty's potential default in connection with: financing provided to a customer in connection with the sale of real property or a good, product or service; a customer's lease of real

property or a good, product or service; a customer's agreement to purchase real property or a good, product or service in the future; or a supplier's commitment to provide or sell a good, product or service in the future;

(ii) Positions established to manage the default risk posed by a financial counterparty (different from the counterparty to the hedging position at issue) in connection with a separate transaction (including a position involving a credit derivative, equity swap, other security-based swap, interest rate swap, commodity swap, foreign exchange swap or other swap, option, or future that itself is for the purpose of hedging or mitigating commercial risk pursuant to this section or 17 CFR 1.3(kkk));

(iii) Positions established to manage equity or market risk associated with certain employee compensation plans, including the risk associated with market price variations in connection with stock-based compensation plans, such as deferred compensation plans and stock appreciation rights;

(iv) Positions established to manage equity market price risks connected with certain business combinations, such as a corporate merger or consolidation or similar plan or acquisition in which securities of a person are exchanged for securities of any other person (unless the sole purpose of the transaction is to change an issuer's domicile solely within the United States), or a transfer of assets of a person to another person in consideration of the issuance of securities of such other person or any of its affiliates;

(v) Positions established by a bank to manage counterparty risks in connection with loans the bank has made; and

(vi) Positions to close out or reduce any of the positions described in paragraphs (a)(2)(i) through (a)(2)(v) of this section; and

(b) Such position is:

(1) Not held for a purpose that is in the nature of speculation or trading; and

(2) Not held to hedge or mitigate the risk of another security-based swap position or swap position, unless that other position itself is held for the purpose of hedging or mitigating commercial risk as defined by this section or 17 CFR 1.3(kkk).

§ 240.3a67-5 Definition of “substantial counterparty exposure.”

(a) General. For purposes of section 3(a)(67) of the Act, 15 U.S.C. 78c(a)(67), and § 3a67-1, the term substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets means a security-based swap position that satisfies either of the following thresholds:

(1) \$2 billion in daily average aggregate uncollateralized outward exposure; or

(2) \$4 billion in:

(i) Daily average aggregate uncollateralized outward exposure; plus

(ii) Daily average aggregate potential outward exposure.

(b) Calculation. For these purposes, daily average aggregate uncollateralized outward exposure and daily average aggregate potential outward exposure shall be calculated the same way as is prescribed in § 3a67-3, except that these amounts shall be calculated by reference to all of the person’s security-based swap positions, rather than by reference to a specific major security-based swap category.

§ 240.3a67-6 Definition of “financial entity.”

(a) General. For purposes of section 3(a)(67) of the Act, 15 U.S.C. 78c(a)(67), and § 3a67-1, the term financial entity means:

(1) A swap dealer;

- (2) A major swap participant;
- (3) A commodity pool as defined in section 1a(10) of the Commodity Exchange Act (7 U.S.C. 1a(10));
- (4) A private fund as defined in section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a));
- (5) An employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002); and
- (6) A person predominantly engaged in activities that are in the business of banking or financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843k).

(b) Exclusion for centralized hedging facilities.

(1) General. Notwithstanding paragraph (a) of this section, for purposes of this section the term financial entity shall not encompass a person that would be a financial entity solely as a result of the person's activities that facilitate hedging and/or treasury functions on behalf of one or more majority-owned affiliates that themselves do not constitute a financial entity.

(2) Meaning of majority-owned. For these purposes the counterparties to a security-based swap are majority-owned affiliates if one counterparty directly or indirectly owns a majority interest in the other, or if a third party directly or indirectly owns a majority interest in both counterparties to the security-based swap, where "majority interest" includes, but is not limited to, the right to vote or direct the vote of a majority of a class of voting securities of an entity, the power to sell or direct the sale of a majority of a class of voting securities of an entity, or the right to receive upon dissolution or the contribution of a majority of the capital of a partnership.

§ 240.3a67-7 Definition of “highly leveraged.”

(a) General. For purposes of section 3(a)(67) of the Act, 15 U.S.C. 78c(a)(67), and § 3a67-1, the term highly leveraged means the existence of a ratio of an entity's total liabilities to equity in excess of 12 to 1 as measured at the close of business on the last business day of the applicable fiscal quarter.

(b) Measurement of liabilities and equity. For purposes of this section, liabilities and equity generally should each be determined in accordance with U.S. generally accepted accounting principles; provided, however, that a person that is an employee benefit plan, as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002), may, for purposes of this paragraph (b):

(1) Exclude obligations to pay benefits to plan participants from the calculation of liabilities; and

(2) Substitute the total value of plan assets for equity.

§ 240.3a67-8 Timing requirements, reevaluation period, and termination of status.

(a) Timing requirements. A person that is not registered as a major security-based swap participant, but that meets the criteria in § 3a67-1 to be a major security-based swap participant as a result of its security-based swap activities in a fiscal quarter, will not be deemed to be a major security-based swap participant until the earlier of the date on which it submits a complete application for registration pursuant to section 15F of the Act (15 U.S.C. 78o-10) or two months after the end of that quarter.

(b) Reevaluation period. Notwithstanding paragraph (a) of this section, if a person that is not registered as a major security-based swap participant meets the criteria in § 3a67-1 to be a

major security-based swap participant in a fiscal quarter, but does not exceed any applicable threshold by more than twenty percent in that quarter:

(1) That person will not immediately be deemed a major security-based swap participant pursuant to the timing requirements specified in paragraph (a) of this section; but

(2) That person will be deemed a major security-based swap participant pursuant to the timing requirements specified in paragraph (a) of this section at the end of the next fiscal quarter if the person exceeds any of the applicable daily average thresholds in that next fiscal quarter.

(c) Termination of status. A person that is deemed to be a major security-based swap participant shall continue to be deemed a major security-based swap participant until such time that its security-based swap activities do not exceed any of the daily average thresholds set forth within § 3a67-1 for four consecutive fiscal quarters after the date on which the person becomes registered as a major security-based swap participant.

§ 240.3a67-9 Calculation of major participant status by certain persons

A person shall not be deemed to be a major security-based swap participant, regardless of whether the criteria in § 3a67-1 otherwise would cause the person to be a major security-based swap participant, provided the person meets the conditions set forth in paragraph (a) of this section.

(a) Conditions.

(1) Caps on uncollateralized exposure and notional positions.

(i) Maximum potential uncollateralized exposure. The express terms of the person's agreements or arrangements relating to security-based swaps with its counterparties at no time would permit the person to maintain a total uncollateralized exposure of more than \$100 million

to all such counterparties, including any exposure that may result from thresholds or minimum transfer amounts established by credit support annexes or similar arrangements; and

(ii) Maximum notional amount of security-based swap positions. The person does not maintain security-based swap positions in an effective notional amount of more than \$2 billion in any major category of security-based swaps, or more than \$4 billion in aggregate; or

(2) Caps on uncollateralized exposure plus monthly calculation.

(i) Maximum potential uncollateralized exposure. The express terms of the person's agreements or arrangements relating to security-based swaps with its counterparties at no time would permit the person to maintain a total uncollateralized exposure of more than \$200 million to all such counterparties (with regard to security-based swaps and any other instruments by which the person may have exposure to those counterparties), including any exposure that may result from thresholds or minimum transfer amounts established by credit support annexes or similar arrangements; and

(ii) Calculation of positions.

(A) At the end of each month, the person performs the calculations prescribed by §§ 3a67-3 and 3a67-5 with regard to whether the aggregate uncollateralized outward exposure plus aggregate potential outward exposure as of that day constitute a substantial position in a major category of security-based swaps, or pose substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; these calculations shall disregard provisions of those rules that provide for the analyses to be determined based on a daily average over a calendar quarter; and

(B) Each such analysis produces thresholds of no more than:

(1) \$1 billion in aggregate uncollateralized outward exposure plus aggregate potential outward exposure in any major category of security-based swaps; if the person is subject to § 3a67-3(a)(2)(iii), by virtue of being a highly leveraged financial entity that is not subject to capital requirements established by an appropriate Federal banking agency, this analysis shall account for all of the person's security-based swap positions in that major category (without excluding hedging positions), otherwise this analysis shall exclude the same hedging and related positions that are excluded from consideration pursuant to § 3a67-3(a)(2)(i); or

(2) \$2 billion in aggregate uncollateralized outward exposure plus aggregate potential outward exposure (without any positions excluded from the analysis) with regard to all of the person's security-based swap positions.

(3) Calculations based on certain information.

(i) At the end of each month:

(A)(1) The person's aggregate uncollateralized outward exposure with respect to its security-based swap positions is less than \$500 million with respect to each of the major security-based swap categories; and

(2) The sum of the amount calculated under paragraph (a)(3)(i)(A)(1) of this section with respect to each major security-based swap category and the total notional principal amount of the person's security-based swap positions in each such major security-based swap category, adjusted by the multipliers set forth in § 3a67-3(c)(2)(i)(A) on a position-by-position basis reflecting the type of security-based swap, is less than \$1 billion with respect to each of the major security-based swap categories.

(B)(1) The person's aggregate uncollateralized outward exposure with respect to its security-based swap positions across all major security-based swap categories is less than \$500 million; and

(2) The sum of the amount calculated under paragraph (a)(3)(i)(B)(1) of this section and the product of the total effective notional principal amount of the person's security-based swap positions in all major security-based swap categories multiplied by 0.10 is less than \$1 billion; or

(ii) For purposes of the calculations set forth in paragraph (a)(3)(i) of this section:

(A) The person's aggregate uncollateralized outward exposure for positions held with security-based swap dealers shall be equal to such exposure reported on the most recent reports of such exposure received from such security-based swap dealers; and

(B) The person's aggregate uncollateralized outward exposure for positions that are not reflected in any report of exposure from a security-based swap dealer (including all security-based swap positions it holds with persons other than security-based swap dealers) shall be calculated in accordance with § 3a67-3(b)(2).

(b) For purposes of the calculations set forth by this section, the person shall use the effective notional amount of a position rather than the stated notional amount of the position if the stated notional amount is leveraged or enhanced by the structure of the position.

(c) No presumption shall arise that a person is required to perform the calculations needed to determine if it is a major security-based swap participant, solely by reason that the person does not meet the conditions specified in paragraph (a) of this section.

§ 240.3a71-1 Definition of "security-based swap dealer."

(a) General. The term security-based swap dealer in general means any person who:

(1) Holds itself out as a dealer in security-based swaps;

(2) Makes a market in security-based swaps;

(3) Regularly enters into security-based swaps with counterparties as an ordinary course of business for its own account; or

(4) Engages in any activity causing it to be commonly known in the trade as a dealer or market maker in security-based swaps.

(b) Exception. The term security-based swap dealer does not include a person that enters into security-based swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of regular business.

(c) Scope of designation. A person that is a security-based swap dealer in general shall be deemed to be a security-based swap dealer with respect to each security-based swap it enters into, regardless of the type, class, or category of the security-based swap or the person's activities in connection with the security-based swap, unless the Commission limits the person's designation as a security-based swap dealer to specified types, classes, or categories of security-based swaps or specified activities of the person in connection with security-based swaps.

(d) Inter-affiliate activities.

(1) General. In determining whether a person is a security-based swap dealer, that person's security-based swaps with majority-owned affiliates shall not be considered.

(2) Meaning of majority-owned. For these purposes the counterparties to a security-based swap are majority-owned affiliates if one counterparty directly or indirectly owns a majority interest in the other, or if a third party directly or indirectly owns a majority interest in both counterparties to the security-based swap, where "majority interest" is the right to vote or direct the vote of a majority of a class of voting securities of an entity, the power to sell or direct

the sale of a majority of a class of voting securities of an entity, or the right to receive upon dissolution or the contribution of a majority of the capital of a partnership.

§ 240.3a71-2 De minimis exception.

(a) Requirements. For purposes of section 3(a)(71) of the Act (15 U.S.C. 78c(a)(71)) and § 3a71-1, a person that is not currently registered as a security-based swap dealer shall be deemed not to be a security-based swap dealer, and, therefore, shall not be subject to section 15F of the Act (15 U.S.C. 78o-10) and the rules, regulations and interpretations issued thereunder, as a result of security-based swap dealing activity that meets the following conditions:

(1) Notional thresholds. The security-based swap positions connected with the dealing activity in which the person – or any other entity controlling, controlled by or under common control with the person – engages over the course of the immediately preceding 12 months (or following the effective date of final rules implementing section 3(a)(68) of the Act (15 U.S.C. 78c(a)(68)) if that period is less than 12 months) have:

(i) An aggregate gross notional amount of no more than \$3 billion, subject to a phase-in level of an aggregate gross notional amount of no more than \$8 billion applied in accordance with paragraph (a)(2)(i) of this section, with regard to credit default swaps that constitute security-based swaps;

(ii) An aggregate gross notional amount of no more than \$150 million, subject to a phase-in level of an aggregate gross notional amount of no more than \$400 million applied in accordance with paragraph (a)(2)(i) of this section, with regard to security-based swaps not described in paragraph (a)(1)(i) of this section; and

(iii) 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 (as that term is defined in section 15F(h)(2)(C) of the Act (15 U.S.C. 78o-10(h)(2)(C))).

(2) Phase-in procedure.

(i) Phase-in period. For purposes of paragraphs (a)(1)(i) and (a)(1)(ii) of this section, a person that engages in security-based swap dealing activity that does not exceed either of the phase-in levels set forth in paragraphs (a)(1)(i) and (a)(1)(ii) of this section, as applicable, shall be deemed not to be a security-based swap dealer, and, therefore, shall not be subject to Section 15F of the Act (15 U.S.C. 78o-10) and the rules, regulations and interpretations issued thereunder, as a result of its security-based swap dealing activity, until the “phase-in termination date” established as provided in paragraph (a)(2)(ii) of this section; provided, however, that this phase-in period shall not be available to the extent that a person engages in security-based swap dealing activity with counterparties that are natural persons, other than natural persons who qualify as eligible contract participants by virtue of section 1a(18)(A)(xi)(II) of the Commodity Exchange Act, (7 U.S.C. 1a(18)(A)(xi)(II)). The Commission shall announce the phase-in termination date on the Commission website and publish such date in the Federal Register.

(ii) Establishment of phase-in termination date.

(A) Nine months after the publication of the staff report described in Appendix A of this section, and after giving due consideration to that report and any associated public comment, the Commission may either:

(1) Terminate the phase-in period set forth in paragraph (a)(2)(i) of this section, in which case the phase-in termination date shall be established by the Commission by order published in the Federal Register; or

(2) Determine that it is necessary or appropriate in the public interest to propose through rulemaking an alternative to the \$3 billion and \$150 million amounts set forth in paragraphs (a)(1)(i) and (a)(1)(ii) of this section, as applicable, that would constitute a de minimis quantity of security-based swap dealing in connection with transactions with or on behalf of customers within the meaning of section 3(a)(71)(D) of the Act, (15 U.S.C. 78c(a)(71)(D)), in which case the Commission shall by order published in the Federal Register provide notice of such determination to propose through rulemaking an alternative, which order shall also establish the phase-in termination date.

(B) If the phase-in termination date has not been previously established pursuant to paragraph (a)(2)(ii)(A) of this section, then in any event the phase-in termination date shall occur five years after the data collection initiation date defined in paragraph (a)(2)(iii) of this section.

(iii) Data collection initiation date. The term "data collection initiation date" shall mean the date that is the later of: the last compliance date for the registration and regulatory requirements for security-based swap dealers and major security-based swap participants under Section 15F of the Act (15 U.S.C. 78o-10); or the first date on which compliance with the trade-by-trade reporting rules for credit-related and equity-related security-based swaps to a registered security-based swap data repository is required. The Commission shall announce the data collection initiation date on the Commission website and publish such date in the Federal Register.

(3) Use of effective notional amounts. For purposes of paragraph (a)(1) of this section, if the stated notional amount of a security-based swap is leveraged or enhanced by the structure of the security-based swap, the calculation shall be based on the effective notional amount of the security-based swap rather than on the stated notional amount.

(b) Registration period for persons that no longer can take advantage of the exception. A person that has not registered as a security-based swap dealer by virtue of satisfying the requirements of paragraph (a) of this section, but that no longer can take advantage of the de minimis exception provided for in paragraph (a) of this section, will be deemed not to be a security-based swap dealer under section 3(a)(71) of the Act (15 U.S.C. 78c(a)(71)) and subject to the requirements of section 15F of the Act (15 U.S.C. 78o-10) and the rules, regulations and interpretations issued thereunder until the earlier of the date on which it submits a complete application for registration pursuant to section 15F(b) (15 U.S.C. 78o-10(b)) or two months after the end of the month in which that person becomes no longer able to take advantage of the exception.

(c) Applicability to registered security-based swap dealers. A person who currently is registered as a security-based swap dealer may apply to withdraw that registration, while continuing to engage in security-based swap dealing activity in reliance on this section, so long as that person has been registered as a security-based swap dealer for at least 12 months and satisfies the conditions of paragraph (a) of this section.

(d) Future adjustments to scope of the de minimis exception. The Commission may by rule or regulation change the requirements of the de minimis exception described in paragraphs (a) through (c) of this section.

(e) Voluntary registration. Notwithstanding paragraph (a) of this section, a person that chooses to register with the Commission as a security-based swap dealer shall be deemed to be a security-based swap dealer, and, therefore, shall be subject to Section 15F of the Act (15 U.S.C. 78o-10) and the rules, regulations and interpretations issued thereunder.

§ 240.3a71-2A Report regarding the “security-based swap dealer” and “major security-based swap participant” definitions (Appendix A to 17 CFR § 240.3a71-2).

Appendix A to § 3a71-2 sets forth guidelines applicable to a report that the Commission has directed its staff to make in connection with the rules and interpretations further defining the Act's definitions of the terms "security-based swap dealer" (including the de minimis exception to that definition) and "major security-based swap participant." The Commission intends to consider this report in reviewing the effect and application of these rules based on the evolution of the security-based swap market following the implementation of the registration and regulatory requirements of Section 15F of the Act (15 U.S.C. 78o-10). The report may also be informative as to potential changes to the rules further defining those terms. In producing this report, the staff shall consider security-based swap data collected by the Commission pursuant to other Title VII rules, as well as any other applicable information as the staff may determine to be appropriate for its analysis.

(a) Report topics. As appropriate, based on the availability of data and information, the report should address the following topics:

(1) De minimis exception. In connection with the de minimis exception to the definition of "security-based swap dealer," the report generally should assess whether any of the de minimis thresholds set forth in paragraph (a)(1) of § 3a71-2 should be increased or decreased;

(2) General security-based swap dealer analysis. In connection with the definition of "security-based swap dealer," the report generally should consider the factors that are useful for identifying security-based swap dealing activity, including the application of the dealer-trader distinction for that purpose, and the potential use of more objective tests or safe harbors as part of the analysis;

(3) General major security-based swap participant analysis. In connection with the definition of "major security-based swap participant," the report generally should consider the

tests used to identify the presence of a “substantial position” in a major category of security-based swaps, and the tests used to identify persons whose security-based swap positions create “substantial counterparty exposure,” including the potential use of alternative tests or thresholds;

(4) Commercial risk hedging exclusion. In connection with the definition of “major security-based swap participant,” the report generally should consider the definition of “hedging or mitigating commercial risk,” including whether that latter definition inappropriately permits certain positions to be excluded from the “substantial position” analysis, and whether the continued availability of the exclusion for such hedging positions should be conditioned on a person assessing and documenting the hedging effectiveness of those positions;

(5) Highly leveraged financial entities. In connection with the definition of “major security-based swap participant,” the report generally should consider the definition of “highly leveraged,” including whether alternative approaches should be used to identify highly leveraged financial entities;

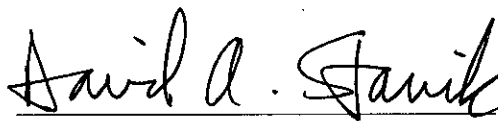
(6) Inter-affiliate exclusions. In connection with the definitions of “security-based swap dealer” and “major security-based swap participant,” the report generally should consider the impact of rule provisions excluding inter-affiliate transactions from the relevant analyses, and should assess potential alternative approaches for such exclusions; and

(7) Other topics. Any other analysis of security-based swap data and information the Commission or the staff deem relevant to this rule.

(b) Timing of report. The report shall be completed no later than three years following the data collection initiation date, established pursuant to § 3a71-2(a)(2)(iii).

(c) Public comment on the report. Following completion of the report, the report shall be published in the Federal Register for public comment.

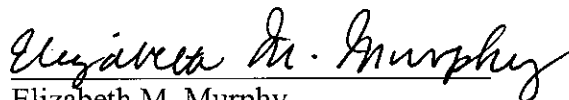
By the Commodity Futures Trading
Commission.



David A. Stawick
Secretary

Date: April 27, 2012

By the Securities and Exchange Commission.



Elizabeth M. Murphy
Secretary

Date: April 27, 2012

Appendices by the Commodity Futures Trading Commission to Joint Final Rule Entitled “Further Definition of ‘Swap Dealer,’ ‘Security-Based Swap Dealer,’ ‘Major Swap Participant,’ ‘Major Security-Based Swap Participant’ and ‘Eligible Contract Participant.’”— Commission Voting Summary and Statements of Commissioners

NOTE: The following appendices will not appear in the Code of Federal Regulations

Appendix 1— Commodity Futures Trading Commission Voting Summary

On this matter, Chairman Gensler and Commissioners Sommers, Chilton and Wetjen voted in the affirmative; Commissioner O’Malia voted in the negative.

Appendix 2—Statement of Chairman Gensler

I support the final rule to further define entities, which is pivotal to lowering risk that swap dealers may pose to the rest of the economy. The entities rule fulfills Congress’ direction to further define the terms “swap dealer,” “major swap participant” and “eligible contract participant” and appropriately addresses the many comments we received. It will provide essential direction to market participants on whether they will be required to register.

Regulating banks and other firms that deal in derivatives as swap dealers is central to financial reform. Leading up to the financial crisis, it was assumed by many that swap dealers were largely regulated. The 2008 crisis revealed the inadequacy of this approach: while banks were regulated for safety and soundness, including their lending activities, there was no comprehensive regulation of their swap dealing activity. Similarly, bank affiliates dealing in swaps, and subsidiaries of insurance and investment bank holding companies dealing in swaps, were not subject to specific regulation of their swap dealing activities under U.S. law, and thus often had ineffective or no oversight.

A prime example of this fact was AIG. AIG was a holding company with a number of regulated insurance companies, but its unregulated swaps subsidiary brought down the company and helped to nearly topple the U.S. economy.

The final rule gives market participants guidance on the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) definition of swap dealer:

- First, it does so by allowing market participants to draw on useful precedents developed by the SEC in the traditional securities market to help distinguish between dealing and trading.
- Second, it does so by providing further clarity on the Dodd-Frank Act's term "makes a market in swaps" by focusing on entities that routinely seek to profit by accommodating other market participants' demand for swaps.
- Third, it does so by clarifying another key term "regular business," focusing on whether a person has an identifiable swap dealing business.
- Fourth, it does so by fulfilling Congress' mandate that swaps entered into by an insured depository institution in connection with originating a loan are not to be considered dealing activity.
- Fifth, it does so by providing direction on the distinction between hedging and dealing and within this provides a specific rule for swaps that hedge price risk associated with a physical commodity.
- Sixth, it does so by clarifying that a swap between an agricultural cooperative or a cooperative financial institution and its members does not constitute dealing.
- Seventh, it does so by setting a de minimis threshold for swap dealing, as directed by Congress. The threshold is \$3 billion total, across all asset classes, subject to a phase in

level of \$8 billion. As we proposed, the final rule would define as a swap dealer any entity with more than \$25 million of dealing activity with pension funds and municipals – so-called “special entities.”

True to congressional intent, end-users other than those genuinely making markets in swaps won't be required to register as swap dealers. The swap dealer definition benefited from the many comments from end-users who use swaps to hedge their risk.

As the swap dealing market is dominated by large entities, though, I believe that the final swap dealer definition will encompass the vast majority of swap dealing activity, as Congress had intended. For those who question the level of the de minimis, we considered the threshold in the context of an overall \$300 trillion notional amount U.S. swaps market. Further, the statute defines swap dealing by referencing “making a market in swaps” and conducting a “regular business” in swaps. The \$3 billion threshold in the rule represents, on average, \$12 million a trading day, with the phase-in of \$8 billion representing, on average, \$32 million notional amount per trading day. Putting this in perspective, the interest rate swap market, transacts, on average, over \$500 billion notional amount per day. As further reference, the futures markets for crude oil traded this year, on average, \$65 billion of notional amount per day.

During this phase-in period the Commissions will collect and analyze data to evaluate the appropriate de minimis threshold.

Another question that has been raised is whether the swap dealer definition should appropriately be activities-based or relate to how an entity is classified. The final rule is consistent with Congressional intent that we take an activities-based approach.

Though many of these large swap dealers are financial entities, Congress anticipated that some non-banks would be registered as swap dealers. Congress provided in Dodd-Frank that

capital and margin for bank swap dealers would be set by the bank regulators, but for non-bank swap dealers, by the CFTC. Instructive in this regard is the list of primary dealers on the International Swaps and Derivatives Association's (ISDA) website, which includes a number of non-bank dealers. The Association describes as meeting that designation an entity "that deals in derivatives as part of its business." Congress closed the so-called "Enron loophole," which let traders evade oversight by using electronic trading platforms. But it is important to recall that Enron was also a swap dealer. Congress did not intend to create a new type of loophole in its place.

Congress drafted the swap dealer definition recognizing the fact that some entities are involved in swap dealing activities, as well as other lines of business. Section 1a(49)(C) provides that an entity is a swap dealer only if it engages in swap dealing as "a regular business." But it does not say that swap dealing must be its only regular business. Further, section 1a(49)(B) specifically provides for the regulation of a single entity as a swap dealer for one part of its business and not for the other part of its business. Given the business realities reflected in the statutory language, there is no compelling reason to think that an entities-based approach would better interpret the statute or that it would, in practice, be simpler than an approach based on what a business actually does.

The rule also further defines the term "major swap participant." Relying on Congress' three-prong test, this category is clearly limited to only those entities with swaps positions that pose a risk large enough to threaten the U.S. financial system.

The further definition of the term "eligible contract participant" provides guidance regarding who is eligible to transact swaps off of an exchange. Based upon the many comments received, we incorporated further guidance to ensure that small businesses and real estate

developers can continue to have access to swaps to hedge commercial risks. The final rule also clarifies how the eligible contract participant definition applies to certain foreign exchange transactions conducted by commodity pools.

Appendix 3—Statement of Commissioner O'Malia

In General

I respectfully dissent from the Commodity Futures Trading Commission's (the "Commission" or "CFTC") approval today of the Entities Rule,¹ which is a joint final and interim final rule with the Securities and Exchange Commission ("SEC") under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").² I have a number of concerns with each definition in the CFTC Entities Rule. However, this dissent focuses on the "swap dealer" definition.

Preliminarily, in its proposal,³ the Commission ignored basic canons of statutory construction⁴ in defining "swap dealer."⁵ Specifically, the statutory definition has four clauses,

¹ Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant;" Final Rule, (to be codified at 17 CFR Part 1), available at [_____]. As stated below, this final rule and interim final rule is joint between the Commission and the SEC. Therefore, within this dissent, (i) the term "Entities Rule" refers to the entire rule, (ii) the term "CFTC Entities Rule" refers to only the CFTC portion of such rule, and (iii) the term "SEC Entities Rule" refers to the SEC portion of such rule.

² Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

³ See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant;" Proposed Rule, 75 FR 80174 (Dec. 21, 2010) (the "Proposal").

⁴ The canons of statutory construction are "important rules and conventions" that the judiciary applies to determine the meaning of statutory provisions. Congressional Research Service, Report for Congress, Statutory Interpretation: General Principles and Recent Trends, updated August 31, 2008 (the "CRS Report") (Summary). In general, it behooves agencies (such as the Commission) to adhere to such canons so that its regulations, if subject to legal challenge, would be more likely to survive judicial scrutiny. In the CFTC Entities Rule, the Commission acknowledges the importance of canons of

lettered (A) through (D). As discussed below, the Commission defined “swap dealer” as encompassed only within CEA section 1a(49)(A). Thus, the Commission advanced a definition focusing on activities, rather than the entities conducting these activities.⁶ The Commission then minimized the other clauses of the definition. Specifically, the Commission characterized CEA section 1a(49)(C) as an “exception” for certain activities. The Commission also characterized CEA section 1a(49)(B) as only authorizing “limited designation.”⁷

statutory construction, since it cites to certain canons in determining the application of its “eligible contract participant” definition. See Section III(B)(4) of the CFTC Entities Rule.

⁵ The statutory definition of “swap dealer” can be found in section 1a(49) of the Commodity Exchange Act (the “CEA”), 7 U.S.C. 1a(49). For purposes of reference, the text of CEA section 1a(49) is as follows:

“(49) SWAP DEALER.—

“(A) IN GENERAL.—The term ‘swap dealer’ means any person who—

“(i) holds itself out as a dealer in swaps;

“(ii) makes a market in swaps;

“(iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or

“(iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps, provided however, in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer.

“(B) INCLUSION.—A person may be designated as a swap dealer for a single type or single class or category of swap or activities and considered not to be a swap dealer for other types, classes, or categories of swaps or activities.

“(C) EXCEPTION.—The term ‘swap dealer’ does not include a person that enters into swaps for such person’s own account, either individually or in a fiduciary capacity, but not as a part of a regular business.

“(D) DE MINIMIS EXCEPTION.—The Commission shall exempt from designation as a swap dealer an entity that engages in a de minimis quantity of swap dealing in connection with transactions with or on behalf of its customers.

The Commission shall promulgate regulations to establish factors with respect to the making of this determination to exempt.”

⁶ See Proposed Rule; 75 FR at 80175, 80179 (stating that “The Dodd-Frank Act defines the terms ‘swap dealer’...in terms of whether a person engages in certain types of activities involving swaps or security-based swaps... Based on the plain meaning of the statutory definition, so long as a person engages in dealing activity that is not de minimis, as discussed below, the person is a swap dealer...”).

⁷ The following example illustrates the difference between (i) an “exception” and (ii) an “exclusion.” Imagine a circle entitled “swap dealer.” “Exceptions” are circles within the “swap dealer” circle. In essence, entities within those circles are subcategories of “swap dealer” permitted special

I have always disagreed with the Proposal. By focusing on the activities in CEA section 1a(49)(A), the Commission essentially used the “swap dealer” definition to capture commercial end-users.⁸ Congress clearly precluded this result. As described below, CEA section 1a(49)(C) provides a mandatory exclusion for commercial end-users.⁹ Alternatively, CEA section 1a(49)(B) permits the Commission to exercise its discretion to exclude commercial end-users, so long as the Commission articulates a rational basis for such differential treatment.¹⁰ The Commission has many reasons for exercising its discretion, including certain statutory reasons.

Today, the Commission has erected the CFTC Entities Rule on the infirm scaffold of the Proposal. To be sure, the Commission has performed astonishing contortions to afford greater certainty to commercial end-users.¹¹ However, the Commission could have provided equivalent

treatment. “Exclusions” are circles entirely separate from the “swap dealer” circle. In essence, entities within those circles are not “swap dealers” in the first instance. As described below, CEA section 1a(49)(C), 7 U.S.C. 1a(49)(C), provides a mandatory “exclusion” from the “swap dealer” definition for – at a minimum – non-financial entities that do not have “a regular business” of entering into swap transactions. To be clear, this “exclusion” applies to entities, and not solely to their activities. Similarly, CEA section 1a(49)(B), 7 U.S.C. 1a(49)(B), provides a discretionary “exclusion” from the “swap dealer” definition (rather than just “limited designation,” as the Commission contends).

⁸ See, e.g., Opening Statement, Sixth Series of Proposed Rulemakings under the Dodd-Frank Act, Dec. 1, 2010, available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/omaliastatement120110>; and Jobs on Main Street vs. Wall Street: The Choice Should be Clear, 2011 Futures Industry Association Energy Forum, New York, Keynote Address, Sept. 14, 2011, available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/opaomalia-8>.

⁹ See *supra* note 5 for the exact text of CEA section 1a(49)(C), 7 U.S.C. 1a(49)(C). See also *supra* note 7 for an explanation of the difference between (i) an “exception” and (ii) an “exclusion.” The collapse of CEA section 1a(49)(C) (referencing “a regular business”) into CEA section 1a(49)(A)(iii), 7 U.S.C. 1a(49)(A)(iii) (referencing “an ordinary course of business”), illustrates that the Commission still considers entities within CEA section 1a(49)(C) as subcategories of “swap dealers,” absent Commission largesse.

¹⁰ *Id.* for the exact text of CEA section 1a(49)(B), 7 U.S.C. 1a(49)(B).

¹¹ In the CFTC Entities Rule, the Commission departs from the Proposal in the following ways, among others: (i) acknowledging that there is a difference between dealing, trading, and hedging; (ii) setting forth an explicit exception for swaps that an entity enters into in its capacity as a floor trader (as defined in CEA section 1a(23), 7 U.S.C. 1a(23)); (iii) providing another explicit exception for certain

or superior certainty by properly construing CEA sections 1a(49)(C) and (B), either initially or in a re-proposal. By preserving and furthering the statutory misconstructions in the Proposal, the CFTC Entities Rule may ultimately provide illusory comfort. Therefore, I cannot support the CFTC Entities Rule.

The “Swap Dealer” Definition: Fundamental Misconstruction

- CEA section 1a(49)(A): Not the Entire “Swap Dealer” Definition

A statute should be read as a “harmonious whole.”¹² This statement is a basic canon of statutory construction.¹³ The Commission has failed to follow such canon in defining “swap dealer.”

As mentioned above, in the CFTC Entities Rule (as in the Proposal), the Commission insists that CEA section 1a(49)(A) is the entirety of the “swap dealer” definition. According to the Commission, any entity engaged in any activity enumerated in CEA section 1a(49)(A) is a “swap dealer”¹⁴ (unless otherwise “excepted”).¹⁵ Specifically, the Commission states: “The Dodd-Frank Act definitions of the term ‘swap dealer’...focus on whether a person engages in particular types of activities involving swaps....”¹⁶ Also, the Commission states: “The

hedging activities; (iv) providing an exception for swaps between majority-owned affiliates; and (iv) setting forth a phase-in period with a higher de minimis threshold.

¹² See, e.g., the CRS Report, p. CRS-2.

¹³ Id.

¹⁴ As mentioned above, CEA section 1a(49)(A), 7 U.S.C. 1a(49)(A), states that the term “swap dealer” means “any person who – (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.”

¹⁵ See supra note 9.

¹⁶ Section II of the CFTC Entities Rule.

CEA...[definition] in general encompass persons that engage in any of the [activities in CEA section 1a(49)(A)].”¹⁷ Finally, the Commission characterizes the activities in CEA section 1a(49)(A) as “dealer activities.”¹⁸

- CEA section 1a(49)(C): Mandatory Exclusion for Entities

CEA section 1a(49) contradicts in both its language and structure the Commission’s focus on the activities of CEA section 1a(49)(A). Specifically, CEA section 1a(49)(C), when properly construed, sets forth a mandatory exclusion that focuses on the characteristics of an entity, and not exclusively on its activities. CEA section 1a(49)(C) states: “The term ‘swap dealer’ does not include a person that enters into swaps for such person’s own account, either individually or in a fiduciary capacity, but not as part of a regular business.”

First, CEA section 1a(49)(C) is as central to the “swap dealer” definition as CEA section 1a(49)(A). CEA section 1a(49)(C) begins with “The term ‘swap dealer’ does not include...”. In comparison, CEA section 1a(49)(A) begins with “The term ‘swap dealer’ means...”. Therefore, according to their plain language, CEA section 1a(49)(C) and CEA section 1a(49)(A) are equal and opposite of each other. In essence, CEA section 1a(49)(C) sets forth the exclusion criteria for the “swap dealer” definition, whereas CEA section 1a(49)(A) sets forth the inclusion criteria.

Second, CEA section 1a(49)(C) focuses on the characteristics of entities, and not solely on their activities. CEA section 1a(49)(C) states that “[t]he term ‘swap dealer’ does not include a person that enters into swaps...not as part of a regular business.” In contrast, CEA section 1a(49)(A)(iii) states that the “swap dealer” definition encompasses any person that “regularly

¹⁷ Id.

¹⁸ Id.

enters into swaps with counterparties as an ordinary course of business for its own account.” If the Commission is correct in presuming that CEA section 1a(49)(A) focuses on activities, then the phrase “regularly enters into swaps...as an ordinary course of business” must refer to an activity. However, Congress used different words in CEA section 1a(49)(C). According to a basic canon of statutory construction, when Congress uses different words, it intends different meanings. In other words, a court should strive to give effect to every word of a statute.¹⁹

The Commission could have easily given effect to every word of CEA section 1a(49)(C), while according the same respect to CEA section 1a(49)(A)(iii). Juxtaposing CEA section 1a(49)(C) and CEA section 1a(49)(A)(iii), the following construction emerges: a “person” (i.e., an entity) is not a “swap dealer” if it enters into swaps for “its own account” (i.e., as principal) in the “ordinary course of business” (i.e., normally while conducting business), provided that entering into these swaps is not its “regular business” (i.e., entering into swaps is ancillary to its core business).²⁰

¹⁹ The CRS Report, p. CRS-14 (stating that “A basic principle of statutory construction is that courts should ‘give effect, if possible to every clause and word of a statute, avoiding, if it may be, any construction which implies that the legislature was ignorant of the meaning of the language it employed.’” (quoting *Montclair v. Ramsdell*, 107 U.S. 147, 152 (1883)). See also the CRS Report, CRS-12, footnote 62 (discussing the “modern variant” of this canon).

²⁰ As mentioned below, certain financial entities may also satisfy these criteria, such as “special entities” (as defined in CEA section 4s(h)(2)(C), 7 U.S.C. 6s(h)(2)(C) (e.g., certain employee benefit plans covered by the Employee Retirement Income Security Act of 1974 (“ERISA”)). If the Commission wanted to prevent other financial entities from abusing CEA section 1a(49)(C), 7 U.S.C. 1a(49)(C), the Commission could have preliminarily limited the exclusion to commercial end-users (or other entities that the Commission determines could be excluded based on a holistic reading of the Dodd-Frank Act and the CEA, including small financial institutions as delineated in CEA section 2(h)(7)(C), 7 U.S.C. 2(h)(7)(C)). Additionally, if the Commission wanted to prevent commercial end-users (or such other entities) from abusing CEA section 1a(49)(C) (by, e.g., entering into non-ancillary transactions in swaps), the Commission has anti-evasion authority under section 721(c) of the Dodd-Frank Act.

The regulations that the Commission promulgates under the Dodd-Frank Act will irrevocably change the structure of the swap markets. Such changes have benefits and costs. To properly weigh the benefits and costs of its regulations under CEA section 15(a), 7 U.S.C. 19(a), it would have behooved the

If the Commission had adopted this construction, the Commission would have per se excluded commercial end-users. Such exclusion would have permitted these entities to freely hedge their business risks, whether financial or physical, without fear of becoming a “swap dealer.” Just to provide some context, commercial end-users include Caterpillar, John Deere, and ConAgra Foods. These entities have “a regular business” of supplying energy, food, and other tangible products to America. To these entities, swaps are ancillary tools that they can use to manage risk. These entities suffered from – rather than perpetrated – the 2008 financial crisis. Yet, these entities (either individually or through trade associations) took the time to draft and submit comment letters to the Commission – sometimes multiple letters – because they were afraid of being defined as “swap dealers.”

If the Commission had any doubt regarding the above construction, the Commission could have referred to various letters from members of Congress. Such letters explicitly state that Congress intended to exclude commercial end-users. For example, former Chairman Christopher Dodd and Chairwoman Blanche Lincoln circulated a joint letter stating: “Congress does not intend to regulate end-users as Major Swap Participants or Swap Dealers just because they use swaps to hedge or manage the commercial risks associated with their business.”²¹ Both

Commission to have discussed (i) categorically excluding certain entities from the “swap dealer” definition within the phase-in period, and (ii) exercising anti-evasion authority, if the Commission found it necessary based on its surveillance of the swaps market.

²¹ Letter from Chairman Christopher Dodd, Committee on Banking, Housing, and Urban Affairs, United States Senate, and Chairman Blanche Lincoln, Committee on Agriculture, Nutrition, and Forestry, United States Senate, to Chairman Barney Frank, Financial Services Committee, United States House of Representatives, and Chairman Colin Peterson, Committee on Agriculture, United States House of Representatives (June 30, 2010) (the “Dodd-Lincoln Letter”).

The Dodd-Lincoln Letter (as well as the Stabenow-Lucas Letter (as defined below)) appears to have embraced a broader conception of “commercial risk” than the Commission. See infra note 42.

senators Dodd and Lincoln were instrumental in shaping the legislation that became the Dodd-Frank Act.

Recently, Chairwoman Debbie Stabenow and Chairman Frank Lucas reiterated this point: [I]t is important for the Commission to finalize the swap dealer definition in a manner that is not overly broad, and that will not impose significant new regulations on entities that Congress did not intend to be regulated as swap dealers. The Commission's final rulemaking further defining 'swap dealing' should clearly distinguish swap activities that end-users engage in to hedge or mitigate the commercial risks associated with their businesses, including swaps entered into by end-users to hedge physical commodity price risk, from swap dealing.²²

It is important to note that Chairwoman Stabenow and Chairman Lucas lead the Congressional committees charged with overseeing the Commission.

- CEA section 1a(49)(B): Discretionary Exclusion for Entities

In the alternative (assuming that the Commission rejects the above construction), CEA section 1a(49)(B) also contradicts the Commission's focus on the activities in CEA section 1a(49)(A). Specifically, CEA section 1a(49)(B), when properly construed, sets forth a permissive exclusion focused on entities, with respect to either their activities or their swaps. CEA section 1a(49)(B) states: "A person may be designated as a swap dealer for a single type or single class or category of swap or activities and considered not to be a swap dealer for other types, classes, or categories of swaps or activities."

²² Letter from Chairwoman Debbie Stabenow, Committee on Agriculture, Nutrition, and Forestry, United States Senate, and Chairman Frank D. Lucas, Committee on Agriculture, United States House of Representatives to Chairman Gary Gensler, United States Commodity Futures Trading Commission (March 29, 2012) (the "Stabenow-Lucas Letter").

First, CEA section 1a(49)(B) references “[a] person.” CEA section 1a(38)²³ defines “person” as “import[ing] the plural or singular.” Read together, the sections indicate that CEA section 1a(49)(B) focuses on either (i) an entity or (ii) multiple entities.

Second, CEA section 1a(49)(B) states that “[a] person” (or “persons”) could be “considered not to be” a “swap dealer” for “types, classes, or categories of swaps.” So, an entity could be excluded from the “swap dealer” definition with respect to, e.g., physical commodity swaps, regardless of its activity with respect to such swaps. That indicates that the “swap dealer” definition does not solely focus on activity, as the Commission maintains. Instead, the characteristics of the entity and the underlying swaps are also relevant.

Third, CEA section 1a(49)(B) states that “[a] person” (or “persons”) could be “considered not to be” a “swap dealer” for certain “activities.” So, even if an entity engages in “activities” in CEA section 1a(49)(A), that entity may nevertheless not be a “swap dealer.” That indicates that the “swap dealer” definition may not even predominantly focus on activity.

Finally, CEA section 1a(49)(B) permits the Commission to include one “person” (or a group of “persons”) engaging in certain activities in the “swap dealer” definition, but to exclude another “person” (or group of “persons”) engaging in the same activities. Of course, the Commission has to articulate a rational basis for differential treatment. As discussed below, there may be certain statutory bases for differentiation (including the reference to “financial entity” in the end-user exception). Nothing in CEA section 1a(49)(B) prevents the Commission from so differentiating through rulemaking (rather than individual determinations).

○ Unnecessary Statutory Contortions

²³

7 U.S.C. 1a(38).

Instead of following the canons of statutory construction and properly interpreting CEA section 1a(49)(C) and CEA section 1a(49)(B), the Commission engages in a series of contortions with seemingly opposing purposes. Upon review, these contortions appear to stem from a desire of the Commission to provide a measure of certainty to commercial end-users in the CFTC Entities Rule, without explicitly contradicting the Proposal.

Preliminarily, the Commission appears to broadly define "swap dealer" to capture commercial end-users. For example, both the Proposal and the CFTC Entities Rule obfuscate the application of CEA section 1a(49)(C) to entities (rather than solely to activities) by collapsing CEA section 1a(49)(C) into CEA section 1a(49)(A)(iii).²⁴ In performing such collapse, the

²⁴ In Section II(A)(4)(d) of CFTC Entities Rule, the Commission states: "We recognize, as noted by one commenter (see letter from ISDA I), that the 'regular business' exclusion is not limited solely to the 'ordinary course of business' test of the swap dealer definition. Our interpretations of the other three tests are, and should be read to be, consistent with the exclusion of activities that are not part of a regular business."

Preliminarily, I would note that more than one commenter observed the collapse.

Secondarily, as noted above, CEA section 1a(49)(C), 7 U.S.C. 1a(49)(C), applies to entities (and not solely to activities). Therefore, the Commission does not (and really cannot) argue that the collapse of CEA section 1a(49)(C) into CEA section 1a(49)(A)(iii), 7 U.S.C. 1a(49)(A)(iii), has little to no impact on its construction of CEA sections 1a(49)(A)(i), (ii), and (iv), 7 U.S.C. 1a(49)(A)(i), (ii), and (iv).

Finally, although it is ambiguous in the CFTC Entities Rule (and not contemplated in the Proposal), it seems like the Commission may be indirectly relying on its reference to the dealer-trader distinction to justify its collapse of CEA section 1a(49)(C) and 1a(49)(A)(iii). Interestingly, the SEC does not state that "regular business" in Exchange Act section 3(a)(71)(C), 15 U.S.C. 78c(a)(71)(C) (parallel to CEA section 1a(49)(C)), is "synonymous" with "ordinary course of business" in Exchange Act section 3(a)(71)(A)(iii), 15 U.S.C. 78c(a)(71)(A) (parallel to CEA section 1a(49)(A)(iii)). Of course, it may have been understood that the SEC would hew more closely to the dealer-trader distinction, as historically applicable to securities, and thus would focus on activities and not entities. See Section II(A)(3) of the Entities Rule. However, one wonders that of all the distinctions that the Commission makes or attempts to preserve between the swaps and securities-based swaps markets, the Commission does not acknowledge (i) the "high degree of concentration" of dealing in the securities-based swaps markets among the largest financial entities and (ii) the lack of similar concentration in the swaps markets (particularly with respect to markets that commercial end-users frequent, such as the physical commodity swaps markets). Compare generally Section II(D)(5) of the SEC Entities Rule (which repeatedly references "high degree of concentration") with Section II(D)(4) of the CFTC Entities Rule (which does not contain such references). See also Section II(A)(2)(e)(iii) of the CFTC Entities Rule (describing

Commission states that it “continue[s] to believe, as stated in the [Proposal], that the phrases ‘ordinary course of business’ and ‘a regular business’ are, for purposes of the definition of ‘swap dealer’ essentially synonymous.”²⁵ Neither the Proposal nor the CFTC Entities Rule fully supports collapsing CEA section 1a(49)(C) – one of four clauses in the statutory “swap dealer” definition – into CEA section 1a(49)(A)(iii) – a subparagraph of one clause. Further, neither the Proposal nor the CFTC Entities Rule fully supports interpreting two separate phrases (i.e., “ordinary course of business” and “regular business”) as meaning the same thing. The Commission similarly minimizes CEA section 1a(49)(B) as providing for “limited designation” only, rather than an alternate source of authority for the Commission to exclude certain entities from the “swap dealer” definition.²⁶

comments with respect to electricity swaps). The Commission should have accorded greater consideration to differences in market structure before dismissing a construction of CEA section 1a(49)(C) as focusing on entities (and as independent of CEA section 1a(49)(A)(iii)).

²⁵ Section II(A)(4)(d) of the CFTC Entities Rule.

²⁶ The Commission characterizes CEA section 1a(49)(B), 7 U.S.C. 1a(49)(B), as “limited designation” based on a series of misconstructions. First, as noted above, the Commission insists that CEA section 1a(49)(A), 7 U.S.C. 1a(49)(A), is the entirety of the “swap dealer” definition. Second, the Commission then interprets CEA section 1a(49)(B) to apply to the registration of an entity as a “swap dealer,” and not to the “swap dealer” definition. Third, because CEA section 1a(49)(B) applies to registration, the Commission concludes that it would be appropriate to apply an individualized, facts-and-circumstances analysis.

In actuality, CEA section 1a(49)(B) does more than provide for “limited designation.” First, as discussed above, CEA section 1a(49)(A) sets forth general parameters for defining “swap dealer.” The entirety of the “swap dealer” definition is actually CEA sections 1a(49)(A), (B), (C), and (D), 7 U.S.C. 1a(49)(A), (B), (C), and (D). Second, CEA section 1a(49)(B) is in the definition of “swap dealer.” It is not in CEA section 4s(a), 7 U.S.C. 6s(a), which pertains to registration of “swap dealers.” Therefore, the Commission should have considered the effect of CEA section 1a(49)(B) in delineating the universe of entities that need to seek registration with the Commission, and not solely the effect of CEA section 1a(49)(B) in determining the scope of registration that the Commission would afford such entities. Third, because CEA section 1a(49)(B) relates to the definition and not the registration of “swap dealers,” the Commission articulates no basis for an individualized, facts-and-circumstances determination.

However, after appearing to broadly define “swap dealer”, the Commission then cobbles together various measures that aim – with differing levels of success – to provide a measure of certainty to commercial end-users. The most important (and successful) of these measures is a higher de minimis threshold. Two other important measures are: (i) referencing the dealer-trader distinction and (ii) incorporating an explicit hedging exception.

Although these measures reflect positive policy choices, they also reflect various compromises that may ultimately diminish the certainty that they seek to provide. As mentioned above, the Commission could have provided equivalent or superior certainty by properly construing CEA sections 1a(49)(C) and (B), either initially or in a re-proposal.

○ Reference to the Dealer-Trader Distinction

In the CFTC Entities Rule, the Commission states that it “believe[s] that the dealer-trader distinction – which already forms a basis for identifying which persons fall within the longstanding Exchange Act definition of ‘dealer’ – in general provides an appropriate framework for interpreting the statutory definition of the term ‘swap dealer.’”²⁷ In so recognizing, the Commission departs from the Proposal.²⁸ I have always argued that differences exist among (i) dealing, (ii) trading, and (iii) hedging. I have also recommended that the Commission provide guidance to clearly distinguish among the three categories. Such guidance would aid market participants in determining whether to register as a “swap dealer.” Although the CFTC Entities

²⁷ Section II(A)(4)(a) of the CFTC Entities Rule.

²⁸ The Commission acknowledges such departure, but attempts to mitigate its legal effect by emphasizing that (i) the dealer-trader framework overlaps with the functional approach in the Proposal, and (ii) the Commission has changed its interpretative approach to the “swap dealer” definition in response to comments. See Section II(A)(4)(a) of the CFTC Entities Rule.

Rule contains (i) an interim final hedging exception²⁹ and (ii) a final “floor trader” exclusion,³⁰ both provisions are limited in scope. Therefore, market participants will still need clear guidance on Commission interpretation of the dealer-trader distinction, in order to determine whether their trading or hedging transactions may cause them to be deemed “swap dealers.”

Unfortunately, the Commission has missed its opportunity in the CFTC Entities Rule. After reading the relevant portions of the rulemaking multiple times, it is still unclear to me exactly how the Commission intends to distinguish among (i) dealing, (ii) trading (outside of the limited “floor trader” exclusion), and (iii) hedging (outside of the specific hedging exception, which I discuss below). For example, the Commission states: “[t]he principles embedded within the ‘dealer trader distinction’ are also applicable to distinguishing dealers from non-dealers such as hedgers or investors.”³¹ I agree with this statement. The Commission also cites to more support from the SEC Entities Rule – specifically the fact that “[t]he ‘dealer-trader’ nomenclature has been used for decades.”³² I also agree with this statement. However, the Commission then states: “These same principles, though instructive, may be inapplicable to

²⁹ As described below, this exception only applies to physical commodity swaps. Therefore, commercial end-users would not be able to rely on this exception for swaps to hedge financial risks. Moreover, small financial institutions would not be able to rely on this exception (as they most likely would be hedging financial risk), even if the Commission were to permit them to use the end-user exception. Finally, even financial entities (such as “special entities”) may engage in “hedging” without “dealing.” The CFTC Entities Rule does not provide much clarity on how such financial entities could demonstrate that they are not “dealing” (other than the amorphous distinction between “purpose” and “consequences”).

³⁰ The final “floor trader” exclusion has many limitations. For example, an entity cannot rely on this exclusion if it participates in a market-making program offered by a designated contract market (“DCM”) or swap execution facility. One wonders what would happen if an entity participates in a DCM market-making program for futures, and then the Commission requires such futures to be converted to swaps in a forthcoming rulemaking. See, e.g., Core Principles and Other Requirements for Designated Contract Markets, 75 FR 80572 (Dec. 22, 2010).

³¹ Section II(A)(4)(a) of the CFTC Entities Rule.

³² Section II(A)(5)(a) of the SEC Entities Rule.

swaps in certain circumstances or may be applied differently in the context of dealing activities involving commodity, interest rate, or other types of swaps.”³³ I do not know whether to agree or disagree with this statement, given its ambiguity. Thus, for all of its girth, the CFTC Entities Rule fails to answer a basic question – namely, under which circumstances would an entity be deemed a dealer (rather than a trader or hedger) with respect to specific swap transactions?³⁴

The Commission appears to argue that inherent differences between the swaps markets and securities markets (other than security-based swaps) justify its selective incorporation of dealer-trader elements (which elements, in themselves, apparently vary according to unknown facts and circumstances). For example, the Commission states that an entity need not engage in two-way transactions in order to fall within the “swap dealer” definition. One justification that the Commission advances is that “swaps thus far are not significantly traded on exchanges or other trading systems” and that this “[attribute] – along with the lack of ‘buying and selling’ language in the swap dealer definition...-- suggest that concepts of what it means to make a market need to be construed flexibly in the contexts of the swap market.”³⁵ However, in the same section of the CFTC Entities Rule, the Commission states: “many cash market securities also are not significantly traded on those systems.”³⁶ Therefore, the Commission advances a justification for selective incorporation of dealer-trader elements and then contradicts its

³³ Section II(A)(3) of the Entities Rule.

³⁴ For example, in Section II(A)(4)(a) of the CFTC Entities Rule, the Commission sets forth a list of indicia that are either “particularly similar to” or “generally consistent with...the dealer-trader distinction as it will be applied to determine whether a person is a security-based swap dealer.” However, the Commission immediately undermines any comfort that such list could provide by stating “[t]o clarify, the activities listed in the text are indicative of acting as a swap dealer. Engaging in one or more of these activities is not a prerequisite to a person being covered by the swap dealer definition.”

³⁵ Section II(A)(4)(a) of the CFTC Entities Rule.

³⁶ Id.

justification in the same paragraph. Thus, even if market participants wished to understand Commission reasoning to determine whether they need to register as “swap dealers,” they may not be able to do so.

Finally, the Commission and the SEC appear to emphasize different dealer-trader elements. For example, the Commission tends to emphasize “accommodating demand or facilitating interest in the instrument.”³⁷ In contrast, the SEC tends to emphasize “a business model that seeks to profit by providing liquidity.”³⁸ The Commission fails to provide a rationale for its difference in focus.³⁹ On its face, “accommodating demand or facilitating interest” seems to capture more traders and hedgers than having “a business model that seeks to profit by providing liquidity.”

○ Interim Final Rule on Hedging

In the CFTC Entities Rule, the Commission has included an interim final rule excepting certain hedging transactions from the “swap dealer” definition (i.e., Regulation 1.3(ggg)(6)(iii)).⁴⁰ I agree that hedging is not dealing. However, I find the interim final rule excessively narrow. First, the interim final rule only applies to a limited set of physical

³⁷ See generally Section II(A)(4) of the CFTC Entities Rule.

³⁸ See generally Section II(A)(5) of the SEC Entities Rule.

The CFTC Entities Rule does acknowledge that seeking to profit from providing liquidity is one indicia of dealing. However, the CFTC Entities Rule limits its discussion of this indicia to CEA section 1a(49)(A)(ii), 7 U.S.C. 1a(49)(A)(ii), which emphasizes market-making. The Commission appears to rely more heavily on “accommodating demand or facilitating interest” (without necessarily emphasizing a “business model that seeks to profit from providing liquidity”) in its interpretation of the remainder of CEA section 1a(49)(A), 7 U.S.C. 1a(49)(A). Therefore, a dissonance still exists between the CFTC Entities Rule and the SEC Entities Rule.

³⁹ See *supra* note 24. The Commission could have focused on differences in market composition. Unfortunately, such focus could have raised other issues with Commission construction of CEA section 1a(49), 7 U.S.C. 1a(49).

⁴⁰ See Section II(A)(4)(e) of the CFTC Entities Rule.

commodity hedges. I am not sure why the Commission does not wish to allow commercial end-users to hedge financial risks (e.g., through interest rate swaps) without fearing that they could be deemed “swap dealers.”⁴¹ Permitting such hedging would be consonant with Congressional intent, as expressed in the letters from members of Congress.⁴² Conversely, I am not sure why the Commission wants to encourage, e.g., banking entities – like Barclays – to own physical commodities and claim the hedge exception.

⁴¹ The Commission relies on its misconstruction of the statutory “swap dealer” definition to justify such a narrow exclusion. In Section II(A)(4)(e) of the CFTC Entities Rule, the Commission states: “In terms of the statutory definition of the term ‘swap dealer,’ the CFTC notes as an initial matter that there is no specific provision addressing hedging activity. Thus, the statutory definition leaves the treatment of hedging swaps to the CFTC’s discretion; it neither precludes consideration of a swap’s hedging purpose, nor does it require an absolute exclusion of all swaps used for hedging.” As noted above, whereas CEA section 1a(49) does not specifically refer to “hedging,” CEA section 1a(49)(C), 7 U.S.C. 1a(49)(C), (as well as CEA section 1a(49)(B), 7 U.S.C. 1a(49)(B)) – as properly construed – would have excluded commercial end-users that engage in swaps for purposes of hedging. It is interesting that the SEC did not endorse these specific sentences.

⁴² As mentioned above, the Commission contorts itself in the CFTC Entities Rule to provide an interim hedging exception that applies only to physical commodity risks. This approach runs contrary to the Dodd-Lincoln Letter (as well as the Stabenow-Lucas Letter). Both letters emphasize exclusions for entities – such as commercial end-users – so that they could freely hedge their risks – whether financial or physical.

The Dodd-Lincoln Letter begins by referencing hedging of interest rate risk. It specifically states: “Whether swaps are used by an airline hedging its fuel costs or a global manufacturing company hedging interest rate risk, derivatives are an important tool businesses use to manage costs and market volatility. This legislation will preserve that tool.” Moreover, the Dodd-Lincoln Letter states: “The end user exemption may also apply to our smaller financial entities – credit unions, community banks, and farm credit institutions.” If such institutions could be categorized as “swap dealers,” then they would be prohibited from relying on the end-user exception. Such institutions would likely seek to hedge financial risk.

As mentioned above, the Stabenow-Lucas Letter states: “The Commission’s final rulemaking further defining ‘swap dealing’ should clearly distinguish swap activities that end-users engage in to hedge or mitigate the commercial risks associated with their businesses, including swaps entered into by end-users to hedge physical commodity price risk, from swap dealing.” In using the term “including,” the Stabenow-Lucas Letter acknowledges that end-users may use swaps to hedge or mitigate risks – such as financial risks – other than those related to physical commodities.

By focusing only on physical commodity risks, therefore, the interim hedging exception fails to fully satisfy Congressional intent.

Second, there are four other hedging definitions that are either (i) currently effective or (ii) the subject of a Dodd-Frank Act proposal.⁴³ Given the call by President Obama to simplify regulation,⁴⁴ I would have expected the Commission to refrain from proposing a fifth hedging definition, unless strictly necessary. In the CFTC Entities Rule, the Commission does not cogently explain the necessity for a fifth hedging exception. For example, the Commission spends a considerable amount of effort to differentiate the interim final rule from bona fide hedging in Regulations 1.3(z) and 151.5(a)(1). The Commission's rationale may be distilled into one circular sentence: the Commission believes that certain bona fide hedging transactions may constitute swap dealing, due to reasons that the Commission declines to fully explain.⁴⁵ Additionally, the Commission spends one paragraph attempting to differentiate between the interim final rule and the "major swap participant" definition (which contains a hedging or mitigating commercial risk exception). In that paragraph, the central argument appears to be that the "swap dealer" definition determines the parameters of the "major swap participant" definition – but not also vice versa.⁴⁶ Preliminarily, the Commission declines to cite where exactly the

⁴³ See Regulation 1.3(z), 17 C.F.R. 1.3(z); (ii) Regulation 151.5(a)(1) (in Position Limits in Futures and Swaps; Final Rule, 76 FR 71626, 71688 (Nov. 18, 2011) (to be codified at 17 C.F.R. Parts 1, 150, and 151)); (iii) Regulation 1.3(hhh) (as set forth in the CFTC Entities Rule); and (iv) Regulation 39.6(c) (in End-User Exception to Mandatory Clearing of Swaps; Proposed Rule, 75 FR 80747, 80757 (Dec. 23, 2010)).

⁴⁴ See Exec. Order No. 13563, 76 FR 3821, Jan. 21, 2011; see also Exec. Order No. 13579, 76 FR 41587, July 14, 2011.

⁴⁵ In Section II(A)(4)(e) of the CFTC Entities Rule, the Commission attempts to distinguish between "purpose" and "effect." Market participants may find such an attempt to be less than clear.

⁴⁶ Section II(A)(4)(e) of the CFTC Entities Rule (stating "...The definition of the term "major swap participant," which applies only to persons who are not swap dealers, is premised on the prior identification, by the swap dealer definition, of persons who accommodate demand for swaps, make a market in swaps, or otherwise engage in swap dealing activity. The major swap participant definition performs the subsequent function of identifying persons that are not swap dealers, but hold swap positions that create an especially high level of risk that could significantly impact the U.S. financial system.").

Dodd-Frank Act states that the “swap dealer” definition is determinative. Secondly, even assuming that the Commission is correct in characterizing the interconnection, the Commission does not clearly explain why it thinks that those transactions (i) falling outside the interim final rule but (ii) falling within hedging or mitigating commercial risk are more likely to constitute swap dealing.

Finally, the Commission is silent on the manner in which the interim final rule interacts with the proposed Regulation 39.6 (detailing hedging or mitigating commercial risk for the end-user exception). If an entity is a “swap dealer,” then it cannot rely on the end-user exception to clearing.⁴⁷ Therefore, if the Commission overreaches in defining “swap dealer,” it may narrow the end-user exception in a way not congruent with Congressional intent.⁴⁸

Other Provisions of the Dodd-Frank Act and the CEA: Further Misconstructions

As mentioned above, the Commission fails to properly construe the various clauses of CEA section 1a(49). As detailed in this section, the Commission also fails to consider other provisions of the CEA or the Dodd-Frank Act in determining the parameters of “swap dealer.” The Commission appears to assume that the “swap dealer” definition is determinative for all such provisions, rather than also vice versa. The Commission does not provide much (if any) rationale for this assumption. Removing this assumption, it becomes clear that other provisions of the CEA or the Dodd-Frank Act may suggest further limitations on “swap dealer.”⁴⁹

- End-User Exemption: Who can take advantage of it?

⁴⁷ See CEA section 2(h)(7), 7 U.S.C. 2(h)(7). See also supra note 43.

⁴⁸ See supra note 42.

⁴⁹ As mentioned above, the Commission has authority to discretionarily exclude certain entities pursuant to CEA section 1a(49)(B), 7 U.S.C. 1a(49)(B).

CEA section 2(h)(7) sets forth what is commonly known as the “end-user clearing exception.” As mentioned above, the “swap dealer” definition is crucial to determining which entities could use the end-user clearing exception. That is because CEA section 2(h)(7) only applies if one counterparty to a swap is not a “financial entity.”⁵⁰ CEA section 2(h)(7)(C) defines “financial entity” as including a “swap dealer.”⁵¹ Therefore, if the Commission defines “swap dealer” expansively, then the Commission will limit the number and types of end-users that may use the clearing exception.

Given the importance of the interconnections between the “swap dealer” definition and the end-user clearing exception, I would have expected the Commission to discuss such interconnections in great detail. Surprisingly, in that portion of the CFTC Entities Rule defining “swap dealer,” the Commission only discusses end-user clearing in a footnote.⁵²

Footnote 213 illustrates in a particularly poignant manner the Commission’s failure to properly consider the interaction between the “swap dealer” definition and the end-user exception. In that footnote, the Commission attempts to dismiss the argument that the “swap dealer” definition should only apply to financial entities. The Commission states:

⁵⁰ CEA section 2(h)(7)(A), 7 U.S.C. 2(h)(7)(A), states: “In General. – The requirements of paragraph (1)(A) shall not apply to a swap if 1 of the counterparties to the swap – (i) is not a financial entity; (ii) is using swaps to hedge or mitigate commercial risk; and (iii) notifies the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations associated with entering into non-cleared swaps.”

⁵¹ Notably, CEA section 2(h)(7)(C)(i), 7 U.S.C. 2(h)(7)(C)(i), also lists commodity pools, certain private funds, certain employee benefit plans, and certain banking and financial entities separately from “swap dealer.” Does this separate listing imply that those entities are not “swap dealers”? Why or why not?

⁵² The Commission discusses the end-user clearing exception more fully in that portion of the CFTC Entities Rule defining “major swap participant.”

Similarly, the absence of any limitation in the statutory definition of the term “swap dealer” to financial entities, when such limitation is included elsewhere in Title VII, indicates that no such limitation applies to the swap dealer definition. CEA section 2(h)(7), 7 U.S.C. 2(h)(7), specifically limits the application of the clearing mandate, in certain circumstances, to only “financial entities.” That section also provides a detailed definition of the term “financial entity.” See CEA section 2(h)(7)(C), 7 U.S.C. 2(h)(7)(C). That such a limitation is included in this section, but not in the swap dealer definition, does not support the view that the statutory definition of the term “swap dealer” should encompass only financial entities.

In actuality, Footnote 213 raises more questions than it answers. In Footnote 213, the Commission presumes that the interaction between the “swap dealer” definition and the end-user exception only goes one way – namely, that the “swap dealer” definition fixes the scope of the end-user exception, but not also vice versa. The Commission provides no basis for this presumption, especially since a basic canon of statutory is that the Commission should construe a statute as a “harmonious whole.” From that perspective, it becomes clear that Footnote 213 raises a series of fundamental questions. Why did Congress use the term “financial entity” in CEA section 2(h)(7)(C)? Does use of this term imply in any way that Congress presumed that the “swap dealer” definition would exclude commercial entities? Why or why not? Surely, Congress need not have specified financial entity in CEA section 2(h)(7)(C) if it had intended to permit the Commission to vitiate the reference to financial by simply defining “swap dealers” to include commercial entities. If Congress intended to so permit, then Congress could have simply used the term “entity” in CEA section 2(h)(7)(C).

- Employee Benefit Plans: “Swap Dealers?”

In Section II(A)(2)(f) of the CFTC Entities Rule, the Commission describes comments requesting categorical exclusions from the “swap dealer” definition. One such comment was from American Benefits Council (“ABC”) and the Committee on the Investment of Employee Benefit Assets (“CIEBA”).⁵³ In their comments, ABC/CIEBA requested that the Commission exclude (or interpret CEA section 1a(49) to exclude) certain employee benefit plans from the “swap dealer” definition. In Section II(A)(6) of the CFTC Entities Rule, the Commission denies this request, mainly on the basis of its misguided construction of CEA section 1a(49).

In so denying, the Commission fails to consider CEA section 4s(h). Specifically, CEA sections 4s(h)(2), (4), and (5) prescribe heightened business conduct standards for “swap dealers” interacting with “special entities.” In fact, the Commission recently promulgated a final rulemaking on these standards.⁵⁴ CEA section 4s(h)(2)(C) defines “special entity” as, among other things, “any employee benefit plan, as defined in section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002).” CEA section 4s(h) raises another series of fundamental questions. Did Congress presume that employee benefit plans would not constitute “swap dealers”?⁵⁵ Why or why not? Indeed, how does the Commission reconcile its denial of the ABC/CIEBA request with its own *de minimis* requirement, which seems to recognize a *per se* difference between a “special entity” and a “swap dealer”?⁵⁶

- Internal Business Conduct Standards: Indication of the Scope of “Swap Dealer?”

⁵³ Comment from ABC/CIEBA, dated February 22, 2011, available at: <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27944&SearchText=American%20Benefits%20Council>.

⁵⁴ Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties; Final Rule, 77 FR 9734 (Feb. 17, 2012).

⁵⁵ See *supra* note 51.

⁵⁶ See Section II(D) of the Entities Rule.

In addition to failing to account for external business conduct standards, the Commission fails to account for certain internal business conduct standards in defining “swap dealer.” For example, CEA section 4s(j)(5) requires “swap dealers” to have systems and procedures to mitigate conflicts of interest resulting from interactions between (i)(A) any person engaged in “research or analysis of the price or market for any commodity or swap” or (B) any person “acting in a role of providing clearing activities or making determinations as to accepting clearing customers” and (ii) certain persons involved in “pricing, trading, or clearing activities.” The Commission recently promulgated a final rulemaking on this requirement.⁵⁷ CEA section 4s(j)(5) raises another fundamental question. Did Congress presume that “swap dealers” generally engage in either “research or analysis” or “providing clearing activities or making determinations” and “pricing, trading, or clearing activities”? Why or why not?

- Volcker: How does the CFTC Entities Rule Fit?

As I have noted previously, the “Volcker Rule”⁵⁸ sets forth detailed metrics to differentiate between (i) market-making and (ii) proprietary trading. To say that the CFTC Entities Rule does not replicate such detail would be an understatement. Worse, the CFTC Entities Rule does not even attempt to explain why the metrics in the Volcker Rule are inapplicable to the “swap dealer” definition. In fact, the Commission addresses the interaction between the Volcker Rule and the CFTC Entities Rule only in one footnote. This footnote states in relevant part:

⁵⁷ Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants; Final Rule, 77 FR 20128 (Apr. 3, 2012).

⁵⁸ Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Covered Funds; Proposed Rule, 77 FR 8332 (Feb. 14, 2012).

The Commissions have proposed an approach to the Volcker Rule under which a person could seek to avoid the Volcker Rule in connection with swap activities by asserting the availability of that market making exception... Under this approach, such a person would likely also be required to register as a swap dealer (unless the person is excluded from the swap dealer definition, such as by the exclusion of certain swaps entered into in connection with the origination of a loan).⁵⁹

Of course, this footnote provides no useful clarification, since the operative question is whether an entity engaging in activities that would not be "market-making" under the Volcker Rule could nonetheless be engaging in "market-making" under the CFTC Entities Rule (and, solely by virtue of such characterization, be required to register as a "swap dealer").

Conclusion

In the CFTC Entities Rule, the Commission has made many positive policy changes. To enable these changes, however, the Commission engages in a series of statutory contortions. Moreover, the Commission ignores a number of important questions. Witnessing these statutory gymnastics, I am reminded of the Robert Frost poem, "The Road Not Taken." In its eagerness to adopt the CFTC Entities Rule, the Commission opted for one road. Specifically, the Commission opted for providing more relief to market participants, without contradicting the fundamental premises of the Proposal. However, once market participants have examined the rulemaking, will the Commission have wished that it had properly construed CEA section 1a(49) instead? Given the Proposal and the final CFTC Entities Rule (and their respective differences),

⁵⁹ Section II(A)(4)(c) of the CFTC Entities Rule.

the Commission may well conclude that "...it took the one less traveled by...And that has made all the difference."⁶⁰

⁶⁰ Generally, because the vast body of administrative law provides guideposts to the road more traveled.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Rel. No. 9314 / April 19, 2012

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 66835 / April 19, 2012

Admin. Proc. File No. 3-14266

In the Matter of

JOHNNY CLIFTON

ORDER GRANTING PARTIAL
PROTECTIVE ORDER

Johnny Clifton has submitted a petition for review of an administrative law judge's initial decision, together with financial disclosure statements containing personal financial information that he requests be protected from public disclosure ("Confidential Information"). The Division of Enforcement has not responded to Clifton's request for a protective order.

Under Rule of Practice 322, any party "may file a motion requesting a protective order to limit from disclosure to other parties or to the public documents or testimony that contain confidential information."¹ That rule further provides that "[a] motion for a protective order shall be granted only upon a finding that the harm resulting from disclosure would outweigh the benefits of disclosure."²

The documents that Clifton submitted contain sensitive information and, at this stage in the proceeding, the harm resulting from complete disclosure appears to outweigh the benefits. However, we have determined that disclosure of certain information included in the record will be necessary to the resolution of the issues before us.

¹ 17 C.F.R. § 201.322(a).

² 17 C.F.R. § 201.322(b).

Accordingly, IT IS ORDERED that:

1. Except as otherwise provided in this Order, the Confidential Information shall be disclosed only to the parties to this action, their counsel, the Commission, any staff advising the Commission in its deliberative processes with respect to this proceeding, and in the event of an appeal of the Commission's determination, any staff acting for the Commission in connection with that appeal.
2. All persons who receive access to the Confidential Information shall keep it confidential and, except as provided in this Order, shall not divulge the Confidential Information to any person.
3. No person to whom the Confidential Information is disclosed shall make any copies or otherwise use such Confidential Information, except in connection with this proceeding or any appeal thereof.
4. The Office of the Secretary shall place the Confidential Information in sealed envelopes or other sealed containers marked with the title of this action, identifying each document, and marked "CONFIDENTIAL."
5. The requirements of sealing and confidentiality shall not apply to any reference to the existence of the Confidential Information or to citation of particular information contained therein in testimony, oral argument, briefs, opinions, or in any other similar use directly connected with this action or any appeal thereof.
6. The Commission expressly reserves the authority to reach a different conclusion regarding the confidentiality of the Confidential Information covered by this Order at any time before it determines the issues raised in the proceeding.

By the Commission.



Elizabeth M. Murphy
Secretary

*Commissioner Aguilar
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 66831 / April 19, 2012

INVESTMENT COMPANY ACT OF 1940
Release No. 30039 / April 19, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14853

In the Matter of

OX Trading, LLC,
optionsXpress, Inc., and
Thomas E. Stern,

Respondents.

ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-
AND-DESIST PROCEEDINGS
PURSUANT TO SECTIONS 15(b) AND
21C OF THE SECURITIES
EXCHANGE ACT OF 1934 AND
SECTION 9(b) OF THE INVESTMENT
COMPANY ACT OF 1940 AND
NOTICE OF HEARING

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against OX Trading, LLC ("OX Trading"), optionsXpress, Inc. ("optionsXpress"), and Thomas E. Stern ("Stern") (collectively, "the Respondents").

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. OX Trading is a Delaware corporation with a principal place of business in Chicago, IL. It was created to provide price improvement to customers of optionsXpress. It was a subsidiary of optionsXpress Holdings, Inc. ("Holdings") until September 1, 2011, when it became a wholly-owned subsidiary of The Charles Schwab Corporation ("Schwab").

2. optionsXpress is a Delaware corporation with a principal place of business in Chicago, IL. optionsXpress is a self-clearing, retail, on-line broker specializing

in options and futures. It is registered with the Commission, the Financial Industry Regulatory Authority ("FINRA"), Chicago Board Options Exchange ("CBOE"), various stock exchanges, and 53 states and territories. optionsXpress was a wholly-owned subsidiary of Holdings until September 1, 2011, when it became a wholly-owned subsidiary of Schwab.

3. Stern, 66, of Chicago, IL, was the Chief Financial Officer, Secretary, Director, and Chief Compliance Officer of OX Trading; the Chief Financial Officer of optionsXpress; the Chief Administrative Officer of Holdings; the President and Chief Executive Officer, Chief Compliance Officer and Director of optionsXpress International, Inc.; and the Chief Financial Officer and Director of brokersXpress, LLC. He is a board member of the Options Clearing Corporation. He holds Series 3, 4, 7, 24, 27, and 63 licenses.

B. ALLEGATIONS

OX Trading Is Registered as a Broker-Dealer

4. OX Trading was formed in August 2007 with Stern as the Chief Financial Officer. Stern also served as OX Trading's Chief Compliance Officer, responsible for the entity's "regulatory functions," including its legal formation and ensuring its proper registration status.

5. OX Trading was created to provide price improvement on orders from optionsXpress' customers and to profit from those trades. The idea originated with the head of optionsXpress' order desk. He felt that price improvement would be beneficial for optionsXpress' customers and a way to generate profit for Holdings.

6. Price improvement generally means the execution of an order at a price better than the public quote at the time the market center received the order.

7. OX Trading was registered with the Commission as a broker-dealer as of February 1, 2008 and became a member of CBOE. According to Stern, it was his decision to have OX Trading register because "it was going to be active enough" and would be conducting "a lot of trades."

8. After becoming registered as a broker-dealer, OX Trading received electronic requests for quotes ("RFQs") from optionsXpress. These RFQs allowed OX Trading to determine whether it wanted to be the counterparty to an optionsXpress customer's order. Generally, the decision whether or not to be a counterparty to the optionsXpress customer trade was done automatically through a computerized system.

9. Although the decision whether or not to be a counterparty to the optionsXpress customer trade was generally done automatically, on at least one occasion, optionsXpress' head trader directed OX Trading to take the trade of an optionsXpress customer who he believed "deserved an execution" but who was "not getting executed in the marketplace."

10. If OX Trading wanted to act as the counterparty to an optionsXpress customer order, OX Trading would send a notice back to optionsXpress with an order identifying an exchange to which the order should be sent. optionsXpress would then send a paired trade to one of several price improvement auctions offered by various exchanges, such as CBOE's Automated Improvement Mechanism ("AIM"). If OX Trading chose not to be the counterparty on an order, optionsXpress would route the trade to an exchange. This process has not changed since OX Trading's formation.

11. Although CBOE's AIM system was the first auction mechanism used by OX Trading, it later began using the NASDAQ Options Market system (no later than May 2009); International Stock Exchange's Price Improvement Mechanism (no later than early 2008); and BATS (no later than the fall of 2010).

12. OX Trading is not a member of FINRA and is not, and has not been, a member of any exchange other than CBOE.

13. OX Trading makes money when it trades as a counterparty to optionsXpress customer orders and hedges the positions created by those trades. According to OX Trading's head trader: "The entity's desire is to make money, so after we price improve a customer order we end up having a position. And we manage those positions in such a way to . . . capture profit within those trades. . . . OX Trading makes money if it sells an option at one price and buys it at a lower price and sells it at a higher price."

14. Holdings' former CEO described OX Trading similarly: "[OX Trading] generates revenue by trading, by entering into primarily options positions and hedging those positions and either letting them expire or trading out of them and generating profit by buying low and selling high or selling high and buying low."

15. OX Trading's personnel describe OX Trading as a liquidity provider.

16. Internal OX Trading documents described OX Trading as providing a "2 sided market."

OX Trading Deregisters

17. On December 31, 2008, an examiner in CBOE's Department of Member Firm Regulation ("DMFR") sent an email to Stern asking why OX Trading lost more than 15% of its excess net capital in November 2008. The CBOE examiner also asked OX Trading to complete a Member Questionnaire and inquired whether OX Trading only conducted proprietary trading or whether it also acted as a market maker.

18. Stern completed the questionnaire stating that OX Trading conducted only proprietary trading. The questionnaire did not list an outside auditor for the firm and stated that OX Trading facilitated "optionsXpress, Inc.'s customer in getting solicited by optionsXpress, Inc. for better than NBBO fill on CBOE AIM system. No other

primary trades other than to hedge or liquidate the above." Stern did not respond to the examiner's inquiry about the November 2008 loss.

19. The CBOE examiner again asked Stern for a detailed explanation of OX Trading's November loss and told Stern that OX Trading was required to have an annual audit based on its CBOE membership status.

20. Stern responded that the loss was "due to the conversion from the inventory range to the customer range because of our desire for optionsXpress, Inc. the clearing firm, to be able to classify its margin debit receivable from OX Trading as a 'good' asset." However, internal OX Trading emails indicate that at least part of the loss was due to poor trading performance.

21. Despite CBOE's request, Stern refused to pay for an audit and subsequently decided to terminate OX Trading's CBOE membership.

22. On February 2, 2009, Stern notified CBOE that "OX Trading has given notice to its lessor to terminate its [CBOE membership] lease. Once the lease is terminated, OX Trading will cease to be a CBOE member and a broker-dealer." Then on February 25, 2009, Stern again notified CBOE that "[w]e will cease being a BD on Saturday."

23. OX Trading ceased being a member of CBOE on March 2, 2009. Despite terminating its CBOE membership, OX Trading continued to conduct the same trading, but through a customer portfolio margin account at optionsXpress. Stern did not inform the CBOE that OX Trading would continue its operations as a customer of optionsXpress.

24. On May 11, 2009, the Commission's Division of Trading and Markets Office of Financial Responsibility ("OFR") notified OX Trading that "[b]roker-dealers who only transact business on an exchange must be a member of that exchange" and "[t]herefore, unless you can demonstrate within 35 days of receipt of this letter that you have applied for membership with an exchange or the FINRA, your registration with the Commission will be cancelled." OFR then cautioned: "Please note that you may not engage in the securities business unless you are a member of an exchange or the NASD and that merely having made application for membership will not satisfy the legal requirement." On June 17, 2009, OFR sent a second letter to OX Trading containing the same admonitions.

25. According to an email sent by Stern, OX Trading "stalled as long as we could," but finally on August 18, 2009, Stern filed a form with the Commission to deregister OX Trading as a broker-dealer. The deregistration became effective October 17, 2009.

26. OX Trading continued to trade through a customer portfolio margin account at optionsXpress.

OX Trading Reregisters as a Broker-Dealer

27. In late 2009, CBOE's DMFR was conducting a routine portfolio margin exam of optionsXpress when they identified an account that was engaged in a significant amount of trading. As part of the exam, a CBOE examiner asked if any subsidiary of Holdings traded with its own capital and cleared through optionsXpress. Stern replied: "No brokerage subsidiary of optionsXpress Holdings, Inc. does any proprietary trading or makes trades with its own capital."

28. On February 3, 2010, CBOE notified Stern that CBOE would like to discuss why OX Trading was being treated as a customer account.

29. On February 8, 2010, Stern and several others from optionsXpress met with CBOE to discuss the registration status of OX Trading.

30. On April 16, 2010, CBOE sent a letter to optionsXpress' Chief Compliance Officer asking for a written statement detailing the reasons why OX Trading was not registered as a broker-dealer, including a legal analysis on which the decision was based.

31. The Compliance Officer forwarded the letter to Stern who replied: "Ask him/them to direct it to OX Trading" adding that "I am happy to spin this however it needs to be." The Compliance Officer then asked CBOE to send the letter to Stern. On April 20, 2010, CBOE resent the same letter, but addressed it to Stern.

32. Stern responded in a letter dated April 23, 2010. Instead of providing an explanation as to OX Trading's registration status, the letter contained numerous factual inaccuracies and no legal opinion or analysis.

33. CBOE responded to Stern's letter on April 27, 2010 and asked again for an explanation of why OX Trading believed it was not required to register as a broker-dealer and for a legal opinion to support its belief. Stern did not provide an explanation or a legal opinion.

34. On June 17, 2010, CBOE sent a letter to Stern stating that CBOE believed OX Trading was functioning as a dealer and was required to register as a broker-dealer. CBOE asked OX Trading to either cease operations or obtain a written opinion from the Commission confirming that OX Trading was not required to register. CBOE asked OX Trading to respond by June 22, 2010.

35. OX Trading did not respond until June 29, 2010, when its outside counsel asked for an extension of time within which to respond. Stern separately emailed the Director of CBOE's DMFR asking whether there was an "unofficial" way to resolve the matter and stating that it looked like OX Trading was "being penalized for trading only on AIM." OX Trading was not trading only on AIM.

36. On June 30, CBOE explained to optionsXpress' counsel that "[t]he characteristic that we see as primary in deeming OX Trading a 'dealer' is that it engages in

a business of buying and selling securities for its own account. Moreover, this business is conducted entirely with optionsXpress, Inc. customer accounts.”

37. In early July 2010, Stern contacted the Commission about reactivating OX Trading’s registration noting that “we have no desire to apply for a no-action letter.” At the same time, OX Trading’s outside counsel sent a letter to CBOE offering to apply for dealer registration with the Commission and to obtain access/membership with an exchange.

38. On July 20, 2010, OX Trading filed an application for registration with the Commission and was granted conditional approval on August 26, 2010. For its SEC registration to become effective, OX Trading was required to be a member of FINRA or an exchange.

39. On August 31, 2010, OX Trading applied for BATS membership but withdrew its application on October 7, 2010. When asked why OX Trading withdrew its BATS application, OX Trading’s head trader responded: “There was more anticipated oversight . . . than we thought.”

40. On October 6, 2010, OX Trading filed an application with CBOE. The application was approved on November 9, 2010 and the necessary access permits were issued on November 12, 2010. However, OX Trading requested an effective date of December 1 so “we don’t get charged [for November].” Nevertheless at CBOE’s insistence, the SEC registration and CBOE trading permit became effective on November 16, 2010.

41. From March 2, 2009 to November 16, 2010, OX Trading executed approximately 1.3 million trades. Its gross profits from March 2009 to November 2010 were approximately \$3.5 million.

Post-Registration Misconduct

42. On July 29, 2011, the staff issued a Wells notice to OX Trading, optionsXpress, and Stern advising them that the staff intended to recommend to the Commission that it institute these proceedings against them in connection with OX Trading’s operation as an unregistered dealer.

43. On August 1, 2011, Stern drafted an allegedly exculpatory letter on optionsXpress letterhead that he backdated to February 2, 2009. The letter was addressed to CBOE and signed by Stern. The letter was purported to show that Stern had informed CBOE that OX Trading would de-register and become a customer of optionsXpress.

44. Stern emailed in-house counsel a copy of the fabricated letter with the intent that it be used in their Wells response. Although it was not eventually attached to the Wells response, the contents and exculpatory purpose of the fabricated letter were reflected in the Wells response.

45. Stern fabricated a second allegedly exculpatory backdated document on July 11, 2011 and amended it on July 12, 2011. The letter was attached to a Wells response submitted to the CBOE in an unrelated proceeding.

46. On February 27, 2012, Schwab informed the Commission staff, pursuant to Rules 17a-5(h)(2) and 17a-11(e) and (g), that it had identified a material internal control inadequacy at OX Trading.

C. VIOLATIONS

47. As a result of the conduct described above, from October 17, 2009 to November 16, 2010, OX Trading willfully violated Section 15(a) of the Exchange Act which makes it unlawful to induce or attempt to induce any purchase or sale of a security unless such a dealer is registered.

48. As a result of the conduct described above, from March 2, 2009 to November 16, 2010, OX Trading willfully violated Section 15(b)(8) of the Exchange Act that makes it unlawful for a broker-dealer to effect any transaction in any security (other than commercial paper, bankers' acceptances, or commercial bills) unless it is a member of a registered national securities association or effects transactions solely on a national exchange of which it is a member.

49. As a result of the conduct described above, Stern and optionsXpress caused and willfully aided and abetted OX Trading's violations of Sections 15(a) and 15(b)(8) of the Exchange Act.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate in the public interest that public administrative and cease-and-desist proceedings be instituted to determine:

A. Whether the allegations set forth in Section II hereof are true and, in connection therewith, to afford Respondents an opportunity to establish any defenses to such allegations;

B. What, if any, remedial action is appropriate in the public interest against Respondents pursuant to Section 15(b) of the Exchange Act including, but not limited to, disgorgement and civil penalties pursuant to Section 21B of the Exchange Act;

C. What, if any, remedial action is appropriate in the public interest against Respondents pursuant to Section 9(b) of the Investment Company Act; and

D. Whether, pursuant to Section 21C of the Exchange Act, Respondents should be ordered to cease and desist from committing or causing violations of and any future violations of Exchange Act Sections 15(a) and 15(b)(8) and whether Respondents should be ordered to pay a civil penalty pursuant to Section 21B(a) of the Exchange Act, and whether

Respondents should be ordered to pay disgorgement pursuant to Sections 21B(e) and 21C(e) of the Exchange Act.

IV.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened not earlier than 30 days and not later than 60 days from service of this Order at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice, 17 C.F.R. § 201.110.

IT IS FURTHER ORDERED that Respondents shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice, 17 C.F.R. § 201.220.

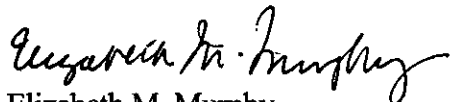
If Respondents fail to file the directed answer, or fail to appear at a hearing after being duly notified, the Respondents may be deemed in default and the proceedings may be determined against them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f) and 310 of the Commission's Rules of Practice, 17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f) and 201.310.

This Order shall be served forthwith upon Respondents personally or by certified mail.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 300 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice.

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.


Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9315 / April 20, 2012

SECURITIES EXCHANGE ACT OF 1934
Release No. 66837 / April 20, 2012

INVESTMENT ADVISERS ACT OF 1940
Release No. 3399 / April 20, 2012

INVESTMENT COMPANY ACT OF 1940
Release No. 30040 / April 20, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14854

In the Matter of

**GMB Capital Management
LLC (currently known as
"Clearstream Investments
LLC"), GMB Capital
Partners LLC, Gabriel
Bitran and Marco Bitran,**

Respondents.

**ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-
AND-DESIST PROCEEDINGS
PURSUANT TO SECTION 8A OF THE
SECURITIES ACT OF 1933, SECTION
21C OF THE SECURITIES
EXCHANGE ACT OF 1934, SECTION
9(b) OF THE INVESTMENT
COMPANY ACT OF 1940, AND
SECTIONS 203(e), 203(f) and 203(k) OF
THE INVESTMENT ADVISERS ACT
OF 1940, MAKING FINDINGS, AND
IMPOSING REMEDIAL SANCTIONS
AND CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") and Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") against GMB Capital Management LLC, GMB Capital Partners LLC (collectively "GMB"), Gabriel Bitran and Marco Bitran

33 of 54

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the "Offers") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act, Section 21C of the Exchange Act, Sections 203(e), 203(f) and 203(k) of the Advisers Act, and Section 9(b) of the Investment Company Act, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission finds¹ that:

A. SUMMARY

1. Gabriel Bitran ("Gabriel") founded GMB Capital Management LLC ("GMB Management") in 2005 for the stated purpose of managing hedge funds using quantitative models he developed, based on his academic optimal pricing research, to trade primarily Exchange Traded Funds ("ETFs"). Gabriel and Marco Bitran ("Marco" or collectively "the Individual Respondents") solicited potential investors with three primary selling points: (1) very successful performance track records purportedly based on actual trades using real money from 1998 to the inception of the hedge funds; (2) the firm's use of Gabriel's proprietary optimal pricing model to trade ETFs; and (3) Gabriel's pedigree and his involvement as the founder and portfolio manager of the hedge funds. Over a period of three years, in connection with raising over \$500 million for eight hedge funds and various managed accounts, Respondents made misrepresentations to investors about each of these points, and at times all three.

2. First, Respondents told potential investors that the pre-inception performance track records since 1998 were based on actual trades using real money when they knew the track record was based on back-tested hypothetical simulations.

3. Second, Respondents solicited investors to two funds invested almost entirely in other hedge funds ("funds of hedge funds") by promising that GMB would use Gabriel's optimal pricing models to trade liquid securities such as ETFs. Contrary to their promises, the funds of hedge funds were invested almost entirely in illiquid investments in other hedge funds and did not use Gabriel's optimal pricing models.

¹ The findings herein are made pursuant to Respondents' Offers of Settlement and are not binding on any other person or entity in this or any other proceeding.

4. Third, in May 2008, the Individual Respondents divided GMB's business. Going forward, Marco advised the hedge funds under a new entity, GMB Capital Partners LLC ("GMB Partners"), and Gabriel managed the other clients through GMB Management. Although Gabriel had no involvement in the GMB Partners' hedge funds, GMB Partners and the Individual Respondents continued to tell potential investors that they were managed by Gabriel.

5. In connection with an examination of GMB Management by the Commission's Boston Regional Office examination staff, GMB Management and the Individual Respondents provided a document that the Individual Respondents said was a contemporaneous record of Gabriel's trades since 1998. They provided this document in response to the exam staff's request for books and records that supported GMB Management's claims in its marketing material of a successful track record since 1998. In fact, the document was not true or accurate and was created solely for the purpose of responding to the staff's books and records request.

B. RESPONDENTS

6. **GMB Management** was a registered investment adviser based in Boston, Massachusetts. GMB Management was founded in November 2005 for the purpose of managing hedge funds and was registered with the Commission from August 2007 to November 22, 2011. Beginning in May 2008, GMB Management advised the non-hedge fund accounts. In January 2011, the firm changed its name to Clearstream Investments LLC.

7. **GMB Partners** is an unregistered investment adviser based in Boston, Massachusetts. GMB Partners was founded in May 2008 for the purpose of managing the GMB hedge funds previously managed by GMB Management. GMB Partners has closed each of its hedge funds and is in the process of liquidating certain hedge funds.

8. **Gabriel R. Bitran**, age 66, resides in Newton, Massachusetts. Gabriel founded GMB Management in 2005 and owned it jointly with his son, Marco, from approximately June 2006 to May 2008. Since May 2008, Gabriel has been the controlling owner of GMB Management.

9. **Marco Bitran**, age 36, resides in Boston, Massachusetts. From approximately June 2006 to May 2008, Marco jointly owned GMB Management with his father, Gabriel. Marco founded GMB Partners in May 2008 and is its sole owner.

C. FACTS

10. In June 2006, Marco joined his father as a managing member of GMB Management. Initially, GMB Management managed the Global Alpha hedge funds ("Global Alpha Funds"). The declared purpose of the Global Alpha Funds was to use Gabriel's quantitative optimal pricing models to invest in ETFs and other liquid securities.

The Global Alpha Funds included GMB Capital I, LP, GMB Global Opportunities, LP, GMB Global Alpha, LP and GMB Global Alpha Flex-X, LP. In addition, GMB entered into a sub-advisory agreement with a registered investment adviser pursuant to which the adviser hired GMB to use the Global Alpha strategy to manage assets.

**Misrepresentations to Investors in the
GMB Global Alpha Funds Regarding Historic Performance**

11. In order to market the Global Alpha Funds, GMB Management and the Individual Respondents created performance track records showing an average annual return of over twenty percent without a single calendar year of investment losses since 1998. GMB Management and the Individual Respondents told potential investors and third party marketers that the Global Alpha pre-inception track records were based on actual trades using real money. GMB Management's marketing materials described these pre-inception returns as "actual performance" in "managed accounts." (Emphasis in original.) As GMB Management's sole owners, the Individual Respondents had ultimate authority over the content of these documents and distributed the marketing materials to potential investors and third party marketers.

12. Contrary to these representations, the Global Alpha pre-inception track records were not based on actual trades but were back-tested hypothetical simulations. GMB Management and the Individual Respondents knew that their representations regarding the pre-inception performance were false. The misrepresentations made by GMB Management and the Individual Respondents regarding the pre-inception performance of the Global Alpha Funds were material to the potential investors and third party marketers.

**Misrepresentations to Investors
in GMB Global Multi-Strategy LP
Regarding the Fund's Strategy and Investments**

13. In addition to the Global Alpha Funds, GMB also managed funds of hedge funds, including the GMB Global Multi-Strategy, L.P. (the "Multi-Strategy Fund"). The Multi-Strategy Fund was invested almost entirely in up to 36 other hedge funds, including several funds of hedge funds. The Respondents did not use Gabriel's quantitative optimal pricing models to select the underlying hedge fund investments in the Multi-Strategy Fund. Yet, Respondents told potential investors and third party marketers that the Multi-Strategy Fund used Gabriel's quantitative optimal pricing models to invest in (1) the same ETFs traded in the Global Alpha Funds, and (2) other asset classes, including commodities, interest rates, volatility and foreign exchange. While the private placement memorandum permitted the Multi-Strategy Fund to invest in a wide variety of instruments, including limited partnerships, the Respondents did not tell investors and third party marketers that the fund invested almost exclusively in other hedge funds. Instead, Respondents told investors and third party marketers that the fund invested in liquid securities, primarily ETFs. At times, the Individual Respondents provided potential investors with very specific examples of the types of liquid securities the Multi-Strategy Fund purportedly invested in,

including "equities" (e.g., long "Brazil"); "futures" (e.g., short "soybeans"); "ForEx" (e.g., long "JPY"); "interest rates" ("Long Short Rates/Short Long Rates") and "Volatility" ("Long 30 day Vol").

14. When Respondents did tell investors that the Multi-Strategy Fund invested in other hedge funds, they misrepresented both how—and how much—it invested in such funds. For example, GMB and the Individual Respondents told certain investors that the Multi-Strategy Fund invested fifty to sixty percent of its assets in GMB Global Alpha, LP and some less liquid country ETFs (such as Spain and Holland) and the remaining forty percent in external hedge funds. At the time, contrary to the Individual Respondents' allocation claims, approximately 1.6% of the Multi-Strategy Fund was invested in GMB Global Alpha, LP and the remainder was invested in approximately 20 external hedge funds (several of which were funds of hedge funds). In follow up communications, the Individual Respondents told these investors that the Multi-Strategy Fund used Gabriel's optimal pricing models to allocate to seven hedge funds: two volatility managers, two interest rate managers, two commodity managers, and one foreign exchange manager. The Individual Respondents never mentioned investments by the Multi-Strategy Fund in any other hedge funds. Contrary to the Respondents' allocation claims, at the time, the Multi-Strategy Fund was invested in approximately 29 external hedge funds (many of which were funds of hedge funds) and had no investments in GMB Global Alpha, LP.

15. Respondents' misrepresentations regarding the Multi-Strategy Fund's strategy, investments and allocations were material to potential investors. The Respondents knew that their material misrepresentations were false.

Misrepresentations Regarding the Multi-Strategy Fund's Historic Performance

16. In order to market the Multi-Strategy Fund, GMB Management and the Individual Respondents created a performance track record from January 1998 to August 2006 showing a 16.2% annualized return without any down years. GMB, the Individual Respondents and others on their behalf distributed this track record to potential investors in marketing material and performance reports. During meetings with potential investors, the Individual Respondents stated that the track record since 1998 was based on actual trading with real money using Gabriel's optimal pricing models. In fact, the track record was based on hypothetical historical allocations to six hedge fund managers. The Individual Respondents knew that their representations regarding the Multi-Strategy Fund's pre-inception performance were false. Respondents' misrepresentations regarding the Multi-Strategy Fund's pre-inception performance were material to potential investors.

17. In or about March 2008, HedgeFund.net printed an interview with Marco regarding Gabriel and the Multi-Strategy Fund. In the interview, Marco falsely stated that they had achieved "compounded returns in managed accounts of approximately 20% per year without any down years," since 1998. Marco also repeated the same misrepresentations regarding the Multi-Strategy Fund's use of Gabriel's optimal pricing models to trade equities, commodities, interest rates, foreign exchange and volatility. He

did not mention that the fund was almost entirely invested in other hedge funds. GMB and the Individual Respondents distributed the article to investors and potential investors.

The Division Between GMB Capital Management and GMB Capital Partners

18. In May 2008, Marco created GMB Partners for the purpose of advising the GMB hedge funds. GMB Management continued to advise the managed accounts. Gabriel had no ownership interest in GMB Partners and, from June 2008 forward, had no involvement in the management of the Multi-Strategy Fund or another fund of hedge funds managed by GMB partners, GMB Low Volatility Fund, LP (the "Low Volatility Fund"). Despite this change, GMB Partners and the Individual Respondents continued to tell investors and potential investors that Gabriel managed the Multi-Strategy and Low Volatility Funds. Gabriel continued to meet with potential investors in the Multi-Strategy and Low Volatility Funds and was introduced as a manager of the funds who was involved in the investment process on a daily basis. The Multi-Strategy and Low Volatility Funds' marketing materials, Private Placement Memoranda and Due Diligence Questionnaires distributed to potential investors after May 2008 by GMB Partners, the Individual Respondents and others on their behalf all falsely stated that Gabriel was the manager and/or Chief Investment Officer of the funds. GMB Partners and the Individual Respondents knew that their misrepresentations regarding Gabriel's involvement in the Low Volatility and Multi-Strategy Funds were false. These misrepresentations were material to potential investors.

Misrepresentations to Investors in the Low Volatility Fund Regarding its Strategy, Investments and Historical Performance

19. When soliciting investments in the Low Volatility Fund, GMB Partners and the Individual Respondents made misrepresentations to potential investors regarding the fund's strategy, its pre-inception performance and Gabriel's role with the fund.

20. For example, during a meeting with an investment adviser, the Individual Respondents stated that the fund used Gabriel's optimal pricing models to invest in equities, interest rates, volatility, currencies and commodities. While the private placement memorandum permitted the Low Volatility Fund to invest in a wide variety of instruments, including limited partnerships, the Individual Respondents told the adviser that the fund invested in ETFs and index funds and gave specific examples of how the fund invested in emerging markets, interest rates, and currencies. The Individual Respondents did not tell the adviser that the Low Volatility Fund invested in other hedge funds. At the time, the Low Volatility Fund was invested almost entirely in 15 external hedge funds, including several funds of hedge funds.

21. The Individual Respondents also reviewed with the adviser a monthly pre-inception track record for the Low Volatility Fund since 1998, showing 11.7% annualized returns with no down years. Respondents created this track record using hypothetical allocations to a few external low volatility hedge funds. But the Individual Respondents

told the adviser that the track record was based on actual trades with real money using Gabriel's optimal pricing models. Specifically, they claimed the track record was based on trades in the Multi-Strategy Fund and, prior to the inception of the Multi-Strategy Fund, trades in accounts Gabriel managed.

22. At the time of the meetings with this adviser, Gabriel had no role in the management of the Low Volatility Fund or the Multi-Strategy Fund. However, the Individual Respondents represented that Gabriel spent 80% of his time managing the funds and was involved in reviewing trades in the funds on a daily basis. GMB Partners and Individual Respondents knew their representations regarding the Low Volatility Fund were false. The misrepresentations were material to investors in the fund.

**Misrepresentations to Investors
in Dynamic Alpha and Persistent Alpha Regarding Historic Performance**

23. In approximately June 2008, Respondents developed two new versions of the Global Alpha strategy: the low volatility Persistent Alpha and the higher volatility Dynamic Alpha strategies. GMB Partners advised the GMB Dynamic Alpha Fund, LP (the "Dynamic Alpha Fund"), and the GMB Persistent Alpha Fund, LP (the "Persistent Alpha Fund"). GMB Management advised the managed accounts that used these two strategies. To market the strategies, the Respondents created performance track records from 1998 to June 2008 based on back-tested hypothetical simulations. GMB and the Individual Respondents distributed the monthly track records to potential investors in both the managed accounts and hedge funds. The Individual Respondents told investors that the pre-inception performance was based on actual trades using real money.

24. GMB hired a professional marketer of hedge funds to be the exclusive marketer ("Exclusive Marketer") of the two strategies in both the hedge fund and managed account formats. The Individual Respondents told the Exclusive Marketer that the Persistent Alpha and Dynamic Alpha pre-inception track records were based on actual trades using real money. Marco and the Exclusive Marketer distributed to potential investors the marketing material showing the Dynamic Alpha and Persistent Alpha track records. When potential investors asked how the track records were created, Marco and the Exclusive Marketer explained that they were based on actual trades using real money.

25. The Respondents' representations regarding the Dynamic Alpha and Persistent Alpha pre-inception track records were material to investors. The Respondents knew that these representations were false.

Dissolution of the Low Volatility and Multi-Strategy Funds

26. At the end of 2008, the Low Volatility and Multi-Strategy Funds experienced a series of losses, and GMB dissolved the funds.

27. First, when possible financial fraud at the Petters Group Worldwide ("Petters Group") was reported in late September 2008, the Low Volatility and Multi-

Strategy Funds' investments in a fund that was entirely invested in the Petters Group became illiquid. GMB did not disclose to investors that it had been impacted by the reported fraud at the Petters Group. Instead, at the end of October, GMB sent a letter to investors stating that "a swap instrument that the Fund entered into seeking to realize a higher return on a portion of its uninvested cash" had become illiquid because "one of the parties underlying the swap instrument is currently experiencing a credit and liquidity crisis, in conjunction with other alleged factors."

28. Second, between October 9 and 16, 2008, GMB invested a large portion of the Low Volatility Fund in S&P index options and lost 56% of the fund's assets on that trade. On November 10, GMB announced that it would dissolve the Low Volatility Fund as a result of the trading losses and large number of pending redemptions.

29. Third, in November and December 2008, a large number of the Multi-Strategy Fund's underlying hedge fund investments suspended withdrawals. As a result, on December 4, GMB sent a letter to Multi-Strategy investors "suspending withdrawals" from the fund.

30. Finally, the Low Volatility and Multi-Strategy Funds suffered significant losses in hedge funds that had invested with Bernard L. Madoff Investment Securities LLC. By March 2009, the Multi-Strategy Fund had over 50% of its total capital pending redemption. In June 2009, GMB Partners notified investors that it would dissolve the Multi-Strategy Fund. GMB Partners continues to liquidate the underlying hedge fund investments in the Multi-Strategy Fund and return capital to its investors.

**Investment in a Basket of Hedge Funds
Leads to Significant Losses in the Global Alpha Flex-X Fund**

31. Beginning in 2006, the Respondents designed and marketed Global Alpha Flex-X L.P. (the "Flex-X Fund") to be a leveraged version of GMB Global Alpha, LP, using Gabriel's optimal pricing model to trade ETFs and other liquid securities. Respondents included this description in marketing material, performance reports and Private Placement Memoranda.

32. GMB Management and the Individual Respondents followed this investment mandate through 2007. Starting in February 2008, GMB Management started investing a substantial portion of the Flex-X Fund in another GMB hedge fund, GMB Global Enhanced L.P. (the "Enhanced Fund"). Like the Multi-Strategy Fund, the Enhanced Fund was invested in a basket of other hedge funds and did not use Gabriel's optimal pricing models to make investment decisions. By April 2008, GMB Management had invested approximately 50% of the Flex-X Fund's assets into the Enhanced Fund.

33. In July 2008, GMB Partners distributed to all the Flex-X investors a new Private Placement Memorandum that described the Flex-X Fund as a leveraged version of GMB Global Alpha, LP, using Gabriel's optimal pricing models.

34. In March through October 2008, GMB distributed monthly Performance Reports to all Flex-X investors which falsely described the fund as a leveraged version of GMB Global Alpha, LP, trading primarily ETFs. The Individual Respondents had ultimate authority over the content of these documents.

35. By July 2008, GMB had invested over 50% of the Flex-X Fund's assets in the Enhanced Fund and the remainder in GMB Dynamic Alpha Fund, LP (the new version of GMB Global Alpha, LP). The Respondents never disclosed this material change in strategy to investors. The Respondents' representations regarding the Flex-X Fund's strategy were material. The Respondents knew these representations were false.

36. During September through November 2008, the Enhanced Fund's basket of hedge funds lost significant value in this period, and as a result, the Flex-X Fund experienced substantial losses.

False Records Provided to the Exam Staff

37. During an unannounced examination of GMB Management by the Commission's examination staff, the staff requested support for GMB's various purported pre-inception track records since 1998. In response, GMB Management provided what it described as "trading logs for the Global Alpha and Multi-Strategy trading strategies," purporting to show ETF trades and positions from 1998 to 2005. Respondents stated that the trading logs were not "back-tested," but were "in fact a record reflecting the trading performance of the GMB trading strategies in personal accounts over time. Gabriel in fact traded these strategies going back well before 1998. The trades were recorded in real-time." These statements were false.

38. During the examination, the staff also requested all GMB Management client correspondence, including emails, sent during a specific time period. In response, GMB Management told the staff that Gabriel did not have any such emails for that time period. When the staff pressed GMB on this issue, GMB Management provided an email from Gabriel's GMB Management email address stating, "during the examination period I (Gabriel Bitran) did not use email as his primary method of communication. I do not recall sending any emails and no such emails were found during this period." In response to the enforcement staff's subpoenas, however, GMB Management produced emails sent from and to Gabriel during that specific time period that are relevant to GMB Management client correspondence.

D. VIOLATIONS

39. As a result of the conduct described above, the Respondents willfully violated Section 17(a)(2) of the Securities Act, which prohibits fraudulent conduct in the offer or sale of securities.

40. As a result of the conduct described above, the Respondents willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in connection with the purchase or sale of securities.

41. As a result of the conduct described above, GMB Management, Gabriel Bitran and Marco Bitran willfully violated Sections 206(1) and 206(2) of the Advisers Act by employing devices, schemes or artifices to defraud clients, and engaging in transactions, practices or courses of business that defrauded clients, including managed accounts.

42. As a result of the conduct described above, GMB Management, GMB Partners, Gabriel Bitran and Marco Bitran willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, which prohibit fraudulent conduct by advisers to "pooled investment vehicles" and specifically prohibit misleading statements to investors or prospective investors in those pools.

43. As a result of the conduct described above, Gabriel Bitran willfully aided and abetted and caused GMB Management's and/or GMB Partners' violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

44. As a result of the conduct described above, Marco Bitran willfully aided and abetted and caused GMB Management's and/or GMB Partners' violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

45. As a result of the conduct described above, GMB Management willfully violated Section 204(a) of the Advisers Act which provides that registered investment advisers "shall make and keep for prescribed periods such records . . . as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors. All records . . . of such investment advisers are subject at any time" to examination by SEC staff.

46. As a result of the conduct described above, GMB Management willfully violated Rule 204-2(a)(16) of the Advisers Act, which requires every investment adviser registered with the Commission to make and keep true, accurate and current records sufficient to form the basis of the performance shown in marketing material distributed to ten or more persons.

47. As a result of the conduct described above, Gabriel Bitran and Marco Bitran willfully aided and abetted and caused GMB Management's violations of Section 204(a) of the Advisers Act and Rule 204-2(a)(16) thereunder.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondents' Offers.

Accordingly, pursuant to Section 8A of the Securities Act, Section 21C of the Exchange Act, Section 9(b) of the Investment Company Act and Sections 203(e), 203(f) and 203(k) of the Advisers Act, it is hereby ORDERED that:

A. Respondents Gabriel Bitran, Marco Bitran, and GMB Management cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 204, 206(1), 206(2) and 206(4) of the Advisers Act and Rules 204-2(a)(16) and 206(4)-8 thereunder.

B. Respondent GMB Partners cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

C. Beginning 60 days from entry of this Order, Respondent Marco Bitran be, and hereby is:

barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; and

prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter.

D. Respondent Gabriel Bitran be, and hereby is:

barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; and

prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter.

E. Respondent GMB Management is censured.

F. Respondent GMB Partners is censured and prohibited from receiving any management or other fees during the 60 days after the entry of this Order.

G. Any reapplication for association by Marco Bitran and Gabriel Bitran will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondents, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

H. Respondents shall be jointly and severally liable for disgorgement of \$4,300,000. This sum shall be paid to the Securities and Exchange Commission in the following installments: \$3,500,000 on or before July 31, 2012 and \$800,000 on or before October 31, 2012. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of disgorgement plus any additional interest accrued pursuant to SEC Rule of Practice 600 shall be due and payable immediately, without further application. Payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Securities and Exchange Commission, Office of Financial Management, 100 F St., NE, Stop 6042, Washington, DC 20549; and (D) submitted under cover letter that identifies Marco Bitran, Gabriel Bitran, GMB Management and GMB Partners as Respondents in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to John T. Dugan, Associate Regional Director, Division of Enforcement, Securities and Exchange Commission, Boston Regional Office, 33 Arch Street, 23rd Floor, Boston, Massachusetts 02110.

I. Respondent Marco Bitran shall pay a civil money penalty in the amount of \$250,000 to the Securities and Exchange Commission. This sum shall be paid to the Securities and Exchange Commission in the following installments: \$150,000 within ten days of entry of this Order and the remainder on or before October 31, 2012. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of civil penalties plus any additional interest accrued pursuant to 31 U.S.C. 3717, shall be due and payable immediately, without further application. Such payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Securities and Exchange Commission, Office of Financial Management, 100 F St., NE, Stop 6042, Washington, DC 20549; and (D) submitted under cover letter that identifies Marco Bitran as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to John T. Dugan, Associate Regional Director, Division of Enforcement, Securities and Exchange Commission, Boston Regional Office, 33 Arch Street, 23rd Floor, Boston, Massachusetts 02110.

J. Respondent Gabriel Bitran shall pay a civil money penalty in the amount of \$250,000 to the Securities and Exchange Commission. This sum shall be paid to the Securities and Exchange Commission in the following installments: \$150,000 within ten days of entry of this Order and the remainder on or before October 31, 2012. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of civil penalties plus any additional interest accrued pursuant to 31 U.S.C. 3717, shall be due and payable immediately, without further application. Such payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Securities and Exchange Commission, Office of Financial Management, 100 F St., NE, Stop 6042, Washington, DC 20549; and (D) submitted under cover letter that identifies Gabriel Bitran as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to John T. Dugan, Associate Regional Director, Division of Enforcement, Securities and Exchange Commission, Boston Regional Office, 33 Arch Street, Boston, Massachusetts 02110.

K. Pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, as amended, a Fair Fund is created for the disgorgement and penalties referenced in paragraphs H through J above. Regardless of whether any such Fair Fund distribution is made, amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondents agree that in any Related Investor Action, they shall not argue that they are entitled to, nor shall they benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondents' payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondents agree that they shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the United States Treasury or to a Fair Fund, as the Commission directs. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related

Investor Action" means a private damages action brought against Respondents by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

SECURITIES AND EXCHANGE COMMISSION
Washington D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 66842 / April 20, 2012

Admin. Proc. File No. 3-14496

In the Matter of

VLADIMIR BORIS BUGARSKI, VLADISLAV WALTER
BUGARSKI, and ALEKSANDER NEGOVAN BUGARSKI
c/o Darryl C. Sheetz, Esq.
Law Offices of Darryl C. Sheetz
335 Centennial Way, Suite 100
Tustin, California 92780

OPINION OF THE COMMISSION

EXCHANGE ACT PROCEEDING

Ground for Remedial Action

Injunction

Respondents were permanently enjoined from violations of the federal securities laws. *Held*, it is in the public interest to bar respondents from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization, and from participating in an offering of penny stock.

APPEARANCES:

Darryl C. Sheetz, of the Law Offices of Darryl C. Sheetz, for Vladimir Boris Bugarski, Vladislav Walter Bugarski, and Aleksander Negovan Bugarski.

34 of 44

I.

Vladimir Boris Bugarski ("Boris Bugarski"), Vladislav Walter Bugarski ("Walter Bugarski"), and Aleksander Negovan Bugarski ("Aleks Bugarski") (collectively, "Respondents") appeal from the decision of an administrative law judge barring them from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization ("collateral bar") and from participating in any offering of penny stock ("penny stock bar").¹ The law judge based her decision on Respondents' having been enjoined from violating various provisions of the securities laws. We base our findings on an independent review of the record, except with respect to those findings not challenged on appeal.

II.

In April 2011, the Commission filed a complaint ("the Complaint") in the U.S. District Court for the Central District of California against Respondents and mUrgent Corporation, a private, California company controlled by Respondents. mUrgent provides Internet-related marketing services, including e-mail advertising, primarily to restaurant franchises. Walter Bugarski, and his identical twin sons, Boris and Aleks Bugarski, are mUrgent's senior executives, majority shareholders, and board members. The Complaint alleged that Respondents and mUrgent violated the securities registration provisions of Sections 5(a) and 5(c) of the Securities Act of 1933;² the broker registration provision of Section 15(a)(1) of the Securities Exchange Act of 1934;³ and the antifraud provisions of Section 17(a) of the Securities Act,⁴ Section 10(b) of the Exchange Act,⁵ and Exchange Act Rule 10b-5.⁶ Specifically, the Complaint alleged that beginning in 2008,⁷ mUrgent and Respondents raised approximately \$9.6 million from at least 130 investors through unregistered offerings by making material misrepresentations and omissions concerning mUrgent's business performance and financing plans.

¹ *Vladimir Boris Bugarski*, Initial Decision Rel. No. 444 (Dec. 8, 2011), 102 S.E.C. Docket 49008.

² 15 U.S.C. § 77e(a) & (c).

³ 15 U.S.C. § 78o(a)(1).

⁴ 15 U.S.C. § 77q(a).

⁵ 15 U.S.C. § 78j(b).

⁶ 17 C.F.R. § 240.10b-5.

⁷ Although the Complaint does not specify the duration of the violative conduct, Respondents did not contest in the injunctive proceeding and do not contest now that the conduct continued up until the filing of the Complaint in 2011.

According to the Complaint, Respondents established a "boiler-room" operation⁸ to sell mUrgent stock. Walter and Aleks Bugarski allegedly hired and supervised more than a dozen employees tasked with promoting and selling mUrgent stock to investors. The sales force was divided between "fronters" and "closers." The fronters made over a thousand cold-calls a month to potential investors, most of whom had never heard of mUrgent before being contacted. The fronters passed on likely investors to the closers, who were paid on a commission basis and used high-pressure tactics to finish the sale. Walter, Aleks, and the closers also contacted individuals who had already purchased mUrgent stock and pressured them to purchase additional mUrgent shares. Walter and Aleks received tens of thousands of dollars in commissions for completing such sales. As mUrgent's CEO, Boris Bugarski knew about the sales operation supervised by Walter and Aleks, and he personally signed all the subscription agreements and stock certificates. He also communicated with investors about mUrgent's financial condition and business prospects.

The Complaint alleged that Respondents directly or through fronters or closers made several material misrepresentations and omissions when soliciting investors. First, investors were told that an initial public offering of mUrgent shares was imminent and would substantially increase the value of mUrgent stock. In fact, mUrgent had no concrete plans to go public, and contrary to explicit representations made to investors, mUrgent had not retained a financial consulting company to assist with an IPO. Second, investors were led to believe that mUrgent had on-going business relationships with certain major, well-known companies. In fact, some of these companies did not have any business relationship with mUrgent at the time investors were solicited. Third, while closers touted mUrgent's business prospects, the offering documents provided to investors failed to include any financial information. And in fact, the company's financial condition was precarious: it had never made a profit, and internal documents forecasted increasing losses. Finally, the offering documents stated that the executive officers were not to receive any cash compensation. In fact, during the relevant period, Respondents received several hundred thousand dollars each in cash salaries and bonuses.

⁸ A "boiler-room" operation is characterized by numerous salespeople making a high volume of telephone calls to previously unknown individuals and using high-pressure tactics to sell securities, often through the use of misrepresentations. *See Gershon Tannenbaum*, 50 S.E.C. 1138, 1139 (1992) (describing a boiler-room operation as "engaging in a wide array of high pressure tactics to sell securities to the public by means of fraudulent representations"); *Charles Michael West*, 47 S.E.C. 39, 40 (1979) (describing respondent's participation in a boiler-room operation as "engag[ing] in a high pressure sales campaign, involving the use of repeated telephone calls, to induce persons previously unknown to him to buy highly speculative" securities); *Palombi Secs. Co., Inc.*, 41 S.E.C. 266, 269 (1962) (describing a boiler-room operation as involving "high-pressure selling methods" and often "the use of false confirmations to generate sales"); *see also* Securities Exchange Act Rel. No. 27160 (Aug. 22, 1989), 54 Fed. Reg. 35468 (Aug. 28, 1989) (describing boiler-room operations as part of a Final Rule addressing sales practice requirements for certain low-priced securities in the wake of misconduct by some broker-dealers).

The Complaint further alleged that Respondents misused investor funds by treating mUrgent "as their personal piggybank." According to the Complaint, Respondents charged the company for numerous personal expenses, including luxury automobiles. And in July 2008, Walter Bugarski allegedly created a slush fund for the benefit of himself and his sons by withdrawing over half a million dollars from mUrgent's bank account and depositing it in a newly opened account at another financial institution from which he wrote checks to himself and his sons totaling more than \$150,000.

In June 2011, Respondents consented, without admitting or denying the allegations of the Complaint, to entry of an injunction against them. Respondents' Consents each stated that the defendant "acknowledges that the Court's entry of a permanent injunction may have collateral consequences" and that, "in any disciplinary proceeding before the Commission based on the entry of the injunction in this action, Defendant understands that he shall not be permitted to contest the factual allegations of the Complaint in this action." Moreover, Respondents agreed in their Consents "not to take any action or to make or permit to be made any public statement denying, directly or indirectly, any allegation in the Complaint or creating the impression that the Complaint is without factual basis." Following the execution of the Consents, the district court permanently enjoined Respondents from violating the antifraud provisions of the securities laws, the broker registration requirements of Section 15(a)(1) of the Exchange Act, and the securities registration requirements of Section 5 of the Securities Act. In addition, the district court imposed an officer-and-director bar and ordered the disgorgement of Respondents' ill-gotten gains.⁹

Based on the injunction, we initiated this administrative proceeding on August 1, 2011, pursuant to Exchange Act Section 15(b). At a prehearing conference, the law judge granted the Division leave to file a motion for summary disposition pursuant to Commission Rule of Practice 250.¹⁰ On December 8, 2011, the law judge granted the Division's motion for summary disposition and imposed both collateral and penny stock bars. Relying on the uncontested allegations in the Complaint, the law judge concluded that Respondents' actions were egregious. The law judge further noted that "Respondents have not given any meaningful assurances against future violations or indication that they recognize the wrongful nature of their conduct." Ultimately, the law judge concluded that "[t]he overwhelming evidence is that the public interest requires that Respondents be barred from participating in the securities industry in the broadest possible way." This appeal followed.

⁹ The court subsequently set the amount of disgorgement at \$9,634,872, plus prejudgment interest of \$1,821,012, for which Respondents are jointly and severally liable, and imposed additional third-tier civil penalties on Boris Bugarski in the amount of \$457,750, on Walter Bugarski in the amount of \$398,511, and on Aleks Bugarski in the amount of \$470,077.

¹⁰ 17 C.F.R. § 201.250.

III.

A. Exchange Act Section 15(b)(6) authorizes us to bar a person from being associated with a broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization, or from participating in an offering of penny stock if the person has been, among other things, enjoined from any conduct or practice in connection with the purchase or sale of a security and if, at the time of the alleged misconduct, the person was participating in an offering of any penny stock.¹¹ It is undisputed that the district court enjoined Respondents from conduct in connection with the purchase or sale of securities and that, at the time of the alleged misconduct, Respondents were participating in an offering of penny stock.¹² Accordingly, we find that the threshold statutory requirements for the imposition of sanctions have been satisfied.

Before imposing sanctions, we must also satisfy ourselves that the sanctions to be imposed are in the public interest.¹³ In analyzing the public interest we consider, among other things: the egregiousness of the respondent's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the respondent's assurances against future violations, the respondent's recognition of the wrongful nature of his or her conduct, and the likelihood that the respondent's occupation will present opportunities for future violations.¹⁸

¹¹ 15 U.S.C. § 78o(b)(6)(A). The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), which was signed into law July 21, 2010, expanded the categories of associational bars authorized by Section 15(b)(6), allowing the Commission to impose a broad collateral bar on participation throughout the securities industry. Respondents do not challenge the law judge's finding that their conduct continued through the filing of the Complaint on April 21, 2011.

¹² It is undisputed that mUrgent stock, as an unregistered, unlisted security priced at less than five dollars per share, fits the definition of a penny stock. See 15 U.S.C. § 78c(a)(51)(A); 17 C.F.R. § 240.3a51-1. It is likewise undisputed that Respondents' activities related to the offering of mUrgent stock bring them within the statute's definition of persons participating in an offering of a penny stock. See 15 U.S.C. § 78o(b)(6)(C) ("[T]he term 'person participating in an offering of penny stock' includes any person acting as any promoter, finder, consultant, agent, or other person who engages in activities with a broker, dealer, or issuer for purposes of the issuance or trading.").

¹³ 15 U.S.C. § 78o(b)(6)(A).

¹⁸ *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981).

Our "inquiry into . . . the public interest is a flexible one, and no one factor is dispositive."¹⁹ Based on these factors, we conclude that collateral and penny stock bars are warranted.

We agree with the law judge that Respondents' conduct was egregious. Respondents were enjoined based on allegations that they established a boiler-room operation through which they sold almost \$10 million in mUrgent shares to unsophisticated investors through flagrant misrepresentations about the company and its plans, including the false promise of an imminent IPO. And the allegations in the Complaint do not represent isolated incidents of misconduct by Respondents. As Respondents admit in their Answer to the Order Instituting Administrative Proceedings, Boris Bugarski is subject to a cease-and-desist order issued by the securities regulator in the State of Wisconsin in 2000, and Walter Bugarski is subject to cease-and-desist orders issued by securities regulators in the Commonwealth of Pennsylvania in 2001, the State of Kansas in 1996, and the State of Wisconsin in 2000.

The allegations supporting the consent injunction, including the use of high-pressure boiler-room tactics, also suggest that Respondents' misrepresentations to investors were no mere oversight but were part of a scheme to defraud. Thus, the allegations in the Complaint describe scienter-based conduct. In addition, we are unconvinced by Respondents' assurances that the sanctions already imposed by the district court are more than sufficient to "deter any future violations of the federal and state securities laws." Indeed, the need for an administrative sanction is underscored by Respondents' seeming failure to recognize the wrongful nature of their actions by down-playing their misconduct and insisting that they are "just businessmen attempting to run a successful corporation for the benefit of their shareholders and employees." In short, the weight of the relevant public interest factors supports imposing both collateral and penny stock bars.

B. Respondents put forward a handful of challenges to the imposition of sanctions, none of which is persuasive. First, Respondents argue that it is "blatantly unfair" for the Commission to use their Consents to prevent them from contesting the allegations in the Complaint. But this is expressly what Respondents agreed to when they voluntarily entered into their Consents: they acknowledged that the entry of an injunction against them "may have collateral consequences" and agreed that "in any disciplinary proceeding before the Commission" they would "not be permitted to contest the factual allegations of the Complaint." It is hardly unfair for the Commission to hold them to the terms of their Consents.²⁰

¹⁹ *David Henry Disraeli*, Exchange Act Rel. No. 57027 (Dec. 21, 2007), 92 SEC Docket 852, 875, *petition denied*, 33 F. App'x 334 (D.C. Cir. 2008) (per curiam).

²⁰ We have noted that a respondent "was obligated to familiarize himself with the terms of the consent order he signed and with the potential collateral consequences of settling an injunctive action It was not the Division's obligation to advise [the respondent] of the legal consequences of his consent." *Ralph W. LeBlanc*, 56 S.E.C. 800, 811 (2003).

In attacking the Commission's use of their Consents, Respondents also point to the court's rejection of the consent judgment in *SEC v. Citigroup Global Markets Inc.*,²¹ noting that "the Commission's use of consents has come under scrutiny." But the *Citigroup* decision is inapposite because, unlike the court in *Citigroup*, the district court here accepted the parties' agreement embodied in the Consents and on that basis entered the injunction against Respondents. Once the injunction was entered, Section 15(b) authorized the Commission to institute administrative proceedings. And when an injunction has been entered by consent, it is appropriate to prohibit Respondents from contesting the factual allegations of the Complaint.²²

Next, Respondents protest that the language of the Complaint—i.e., the use of words such as "scheme," "boiler-room," "family-controlled," "cold-calls," "fronters," "closers," and "ill-gotten gains"—paints an unnecessarily inflammatory and inaccurate picture of them and their business. As just discussed, however, Respondents are not permitted under the terms of their Consents to contest the factual allegations of the Complaint—including the descriptions of their conduct to which they now object. In any event, it is the actual conduct alleged in the Complaint—not merely the labels used—that convinces us that collateral and penny stock bars against Respondents are in the public interest. For example, even if Respondents' effort to sell mUrgent stock is not characterized as a boiler-room operation, their solicitation of investors through the use of high-pressure sales tactics and fraudulent representations was no less egregious.²³ Moreover, as already mentioned, Respondents' insistence that they are simply businessmen looking out for their shareholders and employees reflects a lack of recognition of the wrongful nature of their conduct and further supports the imposition of sanctions.²⁴

²¹ No. 11 Civ 7387 (JSR), 2011 WL 5903733 (S.D.N.Y. Nov. 28, 2011).

²² See *Marshall E. Melton*, 56 S.E.C. 695, 711–12 (2003) ("For purposes of consent injunctions that are agreed to and entered by a court . . . , we will construe the 'neither admit nor deny' language as precluding a person who has consented to an injunction in a Commission enforcement action from denying the factual allegations of the injunctive complaint in a follow-on proceeding before this agency.").

²³ Cf. *Billings Associates, Inc.*, 43 S.E.C. 641, 647 (1967) ("It is clear that the respondents now before us engaged in a scheme to defraud in the sale of a speculative stock by means of a high-pressure sales campaign involving fraudulent representations and predictions. Under the circumstances, the respondents' culpability is established whether or not their activity is specifically described as that of a boiler-room.").

²⁴ To the extent Respondents are arguing that sanctioning them would harm current mUrgent shareholders, we note that "we look beyond the interests of particular investors, in assessing the need for sanctions, to the protection of investors generally." *Jeffery L. Gibson*, Exchange Act Rel. No. 57266 (Feb. 4, 2008), 92 S.E.C. Docket 2104, 2110; see also *Christopher* (continued...)

Finally, Respondents insist that the "imposition of additional remedial action against [them] would be simply adding to the severe sanctions that have already been imposed" and therefore would not be in the public interest. We reject this argument. While the sanctions imposed by the district court—the permanent injunction, disgorgement, and third-tier civil penalties—are severe, this simply underscores the seriousness of Respondents' misconduct. Indeed, "conduct that violates the antifraud provisions of the securities laws is especially serious and subject to the severest of sanctions under the securities laws."²⁵ As we have previously held, an injunction against violations of the antifraud provisions of the securities laws "has especially serious implications for the public interest," and "ordinarily, and in the absence of evidence to the contrary, it will be in the public interest to . . . suspend or bar from participation in the securities industry, or prohibit from participation in an offering of penny stock, a respondent who is enjoined from violating the antifraud provisions."²⁶ In this case, barring Respondents from participating in the securities industry and from participating in an offering of penny stock provides an important additional layer of protection to the public beyond the sanctions imposed by the district court. Accordingly, in light of the allegations of fraud in connection with Respondents' offering and sale of mUrgent securities, we are convinced that these additional sanctions are in the public interest.

* * * *

²⁴ (...continued)

A. Lowry, 55 S.E.C. 1133, 1145 (2003) (stating that the public interest analysis extends beyond interests of a particular group of investors), *aff'd*, 340 F.3d 501 (8th Cir. 2003).

²⁵ *Melton*, 56 S.E.C. at 713.

²⁶ *Id.*; see also *Gibson*, 92 S.E.C. Docket at 2114 (imposing a securities industry bar based on allegations of fraud and noting that "[f]idelity to the public interest' requires a severe sanction when respondent's misconduct involves fraud because the 'securities business is one in which opportunities for dishonesty recur constantly'" (quoting *Richard C. Spangler, Inc.*, 46 S.E.C. 238, 252 (1976))).

After considering the relevant factors, we hold that the public interest requires barring Respondents from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization and from participating in an offering of penny stock.

An appropriate order will issue.²⁷

By the Commission (Chairman SCHAPIRO and Commissioners WALTER, AGUILAR, PAREDES and GALLAGHER).

Elizabeth M. Murphy
Secretary


By: Jill M. Peterson
Assistant Secretary

²⁷ We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Rel. No. 66842 / April 20, 2012

Admin. Proc. File No. 3-14496

In the Matter of

VLADIMIR BORIS BUGARSKI, VLADISLAV WALTER
BUGARSKI, and ALEKSANDER NEGOVAN BUGARSKI
c/o Darryl C. Sheetz, Esq.
Law Offices of Darryl C. Sheetz
335 Centennial Way, Suite 100
Tustin, California 92780

ORDER IMPOSING REMEDIAL SANCTIONS

On the basis of the Commission's opinion issued this day, it is

ORDERED that Vladimir Boris Bugarski, Vladislav Walter Bugarski, and Aleksander Negovan Bugarski be, and they hereby are, barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization, and from participating in an offering of penny stock.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: **Jill M. Peterson**
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-66839)

April 20, 2012

Order Temporarily Exempting Broker-Dealers from the Recordkeeping, Reporting, and Monitoring Requirements of Rule 13h-1 under the Securities Exchange Act of 1934 and Granting an Exemption for Certain Securities Transactions

I. Introduction

On July 27, 2011, the Securities and Exchange Commission ("Commission") adopted Rule 13h-1 under the Securities Exchange Act of 1934 ("Exchange Act") concerning large trader reporting to assist the Commission in both identifying, and obtaining trading information on, market participants that conduct a substantial amount of trading activity, as measured by volume or market value, in U.S. securities (such persons are referred to as "large traders").¹

Pursuant to Exchange Act Section 13(h)(6) and Rule 13h-1(g) thereunder,² the Commission, by order, may exempt from the provisions of Rule 13h-1, upon specified terms and conditions or for stated periods, any person or class of persons or any transaction or class of transactions from the provisions of Rule 13h-1 to the extent that such exemption is consistent with the purposes of the Exchange Act.

Currently, the compliance date for the broker-dealer recordkeeping and reporting requirements of Rule 13h-1(d) and (e), respectively, as well as the requirement under Rule 13h-1(f) for broker-dealers to monitor their customers' accounts for activity that may trigger the large trader identification requirements of Rule 13h-1, is April 30, 2012. As discussed below, the Commission is temporarily exempting registered broker-dealers from the requirements of new

¹ See Securities Exchange Act Release No. 64976 (July 27, 2011), 76 FR 46960 (Aug. 3, 2011) ("Rule 13h-1 Adopting Release"). The effective date of Rule 13h-1 was October 3, 2011.

² See 15 U.S.C. 78m and 17 CFR 240.13h-1(g), respectively.

Rule 13h-1 by extending the April 30, 2012 compliance date to provide them with additional time to comply with the recordkeeping, reporting, and monitoring requirements of the Rule.

Specifically, and as discussed more fully below, the Commission is extending the April 30, 2012 compliance date for registered broker-dealers to May 1, 2013, except for certain broker-dealers that: (1) are large traders or (2) have large trader customers that are either broker-dealers or that trade through a “sponsored access” arrangement, for which the Commission is extending the compliance date to November 30, 2012.³ The extension of the compliance date will allow broker-dealers additional time to develop, test, and implement enhancements to their recordkeeping and reporting systems as required under Rule 13h-1 and, for those broker-dealer requirements for which the compliance date has been extended to May 1, 2013, for the Commission to consider requests for relief from certain provisions of the Rule.

In addition, the Commission is exempting certain transactions from the definition of the term “transaction” provided in Rule 13h-1(a)(6), but for the sole purpose of determining whether a person is a large trader.

II. Broker-Dealer Recordkeeping and Reporting

A. Introduction

Recordkeeping. In addition to requiring large traders to register with the Commission by filing and periodically updating Form 13H, Rule 13h-1 requires certain broker-dealers to, among other things, maintain specified records of transactions that they effect, directly or indirectly, for large traders, and to report to the Commission, upon request of the Commission, such records in electronic format. Specifically, Rule 13h-1(d) requires broker-dealers to maintain records of the

³ The effective date for Rule 13h-1 remains October 3, 2011. The compliance date for the requirement on large traders to identify to the Commission pursuant to Rule 13h-1(b) was December 1, 2011.

information specified in Rule 13h-1(d) for all transactions effected directly or indirectly by or through:

- (i) An account such broker-dealer carries for a large trader or an Unidentified Large Trader,⁴ or
- (ii) If the broker-dealer is a large trader, any proprietary or other account over which such broker-dealer exercises investment discretion.
- (iii) Additionally, where a non-broker-dealer carries an account for a large trader or an Unidentified Large Trader, the broker-dealer effecting transactions directly or indirectly for such large trader or Unidentified Large Trader shall maintain records of all of the information required under the Rule for those transactions.

The information required to be maintained for large trader accounts includes the standard information currently captured pursuant to Rule 17a-25 and the Electronic Blue Sheets ("EBS") system, plus two new fields that are unique to Rule 13h-1: (1) the time that the transaction was executed ("execution time")⁵ and (2) the large trader identification ("LTID") number(s) associated with the account.⁶

Reporting. Rule 13h-1(e) requires every registered broker-dealer who is itself a large trader or carries an account for a large trader or an Unidentified Large Trader to report

⁴ The term "Unidentified Large Trader" means each person who has not complied with the identification requirements of paragraphs (b)(1) and (b)(2) of Rule 13h-1 that a registered broker-dealer knows or has reason to know is a large trader. See 17 CFR 240.13h-1(a)(9). For purposes of determining whether a registered broker-dealer has reason to know that a person is large trader, a registered broker-dealer need take into account only transactions in NMS securities effected by or through such broker-dealer. See *id.*

⁵ See 17 CFR 240.13h-1(d)(2)(xii).

⁶ See 17 CFR 240.13h-1(d)(2)(xiii).

electronically to the Commission, at the Commission's request, the required transaction information on such persons whose activity is equal to or greater than the reporting activity level.⁷ In addition, the Rule provides that where a non-broker-dealer carries an account for a large trader or an Unidentified Large Trader, the broker-dealer effecting such transactions directly or indirectly for a large trader must electronically report such information, at the Commission's request.

Broker-dealers are required to report information to the Commission upon request of the Commission.⁸ Information must be reported to the Commission no later than the day and time specified in the Commission's request for transaction information, which shall be no earlier than the open of business of the day following the request, unless in unusual circumstances same day submission of information is requested.⁹

B. Request for Extension of Compliance Date and Other Relief from Broker-Dealer Recordkeeping and Reporting Requirements

⁷ The reporting activity level is 100 shares. See 17 CFR 240.13h-1(a)(8). Accordingly, in response to a Commission request for EBS information, broker-dealers are required to report information for each account in which any large trader's or Unidentified Large Trader's activity amounts to at least 100 shares in the aggregate.

In response to a Commission request for transaction records, in addition to reporting information for any identified large trader (i.e., a person for whom the broker-dealer has received an LTID number), the broker-dealer also should report records for each Unidentified Large Trader, as applicable, including any unique indentifying number that the broker-dealer has assigned to such person.

⁸ See 17 CFR 240.13h-1(e).

⁹ See 17 CFR 240.13h-1(e). See also 17 CFR 240.13h-1(d)(5) (requiring that the records required to be kept pursuant to the provisions of Rule 13h-1 must be available for reporting on the morning after the day the transactions were effected (including Saturdays and holidays)).

The Financial Information Forum ("FIF"), representing a variety of broker-dealers and other market participants, has requested that the Commission extend the compliance date to November 30, 2012 for the broker-dealer recordkeeping and reporting provisions of Rule 13h-1, and provide certain substantive relief with respect to those provisions.¹⁰ The Securities Industry and Financial Markets Association ("SIFMA") also has approached Commission staff with an outline for relief similar to that requested by FIF, including a phased implementation approach.¹¹

FIF and SIFMA believe that broker-dealers need additional time to perform the business analysis, development, and testing required to implement the Rule's recordkeeping and reporting requirements. FIF and SIFMA also believe that relief from certain of the substantive requirements of the Rule is warranted in order to reduce the implementation costs for some broker-dealers.¹² Among other things, FIF has requested relief from the reporting requirements for non-self clearing broker-dealers, such that only clearing broker-dealers (including large traders that are themselves self-clearing broker-dealers) would report large trader transaction data to the Commission through the EBS infrastructure. Further, for large trader customers other than those using "sponsored access" arrangements, FIF has requested relief from providing LTID numbers on executions in average price processing accounts, and execution time on allocations

¹⁰ See Letter from Manisha Kimmel, Executive Director, Financial Information Forum, to Robert Cook, Director, and David Shillman, Associate Director, Division of Trading and Markets, Commission, dated January 25, 2012 ("FIF Letter"), available at: <http://www.sec.gov/comments/s7-10-10/s71010.shtml>.

¹¹ See Letter from Ann L. Vlcek, Managing Director and Associate General Counsel, SIFMA, to David S. Shillman, Associate Director, Division, Commission, dated March 29, 2012, available at: <http://www.sec.gov/comments/s7-10-10/s71010.shtml>.

¹² See FIF Letter, supra note 10, at 5.

made out of average price processing accounts.¹³ FIF also requested relief for broker-dealers effecting transactions for a large trader other than the large trader's clearing broker.¹⁴ FIF did not request relief from the substantive requirements of the Rule for clearing brokers¹⁵ where the large trader customer either (1) is a U.S. registered broker-dealer or (2) has a "sponsored access" arrangement.¹⁶ Finally, FIF and SIFMA requested that the Commission coordinate the Rule's implementation dates with those for a series of separate changes to the EBS record layout that have been proposed by the Intermarket Surveillance Group,¹⁷ and that Commission staff provide guidance on a range of suggested "Frequently Asked Questions" relating to the Rule.¹⁸

¹³ In other words, executions in average price processing accounts would be reported with the execution time for each trade but would not include the applicable LTID number(s) associated with the transaction, and allocations out of average price processing accounts would be reported with the applicable LTID number(s) but not the execution times of the constituent trades.

¹⁴ See FIF Letter, supra note 10, at 2.

¹⁵ This includes the large trader broker-dealer itself, if self-clearing.

¹⁶ See FIF Letter, supra note 10, at 2 and 22. FIF defines a "sponsored access" arrangement by reference to the Commission's Market Access release (Securities Exchange Act Release No. 63241 (November 3, 2010), 75 FR 69792 (November 15, 2010) (S7-03-10)), generally as an arrangement where a broker-dealer permits a customer to enter orders into a trading center without using the broker-dealer's trading system (*i.e.*, using the customer's own technology or that of a third party provider). FIF indicates that compliance is easier for sponsored access customers because those arrangements typically are distinct from all other business lines of the broker-dealer, with infrastructure that processes this order flow that is separate from the platforms that handle other client and proprietary flows. See *id.* at 5.

¹⁷ See, *e.g.*, FINRA Regulatory Notice 11-56 (December 2011) (concerning proposed enhancements to EBS submissions). As reflected in that Regulatory Notice, the ISG's proposed enhancements currently have an effective date of August 31, 2012. Commission staff are currently working with the ISG on the changes to the EBS record layout and expects to be able to coordinate the implementation dates as requested.

¹⁸ Commission staff have published written responses to a series of "Frequently Asked Questions" that staff have received since the Commission's adoption of Rule 13h-1 and Form 13H. See Responses to Frequently Asked Questions Concerning Large Trader Reporting, available at: <http://www.sec.gov/divisions/marketreg/mrfaq.htm>.

C. Extension of Compliance Date for the Broker-Dealer Requirements

The Commission believes that it is appropriate and consistent with the purposes of the Exchange Act to provide a temporary exemption from the broker-dealer recordkeeping, reporting, and monitoring requirements of Rule 13h-1 by extending the Rule's compliance date on a limited basis. FIF raised a variety of implementation concerns relating to the application of the Rule to broker-dealers other than the large trader's clearing broker, and in cases where the large trader customer is neither a U.S.-registered broker-dealer nor a sponsored access customer. An extension of the compliance date should provide the Commission an opportunity to work with market participants to more fully examine the implementation issues raised by FIF, assess the appropriateness of any exemptive relief, and allow broker-dealers time to develop, test, and implement the necessary systems changes once the examination of implementation issues is complete. However, the Commission believes a more modest extension of the compliance date is appropriate for those aspects of the Rule for which substantive relief was not requested – namely compliance by the large trader's clearing broker (including the large trader itself if it is a self-clearing broker-dealer) where the large trader customer either (1) is a U.S. registered broker-dealer or (2) has a "sponsored access" arrangement. The Commission believes that temporarily exempting registered broker-dealers from the recordkeeping, reporting, and monitoring requirements of Rule 13h-1 for the stated periods should facilitate the orderly and meaningful implementation of the requirements for those broker-dealers that need more time to comply with the new rule.

Recordkeeping and Reporting Requirements for Broker-Dealers. Accordingly, the Commission is providing a temporary exemption to extend the compliance date to May 1, 2013,

for the broker-dealer recordkeeping, reporting, and monitoring requirements of Rule 13h-1, except as described below.¹⁹

The Commission is providing a temporary exemption to extend the compliance date to November 30, 2012, for the broker-dealer recordkeeping and reporting requirements of Rule 13h-1 with respect to a clearing broker-dealer for a large trader²⁰ where the large trader:

- (1) is a U.S.-registered broker-dealer,²¹ or
- (2) trades through a sponsored access arrangement.²²

¹⁹ In connection with any potential relief that the Commission may grant on or before the new May 1, 2013 date, the Commission would consider the appropriateness of an implementation period as well as a systems testing schedule beyond May 1, 2013.

²⁰ In its request, FIF asked the Commission for “relief for broker dealers involved in Large Trader transactions that do not have a direct relationship with the Large Trader. Only the self-clearing and clearing broker dealers with a direct relationship with the Large Trader would perform Large Trader Reporting.” See FIF Letter, *supra* note 10, at 2. In Appendix C of its letter, FIF provides an example of the entities for whom it recommends imposing a recordkeeping and reporting obligation. See *id.* at 25. Specifically, FIF recommends that the reporting of execution time should rest with the clearing broker for the originating broker, and any prime broker would be relieved from being required to report execution times. The term “a clearing broker-dealer for a large trader” refers to self-clearing and clearing broker-dealers that have a direct relationship with the large trader (including the large trader broker-dealer itself, if self-clearing).

²¹ The reportable activity would include proprietary trading by a large trader broker-dealer where the large trader is trading for its own account.

²² A “sponsored access arrangement” in this context refers to an arrangement in which a broker-dealer permits a large trader customer to enter orders directly to a trading center where such orders are not processed through the broker-dealer’s own trading system (other than any risk management controls established for purposes of compliance with Rule 15c3-5 under the Exchange Act) and where the orders are routed directly to a trading center, in some cases supported by a service bureau or other third party technology provider. See Securities Exchange Act Release No. 63241 (November 3, 2010), 75 FR 69792 (November 15, 2010) (S7-03-10).

On November 30, 2012, these clearing brokers should be prepared to record and report disaggregated trade information, together with the LTID number (or numbers, if applicable) and execution time, for these two categories of large traders, in accordance with the requirements of Rule 13h-1.²³

As explained in FIF's letter, the trading activity of these categories of large traders typically is processed by clearing brokers on infrastructure separate from that used for other customers, so that compliance with the Rule requires substantially less effort than for other types of large trader customers.²⁴ Further, the Commission believes that limiting the recordkeeping and reporting responsibility to clearing brokers for this initial compliance period is reasonable as it narrows the universe of reporting entities to broker-dealers that currently are connected to the EBS system.

Monitoring Requirements. The Commission also is providing a temporary exemption to extend the compliance date to May 1, 2013 for the requirement on registered broker-dealers to monitor their customers' accounts for activity that may trigger the large trader identification

²³ Accordingly, large traders that are themselves registered broker-dealers but that are not self-clearing would not be required to connect to the EBS system to report their transactions as of November 30, 2012, and instead could rely on their clearing broker to perform the reporting responsibilities with respect to their reportable transactions during that interim period.

In addition, FIF requested in its letter that the Commission provide guidance on whether execution times are required to be reported in connection with options exercises and assignments as well as exchange traded fund creations and redemptions (i.e., the actual transfers involving the authorized participant and the exchange traded fund sponsor, not the underlying purchases or sales of securities in the secondary market by an authorized participant in connection with the creation or redemption process). See FIF Letter, *supra* note 10, at 1. While the Commission continues to consider FIF's broader request for relief, in the interim period, firms will not be required to provide execution times on any options exercises and assignments or exchange traded fund creations and redemptions that they report through EBS for large traders prior to May 1, 2013.

²⁴ See FIF Letter, *supra* note 10, at 5.

requirements of Rule 13h-1. This extension should allow firms to focus their resources on the recordkeeping and reporting provisions and facilitate the orderly implementation of those provisions.

III. Exemption for Certain Transactions

Rule 13h-1(a)(1)(i) defines a large trader as a person who, among other things, “effects transactions for the purchase or sale of any NMS security...”²⁵ Rule 13h-1(a)(6) defines the term “transactions” as “all transactions in NMS securities, excluding exercises or assignments of option contracts,” except for certain specifically enumerated transactions.²⁶ The exceptions from the term “transaction” were designed to exclude certain transactions from the identifying activity level calculation that are not effected with an intent that is commonly associated with the arm’s-length trading of securities in the secondary market and therefore would not fall within the types of transactions that are characterized by the exercise of investment discretion for purposes of Rule 13h-1.²⁷ Rather, these enumerated categories of transactions generally are effected for materially different reasons that reflect fundamental corporate decision-making or capital formation objectives and therefore are not effected with an intent that is normally associated with secondary-market trading activity in NMS securities.

SIFMA has requested that certain additional types of transactions involving securities offerings be excluded from being counted towards the identifying activity level.²⁸ Under the

²⁵ See 17 CFR 240.13h-1(a)(1)(i).

²⁶ See 17 CFR 240.13h-1(a)(6).

²⁷ See Rule 13h-1 Adopting Release, *supra* note 1, 76 FR at 46967.

²⁸ See Letter from Sean Davy, Managing Director, SIFMA, to David S. Shillman, Associate Director, Division, Commission, dated March 26, 2012, available at: <http://www.sec.gov/comments/s7-10-10/s71010.shtml> (“SIFMA Capital Markets Letter”).

Rule, offerings of securities by or on behalf of an issuer generally are excluded for purposes of determining whether a person is a large trader, but that exemption expressly does not apply to “an offering of securities effected through the facilities of a national securities exchange.”²⁹ The Commission understands from SIFMA that, while the Rule does exclude the vast majority of primary offerings, certain offerings such as “dribble out” programs³⁰ or offerings “crossed” on a national securities exchange³¹ occur with enough regularity to warrant relief for the reasons discussed below. In addition, while the Rule excludes offerings of securities by or on behalf of an issuer, it does not exclude sales of stock acquired as part of employee compensation by current or former selling employees of the issuer in connection with those offerings. SIFMA argues in its letter that offerings effected through the facilities of a national securities exchange, as well as sales by issuer employees in an initial public offering or registered secondary offering, similarly are effected for materially different reasons than those normally associated with

²⁹ See 17 CFR 240.13h-1(a)(6)(ii) (providing an exclusion for “[a]ny transaction that is part of an offering of securities by or on behalf of an issuer, or by an underwriter on behalf of an issuer, or an agent for an issuer, whether or not such offering is subject to registration under the Securities Act of 1933 (15 U.S.C. 77a), provided, however, that this exemption shall not include an offering of securities effected through the facilities of a national securities exchange”).

³⁰ SIFMA notes that a “dribble out program” enables an issuer to offer and sell its equity securities through one or more registered broker-dealers in incremental registered transactions that are effected over a period of time. See SIFMA Capital Markets Letter, supra note 28, at 3. Such offerings involve prospectus supplements, comfort letters, opinions of counsel, due diligence, officer’s certificates, and filings with the SEC. See id. SIFMA states that these transactions can facilitate capital formation for issuers, particularly during periods of high volatility, by avoiding some of the risks of underwritten offerings. See id.

³¹ SIFMA notes that all of part of an offering of securities by an issuer may be “crossed” on a national securities exchange purely for ease of settlement. See id. SIFMA believes that the character of this type of offering makes it distinguishable from ordinary secondary market trading. See id.

secondary-market trading activity, and should be excluded for purposes of determining whether a person is a large trader.³²

The Commission believes that it is appropriate and consistent with the purposes of the Exchange Act to not count these transactions for the purpose of determining whether a person meets the identifying activity level. Accordingly, the Commission hereby is exempting from the definition of the term "transaction," for the sole purpose of determining whether a person is a large trader: (1) any transaction that is part of an offering of securities by or on behalf of an issuer, or by an underwriter on behalf of an issuer, or an agent for an issuer, whether or not such offering is subject to registration under the Securities Act of 1933, regardless of whether such transaction is effected through the facilities of a national securities exchange; and (2) sales of securities by a selling shareholder in connection with an initial public offering or in a registered secondary offering if such selling shareholder is a current or former employee of the issuer and the securities being sold were acquired as part of the person's compensation as an employee of the issuer. The Commission believes that providing this limited exemption will continue to ensure that Rule 13h-1 provides a mechanism for the Commission to gather data on persons that conduct a significant amount of secondary market trading in NMS securities, while providing limited relief to issuers and selling shareholders who would not otherwise meet the definition of large trader in the absence of these capital market transactions. Because such transactions typically are infrequent in nature and are distinguishable in character from the secondary market activity that is the focus of Rule 13h-1, this exemption should preserve the Commission's ability to identify large traders while reducing burdens on issuers and selling shareholders and thereby assist in the promotion of capital formation.

³²

See id.

IV. Conclusion

IT IS HEREBY ORDERED, pursuant to Exchange Act Section 13(h)(6) and Rule 13h-1(g) thereunder, that broker-dealers subject to the recordkeeping, reporting, and monitoring requirements of Rule 13h-1 are temporarily exempted from those requirements until May 1, 2013, except that clearing broker-dealers for a large trader that either (1) is a U.S.-registered broker-dealer,³³ or (2) trades through a sponsored access arrangement,³⁴ are temporarily exempted from the recordkeeping and reporting provisions of Rule 13h-1 only until November 30, 2012.

Further, IT IS HEREBY ORDERED, pursuant to Exchange Act Section 13(h)(6) and Rule 13h-1(g) thereunder, that: (1) transactions that are part of an offering of securities by or on behalf of an issuer, or by an underwriter on behalf of an issuer, or an agent for an issuer, whether or not such offering is subject to registration under the Securities Act of 1933, or such transaction is effected through the facilities of a national securities exchange, and (2) sales of securities by a selling shareholder in connection with an initial public offering or in a registered secondary offering if such selling shareholder is a current or former employee of the issuer and

³³ This includes the large trader broker-dealer itself, if self-clearing.

³⁴ A "sponsored access arrangement" in this context refers to an arrangement in which a broker-dealer permits a large trader customer to enter orders directly to a trading center where such orders are not processed through the broker-dealer's own trading system (other than any risk management controls established for purposes of compliance with Rule 15c3-5 under the Exchange Act) and where the orders are routed directly to a trading center, in some cases supported by a service bureau or other third party technology provider. See Securities Exchange Act Release No. 63241 (November 3, 2010), 75 FR 69792 (November 15, 2010) (S7-03-10).

the securities being sold were acquired as part of the person's compensation as an employee of the issuer, are hereby exempt from the definition of the term "transaction" under Rule 13h-1(a)(6) for the sole purpose of determining whether a person is a large trader.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Ch. II

[Release Nos. 33-9316, 34-66845, IA-3400, IC-30041, File No. S7-4-12]

Regulatory Flexibility Agenda

AGENCY: Securities and Exchange Commission.

ACTION: Notice of semiannual regulatory agenda.

SUMMARY: The Securities and Exchange Commission approved the publication of an agenda of its rulemaking actions pursuant to the Regulatory Flexibility Act. The agenda, which is not a part of or attached to this document, was submitted by the Commission to the Regulatory Information Service Center for inclusion in the Unified Agenda of Federal Regulatory and Deregulatory Actions, which is scheduled for publication in its entirety on www.reginfo.gov in April 2012. The version of the Unified Agenda to be published in the Federal Register will include only those rules for which the agency has indicated that preparation of an analysis under the Regulatory Flexibility Act is required. Information in the Commission's agenda was accurate on April 23, 2012, the date on which the Commission's staff completed compilation of the data. To the extent possible, rulemaking actions by the Commission after that date will be reflected in the agenda. The Commission invites questions and public comment on the agenda and on the individual agenda entries.

DATES: Comments should be received on or before [30 days after publication in the Federal Register].

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/other.shtml>); or

substantial number of small entities (5 U.S.C. 602(a)). The RFA specifically provides that publication of the agenda does not preclude an agency from considering or acting on any matter not included in the agenda, and that an agency is not required to consider or act on any matter that is included in the agenda (5 U.S.C. 602(d)). Actions that do not have an estimated date are placed in the long term category; the Commission may nevertheless act on items in that category within the next twelve months. The agenda includes new entries, entries carried over from previous publications, and rulemaking actions that have been completed (or withdrawn) since publication of the last agenda. The Commission invites public comment on the agenda and on the individual agenda entries.

By the Commission.

A handwritten signature in black ink, reading "Elizabeth M. Murphy". The signature is written in a cursive, flowing style.

Elizabeth M. Murphy
Secretary

Dated: April 23, 2012

*Commissioner Gallagher
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 66854 / April 24, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14856

In the Matter of

EGAN-JONES RATINGS
COMPANY and SEAN EGAN,

Respondents.

ORDER INSTITUTING ADMINISTRATIVE
AND CEASE-AND-DESIST PROCEEDINGS,
PURSUANT TO SECTIONS 15E(d) AND 21C
OF THE SECURITIES EXCHANGE ACT OF
1934

I.

The Securities and Exchange Commission ("Commission") deems it necessary for the protection of investors and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15E(d) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Egan-Jones Ratings Company ("EJR") and Sean Egan ("Egan") (collectively, "Respondents").

II.

After an investigation, the Division of Enforcement alleges that:

RESPONDENTS

1. EJR is a subscriber-based credit rating agency located in Haverford, Pennsylvania. On December 21, 2007, the Commission approved EJR's application to become registered as a Nationally Recognized Statistical Rating Organization ("NRSRO") for financial institutions, insurance companies, and corporate issuers. On December 4, 2008, the Commission approved EJR's application for registration as an NRSRO for issuers of asset-backed securities ("ABS") and issuers of government securities, municipal securities, or securities issued by a foreign government ("government securities").

2. Sean Egan is the founder, president and owner of EJR. Since EJR became registered as an NRSRO, Egan has been EJR's primary, and at times sole, analyst responsible for issuing credit ratings. Egan signed the applications for NRSRO registration and annual certifications that EJR submitted to the Commission, and provided the majority of the information contained in those submissions.

37 of 54

SUMMARY

3. EJR violated Exchange Act Section 15E(a)(1) and Rule 17g-1(b) thereunder when it made willful and material misrepresentations and omissions in its July 2008 application to the Commission to register as an NRSRO for issuers of ABS and government securities. In EJR's July 2008 application to register in these two additional classes, EJR falsely stated that, as of the date of its application, it had 150 outstanding ABS issuer ratings and 50 outstanding government issuer ratings. EJR further falsely stated in its application that it had been issuing credit ratings in these categories as a credit rating agency on a continuous basis since 1995. In fact, at the time of its July 2008 application, EJR had not issued – that is, made available on the Internet or through another readily accessible means – any ABS or government issuer ratings. EJR willfully made these misstatements and omissions to conceal the fact that it had no experience issuing ratings on ABS or government issuers, and therefore did not meet the requirements for registration of an NRSRO with respect to these categories. Egan signed the application on EJR's behalf, certifying that it was "accurate in all significant respects," even though he knew that it contained these material misrepresentations and omissions.

4. EJR violated Exchange Act Section 15E(b)(2) and Rule 17g-1(f) when it made willful and material misrepresentations or omissions regarding the number of EJR's outstanding ABS and government issuer ratings, and the length of time that it had been issuing credit ratings in these categories on a continuous basis, in subsequent annual certifications submitted to the Commission. EJR willfully made these misstatements and omissions in order to maintain its registration as an NRSRO in these classes.

5. In addition, EJR falsely stated in submissions to the Commission that it was unaware whether its subscribers held long or short positions in particular securities. In fact, EJR's salespeople were aware of certain clients' holdings, and in some instances knew whether clients had long or short positions. In at least three instances, information about whether a client had a long or short position was conveyed to Egan, EJR's primary analyst.

6. EJR also violated numerous statutory provisions and Commission rules governing NRSROs. EJR failed to enforce its policies to address conflicts of interest arising from employee ownership of securities, and allowed two analysts to participate in determining the credit ratings for issuers whose securities they owned. EJR also (1) failed to make or retain a record of the procedures and methodologies it used to determine credit ratings; (2) failed to make or retain certain internal records regarding its outstanding ratings; and (3) failed to retain emails regarding its determination of credit ratings for approximately eighteen months after it became registered as an NRSRO.

7. Egan knowingly provided substantial assistance and caused EJR's misstatements. He provided inaccurate information for inclusion in EJR's applications and annual certifications and signed the applications, certifying that the information provided in them was "accurate in all significant respects," when he knew that it was not.

8. Egan knowingly provided substantial assistance and caused EJR's violations of the conflicts-of-interest and books and records violations by failing to ensure EJR's compliance with NRSRO rules. Egan was aware of these requirements and, as EJR's president, was ultimately responsible for EJR's compliance with these provisions, yet failed to take appropriate action to ensure that EJR complied. As EJR's primary analyst, he failed to maintain the required records of

credit ratings and as EJR's president, he failed to establish procedures for record retention among the members of his staff.

FACTUAL BACKGROUND

A. The Credit Rating Agency Reform Act and Rules Governing NRSROs

9. The Credit Rating Agency Reform Act of 2006 ("Rating Agency Act"), enacted on September 29, 2006, defined the term "nationally recognized statistical rating organization" to mean a credit rating agency that: (1) issues credit ratings certified by qualified institutional buyers for certain classes of issuers; and (2) is registered with the Commission. The Exchange Act defines a credit rating agency as an entity that, among other things, is "engaged in the business of issuing credit ratings on the Internet or through another readily accessible means." Accordingly, an entity seeking registration with the Commission as an NRSRO must be a credit rating agency that issues credit ratings on the Internet or through another readily accessible means.

10. The Rating Agency Act also provided authority for the Commission to implement registration, recordkeeping, financial reporting, and oversight rules for registered credit rating agencies. Under this authority, the Commission has adopted Rules 17g-1 through 17g-7 and Form NRSRO. Exchange Act Rule 17g-1(a) requires a credit rating agency applying for registration as an NRSRO to use Form NRSRO to furnish the Commission with an initial application. Section 15E(b)(1) of the Exchange Act and Rule 17g-1(e) require a firm, after becoming registered as an NRSRO, to promptly update its registration application if any of the information becomes materially inaccurate, and Section 15E(b)(2) of the Exchange Act and Rule 17g-1(f) require NRSROs to provide the Commission with an annual certification on Form NRSRO. The annual certification must contain updates of certain information, a certification that the information furnished with Form NRSRO continues to be accurate, and a list of material changes to the application for registration that occurred during the previous calendar year.

11. An applicant or NRSRO must also furnish the Commission with information on Form NRSRO regarding the procedures and methodologies that the applicant or NRSRO uses to determine credit ratings, policies and procedures to prevent the misuse of material, nonpublic information, any conflict of interest relating to the issuance of credit ratings, whether it has a code of ethics in effect, and financial information.

12. In addition to registration and annual certification requirements, NRSROs must comply with recordkeeping requirements and rules governing conflicts of interest. For example, Rule 17g-2 provides that NRSROs must create and maintain certain records, including records regarding each rating issued by the NRSRO. Rule 17g-5 prohibits an NRSRO from having certain conflicts of interest relating to the issuance or maintenance of a credit rating and requires an NRSRO to disclose and to establish and maintain written policies and procedures to address and manage other potential conflicts of interest.

B. EJR's Applications for NRSRO Registration

13. EJR submitted its initial application on Form NRSRO on August 16, 2007. In the application, EJR sought NRSRO registration for three classes of credit ratings: (i) issuers of financial institutions, brokers, and dealers; (ii) issuers of insurance companies; and, (iii) corporate issuers. EJR submitted supplements to its pending application on September 20, 2007 and November 13, 2007. Egan signed the application and supplements on EJR's behalf (collectively, "August 2007 Application"), in his capacity as president of EJR, and provided the majority of the

information contained in the August 2007 Application. On December 21, 2007, the Commission granted EJR's application.

14. On July 14, 2008, EJR submitted an application for NRSRO registration in the remaining two classes of credit ratings: (i) issuers of ABS and (ii) issuers of government securities.¹ EJR submitted a supplement to this application on September 2, 2008. As president of EJR, Egan signed the application and supplemental submission for EJR (collectively, "July 2008 Application"), and provided the majority of the information contained in the July 2008 Application. On December 4, 2008, the Commission granted EJR's application.

15. EJR submitted an annual certification to the Commission for calendar year 2007 on March 28, 2008 ("2007 Annual Certification"), an annual certification for 2008 on March 27, 2009 ("2008 Annual Certification"), an annual certification for 2009 on March 30, 2010 ("2009 Annual Certification"), an annual certification for 2010 on March 28, 2011 ("2010 Annual Certification"), and an annual certification for 2011 on March 30, 2012 ("2011 Annual Certification"). Egan signed each of these certifications, certifying that they were "accurate in all significant respects," and provided the majority of the information contained in them when, in fact, certain of the misstatements and omissions alleged herein were neither corrected nor acknowledged as incorrect as the rules required.

C. EJR's Misstatements Concerning its Experience Rating Issuers of ABS and Government Securities

16. Form NRSRO requires an applicant seeking NRSRO registration to indicate for each class of ratings: (1) the approximate number of credit ratings that it had outstanding in that class at the time of the registration application; and (2) "the approximate date the Applicant/NRSRO began issuing credit ratings as a 'credit rating agency' in that class on a continuous basis through the present."

17. Consistent with the definition of "NRSRO" in effect at the times of EJR's applications, the instructions concerning this section of Form NRSRO stated that "an Applicant/NRSRO must have been in business as a 'credit rating agency' for at least the 3 consecutive years immediately preceding the date of its application for registration as an NRSRO." The instructions further stated that to meet the definition of "credit rating agency" under the Exchange Act, "the Applicant must, among other things, issue 'credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee.'"²

¹ The term "asset-backed security" is defined as "a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to the security holders; provided that in the case of financial assets that are leases, those assets may convert to cash partially by the cash proceeds from the disposition of the physical property underlying such leases." 17 C.F.R. § 229.1101(c). Securities Act Rule 191 and Exchange Act Rule 3b-19 provide that the "issuer" of an asset-backed security is the "depositor" for that asset-backed security. 17 C.F.R. § 230.191(a); 17 C.F.R. § 240.3b-19(a). Pursuant to Regulation AB, each ABS prospectus explicitly identifies the depositor on the front cover of the prospectus. 17 C.F.R. § 229.1002(a).

² Section 3(a)(61) of the Exchange Act defines a "credit rating agency" as "any person (A) engaged in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee, but does not include a commercial credit reporting company; (B) employing either a quantitative or

18. The applicant must furnish at least two qualified institutional buyer ("QIB") certifications that address each class of credit ratings for which it is applying for registration, and those certifications must state that the QIB has "seriously considered" the credit ratings of the applicant "in the course of making some of its investment decisions" for at least three years.

19. Accordingly, an applicant seeking to become registered as an NRSRO for a class of ratings was required to have issued credit ratings in that category on the Internet or through another readily accessible means for at least three years prior to its application.

20. In its July 2008 Application, which Egan signed and certified as being "accurate in all significant respects," EJR falsely stated that it had 150 outstanding credit ratings on issuers of ABS and 50 outstanding credit ratings on issuers of government securities. Months later, in its 2008 Annual Certification, EJR revised its number of outstanding ABS issuer ratings from 150 to fourteen and the number of outstanding government issuer ratings from 50 to nine. Egan provided these numbers to his staff for purposes of filling out the application and certification.

21. Moreover, in its July 2008 Application, EJR falsely stated that it had been issuing ratings on ABS and government issuers on a continuous basis since 1995. EJR reiterated this 1995 date in its 2008 Annual Certification. However, in its 2009 Annual Certification, EJR stated that it had been issuing ratings on issuers of ABS on a continuous basis only since December 2005 and on issuers of government securities since April 2005. EJR reiterated these 2005 dates in its 2010 and 2011 Annual Certifications.

22. In fact, at the time of its July 2008 Application and 2008 Annual Certification, EJR had never issued credit ratings on issuers of ABS or government securities on the internet or through another readily accessible means.

23. Although EJR claimed to have 150 outstanding ABS issuer ratings and 50 government issuer ratings at the time of its July 2008 Application, EJR has no contemporaneous reports, work papers, or other records showing that it had issued credit ratings on ABS or government issuers prior to July 2008. Similarly, EJR does not have reports, work papers, or other contemporaneous records showing that it had issued fourteen ABS issuer ratings or nine government issuer ratings at the time of its 2008 Annual Certification.

24. As the primary, and at times sole, research analyst at EJR throughout the entire period from 1995 through 2011, Egan knew that EJR had not been issuing ratings on issuers of ABS and government securities on a "continuous basis" since 1995 or making such ratings accessible to EJR's subscribers.

25. EJR's sales representatives did not market or distribute ABS or government issuer ratings to the firm's subscribers at any time prior to the 2008 Annual Certification. By contrast, during the same period EJR's salespeople actively marketed the firm's ratings on corporate issuers, and EJR published these ratings on its website and distributed them to its subscribers through blast e-mails. Furthermore, apart from Egan, the other main analyst employed by EJR between October 2008 and September 2009, did not rate any ABS or government issuers and was not aware that EJR had ever issued such ratings.

qualitative model, or both, to determine credit ratings; and (C) receiving fees from either issuers, investors, or other market participants, or a combination thereof."

26. In addition, although EJR claimed to have significant experience rating issuers of ABS in its NRSRO application, from early 2008 through 2009, Egan and EJR engaged in discussions with at least five different third parties regarding arrangements under which these third parties would analyze or rate ABS issuers on behalf of EJR. Agreements and term sheets with two of these entities that were retained by EJR on a trial basis specifically provided for the third parties to provide ABS ratings to EJR or help EJR "develop" models or methodologies for ABS ratings.

27. EJR did not issue ratings on issuers of ABS or government securities on the internet or otherwise make such ratings readily accessible until January 2010, when Egan asked a member of his staff to post ABS and government issuer ratings on its website.

28. EJR's misstatements concerning its experience rating issuers of ABS and government securities were material. In its application, EJR concealed the fact that it had not issued any ABS or government issuer ratings at the time of the application and therefore did not meet the requirements for registration as an NRSRO with respect to issuers in these classes. Accordingly, without EJR's misstatements and omissions, EJR would not have satisfied the Commission's requirements for registration as an NRSRO for issuers of ABS and government securities.

D. EJR Submitted Inaccurate QIB Certifications with its July 2008 Application

29. Form NRSRO requires applicants to submit two certifications from QIBs that address each class of credit ratings for which the applicant is seeking registration. At the time of EJR's 2007 and 2008 NRSRO applications, a QIB was required to certify that it: (1) meets the definition of QIB; and (2) has "seriously considered" the credit ratings of the applicant in the course of making some of its investment decisions in the classes of credit ratings listed by the QIB for at least the three years immediately preceding the date of the certification.

30. The QIB certifications EJR submitted with its application for registration in the categories of issuers of ABS and government securities were inaccurate because neither QIB actually had received ratings from EJR on issuers of ABS or government securities. Moreover, one of the entities had not been an EJR client for three years as of the date of the certification.

31. Egan knew or should have known that the QIBs who submitted the certifications had not, in fact, "seriously considered" any credit ratings of EJR for ABS or government issuers because neither QIB had received such ratings. EJR and Egan did not make any effort to verify the accuracy of the forms.

E. Additional Misstatements by EJR

32. EJR inaccurately stated in its August 2007 NRSRO Application, 2007 Annual Certification, and July 2008 Application that it "does not know if a subscriber is long or short a particular security." In fact, EJR salespeople were aware of certain clients' holdings, and EJR even marketed a portfolio monitoring service whereby clients would be alerted to "specific names we recognize as emerging risks among your holdings." On multiple occasions, EJR's salespeople were informed whether clients had long or short positions in particular securities. In at least three instances, Egan received information about whether a client had a long or a short position.

33. Exhibit 5 to Form NRSRO requires an applicant or NRSRO to provide a copy of its written code of ethics in effect or a statement of the reasons it does not have a written code of ethics. EJR's code of ethics in its November 2007 supplemental response to its initial application and its 2007 Annual Certification stated that employees were not permitted to trade in securities of

issuers rated by EJR, except in certain limited circumstances. However, this provision was missing in versions of EJR's code of ethics signed by two EJR analysts.

F. EJR's Conflict of Interest Violations

34. Exchange Act Section 15E(h)(1) requires an NRSRO to establish, maintain, and enforce written policies and procedures reasonably designed to address and manage conflicts of interest. Rule 17g-5(c)(2) prohibits an NRSRO from issuing a credit rating when an analyst who participated in determining the rating owned the securities of the entity subject to that rating.

35. EJR violated these provisions because two EJR analysts participated in determining credit ratings for issuers whose securities they owned. In 2009, an EJR analyst participated in determining ratings on at least seventeen different issuers while owning the securities of those issuers. Subsequently, a second EJR analyst determined a credit rating of an issuer whose securities he owned. Before the report was published, Egan emailed the analyst and informed him that he should talk to EJR's compliance officer before publishing the report on the issuer, and stated that Egan, rather than the analyst, "might have to release it." EJR's compliance officer subsequently advised the analyst that he was permitted to publish the report, as long as he did not trade the security.

36. Exchange Act Rule 17g-5(a)(2) provides that an NRSRO is prohibited from having certain conflicts of interest relating to the issuance or maintenance of a credit rating, unless the NRSRO establishes, maintains, and enforces written policies and procedures to address the conflict of interest. One of those conflicts, listed in Rule 17g-5(b)(6), is allowing persons within the NRSRO to directly own the securities of an issuer or obligor subject to a credit rating of the NRSRO.

37. EJR repeatedly failed to adequately enforce its written policies and procedures to address conflicts of interest. Although EJR's code of ethics generally prohibited employees from owning securities of issuers rated by EJR, EJR did not undertake any effort to verify that employees had produced statements for all of their securities accounts, and at least one employee failed to provide statements for all of his accounts. EJR thus failed to discover until months later that this employee had traded in securities of issuers rated by EJR, in violation of EJR's conflict of interest policy.

G. EJR's Books and Records Violations

38. Rule 17g-2(a)(6) requires an NRSRO to make and retain records documenting the established procedures and methodologies used by the NRSRO for determining credit ratings, and Rule 17g-1(i) requires NRSROs to make its current Form NRSRO and certain exhibits to the Form public, including, in Exhibit 2, a general description of the procedures and methodologies. These requirements are intended to allow the Commission to determine whether the NRSRO is adhering to its policies and whether the publicly available description in the NRSRO's Form NRSRO is sufficient for users to understand the methods. EJR did not make or retain the documentation required under Rule 17g-2(a)(6). Other than the brief descriptions provided in its Form NRSRO Exhibit 2, EJR had no written procedures and methodologies for determining credit ratings.

39. Rule 17g-2(a)(2) requires an NRSRO to make and retain records of the identity of the credit analyst(s) that participated in determining a credit rating, the identity of the credit analyst(s) that approved the credit rating before it was issued, and whether the credit rating was solicited or unsolicited. EJR failed to maintain these records.

40. Rule 17g-2(b)(2) requires an NRSRO to retain all internal records used to form the basis of a credit rating issued by the NRSRO. EJR did not retain these records. EJR had no procedures for maintaining work papers used in determining credit ratings, and did not implement procedures until mid-2009. Even after 2009, EJR failed to retain individual copies of the model that was used in determining each rating, and did not retain records of manual adjustments to the model output made by analysts.

41. Rule 17g-2(b)(7) requires an NRSRO to retain all communications, including electronic communications, received or sent by the NRSRO and its employees that relate to "initiating, determining, maintaining, monitoring, changing, or withdrawing a credit rating." EJR had no system in place to retain employee emails until June 2009 when, a few days before the Commission staff was scheduled to conduct its periodic examination of EJR, EJR hired a third-party consultant to implement an email retention system that would retain all EJR staff emails. Prior to June 2009, no system was in place to prevent employees from deleting emails, and those deleted emails were not retained.

H. Egan's Liability

42. Egan knowingly provided substantial assistance and caused EJR to make the material misstatements and omissions in its applications and annual certifications. Egan provided the information to his staff so that they could make the submissions and knew that the information was inaccurate, yet certified that the information in the submissions was "accurate in all significant respects."

43. Egan knowingly provided substantial assistance and caused EJR to violate the conflict-of-interest and books and records requirements. Egan failed to retain the required records for EJR's ratings, failed to ensure that others retained the required records, and failed to institute a system for staff to do so. He failed to ensure compliance with the conflict of interest provisions by not preventing impermissible employee trading.

VIOLATIONS

44. Section 15E(d) of the Exchange Act provides that the Commission shall, by order, censure, place limitations on, suspend, or revoke the registration of any NRSRO, or with respect to any associated person, censure, place limitations on, suspend or bar such person from being associated with an NRSRO, if the Commission finds that such action is necessary for the protection of investors and in the public interest and that the NRSRO or any person associated with the NRSRO has, among other things, committed any act specified in Sections 15(b)(4)(A), (D) or (E) of the Exchange Act. These acts include that the NRSRO "willfully made or caused to be made" statements that were false or misleading in any application for registration (15(b)(4)(A)), "has willfully violated any provision of . . . this title" (15(b)(4)(D)), or "willfully aided, abetted, counseled, . . . or procured" the violation of any provision of the Exchange Act or any Exchange Act rule by any other person (15(b)(4)(E)).

45. Pursuant to Section 15E(a)(1) of the Exchange Act, a credit rating agency that elects to be treated as an NRSRO:

shall furnish to the Commission an application for registration . . . containing . . . the procedures and methodologies that the applicant uses in determining credit ratings . . . and . . . any other information and documents concerning the applicant . . . as the Commission, by

rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.

46. By willfully making material misstatements and omissions in its August 2007 Application, EJR willfully violated Section 15E(a)(1) and Rule 17g-1(a), which require a credit rating agency applying for registration as an NRSRO to furnish the Commission with an initial application on Form NRSRO that follows the Form's instructions.

47. By willfully making material misstatements and omissions in its July 2008 Application for the two additional classes, EJR willfully violated Section 15E(a)(1) and Rule 17g-1(b), which require an NRSRO applying for registration in an additional class of credit ratings to furnish the Commission with an application on Form NRSRO that follows the Form's instructions.

48. By willfully making material misstatements and omissions in its annual certifications, EJR willfully violated Section 15E(b)(2) and Rule 17g-1(f), which require NRSROs to, not later than 90 days after the end of each calendar year, file with the Commission an amendment to its registration certifying that the information and documents in the application for registration continue to be accurate.

49. By willfully submitting false QIBs, EJR willfully violated Sections 15E(a)(1)(B)(ix) and 15E(a)(1)(C), which require applicants to provide written certifications from clients who had used the applicant's ratings in the specified classes.

50. By willfully failing to have employees sign the Code of Ethics on a timely basis and allowing two employees to sign a version of the Code that omitted the provision governing ownership of securities, and by failing to adequately collect and review employees' brokerage statements, EJR willfully violated Section 15E(h)(1), which requires an NRSRO to establish, maintain, and enforce written policies and procedures to address and manage conflicts of interest, and Rule 17g-5(c)(2).

51. By willfully failing to make and retain records with respect to each current credit rating, EJR willfully violated Section 17(a) of the Exchange Act and Rule 17g-2(a)(2), which require an NRSRO to make and retain such records, including the identity of the analysts that participated in determining the credit rating, the identity of the person who approved the rating, and whether the rating was solicited or unsolicited.

52. By willfully failing to make and retain a record documenting the established procedures and methodologies it uses to determine credit ratings, EJR willfully violated Section 17(a) of the Exchange Act and Rule 17g-2(a)(6).

53. By willfully failing to retain internal records, including nonpublic information and work papers, used to form the basis of a credit rating, EJR willfully violated Section 17(a) of the Exchange Act and Rule 17g-2(b)(2).

54. By willfully failing to retain internal and external communications, including electronic communications received and sent by the NRSRO and its employees that relate to initiating, determining, maintaining, changing, or withdrawing a credit rating, EJR willfully violated Section 17(a) of the Exchange Act and Rule 17g-2(b)(7).

55. EJR willfully violated Section 15E(h)(1) of the Exchange Act and Rule 17g-5(c)(2) by issuing or maintaining a credit rating where an analyst involved in determining the credit rating, or a person responsible for approving the credit rating, owns securities in the rated entity.

56. As a result of the conduct described above, Egan willfully made, or caused EJR to make, material misstatements in its Form NRSRO; and caused or willfully aided, abetted, counseled, commanded, induced or procured EJR's violations of Sections 15E and 17(a) of the Exchange Act and Rules 17g-1, 17g-2, and 17g-5.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary for the protection of investors and in the public interest that public administrative and cease-and-desist proceedings be instituted to determine:

A. Whether the allegations set forth in Section II hereof are true and, in connection therewith, to afford Respondents an opportunity to establish any defenses to such allegations;

B. What, if any, remedial action is appropriate against Respondents pursuant to Section 15E(d) of the Exchange Act including, but not limited to, civil penalties pursuant to Section 21B of the Exchange Act;

C. Whether, pursuant to Section 21C of the Exchange Act, Respondents should be ordered to cease and desist from committing or causing violations of and any future violations of Sections 15E(a)(1), 15E(b)(2), 15E(h)(1) and 17(a) of the Exchange Act and Rules 17g-1(a), 17g-1(b), 17g-1(f), 17g-2(a)(2), 17g-2(a)(6), 17g-2(b)(2), 17g-2(b)(7) and 17g-5(c)(2), whether Respondents should be ordered to pay a civil penalty pursuant to Section 21B(a) of the Exchange Act.

IV.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened not earlier than 30 days and not later than 60 days from service of this Order at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice, 17 C.F.R. § 201.110.

IT IS FURTHER ORDERED that Respondents shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice, 17 C.F.R. § 201.220.

If Respondents fail to file the directed answer, or fail to appear at a hearing after being duly notified, the Respondents may be deemed in default and the proceedings may be determined against them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f) and 310 of the Commission's Rules of Practice, 17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f) and 201.310.

This Order shall be served forthwith upon Respondents personally or by certified mail.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 300 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice.

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within

the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
April 27, 2012

In the Matter of

**Berman Center, Inc., Cyberkinetics
Neurotechnology Systems, Inc., and
Java Detour, Inc.**

File No. 500-1

**ORDER OF SUSPENSION OF
TRADING**

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Berman Center, Inc. because it has not filed any periodic reports since the period ended December 31, 2007.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Cyberkinetics Neurotechnology Systems, Inc. because it has not filed any periodic reports since the period ended June 30, 2008.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Java Detour, Inc. because it has not filed any periodic reports since the period ended September 30, 2009.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed companies. Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the

38 of 54

securities of the above-listed companies is suspended for the period from 9:30 a.m. EDT on April 27, 2012, through 11:59 p.m. EDT on May 10, 2012.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Release No. 66870 / April 27, 2012

ADMINISTRATIVE PROCEEDING

File No. 3-14857

In the Matter of

**Berman Center, Inc., Cyberkinetics
Neurotechnology Systems, Inc., and
Java Detour, Inc.**

Respondents.

**ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS AND
NOTICE OF HEARING PURSUANT TO
SECTION 12(j) OF THE SECURITIES
EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against the Respondents named in the caption.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Berman Center, Inc. ("BRMC")¹ (CIK No. 876160) is a Delaware corporation located in Chicago, Illinois with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). BRMC is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-KSB for the period ended December 31, 2007, which reported a net loss of \$1,430,597 for the prior twelve months. As of April 13, 2012, the common stock of BRMC was quoted on OTC Link (previously "Pink Sheets") operated by OTC Markets Group, Inc. ("OTC Link"), had four market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

2. Cyberkinetics Neurotechnology Systems, Inc. ("CYKN") (CIK No. 1180253) is a Delaware corporation located in Foxborough, Massachusetts with a class of securities registered

¹The short form of each issuer's name is also its stock symbol.

with the Commission pursuant to Exchange Act Section 12(g). CYKN is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended June 30, 2008, which reported a net loss of \$3,933,387 for the prior six months. As of April 13, 2012, the common stock of CYKN was quoted on OTC Link, had eight market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

3. Java Detour, Inc. ("JVDTQ") (CIK No. 1122887) is a Delaware corporation located in San Francisco, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). JVDTQ is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2009, which reported a net loss of \$3,372,074 for the prior nine months. On September 9, 2009, JVDTQ filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Northern District of California, which was still pending as of December 13, 2011. As of April 13, 2012, the common stock of JVDTQ was quoted on OTC Link, had four market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

4. As discussed in more detail above, each of the Respondents are delinquent in their periodic filings with the Commission, have repeatedly failed to meet their obligations to file timely periodic reports, and failed to heed delinquency letters sent to them by the Division of Corporation Finance requesting compliance with their periodic filing.

5. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports, and Rule 13a-13 requires domestic issuers to file quarterly reports.

6. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate for the protection of investors that public administrative proceedings be instituted to determine:

A. Whether the allegations contained in Section II hereof are true and, in connection therewith, to afford the Respondents an opportunity to establish any defenses to such allegations; and,

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of each class of securities registered pursuant to Section 12 of the Exchange Act of the Respondents identified in Section II

hereof, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents.

IV.

IT IS HEREBY ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice [17 C.F.R. § 201.110].

IT IS HEREBY FURTHER ORDERED that Respondents shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If Respondents fail to file the directed Answers, or fail to appear at a hearing after being duly notified, the Respondents, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents, may be deemed in default and the proceedings may be determined against it upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means permitted by the Commission's Rules of Practice.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 120 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice [17 C.F.R. § 201.360(a)(2)].

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-66871; File No.10-206)

In the Matter of the Application of BOX Options Exchange LLC for Registration as a National Securities Exchange

Findings, Opinion, and Order of the Commission

April 27, 2012

I. Introduction

On December 19, 2011, BOX Options Exchange LLC ('BOX Exchange' or 'Exchange') submitted to the Securities and Exchange Commission ('Commission') an Application for Registration as a National Securities Exchange ('Form 1 Application')¹ under Section 6 of the Securities Exchange Act of 1934 ('Act').² On December 28, 2011, BOX Exchange submitted Amendment No. 1 to its Form 1 Application.³ Notice of the Form 1 Application, as modified by Amendment No. 1, was published for comment in the Federal Register on January 31, 2012.⁴ The Commission has not received any comment letters regarding the Form 1 Application. On April 2, 2012, BOX Exchange submitted Amendment No. 2 to the Form 1 Application.⁵

¹ On January 26, 2012, the Commission issued an order granting BOX Exchange exemptive relief, subject to certain conditions, in connection with the filing of its Form 1 Application. See Securities Exchange Act Release No. 66241, 77 FR 4845 (January 31, 2012). Because BOX Exchange's Form 1 Application was incomplete without the exemptive relief, the date of filing of such application is January 26, 2012.

² 15 U.S.C. 78f.

³ Amendment No. 1, among other things, provides the unconsolidated financial statements for certain affiliates of BOX Exchange that are required in Exhibit D to Form 1 but were not included in BOX Exchange's initial Form 1 Application. In its initial Form 1 Application, BOX Exchange only submitted consolidated financials for certain of these affiliates.

⁴ See Securities Exchange Act Release No. 66242 (January 26, 2012), 77 FR 4841 ('Notice').

⁵ In Amendment No. 2, BOX Exchange, among other things: (1) amends the BOX Exchange Bylaws to provide: (a) that at least one public, non-industry director of BOX

BOX Options Exchange Group, LLC ('BOX Group LLC') currently operates the Boston Options Exchange options trading platform ('BOX') as a facility of Nasdaq OMX BX, Inc. ('BX'). In January 2004, the Boston Stock Exchange, Inc. ('BSE') (n/k/a BX) established BOX as its options trading facility.⁶ BOX Group LLC was formed to operate BOX. Bourse de Montréal Inc. ('Bourse'), BSE, and Interactive Brokers Group LLC ('IB') each held more than a 20% interest in BOX Group LLC, and none of the remaining owners of BOX Group LLC held more than a 5% interest.⁷ Subsequently, the Bourse transferred its 31.37% ownership interest in BOX Group LLC to Bourse's wholly-owned subsidiary, MX US 2, Inc. ('MX US 2').⁸ As a result of a merger

Exchange will not be associated with a broker or dealer, as required by Section 6(b)(3) of the Act; (b) that BOX Exchange will have a chief regulatory officer ('CRO') with general day-to-day supervision over BOX Exchange's regulatory operations; (c) that a majority of the members of the BOX Exchange nominating committee will be non-industry representatives; (d) that the CRO will report to the regulatory oversight committee and to the President of BOX Exchange; (e) that the compensation committee of BOX Exchange will set, among other things, the CRO's compensation, taking into consideration any recommendations made by the President of BOX Exchange; and (f) that the regulatory oversight committee will make hiring and termination decisions with respect to the CRO, taking into consideration any recommendations made by the President of BOX Exchange; (2) represents that the regulatory oversight committee will meet regularly with the CRO to review regulatory matters; (3) represents that the only individual entitled to observation rights on the BOX Exchange Board to attend board or committee meetings if the BOX Holdings Director is unable to attend is the person appointed by the BOX Holdings Director (as defined below); (4) provides further information regarding BOX Exchange's regulatory services agreement ('RSA') with the Financial Industry Regulatory Authority ('FINRA'); (5) states the names of the initial BOX Exchange Board and describes the process for selecting such initial board; (6) updates Exhibit I to the Form 1 Application; and (7) updates the ownership schedule of BOX Exchange in Schedule 1 to the BOX Exchange LLC Agreement.

⁶ See Securities Exchange Act Release No. 49068 (January 13, 2004), 69 FR 2775 (January 20, 2004) (establishing, among other things, BOX as an options trading facility of BSE).

⁷ See Securities Exchange Act Release No. 49067 (January 13, 2004), 69 FR 2761 (January 20, 2004) (approving the operating agreement of BOX Group LLC).

⁸ See Securities Exchange Act Release No. 57713 (April 25, 2008), 73 FR 24327 (May 2, 2008).

in 2008 involving Bourse and a subsidiary of TSX Group, Inc., a company incorporated in Ontario, Canada (n/k/a TMX Group, Inc.), MX US 2 became an indirect wholly-owned subsidiary of TMX Group, Inc. ("TMX").

In August 2008, The Nasdaq OMX Group, Inc. ("Nasdaq") acquired BSE but did not acquire any interest in BOX Group LLC. As part of that acquisition, BSE transferred its ownership interest in BOX Group LLC to MX US 2.⁹ MX US 2 thereafter held over 50% ownership interest in BOX Group LLC.¹⁰ Although BX (f/k/a BSE) no longer holds an ownership interest in BOX Group LLC, BOX continues to be a facility of BX, and, as such, BX is responsible for regulating this facility and ensuring that it operates in compliance with the federal securities laws.¹¹

BOX Exchange has filed to register as a national securities exchange pursuant to the Form 1 Application that is the subject of this Order. As a registered national securities exchange, BOX Exchange will be a self-regulatory organization ("SRO") under the Act.¹² BOX Exchange will be responsible for the operation and oversight of BOX as its facility¹³ following commencement of operations of BOX Exchange as a national securities exchange. In contemplation of this registration, the owners of BOX Group LLC formed the following three entities: BOX Exchange; BOX Market LLC ("BOX Market"); and BOX Holdings Group LLC

⁹ See Securities Exchange Act Release No. 58324 (August 7, 2008), 73 FR 46936 (August 12, 2008) (approving, among other things, the acquisition of BSE by Nasdaq and the transfer of BSE's ownership interest in Boston Group LLC to MX US 2).

¹⁰ See *id.*

¹¹ BX regulates BOX through its wholly-owned regulatory subsidiary, the Boston Options Exchange Regulation, LLC ("BOXR").

¹² See 15 U.S.C. 78c(a)(26) (defining a "self-regulatory organization" to include a national securities exchange).

¹³ See 15 U.S.C. 78c(a)(2) (defining "facility").

(BOX Holdings³). As noted above, BOX Exchange will be the registered national securities exchange and SRO. BOX Market will be the successor-in-interest to the current BOX Group LLC and will own and operate BOX as a facility of BOX Exchange. BOX Holdings will be the sole owner of BOX Market.

II. Discussion

Under Sections 6(b) and 19(a) of the Act,¹⁴ the Commission shall by order grant an application for registration as a national securities exchange if the Commission finds, among other things, that the proposed exchange is so organized and has the capacity to carry out the purposes of the Act and can comply, and can enforce compliance by its members and persons associated with its members, with the provisions of the Act, the rules and regulations thereunder, and the rules of the exchange.

As discussed in greater detail below, the Commission finds that BOX Exchange's application for exchange registration meets the requirements of the Act and the rules and regulations thereunder. Further, the Commission finds that the proposed rules of BOX Exchange are consistent with Section 6 of the Act in that, among other things, they are designed to: (1) assure fair representation of the exchange's members in the selection of its directors and administration of its affairs and provide that, among other things, one or more directors shall be representative of investors and not be associated with the exchange, or with a broker or dealer;¹⁵ (2) prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, and

¹⁴ 15 U.S.C. 78f(b) and 15 U.S.C. 78s(a), respectively.

¹⁵ See 15 U.S.C. 78f(b)(3).

remove impediments to and perfect the mechanisms of a free and open market and a national market system;¹⁶ (3) not permit unfair discrimination between customers, issuers, or dealers;¹⁷ and (4) protect investors and the public interest.¹⁸ Finally, the Commission finds that the proposed rules of BOX Exchange do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.¹⁹

A. Governance of BOX Exchange

1. BOX Exchange Board of Directors

The BOX Exchange Board will be the governing body of the Exchange and will possess all of the powers necessary for the management of the property, business and affairs of BOX Exchange and the governing of BOX Exchange as a SRO. The BOX Exchange Board will initially be comprised of five directors, and must have at least five, but no more than eleven, directors.²⁰ Under the BOX Exchange Bylaws, the BOX Exchange Board will be required to include:

- A majority non-industry directors;²¹

¹⁶ See 15 U.S.C. 78f(b)(5).

¹⁷ See *id.*

¹⁸ See *id.*

¹⁹ See 15 U.S.C. 78f(b)(8).

²⁰ See BOX Exchange Bylaws Section 4.02.

²¹ See BOX Exchange Bylaws Section 1.01(q). A non-industry director is defined as a person who is a public director or is not an industry representative. An industry representative is an individual who is an officer, director or employee of a broker or dealer or who has been employed in any such capacity at any time within the prior three years, as well as an individual who has, or has had, a consulting or employment relationship with BOX Exchange or any affiliate of BOX Exchange, within the prior three years. See BOX Exchange Bylaws Section 1.01(m). Because BOX Market is an affiliate of BOX Exchange, anyone affiliated with BOX Market will not be considered a non-industry director. This definition generally is consistent with that approved with

- At least one public director;²² and
- One director appointed by BOX Holdings ('BOX Holdings Director'), who will be an officer or director of BOX Holdings, MX US 2, or an affiliate of MX US 2.²³

In addition, at least 20% of the BOX Exchange Board must be officers, directors, or employees of a firm that is a BOX Options Participant (each a 'Participant Director').²⁴

Prior to the commencement of operations as an exchange, BOX Exchange will submit the name of its nominee for the Participant Director²⁵ to all current BOX Options Participants. BOX Options Participants will thereafter be allowed the same periods for submitting the names of alternative candidates and to vote (14 days and 5 days, respectively) that are provided in the BOX Exchange Bylaws.²⁶ All other interim directors except for the Participant Director will be

regard to other exchanges. See e.g., Securities Exchange Act Release Nos. 61698 (March 12, 2010), 75 FR 13151 (March 18, 2010) ('DirectEdge Exchanges Order') and 58375 (August 18, 2008), 73 FR 49498 (August 21, 2008) ('BATS Order').

²² See BOX Exchange Bylaws Section 1.01(v). Public Director means a person who has no material business relationship with BOX Exchange or any affiliate of BOX Exchange, or any BOX Options Participant or any affiliate of any BOX Options Participant; provided, however, that an individual who otherwise qualifies as a Public Director shall not be disqualified from serving in such capacity solely because such individual is a director of BOX Exchange and/or the Chairman or Vice Chairman of the Board.

²³ The BOX Holdings Director will be on each committee of the BOX Exchange Board except the compensation committee and the regulatory oversight committee, unless he or she declines. See BOX Exchange Bylaws Section 6.01.

²⁴ A BOX Options Participant cannot have more than one officer, director or partner serving as a member of the BOX Exchange Board at any time. See BOX Exchange Bylaws Section 4.02.

²⁵ For the initial interim BOX Exchange Board, the BOX Exchange owners will propose James Boyle of UBS Americas Inc. as the initial Participant Director nominee.

²⁶ Current BOX Options Participants will be permitted to nominate alternative Participant Directors candidates by submitting a petition naming an alternative candidate signed by not less than 10% of all current BOX Options Participants. Each BOX Options Participant will then have one vote to elect the Participant Director and the Participant

appointed and elected by the owners of BOX Group LLC, which persons will be the owners of BOX Exchange, and must meet the BOX Exchange board composition requirements as set forth in the BOX Exchange Bylaws.²⁷ This interim board will serve until BOX Exchange elects a new Board pursuant to the full nomination, petition, and voting process set forth in the BOX Exchange Bylaws.²⁸ BOX Exchange will complete such election within 90 days after BOX Exchange's application for registration as a national securities exchange is granted.²⁹

BOX Exchange owners will elect those candidates nominated by the nominating committee as BOX Exchange Board directors subsequent to the initial Board election process set forth above.³⁰ The owners of BOX Exchange that together hold a majority of voting percentage interest in BOX Exchange will have the right to object to any director nominee, but only if the nominee had been disciplined by a securities regulatory authority or the nominee would be subject to statutory disqualification under the Act.³¹ If there is no objection to the proposed director nominees, then they would take office at the annual meeting.³²

Director with the majority of votes will be included as a member of the initial BOX Exchange Board elected by the owners of BOX Exchange. See Amendment No. 2.

²⁷ See Amendment No. 2.

²⁸ See Amendment No. 2. See also BOX Exchange Bylaws Section 4.02.

²⁹ See BOX Exchange Bylaws Sections 4.02 and 4.06. See also Securities Exchange Act Release No. 61152 (December 10, 2009), 74 FR 66699 (December 16, 2009) ("C2 Order") (allowing CBOE to appoint the initial board members and to issue a circular to trading permit holders identifying a slate of representative directors within 45 days from the date on which trading commenced on C2).

³⁰ See BOX Exchange Bylaws Section 4.06(d)(iv). See infra Section II.A.2. for discussion of the nominating committee.

³¹ See BOX Exchange Bylaws Section 4.06(e)(iv).

³² Id.

The Commission believes that the requirement in the BOX Exchange Bylaws that 20% of the directors be Participant Directors and the means by which they will be chosen by BOX Options Participants provide for the fair representation of members in the selection of directors and the administration of BOX Exchange and is consistent with the requirement in Section 6(b)(3) of the Act.³³ As the Commission has previously noted, this requirement helps to ensure that members have a voice in the use of self-regulatory authority, and that an exchange is administered in a way that is equitable to all those who trade on its market or through its facilities.³⁴

The Commission has previously stated that the inclusion of public, non-industry representatives on exchange oversight bodies is critical to an exchange's ability to protect the public interest.³⁵ Further, public, non-industry representatives can help to ensure that no single group of market participants has the ability to systematically disadvantage other market participants through the exchange governance process. The Commission believes that public directors can provide unique, unbiased perspectives, which are designed to enhance the ability of the BOX Exchange Board to address issues in a non-discriminatory fashion and foster the integrity of BOX Exchange.³⁶ The Commission believes that the composition of the BOX

³³ 15 U.S.C. 78f(b)(3).

³⁴ See, e.g., Securities Exchange Act Release No. 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006 (granting the exchange registration of Nasdaq Stock Market, Inc.) ('Nasdaq Order'), and BATS Order, supra note 21. See also Securities Exchange Act Release No. 53382 (February 27, 2006), 71 FR 11251 (March 6, 2006) ('NYSE/Archipelago Merger Approval Order').

³⁵ See, e.g., Regulation of Exchanges and Alternative Trading Systems, Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998) ('Regulation ATS Release').

³⁶ See Nasdaq Order and NYSE/Archipelago Merger Approval Order, supra note 34, and BATS Order, supra note 21.

Exchange Board satisfies the requirements in Section 6(b)(3) of the Act,³⁷ which requires in part that one or more directors be representative of issuers and investors and not be associated with a member of the exchange, or with a broker or dealer.³⁸

The Commission believes that the process for electing the initial interim board, as proposed, is consistent with the requirements of the Act, including that the rules of the exchange assure fair representation of the exchange's members in the selection of its directors and administration of its affairs.³⁹ The initial members of BOX Exchange will likely consist substantially of the current BOX Options Participants.⁴⁰ As noted, prior to the commencement of operations as an exchange, BOX Exchange will provide all current BOX Options Participants the opportunity to participate in the selection of a Participant Director consistent with the BOX Exchange Bylaws. Further, BOX Exchange represents that it will complete the full nomination, petition, and voting process as set forth in the BOX Exchange Bylaws, which will provide persons that are approved as BOX Options Participants after the effective date of this Order with the opportunity to participate in the selection of a Participant Director(s), within 90 days of when BOX Exchange's application for registration as a national securities exchange is granted. The Commission therefore believes BOX Exchange's initial interim board will provide member representation sufficient to allow the Exchange to commence operations for an interim period

³⁷ 15 U.S.C. 78f(b)(3).

³⁸ See BOX Exchange Bylaws Section 4.02 and Amendment No. 2 (representing that at least one director will not be associated with a member of BOX Exchange or with a broker or dealer, as required by Section 6(b)(3) of the Act).

³⁹ 15 U.S.C. 78f(b)(3).

⁴⁰ See Amendment No. 2.

prior to going through the process to elect a new Board pursuant to the full nomination, petition, and voting process set forth in the BOX Exchange Bylaws.⁴¹

2. Exchange Committees

In the BOX Exchange Bylaws, BOX Exchange has proposed to establish several standing committees of the BOX Exchange Board. The standing committees of the BOX Exchange Board will be the audit, compensation, and regulatory oversight committees, and if applicable, the executive committee. The audit committee will consist of three to five directors, a majority of which will be required to be non-industry directors.⁴² Each of the compensation and regulatory oversight committees will consist of three to five directors, all of which will be required to be non-industry directors.⁴³ The BOX Exchange Board will have the authority to appoint an executive committee, which will be required to have a majority of non-industry directors and at least 20% Participant Directors.⁴⁴ The BOX Holdings Director will sit on each committee of the BOX Exchange Board except the compensation and regulatory oversight committees, unless he or she declines.⁴⁵

⁴¹ See BOX Exchange Bylaws Sections 4.02 and 4.06. See C2 Order, supra note 29 at 66701 (December 16, 2009) (noting that because C2's initial permit holders will likely consist substantially of current CBOE members, "the Commission believes C2's initial Board will provide member representation sufficient to allow the Exchange to commence operations").

⁴² See BOX Exchange Bylaws Section 6.05.

⁴³ See BOX Exchange Bylaws Section 6.06 and 6.07.

⁴⁴ See BOX Exchange Bylaws Section 6.04.

⁴⁵ See BOX Exchange Bylaws Section 6.01.

In addition, the BOX Exchange Bylaws provide that a nominating committee will be established to select nominees for the BOX Exchange Board.⁴⁶ The nominating committee will be a committee of BOX Exchange but will not be a committee of the BOX Exchange Board. The nominating committee will have at least five members.⁴⁷ The nominating committee will nominate candidates for each director position on the BOX Exchange Board.⁴⁸ BOX Options Participants also will be able to nominate alternate candidates for the Participant Directors through a petition process and vote by BOX Options Participants.⁴⁹ If no candidates are nominated pursuant to the petition process, then the nominating committee will nominate its nominees for the Participant Director positions.⁵⁰ If a petition process produces additional candidates, then the candidates nominated pursuant to the petition process, together with those

⁴⁶ The BOX Exchange owners will appoint the initial nominating committee, which will serve until the first annual meeting. Thereafter, prior to each annual meeting, the sitting nominating committee will select individuals for the next nominating committee. BOX Exchange owners will then vote on the full slate of the nominating committee at the annual meeting. If the full slate fails to obtain the required vote of BOX Exchange owners, then the nominating committee will select a new slate and the process will be repeated. See BOX Exchange Bylaws Section 4.06.

⁴⁷ BOX Holdings will have the right to appoint one representative to sit on the nominating committee, at least 20% of the nominating committee will be composed of representatives of BOX Options Participants, and a majority of the members of the BOX Exchange nominating committee will be non-industry representative. See BOX Exchange Bylaws Section 4.06(a) and Amendment No. 2.

⁴⁸ See id.

⁴⁹ See BOX Exchange Bylaws Section 4.06(e). Specifically, the Secretary of BOX Exchange must provide to each BOX Options Participant the name of the nominating committee's nominees for the Participant Director positions. BOX Options Participants may nominate alternative candidates for election to the Participant Director positions by submitting a petition signed by not less than 10% of all then-current BOX Options Participants. Id.

⁵⁰ Id.

nominated by the nominating committee, will be presented to BOX Options Participants for a vote to determine the final list of nominees for the Participant Director positions.⁵¹

The Commission believes that BOX Exchange's proposed committees, which are similar to the committees maintained by other exchanges,⁵² are designed to help enable BOX Exchange to carry out its responsibilities under the Act and are consistent with the Act.

B. Regulation of BOX Exchange and BOX

Following BOX Exchange's commencement of operations as a national securities exchange, BOX Exchange will have all the attendant regulatory obligations under the Act. In particular, BOX Exchange will be responsible for the operation and regulation of BOX, its options trading facility. Certain provisions in the BOX Exchange, BOX Market, and BOX Holdings governance documents are designed to facilitate the ability of BOX Exchange and the Commission to fulfill their regulatory obligations. The discussion below summarizes some of these key provisions.

1. Changes in Control

a. Ownership Structure of BOX Exchange, BOX Holdings, and BOX Market

BOX Exchange will issue Economic Units, as well as Voting Units, to each of its owners, or Members.⁵³ Economic Units, comprising all interests in the profits and losses of BOX Exchange and all rights to receive distributions from BOX Exchange, will not have any voting

⁵¹ Id.

⁵² See, e.g., BATS Order, supra note 21, and Nasdaq Order, supra note 34.

⁵³ BOX Exchange's limited liability company agreement ('BOX Exchange LLC Agreement') refers to the owners of BOX Exchange as "Members."

rights.⁵⁴ Voting Units will have voting rights and not include any right to, or interest in, any profits and losses of BOX Exchange, distributions from BOX Exchange, assets of BOX Exchange or other economic value in BOX Exchange.⁵⁵ The total number of Voting Units will be equal to the total number of Economic Units. Voting Units cannot be transferred separately from their related Economic Units.

The Members of BOX Exchange and their respective interests are: MX US 2 (40.000% of Economic Units and 20.000% of Voting Units); IB (20.000% of Economic Units and 20.000% of Voting Units); Citadel Securities LLC (6.445% of Economic Units and 12.179% of Voting Units); Citigroup Financial Products (6.445% of Economic Units and 12.179% of Voting Units); Strategic Investments II Inc. (6.445% of Economic Units and 4.990% of Voting Units); UBS Americas Inc. (6.253% of Economic Units and 4.990% of Voting Units); CSFB Next Fund Inc. (6.123% of Economic Units and 10.00% of Voting Units); LabMorgan Corp. (6.123% of Economic Units and 11.570% of Voting Units); and Aragon Solutions Ltd. (2.166% of Economic Units and 4.092% of Voting Units).

As noted above, BOX Holdings will own 100% of BOX Market. Unlike BOX Exchange, BOX Holdings will issue one class of units. The Members of BOX Holdings⁵⁶ and their respective interests are: MX US 2 (53.83%); IB (20.09%); Citadel Securities LLC (4.20%); Citigroup Financial Products (4.20%); Strategic Investments II Inc. (4.20%); UBS Americas Inc. (4.08%); CSFB Next Fund Inc. (3.99%); LabMorgan Corp. (3.99%); and Aragon Solutions Ltd. (1.41%).

⁵⁴ See Article 2.5(a) of the BOX Exchange LLC Agreement.

⁵⁵ See Article 2.5(b) of the BOX Exchange LLC Agreement.

⁵⁶ BOX Holdings' limited liability company agreement ('BOX Holdings LLC Agreement') refers to the owners of BOX Holdings as "Members."

As stated above, MX US 2 is a Member in both BOX Exchange (40% of Economic Units and 20% of Voting Units) and BOX Holdings (53.83%). Further, MX US 2 is a wholly-owned indirect subsidiary of the Bourse.⁵⁷ The Bourse, a company incorporated in Quebec, Canada, is a wholly-owned direct subsidiary of TMX, a company incorporated in Ontario, Canada. Therefore, MX US 1, the Bourse, and TMX (collectively, the 'Controlling Upstream Owners') will be indirect owners of BOX Exchange, BOX Holdings, and BOX Market.

b. BOX Exchange Ownership and Voting Limits

The BOX Exchange LLC Agreement contains limits on the ownership of Economic Units and Voting Units, and on the voting of Voting Units.⁵⁸ Specifically, with respect to the limits on the Economic Units, no person, either alone or together with any related persons (including affiliates) may own, directly or indirectly, of record or beneficially, Economic Units representing a percentage interest of more than 40%.⁵⁹ In addition, BOX Options Participants, alone or together with any related persons (including affiliates) may not own, directly or indirectly, of record or beneficially, Economic Units representing a percentage interest of more than 20%.⁶⁰ With respect to limits on the Voting Units, no person, either alone or together with any related person (including affiliates), may own, directly or indirectly, of record or beneficially, Voting Units representing a percentage interest of more than 20%, have the power to vote, direct the vote or give any consent or proxy in excess of the 20% voting limit, or enter into any agreement,

⁵⁷ Specifically MX US 2 is a wholly-owned direct subsidiary of MX US 1, Inc. (MX US 1), a company incorporated in Delaware and a wholly-owned direct subsidiary of the Bourse.

⁵⁸ These provisions are consistent with ownership and voting limits approved by the Commission for other exchanges. See, e.g., DirectEdge Exchanges Order and BATS Order, supra note 21. See also C2 Order, supra note 29 and Nasdaq Order, supra note 34.

⁵⁹ See Article 7.3(f) of the BOX Exchange LLC Agreement.

⁶⁰ Id.

plan or other arrangement that would result in the Voting Units that are subject to such agreement, plan or other arrangement not being voted on any matter or matters or any proxy relating thereto being withheld, where the effect would be to enable any person, either alone or together with any related persons (including affiliates), to vote, possess the right to vote or cause the voting of, Voting Units in excess of the 20% voting limit.⁶¹

Notwithstanding the limits described above, the BOX Exchange Board may waive the 40% ownership limit for Economic Units if it makes certain determinations.⁶² The BOX Exchange Board also may waive the 20% ownership limit for Voting Units if it makes certain determinations.⁶³ However, BOX Options Participants will be subject to the 20% ownership limit for Economic Units and the 20% ownership limit for Voting Units and will not be eligible for a waiver to exceed such thresholds.⁶⁴

⁶¹ See Article 7.3(g)(i) of the BOX Exchange LLC Agreement. An owner of BOX Exchange may also voluntarily impose a lower voting restriction on itself. *Id.* Strategic Investments II Inc. and UBS Americas Inc. each have voluntarily imposed a lower voting limit of 4.99%. See Amendment No. 2.

⁶² See Article 7.3(f) of the BOX Exchange LLC Agreement. The required determinations are that (A) such waiver will not impair the ability of BOX Exchange to carry out its functions and responsibilities under the Act and the rules and regulations promulgated thereunder, (B) such waiver is otherwise in the best interests of BOX Exchange and its owners, (C) such waiver will not impair the ability of the Commission to enforce the Act and (D) if applicable, the transferee in such transfer and its related persons are not subject to any applicable 'statutory disqualification' (within the meaning of Section 3(a)(39) of the Act). *Id.* The Commission has previously approved the rules of other exchanges that provide for the ability of the exchange to waive the ownership and voting limitations discussed above for non-members of the exchange. See, e.g., DirectEdge Exchanges Order, *supra* note 21.

⁶³ See Article 7.3(g)(i) of the BOX Exchange LLC Agreement. The required determinations for waiving the voting limitation are the same as the required determinations for waiving the ownership limitation.

⁶⁴ See Articles 7.3(f) and 7.3(g)(i) of the BOX Exchange LLC Agreement.

The BOX Exchange LLC Agreement also contains a provision designed to ensure that no owner of BOX Exchange will exceed the applicable ownership limit on Voting Units.

Specifically, if an owner of BOX Exchange owns Voting Units in excess of the applicable voting limit, then the excess Voting Units will be distributed, pro rata according to Economic Units percentage, to the other owners so that the owner does not exceed the applicable voting limit.⁶⁵

In addition, the BOX Exchange LLC Agreement provides that, if an owner of BOX Exchange subsequently becomes a BOX Options Participant, and that owner's Economic Units or Voting Units percentage exceeds 20%, then such owner will have no voting rights on the Voting Units that exceeds the voting limit.⁶⁶

The BOX Exchange LLC Agreement contains other provisions that are designed to safeguard the Economic Units and Voting Units limits. For example, any transfer that would violate the BOX Exchange LLC Agreement, such as exceeding the limits, will be void.⁶⁷ Moreover, any owner involved in a transaction in which a person, either alone or together with any related person (including affiliates), would exceed 5% ownership in Economic Units or Voting Units will be required to provide written notice to BOX Exchange fourteen days before the transaction that would exceed the 5% limit.⁶⁸ BOX Exchange will then be required to

⁶⁵ See Article 7.3(g)(ii) of the BOX Exchange LLC Agreement. Pursuant to this provision, upon any transfer of Economic Units, each owner's Voting Units percentage will be reset to equal its percentage of Economic Units. Should any owner, after the Voting Units reset, exceed the voting limit, then the excess Voting Units will be distributed pro rata according to Economic Units percentage, to the other owners so that the owner does not exceed the applicable voting limit. Id.

⁶⁶ See Article 7.3(i) of the BOX Exchange LLC Agreement. Any Voting Units that exceed the voting limit will be voted in the same proportion as the Voting Units held by the other owners of BOX Exchange are voted. Id.

⁶⁷ See Article 7.3(d) of the BOX Exchange LLC Agreement.

⁶⁸ See Article 7.3(e) of the BOX Exchange LLC Agreement.

provide written notice to the Commission ten days before the transaction.⁶⁹ In addition, each person or entity that acquires 5% or more in Economic Units or Voting Units will be required to immediately notify BOX Exchange in writing and will need to update BOX Exchange if the ownership limits applicable to the person or entity are exceeded. Further, in addition to these notices, owners of BOX Exchange have agreed that any transfer of units that results in the acquisition and holding by any person, alone or with its related persons, of a percentage interest that meets or crosses the threshold level of 20% or any successive 5% percentage interest will be subject to the rule filing process of Section 19 of the Act.⁷⁰

The Commission believes that these provisions are consistent with the requirements of the Act. These limitations are designed to help prevent any owner of BOX Exchange from

⁶⁹ Id. This provision is consistent with the current operating agreement of BOX Group LLC. See Section 8.4(e) of the Sixth Amended and Restated Operating Agreement of BOX Group LLC.

⁷⁰ Id. The BOX Exchange LLC Agreement also requires a "controlling person" of a BOX Exchange owner to execute an amendment to the BOX Exchange LLC Agreement agreeing to be bound by that agreement upon establishing a controlling interest in any BOX Exchange owner that, alone or together with its related persons, holds BOX Exchange Economic Units or Voting Units representing a percentage interest equal to or greater than 20%. See Article 7.3(h) of the BOX Exchange LLC Agreement. As noted above, MX US 2 is an owner of BOX Exchange (40% of Economic Units and 20% of Voting Units). In addition, as noted above, MX US 2 (through MX US 1) is a wholly-owned indirect subsidiary of the Bourse and the Bourse is a wholly-owned direct subsidiary of TMX. Under the BOX Exchange LLC Agreement, each of MX US 1, Bourse, and TMX will be required to become parties to the BOX Exchange LLC Agreement through such an amendment and will have all the rights and responsibilities of the owners of BOX Exchange. This will be effectuated pursuant to Instruments of Accession. If in the future there is another such "controlling person," it also will be required to execute an Instrument of Accession, which will be an amendment to the BOX Exchange LLC Agreement that is required to be filed with the Commission. See Article 7.3(h)(iv) of the BOX Exchange LLC Agreement. The BOX Exchange LLC Agreement further provides that "[t]he rights and privileges, including all voting rights, of the Member in whom a controlling interest is held...shall be suspended until such time as the amendment...[to the Agreement] has become effective pursuant to Section 19 of the Exchange Act or the Controlling Person no longer holds a controlling interest in the Member." See Section 7.4(h)(iv) of the BOX Exchange LLC Agreement.

exercising undue control over the operation of BOX Exchange and to help assure that BOX Exchange is able to effectively carry out its regulatory obligations under the Act. In addition, these limitations are designed to address the conflicts of interests that might result from a member of a national securities exchange owning interests in the exchange. As the Commission has noted in the past, a member's interest in an exchange could become so large as to cast doubts on whether the exchange may fairly and objectively exercise its self-regulatory responsibilities with respect to such member.⁷¹ A member that is a controlling shareholder of an exchange could seek to exercise that controlling influence by directing the exchange to refrain from, or the exchange may hesitate to, diligently monitor and conduct surveillance of the member's conduct or diligently enforce the exchange's rules and the federal securities laws with respect to conduct by the member that violates such provisions. As such, these requirements are expected to minimize the potential that a person or entity can improperly interfere with or restrict the ability of BOX Exchange to effectively carry out its regulatory oversight responsibilities under the Act.

c. BOX Holdings and BOX Market

The BOX Holdings limited liability company agreement ('BOX Holdings LLC Agreement') and the BOX Market limited liability company agreement ('BOX Market LLC Agreement') also contain provisions related to direct and indirect changes in control.

Specifically, any owner involved in a transaction in which the owner's percentage interest in BOX Holdings, either alone or together with any related person (including affiliates), will meet or cross the threshold level of 5% or the successive 5% percentage levels of 10% and 15% will be required to provide written notice to BOX Holdings fourteen days before the

⁷¹ See, e.g., DirectEdge Exchanges Order and BATS Order, supra note 21.

transaction.⁷² BOX Holdings will then be required to provide written notice to BOX Exchange and the Commission ten days before the transaction.⁷³ In addition any person that, either alone or together with any related person⁷⁴ (including affiliates) owns, directly or indirectly, of record or beneficially, 5% or more of BOX Holdings will be required to immediately notify in writing BOX Holdings upon acquiring knowledge of such ownership.⁷⁵ In addition to these notices, owners of BOX Holdings have agreed that any transfer of units that results in the acquisition and holding by any person, alone or with its related persons, of a percentage interest that meets or crosses the threshold level of 20% or any successive 5% percentage interest will be subject to the rule filing process of Section 19 of the Act.⁷⁶ Further, any transfer that would be in contravention of these notification and filing provisions will be void.⁷⁷

In addition, if an owner of BOX Holdings or any of its related persons is approved as a BOX Options Participant, and if such owner, alone or together with the related persons, own more than 20% of BOX Holdings, then such owner and any director of BOX Holdings designated by such owner will not have any voting rights with respect to any units owned in excess of 20%.⁷⁸ Further, the owner will not be entitled to give any proxy with respect to any

⁷² See Article 7.4(e) of the BOX Holdings LLC Agreement.

⁷³ Id. This provision is consistent with the current operating agreement of BOX Group LLC. See Section 8.4(e) of the Sixth Amended and Restated Operating Agreement of BOX Group LLC.

⁷⁴ See Article 1.1 of the BOX Holdings LLC Agreement for a definition of "related person."

⁷⁵ See id. The notice will require the person's full legal name; the number of units owned, directly or indirectly, of record or beneficially, by the person together with any related person; and whether the person has power, directly or indirectly, to direct the management or policies of BOX Holdings.

⁷⁶ See Article 7.4(f) of the BOX Holdings LLC Agreement.

⁷⁷ See Article 7.4(d) of the BOX Holdings LLC Agreement.

⁷⁸ See Article 7.4(h) of the BOX Holdings LLC Agreement.

units owned in excess of 20%.⁷⁹ IB, however, will have an exemption until January 1, 2014, from the voting limitation described in this paragraph, but only with respect to any votes regarding a merger, consolidation or dissolution of BOX Holdings or a sale of all or substantially all of the assets of BOX Holdings.⁸⁰

The BOX Holdings LLC Agreement also provides that a “controlling person”⁸¹ of a BOX Holdings owner is required to execute an amendment to the BOX Holdings LLC Agreement agreeing to be bound by the BOX Holdings LLC Agreement upon establishing a controlling interest in any BOX Holdings owner⁸² that, alone or together with its related persons, holds BOX Holdings units representing a percentage interest equal to or greater than 20%.⁸³ As noted above, MX US 2 is an owner of BOX Holdings (53.83%). In addition, as noted above, MX US 2 (through MX US 1) is a wholly-owned indirect subsidiary of the Bourse and the Bourse is a wholly-owned direct subsidiary of TMX. Under the BOX Holdings LLC Agreement, each of MX US 1, Bourse, and TMX will be required to become a party to the BOX Holdings LLC Agreement through such an amendment and will have all the rights and responsibilities of the

⁷⁹ Id.

⁸⁰ Id.

⁸¹ A “controlling person” is defined as a Person who, alone or together with any related persons of such person, holds a controlling interest in an owner of BOX Holdings. See Article 7.4(g)(v) of the BOX Holdings LLC Agreement.

⁸² A “controlling interest” is defined as the direct or indirect ownership of 25% or more of the total voting power of all equity securities of an owner of BOX Holdings (other than voting rights solely with respect to matters affecting the rights, preferences, or privileges of a particular class of equity securities), by any person, alone or together with any related persons of such person. See Article 7.4(g)(v) of the BOX Holdings LLC Agreement.

⁸³ See Article 7.4(g) of the BOX Holdings LLC Agreement.

owners of BOX Holdings.⁸⁴ The BOX Holdings LLC Agreement further provides that "[t]he rights and privileges, including all voting rights, of the Member in whom a controlling interest is held...shall be suspended until such time as the amendment...[to the Agreement] has become effective pursuant to Section 19 of the Exchange Act or the Controlling Person no longer holds a controlling interest in the Member."⁸⁵

The BOX Market LLC Agreement does not explicitly include change of control provisions that are similar to those in the BOX Holdings LLC Agreement. However, the BOX Market LLC Agreement explicitly provides that BOX Holdings is the sole Member of BOX Market.⁸⁶ Thus, if BOX Holdings were no longer the sole Member of BOX Market, BOX Market will be required to amend the BOX Market LLC Agreement, which will be required to be filed with and approved by the Commission before such amendment may be effective.⁸⁷

Although BOX Holdings and BOX Market are not independently responsible for regulation, their activities with respect to the operation of BOX must be consistent with, and not interfere with, the self-regulatory obligations of BOX Exchange. The Commission believes that the requirements in the BOX Holdings LLC Agreement and the BOX Market LLC Agreement applicable to direct and indirect changes in control of BOX Holdings and BOX Market described above, as well as the voting limitation imposed on owners of BOX Holdings who also are BOX

⁸⁴ This will be effectuated pursuant to Instruments of Accession included in the Form 1. If in the future there is another such "controlling person," it too will be required to execute an Instruments of Accession, which will be an amendment to the BOX Holdings LLC Agreement that is required to be filed with the Commission. See Article 7.4(g)(iv) of the BOX Holdings LLC Agreement.

⁸⁵ See Section 7.4(g)(iv) of the BOX Holdings LLC Agreement.

⁸⁶ See Article 1.1 of the BOX Market LLC Agreement.

⁸⁷ See Article 14.1 of the BOX Market LLC Agreement. A proposed rule change can also become effective by operation of law. See 15 U.S.C. 78s(b)(2).

Options Participants described above, are appropriate to help ensure that BOX Exchange is able to effectively carry out its self-regulatory responsibilities, including over BOX, and are consistent with the requirements of the Act. In addition, the Commission believes that the exemption from the BOX Options Participant voting limitation granted to IB is appropriate and is not expected to limit BOX Exchange's ability to effectively carry out its self-regulatory responsibilities. The Commission also notes that IB was provided with a similar exemption with respect to its current ownership of BOX Group LLC.⁸⁸

2. Regulatory Independence

BOX Exchange, BOX Market, and BOX Holdings propose to adopt certain provisions in their respective governing documents designed to help maintain the independence of the regulatory functions of BOX Exchange. These proposed provisions are substantially similar to those included in the governing documents of exchanges that recently have been granted registration.⁸⁹ Specifically:

- The owners, directors, officers, employees, and agents of BOX Exchange, BOX Market, and BOX Holdings must give due regard to the preservation of the

⁸⁸ See Securities Exchange Act Release No. 49607 (January 13, 2004), 69 FR 2761, 2767 (January 20, 2004) (approving a limited temporary exemption for IB from the voting limitation provisions in the limited liability company agreement of BOX Group LLC and noting that the exemption is designed to afford IB some ability to protect its investment but also to limit the possibility that BSE's ability to carry out its self-regulatory responsibilities would be impaired). This exemption is substantially similar to an exemption granted to founder members of the International Securities Exchange ("ISE"). See Securities Exchange Act Release Nos. 45803 (April 23, 2002), 67 FR 21306, 21307 (April 30, 2002) (approval of SR-ISE-2002-01) (conversion of ISE from an LLC to a corporation); and 42455 (February 24, 2000), 65 FR 11388, 11391-92 (March 2, 2000) (File No. 10-127) (approval of registration of ISE as a national securities exchange) ("ISE Order").

⁸⁹ See e.g., DirectEdge Exchanges Order and BATS Order, *supra* note 21, and C2 Order, *supra* note 29.

independence of the self-regulatory function of BOX Exchange and must not take actions that would interfere with the effectuation of decisions by the BOX Exchange Board relating to its regulatory functions or that would interfere with BOX Exchange's ability to carry out its responsibilities under the Act.⁹⁰

- Each of BOX Exchange, BOX Market, and BOX Holdings and their respective owners must comply with federal securities laws and the rules and regulations promulgated thereunder and agree to cooperate with the Commission and BOX Exchange pursuant to and to the extent of their respective regulatory authority.⁹¹
- BOX Exchange, BOX Market, and BOX Holdings, and the owners, officers, directors, employees and agents of each, must submit to the jurisdiction of the U.S. federal courts and the Commission for any action, suit or proceeding arising out of or related to BOX Exchange activities.⁹²
- All books and records of BOX Exchange reflecting confidential information pertaining to the self-regulatory function of BOX Exchange (including but not limited to disciplinary matters, trading data, trading practices, and audit information) shall be retained in confidence by BOX Exchange and its personnel, including any individuals entitled to information pursuant to Board observation rights, and will not be used by BOX Exchange for any non-regulatory purpose and shall not be made available to persons (including, without limitation, any owners of BOX Exchange) other than to

⁹⁰ See Article 4.6(a) of the BOX Exchange LLC Agreement, Article 4.12(a) of the BOX Market LLC Agreement, and Article 4.12(a) of the BOX Holdings LLC Agreement.

⁹¹ See Article 4.6(b) of the BOX Exchange LLC Agreement, Article 4.12(b) of the BOX Market LLC Agreement, and Article 4.12(b) of the BOX Holdings LLC Agreement.

⁹² See Article 18.6(b) of the BOX Exchange LLC Agreement, Article 14.6(b) of the BOX Market LLC Agreement, and Article 18.6(a) of the BOX Holdings LLC Agreement.

those personnel of BOX Exchange, to members of the BOX Exchange Board and any observer, to the extent necessary or appropriate to properly discharge the self-regulatory function of BOX Exchange, or unless required by court order or applicable law.⁹³

- The books and records of BOX Exchange and BOX Market and, to the extent related to the operation or administration of BOX Exchange and BOX Market, the books and records of BOX Holdings, must be maintained in the United States and will be subject at all times to inspection and copying by the Commission.⁹⁴
- Furthermore, for so long BOX Holdings directly or indirectly controls BOX Market, and to the extent related to the operation or administration of BOX Exchange or the BOX Market, the books, records, premises, officers, directors, employees and agents of BOX Holdings and its owners will be deemed to be the books, records, premises, officers, directors, employees and agents of BOX Exchange.⁹⁵
- BOX Exchange, BOX Market, and BOX Holdings will take such action as is necessary to ensure that their officers, directors and employees, and each owner's officers, directors, and employees, consent to the applicability of provisions regarding

⁹³ See BOX Exchange Bylaws Section 5.02. The Commission notes that the BOX Exchange LLC Agreement, the BOX Market LLC Agreement and the BOX Holdings LLC Agreement also provide that confidential information pertaining to regulatory matters related to BOX Exchange, BOX Market and BOX Holdings will be subject to confidentiality restrictions. See Article 15.5 of the BOX Exchange LLC Agreement, Article 12.6 of the BOX Market LLC Agreement, and Article 15.6 of the BOX Holdings LLC Agreement.

⁹⁴ See Article 11.1 and 18.6(a) of the BOX Exchange LLC Agreement, Article 9.1 of the BOX Market LLC Agreement, and Article 11.1 of the BOX Holdings LLC Agreement.

⁹⁵ See Article 11.1 of the BOX Holdings LLC Agreement.

books and records, confidentiality, jurisdiction, and regulatory obligations, to the extent related to the operation or administration of BOX Exchange.⁹⁶

As noted above, each of the Controlling Upstream Owners will be required to become a party to the BOX Exchange LLC Agreement and the BOX Holdings LLC Agreement and will have all the rights and obligations of the owners of BOX Exchange and BOX Holdings. Thus, for example, as a party to the BOX Exchange LLC Agreement and the BOX Holdings LLC Agreement, each Controlling Upstream Owner will be required to comply with the U.S. federal securities laws and the rules and regulations thereunder and cooperate with the Commission and BOX Exchange⁹⁷ and will be required to take such action as is necessary to ensure that its directors, officers and employees consent to complying with the U.S. federal securities laws and the rules and regulations thereunder and cooperating with the Commission and BOX Exchange to the extent related to the operation or administration of the BOX Exchange or BOX Market.⁹⁸ Moreover, each Controlling Upstream Owner, its officers, directors, employees and agents will irrevocably submit to the jurisdiction of the U.S. federal courts and the Commission for purposes of any action arising out of, or relating to, activities of BOX Exchange and/or BOX Market.⁹⁹ Further, TMX, Bourse, and MX US 1 (and any future controlling upstream owner of BOX Market), by becoming parties to the BOX Holdings LLC Agreement and having the responsibilities of BOX Holdings' owners, will agree (to the extent related to the operation or

⁹⁶ See Article 18.6(c) of the BOX Exchange LLC Agreement, Article 14.6(c) of the BOX Market LLC Agreement, and Article 18.6(b) of the BOX Holdings LLC Agreement.

⁹⁷ See Article 4.6(b) of the BOX Exchange LLC Agreement and Article 4.12(b) of the BOX Holdings LLC Agreement.

⁹⁸ See Articles 4.6(b) and 18.6(c) of the BOX Exchange LLC Agreement and Articles 4.12(b) and 18.6(b) of the BOX Holdings LLC Agreement.

⁹⁹ See Article 18.6(b) of the BOX Exchange LLC Agreement and Article 18.6(a) of the BOX Holdings LLC Agreement.

administration of BOX Exchange or the BOX Market) that their books and records must be maintained within the United States and shall be subject at all times to inspection and copying by the Commission and BOX Exchange; and that their books, records, premises, directors, officers, employees and agents shall be deemed to be those of the Exchange for the purposes of , and subject to oversight pursuant to, the Act.

In addition, each Controlling Upstream Owner must give due regard to the preservation of the independence of the self-regulatory function of BOX Exchange and must not take any action that would interfere with the effectuation of decisions by the BOX Exchange Board or interfere with BOX Exchange's ability to carry out its responsibilities under the Act.¹⁰⁰ Each Controlling Upstream Owner also is required to take such action as is necessary to ensure that its directors, officers and employees consent to giving due regard to the preservation of the independence of the self-regulatory function of BOX Exchange and to not taking any action that would interfere with the effectuation of decisions by the BOX Exchange Board or interfere with BOX Exchange's ability to carry out its responsibilities under the Act to the extent related to the operation or administration of the BOX Exchange or BOX Market.¹⁰¹

The Commission believes that the provisions discussed in this section, which are designed to help maintain the independence of BOX Exchange's regulatory function, are appropriate and consistent with the requirements of the Act, particularly with Section 6(b)(1), which requires, in part, an exchange to be so organized and have the capacity to carry out the

¹⁰⁰ See Article 4.6(a) of the BOX Exchange LLC Agreement and Article 4.12(a) of the BOX Holdings LLC Agreement.

¹⁰¹ See Articles 4.6(a) and 18.6(c) of the BOX Exchange LLC Agreement and Articles 4.12(a) and 18.6(b) of the BOX Holdings LLC Agreement.

purposes of the Act.¹⁰² The Commission notes that, even in the absence of these provisions, Section 20(a) of the Act (as applied to the BOX entities) provides that any person with a controlling interest in BOX Exchange or BOX Market would be jointly and severally liable with and to the same extent that BOX Exchange or BOX Market, as the case may be, is liable under any provision of the Act, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action. In addition, Section 20(e) of the Act creates aiding and abetting liability for any person who knowingly provides substantial assistance to another person in violation of any provision of the Act or rule thereunder. Further, Section 21C of the Act authorizes the Commission to enter a cease-and-desist order against any person who has been “a cause of a violation of any provision of the Act through an act or omission that the person knew or should have known would contribute to the violation. These provisions are applicable to all entities’ dealings with BOX Exchange and BOX Market, including the Controlling Upstream Owners.

3. Regulation of BOX

As a prerequisite for the Commission’s granting of an exchange’s application for registration, an exchange must be organized and have the capacity to carry out the purposes of the Act.¹⁰³ Specifically, an exchange must be able to enforce compliance by its members, and persons associated with its members, with the federal securities laws and the rules of the exchange.¹⁰⁴ The discussion below summarizes how BOX Exchange proposes to conduct and structure its regulatory operations.

¹⁰² 15 U.S.C. 78f(b)(1).

¹⁰³ See Section 6(b)(1) of the Act, 15 U.S.C. 78f(b)(1).

¹⁰⁴ Id. See also Section 19(g) of the Act, 15 U.S.C. 78s(g).

a. Regulatory Oversight Committee

The regulatory operations of BOX Exchange will be monitored by the regulatory oversight committee of the BOX Exchange Board. The regulatory oversight committee will consist of at least three directors, all of whom will be non-industry directors. The regulatory oversight committee generally will be responsible for overseeing the adequacy and effectiveness of BOX Exchange's regulatory and SRO responsibilities, assessing BOX Exchange's regulatory performance, and assisting the BOX Exchange Board (and committees of the BOX Exchange Board) in reviewing BOX Exchange's regulatory plan and the overall effectiveness of BOX Exchange's regulatory functions.¹⁰⁵ Further, a CRO of BOX Exchange will have general day-to-day supervision over BOX Exchange's regulatory operations.¹⁰⁶ The regulatory oversight committee will be charged with all hiring and termination decisions over the CRO, taking into account the recommendation of the President of BOX Exchange.¹⁰⁷ The CRO will report to both the regulatory oversight committee and the President of BOX Exchange.¹⁰⁸

To help assure the Commission that it has and will continue to have adequate funding to be able to meet its responsibilities under the Act, BOX Exchange represented that, upon the granting of its application as a national securities exchange and prior to commencing operations as such, BOX Group LLC will contribute sufficient operational assets to the Exchange, including furnishings, equipment and servers previously used in connection with the regulation of BOX, and industry and regulatory memberships. In addition, BOX Exchange stated that it has received

¹⁰⁵ See BOX Exchange Bylaws Section 6.07.

¹⁰⁶ See BOX Exchange Bylaws Section 7.01. See also Amendment No. 2.

¹⁰⁷ See BOX Exchange Bylaws Section 6.07. See also Amendment No. 2.

¹⁰⁸ See BOX Exchange Bylaws Section 7.01. See also Amendment No. 2.

from BOX Group LLC a loan of \$1,000,000.¹⁰⁹ In addition, because BOX Exchange would be the registered national securities exchange, BOX Exchange would be entitled to receive all fees, including regulatory fees and trading fees, payable by BOX Option Participants, as well as any funds received from any applicable market data fees and Options Price Reporting Authority tape revenue.¹¹⁰ Any excess funds, as determined solely by BOX Exchange, will be remitted to BOX Market.¹¹¹ To the extent BOX Exchange's assets were not sufficient, BOX Market (and BOX Holdings, to the extent it holds BOX Market funds) will reimburse BOX Exchange.¹¹² Further, any revenues received by BOX Exchange from fees derived from its regulatory function or regulatory penalties will not be used for non-regulatory purposes.¹¹³

b. Rule 17d-2 Agreements and Regulatory Contract

Rule 17d-2 of the Act¹¹⁴ permits SROs to propose joint plans allocating regulatory responsibilities concerning members, as such term is defined in Section 3(a)(3) of the Act, of

¹⁰⁹ See Amendment No. 2. In addition, BOX Exchange represents that the \$1,000,000 loan it received from BOX Group LLC will be sufficient to cover the expenses of BOX Exchange until BOX Exchange begins receiving revenues from transaction fees, market data fees and regulatory fees. See letter from Lisa Fall, President, BOX Exchange, to Heather Seidel, Associate Director, Division, Commission, dated April 2, 2012 ("April 2 Letter").

¹¹⁰ BOX Exchange acknowledged this fact in Amendment No. 2.

¹¹¹ See Form 1 Application, Exhibit I. BOX Exchange represents that, in determining the excess funds to remit to BOX Market, it will exercise prudent financial management (including cash flow management) and may retain funds for anticipated and unanticipated expenses. See April 2 Letter, *supra* note 109.

¹¹² See Form 1 Application, Exhibit I.

¹¹³ Article 8.1 of the BOX Exchange LLC Agreement.

¹¹⁴ See Section 17(d)(1) of the Act and Rule 17d-2 thereunder, 15 U.S.C. 78q(d)(1) and 17 CFR 240.17d-2. Section 17(d)(1) of the Act allows the Commission to relieve an SRO of certain responsibilities with respect to members of the SRO who are also members of another SRO. Specifically, Section 17(d)(1) allows the Commission to relieve an SRO of its responsibilities to: (i) receive regulatory reports from such members; (ii) examine

more than one SRO ("Common Members").¹¹⁵ These agreements, which must be filed with and approved by the Commission, generally cover such regulatory functions as personnel registration and sales practices. Commission approval of a Rule 17d-2 plan relieves the specified SRO of those regulatory responsibilities allocated by the plan to another SRO.¹¹⁶ Many SROs have entered into Rule 17d-2 agreements.¹¹⁷ BOX Exchange has represented to the Commission that it intends to become a party to the existing multiparty options Rule 17d-2 plans concerning sales practice regulation and market surveillance.¹¹⁸ Under these agreements, the examining SROs examine firms that are common members of BOX Exchange and the particular examining SRO

such members for compliance with the Act and the rules and regulations thereunder, and the rules of the SRO; or (iii) carry out other specified regulatory responsibilities with respect to such members.

¹¹⁵ 17 CFR 240.17d-2. Section 19(g)(1) of the Act requires every SRO to examine its members and persons associated with its members and to enforce compliance with the federal securities laws and the SRO's own rules, unless the SRO is relieved of this responsibility pursuant to Section 17(d) of the Act. Section 17(d) was intended, in part, to eliminate unnecessary multiple examinations and regulatory duplication with respect to Common Members. See Securities Exchange Act Release No. 12935 (October 28, 1976), 41 FR 49091 (November 8, 1976) ("Rule 17d-2 Adopting Release").

¹¹⁶ See id.

¹¹⁷ See, e.g., Securities Exchange Act Release Nos. 59218 (January 8, 2009), 74 FR 2143 (January 14, 2009) (File No. 4-575) (FINRA/Boston Stock Exchange, Inc.); 58818 (October 20, 2008), 73 FR 63752 (October 27, 2008) (File No. 4-569) (FINRA/BATS Exchange, Inc.); 55755 (May 14, 2007), 72 FR 28057 (May 18, 2007) (File No. 4-536) (National Association of Securities Dealers, Inc. (NASD) n/k/a FINRA and CBOE concerning the CBOE Stock Exchange); 55367 (February 27, 2007), 72 FR 9983 (March 6, 2007) (File No. 4-529) (NASD/ISE); and 54136 (July 12, 2006), 71 FR 40759 (July 18, 2006) (File No. 4-517) (NASD/Nasdaq).

¹¹⁸ See Securities Exchange Act Release Nos. 61589 (February 25, 2010), 75 FR 9976 (March 4, 2010) (File No. S7-966) (notice of filing and order approving and declaring effective an amendment to the multiparty 17d-2 plan concerning options-related sales practice matters); 61588 (February 25, 2010), 75 FR 9970 (March 4, 2010) (File No. 4-551) (notice of filing and order approving and declaring effective an amendment to the multiparty 17d-2 plan concerning options-related market surveillance).

for compliance with certain provisions of the Act, certain rules and regulations adopted thereunder, and certain BOX Exchange Rules.

In addition, BOX Exchange has entered into an RSA with FINRA, under which FINRA will perform certain regulatory functions on behalf of BOX Exchange.¹¹⁹ Specifically, BOX Exchange states that FINRA will: assist BOX Exchange in conducting investigations of potential violations of BOX Exchange rules and/or federal securities laws related to activity on the Exchange; conduct examinations related to BOX Option Participants' conduct on BOX Exchange; assist BOX Exchange with disciplinary proceedings pursuant to BOX Exchange rules, including issuing charges and conducting hearings; and provide dispute resolution services to BOX Option Participants on behalf of BOX Exchange, including operation of the BOX Exchange's arbitration program.¹²⁰ Notwithstanding the RSA, BOX Exchange acknowledges it will retain ultimate legal responsibility for the regulation of its members and its market.¹²¹

The Commission believes that it is consistent with the Act for BOX Exchange to contract with FINRA to perform certain examination, enforcement, and disciplinary functions.¹²² These functions are fundamental elements of a regulatory program, and constitute core self-regulatory

¹¹⁹ See Form 1 Application, Exhibit L.

¹²⁰ See BOX Exchange IM-12150-1 and Amendment No. 2, supra note 5.

¹²¹ See Amendment No. 2, supra note 5.

¹²² See, e.g., Regulation ATS Release, supra note 35. See also Securities Exchange Act Release Nos. 50122 (July 29, 2004), 69 FR 47962 (August 6, 2004) (SR-Amex-2004-32) (order approving rule that allowed Amex to contract with another SRO for regulatory services) ("Amex Regulatory Services Approval Order"); 57478 (March 12, 2008), 73 FR 14521 (March 18, 2008) (SR-NASDAQ-2007-004) ("NOM Approval Order"); Nasdaq Order, supra note 34; and BATS Order, supra note 21.

functions. The Commission believes that FINRA has the expertise and experience to perform these functions on behalf of BOX Exchange.¹²³

BOX Exchange, unless relieved by the Commission of its responsibility,¹²⁴ bears the ultimate responsibility for self-regulatory responsibilities and primary liability for self-regulatory failures, not the SRO retained to perform regulatory functions on the Exchange's behalf. In performing these regulatory functions, however, the SRO retained to perform regulatory functions may nonetheless bear liability for causing or aiding and abetting the failure of BOX Exchange to perform its regulatory functions.¹²⁵ Accordingly, although FINRA will not act on its own behalf under its SRO responsibilities in carrying out these regulatory services for BOX Exchange, as the SRO retained to perform regulatory functions, FINRA may have secondary liability if, for example, the Commission finds that the contracted functions are being performed so inadequately as to cause a violation of the federal securities laws by BOX Exchange.¹²⁶

4. Regulatory Oversight Over BOX Market

There is an inherent tension between a national securities exchange's role as a regulator and as the operator of a market, and between its role as a regulator and as a membership

¹²³ See, e.g., Amex Regulatory Services Approval Order, supra note 122; NOM Approval Order, supra note 122; and Nasdaq Order, supra note 34. The Commission notes that the RSA is not before the Commission and, therefore, the Commission is not acting on it.

¹²⁴ See supra note 114.

¹²⁵ For example, if failings by the SRO retained to perform regulatory functions have the effect of leaving an Exchange in violation of any aspect of the exchange's self-regulatory obligations, the exchange will bear direct liability for the violation, while the SRO retained to perform regulatory functions may bear liability for causing or aiding and abetting the violation. See, e.g., Nasdaq Order, supra note 34; BATS Order, supra note 21; and ISE Order, supra note 88.

¹²⁶ Id.

organization.¹²⁷ The existence of a shareholder class separate from membership adds yet another constituency with interests potentially in conflict with the regulatory responsibilities of the SRO.¹²⁸ An exchange should have in place a structure and be operated in a manner designed to mitigate any potential conflicts between its commercial interests and its regulatory responsibilities so as to assure that it is able to carry out its responsibilities in compliance with the Act.¹²⁹

As noted above, BOX Exchange and BOX Market will be separate corporate entities, and BOX Market will not be a wholly-owned subsidiary of BOX Exchange.¹³⁰ The structural separation of the entity responsible for regulation from the entity that operates the trading platform may serve to mitigate to some degree the influence of commercial interests on regulation. However, although BOX Exchange will be structurally separate from BOX Market as the entity that operates the trading platform, the ultimate owners of such entities are the same,

¹²⁷ See Securities Exchange Act Release No. 50699, 69 FR 71126, 71141 (December 8, 2004) (File No. S7-39-04).

¹²⁸ Id.

¹²⁹ See id. at 71141-2 (stating that national securities exchanges and associations should have policies and procedures that provide for the independence of their regulatory programs from the operation or administration of their trading facilities and other businesses; that the proposals should require that the exchange's or association's regulatory program be either structurally separated from the exchange's or association's market operations and other commercial interests, by means of separate legal entities or functionally separated within the same legal entity from the exchange's or association's market operations and other commercial interests; and that, in Commission's view, such separation must be designed to permit the regulatory program to function independently from the market operations and other commercial interests of the exchange or association).

¹³⁰ There is precedent for this type of structure in the current structure of BOX, with BOX being a facility of BX, as well as a prior structure when Archipelago Exchange was operated as the equity trading facility of the Pacific Exchange (PCX). See Securities Exchange Act Release Nos. 49068, supra note 6 (establishing, among other things, BOX as an options trading facility of BSE), and 44983 (October 25, 2001), 66 FR 55225 (November 1, 2001) (approving PCX's use of the Archipelago Exchange as its equity trading facility).

albeit in different percentages.¹³¹ In particular, as outlined above, in addition to being owners of BOX Exchange, MX US 2 directly owns (and TMX, Bourse and MX US 1 indirectly own) 53.83% of BOX Holdings. BOX Holdings has certain rights with respect to BOX Exchange that, in conjunction with this overlapping ownership structure, raise questions regarding the ability of BOX Holdings and its controlling owner to exert undue influence over BOX Exchange's regulatory functions. Specifically, the BOX Exchange Bylaws provides that BOX Holdings may appoint one director on the BOX Exchange Board and each board committee (including the nominating committee but excluding the regulatory oversight committee and the compensation committee).¹³²

The Commission believes that this right potentially increases the likelihood that the owners of BOX Holdings, particularly MX US 2 (and its controlling owners, TMX, Bourse and MX US 1), can exercise undue influence over BOX Exchange's regulatory functions through the BOX Holdings Director. However, the following provisions in the BOX Exchange governing documents are designed to mitigate such concern: (1) BOX Holdings is permitted to appoint only one director to the BOX Exchange Board;¹³³ (2) because a majority of the BOX Exchange Board will be non-industry directors and 20% will be representative of BOX Options Participants,¹³⁴ there will at most be one other director that can potentially be selected by MX US 2;¹³⁵ (3) the BOX Holdings Director can not constitute more than 20% of the nominating

¹³¹ The owners of BOX Holdings are indirect owners of BOX Market because BOX Market is a wholly-owned subsidiary of BOX Holdings.

¹³² See BOX Exchange Bylaws Section 4.02.

¹³³ Id.

¹³⁴ Id.

¹³⁵ Id.

committee¹³⁶; and (4) the compensation committee and the regulatory oversight committee will not include the BOX Holdings Director.¹³⁷

The separation of BOX Exchange and BOX Market also raises questions as to how effectively BOX Exchange will be kept informed about BOX Market's commercial operations that might be of regulatory concern, and whether BOX Exchange will be sufficiently empowered, and have the ability, to assure that the trading platform and related services are operated in accordance with the Act. To help address these concerns, the BOX Market LLC Agreement includes several provisions that are specifically designed to help facilitate the ability of BOX Exchange to oversee the BOX options trading facility and BOX Market as the operator of the BOX facility. Specifically:

- BOX Exchange must receive notice of, and will be required to affirmatively approve, any planned or proposed changes of BOX Market including, but not limited to, any planned or proposed changes to BOX, the sale by BOX Market of any material portion of its assets, and any action to effect a voluntary, or which would precipitate an involuntary, dissolution or winding up of BOX Market;¹³⁸

¹³⁶ See BOX Exchange Bylaws Section 4.06.

¹³⁷ See BOX Exchange Bylaws Sections 6.06 and 6.07.

¹³⁸ Changes relating solely to one or more of the following will not be subject to this notice requirement: marketing; administrative matters; personnel matters; social or team-building events; meetings of the owner of BOX Market; communication with the owner of BOX Market; finance; location and timing of board meetings; market research; real property; equipment; furnishings; personal property; intellectual property; insurance; contracts unrelated to the operation of the BOX Market; and de minimis items. See Article 3.2(a)(ii) of the BOX Market LLC Agreement.

- BOX Market is prohibited from implementing any such changes until they are approved by the BOX Exchange Board;¹³⁹
- BOX Exchange has the right to direct BOX Market to make any modifications to prevent or eliminate a regulatory deficiency;¹⁴⁰ and
- BOX Exchange will have the right to designate a non-voting director to serve on the BOX Market board of directors, as long as BOX remains a facility of BOX Exchange ('regulatory director').¹⁴¹

The Commission believes that the provisions discussed above, which are designed to facilitate the ability of BOX Exchange to oversee BOX Market and BOX, are appropriate and consistent with the requirements of the Act, particularly with Section 6(b)(1), which requires in part an exchange to be so organized and have the capacity to carry out the purposes of the Act.¹⁴² As noted, the BOX Market LLC Agreement will require BOX Market to notify and receive prior approval from BOX Exchange of planned or proposed changes related to BOX Market or the BOX options trading facility.¹⁴³ In addition, BOX Exchange has full discretion to direct BOX

¹³⁹ See *id.*

¹⁴⁰ See Articles 3.2(a)(iii) and (iv) of the BOX Market LLC Agreement. A 'regulatory deficiency' means the operation of BOX or the BOX Market in a manner that is not consistent with the rules of BOX Exchange and/or the rules of the Commission governing the BOX Market or BOX Options Participants, or that otherwise impedes the ability of BOX Exchange to regulate the BOX Market or BOX Options Participants or to fulfill its obligations under the Act as an SRO. See Article 1.1 of the BOX Market LLC Agreement.

¹⁴¹ This regulatory director will have not the right to vote or to serve on a committee, but will have the right to attend all meetings of the BOX Market board of directors, receive equivalent notice of such meetings, and receive a copy of all meeting materials provided to the other directors. See Article 4.1(a) of the BOX Market LLC Agreement.

¹⁴² 15 U.S.C. 78f(b)(1).

¹⁴³ See Article 3.2(a)(ii) of the BOX Market LLC Agreement.

Market to modify any proposed or planned changes to BOX to prevent or eliminate a regulatory deficiency.¹⁴⁴ Further, the inclusion of the regulatory director on the BOX Market board of directors is designed to help facilitate the ability of BOX Exchange to become informed about the operations of the BOX trading platform and any proposed changes thereto.

Section 6(b)(1) of the Act¹⁴⁵ requires an exchange—including BOX Exchange - to be so organized and have the capacity to be able to carry out the purposes of the Act. In addition, Section 19(g)(1) of the Act¹⁴⁶ requires an exchange—including BOX Exchange—to comply with the provisions of the Act, the rules and regulations thereunder, and its own rules, and, absent reasonable justification or excuse, to enforce compliance by its members with such provisions. At this time, the Division believes that the overall corporate and governance structure proposed by BOX Exchange is designed to help facilitate the ability of BOX Exchange to carry out its responsibility and operate in a manner consistent with the Exchange Act.¹⁴⁷ Whether BOX Exchange operates in compliance with the Act, however, depends on how BOX Exchange and BOX Market in practice implement the governance and other provisions that are the subject of this Order.¹⁴⁸

¹⁴⁴ See Article 3.2(a)(iii) and (iv) of the BOX Market LLC Agreement.

¹⁴⁵ 15 U.S.C. 78f(b)(1).

¹⁴⁶ 15 U.S.C. 78s(g)(1).

¹⁴⁷ The Commission notes that it is reviewing the various standards and processes it uses to facilitate the registration of national securities exchanges and other entities required to register with the Commission and plans to issue a concept release designed to collect information and evaluate different aspects of these registration standards and processes, including the policy objectives of registration, how best to achieve those policy objectives through registration and other means, and the relative benefits and costs of the various means available. See Securities Exchange Act Release No. 65543 (October 12, 2011), 76 FR 65784, 65786 fn. 13 (October 24, 2011).

¹⁴⁸ According to Amendment No. 2, the person that will initially be the Chief Executive Officer of BOX Exchange also will be the Chief Executive Officer of BOX Market, and

Section 19(h)(1) of the Act¹⁴⁹ provides the Commission with the authority “to suspend for a period not exceeding twelve months or revoke the registration of [an SRO], or to censure or impose limitations upon the activities, functions, and operations of [an SRO], if [the Commission] finds, on the record after notice and opportunity for hearing, that [the SRO] has violated or is unable to comply with any provision of the Act, the rules or regulations thereunder, or its own rules or without reasonable justification or excuse has failed to enforce compliance’ with any such provision by its members (including associated persons thereof).¹⁵⁰ If Commission staff were to find, or become aware of, through staff review and inspection or otherwise, facts indicating any violations of the Act, including without limitation Sections 6(b)(1) and 19(g)(1), these matters could provide the basis for a disciplinary proceeding under Section 19(h)(1) of the Act.

the person that will initially be the President of BOX Exchange also will be the Executive Vice President, Chief Legal Officer and Company Secretary of BOX Market. See Amendment No. 2. Thus, senior executives of BOX Exchange also will hold senior executive positions at BOX Market. Further, BOX Exchange’s CRO will, in addition to reporting to BOX Exchange’s regulatory oversight committee, report to the President of BOX Exchange. See BOX Exchange Bylaws Section 7.01. The CRO will have general day-to-day supervision over BOX Exchange’s regulatory operations. See id. The compensation committee of BOX Exchange will set the CRO’s compensation and the regulatory oversight committee, in its sole discretion, will make hiring and termination decisions with respect to the CRO, in each case taking into consideration any recommendations made by the President of BOX Exchange. See BOX Exchange Bylaws Sections 6.06 and 6.07.

¹⁴⁹ See 15 U.S.C. 78s(h)(1).

¹⁵⁰ Id.

C. Trading Host

1. Order Display, Execution, and Priority

As noted above, BOX Market will operate the automated trading system used for the trading of options contracts (the "Trading Host").¹⁵¹ The Trading Host includes a fully automated electronic order book ("BOX Book") for orders to buy or sell securities. BOX Options Participants are entitled to enter orders into and receive executions through the electronic order book. Liquidity is derived from orders to buy and sell submitted electronically by BOX Options Participants in remote locations. There will be no physical trading floor.

BOX Options Participants' Limit Orders submitted to the Trading Host will be ranked and maintained in the BOX Book according to price/time priority, such that within each price level, all orders will be organized by the time of entry.¹⁵² No distinction is made to this priority with regard to account designation (Public Customer, Broker-Dealer or Market Maker). The number of orders and the total quantity at each of the five best price levels in the BOX Book will be displayed to all BOX Options Participants on an anonymous basis.¹⁵³

BOX Options Participants may submit the following types of orders: Limit; BOX-Top;¹⁵⁴ Market-on-Opening; Market; and Intermarket Sweep Order ("ISO").¹⁵⁵ Options

¹⁵¹ BOX Exchange's proposed trading rules are substantially similar to the current rules of BOX, which rules have been subject to the rule filing process under Section 19(b) of the Act.

¹⁵² See BOX Exchange Rule 7130(a).

¹⁵³ See BOX Exchange Rule 7130(a)(2).

¹⁵⁴ BOX-Top orders that are entered into the BOX Book are executed at the best price available in the market for the total quantity available from any contra bid (offer). Any residual volume left after part of a BOX-Top Order has been executed is automatically converted to a limit order at the price at which the original BOX-Top Order was executed. See BOX Exchange Rule 7110(c)(2).

¹⁵⁵ See BOX Exchange Rule 7110(c).

Participants can add the designation of Good 'Til Cancelled, Fill and Kill, or Session Order¹⁵⁶ to each of the above mentioned order types.¹⁵⁷ These order types and designations are substantially similar to the order types currently offered by BOX.¹⁵⁸

BOX Exchange also permits Order Flow Providers ('OFPs')¹⁵⁹ to utilize Directed Orders.¹⁶⁰ A 'Directed Order' refers to a Customer Order that an OFP directs to a particular BOX market maker. Unlike all other orders submitted to the Trading Host, Directed Orders are not anonymous. A market maker who wishes to accept Directed Orders must systemically indicate that it wishes to receive Directed Orders, must be willing to accept Directed Orders from all OFPs, may receive Directed Orders only through the Trading Host, and may not reject Directed Orders.¹⁶¹

Trades will execute when orders or quotations on the BOX Book match one another. The priority of orders at the same price will be determined by time of order entry. An order entered into the Trading Host that matches an order in the Trading Host will trade at the price of the order in the Trading Host up to the available size.¹⁶²

¹⁵⁶ An order with a Session Order designation will remain active in the BOX trading system until certain triggering events occur (e.g., disconnection of the connection between the BOX Options Participant and BOX). See BOX Exchange Rule 7110(e)(iii).

¹⁵⁷ See BOX Exchange Rule 7110(e).

¹⁵⁸ See Chapter V, Section 14 of the current BOX Rules.

¹⁵⁹ An OFP means those BOX Options Participants representing as agent customer orders on the Trading Host and those non-market-maker BOX Options Participants conducting proprietary trading. See BOX Exchange Rule 100(a)(45).

¹⁶⁰ See BOX Exchange Rule 8040. This rule is substantially similar to Chapter VI, Section 5(c) of the current BOX Rules.

¹⁶¹ See BOX Exchange Rule 8040(d).

¹⁶² See BOX Exchange Rule 7130(a)(4).

With the exception of Improvement Orders and Primary Improvement Orders submitted during a Price Improvement Period (PIP) auction,¹⁶³ Directed Orders,¹⁶⁴ and ISOs,¹⁶⁵ all orders submitted to the Trading Host will be filtered by the Trading Host prior to entry on the BOX Book, which is designed to ensure that such orders will not execute at a price outside of the current NBBO.¹⁶⁶

BOX Exchange will limit an OFP's ability to trade as principal with an order it represents as agent, unless the agency order is first given the opportunity to interact with other trading interest on the Exchange. Specifically, an OFP may not execute as principal an order it represents as agent unless: (i) the agency order is first exposed to the BOX Book for at least one second; (ii) the OFP has been bidding or offering on the BOX Book for a least one second prior to receiving an agency order that is executable against such bid or offer; (iii) the OFP sends the agency order to the PIP; or (iv) the OFP sends the agency order to the Facilitation Auction.¹⁶⁷

BOX Exchange Rules also will prohibit the disclosure of information about agency orders to third parties. Specifically, prior to submitting an order to the PIP, the Facilitation Auction, or the Solicitation Auction, a BOX Options Participant cannot inform another BOX

¹⁶³ These orders will be processed in accordance with BOX Exchange Rule 7150.

¹⁶⁴ Directed Orders will be processed in accordance with BOX Exchange Rule 8040.

¹⁶⁵ See BOX Exchange Rule 7110(c)(5).

¹⁶⁶ See BOX Exchange Rule 7130(b) (noting that BOX will "filter" or check to ensure that the order will not: (i) in the case of a sell order, execute at a price below the NBBO bid price or (ii) in the case of a buy order, the execute at a price above the NBBO offer execute at a price above the NBBO offer price). This rule is substantially similar to Chapter V, Section 16(b) of the current BOX Rules.

¹⁶⁷ See BOX Exchange IM-7140-3.

Options Participant or any other third party of any of the terms of the order, except as provided for in the rules regarding Directed Orders.¹⁶⁸

The PIP process may be used by BOX Options Participants seeking to execute their agency orders as principal. BOX Exchange's PIP rule is the same as BOX Group LLC's current PIP rule.¹⁶⁹ Under the PIP rule, Customer Orders designated for the PIP ('PIP Orders') will be submitted to BOX with a matching contra order ('Primary Improvement Order') equal to the full size of the PIP Order. The Primary Improvement Order must be on the opposite side of the market than that of the PIP Order and represent either: (1) a single price that is equal to or better than that of the NBBO at the time of the commencement of the PIP; or (2) an auto-match submission that will automatically match both the price and size of all competing quotes and orders at any price level achieved during the PIP or only up to a limit price. The Primary Improvement Order will designate the PIP auction start price, which must be equal to or better than the NBBO at the time of commencement of the PIP. BOX Exchange will commence a PIP by broadcasting a message to Options Participants, and the exposure period will last for one hundred milliseconds. At the conclusion of the auction, the PIP Order will be matched on price/time priority with orders on the opposite side (with the Initiating Participant retaining priority for 40% of the order),¹⁷⁰ subject to certain conditions.¹⁷¹

¹⁶⁸ See BOX Exchange IM-7140-4.

¹⁶⁹ See Chapter V, Section 18 of the current BOX Rules.

¹⁷⁰ See BOX Exchange Rule 7150(g). At its option, the Initiating Participant may designate a lower amount for which it retains certain priority and trade allocation privileges upon the conclusion of the PIP than the forty percent (40%) of the PIP Order to which it is entitled. See Rule 7150(g)(5).

¹⁷¹ See BOX Exchange Rule 7150.

BOX Exchange will have no minimum size requirement for orders entered into the PIP, for a pilot period to expire July 18, 2012.¹⁷² During the pilot period, BOX Exchange will submit certain data, periodically as required by the Commission, to help evaluate whether, among other things: (1) there is meaningful competition for all size PIP orders; and (2) there is significant price improvement for all orders executed through the PIP.¹⁷³ This data is expected to aid the Commission in evaluating the PIP during the pilot period to determine whether it would be beneficial to customers and to the options market as a whole to approve any proposal requesting permanent approval to permit orders of fewer than 50 contracts to be submitted to the PIP.

BOX Exchange's proposed Facilitation Auction is the same as BOX Group LLC's current Facilitation Auction.¹⁷⁴ The Facilitation Auction is a process by which an OFP seeks either to facilitate a block-size order it represents as agent, or to execute an order it solicited to execute against the agency order. OFPs must be willing to execute the entire size of agency orders entered into the Facilitation Auction through the submission of a contra-Facilitation Order.¹⁷⁵

¹⁷² See BOX Exchange IM-7150-1.

¹⁷³ See Form I Application, Exhibit B. This data is substantially the same data currently provided to the Commission by BOX Group LLC. See Securities and Exchange Commission Release Nos. 61805 (March 31, 2010), 75 FR 17454 (April 6, 2010); 60337 (July 17, 2009), 74 FR 36805 (July 24, 2009); 51821 (June 10, 2005), 70 FR 35143 (June 16, 2005); and 49068, *supra* note 6.

¹⁷⁴ See Chapter V, Section 31(a) of the current BOX Rules.

¹⁷⁵ Upon the entry of an agency order and Facilitation Order into the Facilitation Auction, a broadcast message will be sent and Options Participants will be given an opportunity to enter responses with the prices and sizes at which they will be willing to participate in the facilitation of the agency order. At the end of the one second period for the entry of responses, the agency order will be automatically executed. Unless there is sufficient size to execute the entire Agency Order at a price better than the facilitation price, Public Customer bids (offers) and Public Customer responses on BOX at the time the agency order is executed that are price higher (lower) than the facilitation price will be executed at the facilitation price. Non-Public Customer and Market Maker bids (offers) and Non-Public Customer and Market Maker Response on BOX at the time the Agency Order is

BOX Exchange also is proposing to have a Solicitation Auction, which is the same as BOX Group LLC's current Solicitation Auction.¹⁷⁶ The Solicitation Auction allows an OFP to seek to execute orders of 500 or more contracts it represents as agent against contra orders that it has solicited ("Solicited Order").¹⁷⁷

executed that are priced higher (lower) than the facilitation price will be executed against the agency order at their stated price. The facilitating OFP will execute at least forty percent (40%) of the original size of the Facilitation Order, but only after better-priced bids (offers) and auction responses on BOX, as well as Public Customer bids (offers) and responses at the facilitation price, are executed in full, based upon price/time priority. Thereafter, Non-Public Customer and Market Maker bids (Offers) and Non-Public Customer and Market Maker responses on BOX at the facilitation price will participate in the execution of the agency order based upon price/time priority. See BOX Exchange Rule 7270(a).

¹⁷⁶ See Chapter V, Section 31(b) of the current BOX Rules.

¹⁷⁷ Each agency order entered into the Solicitation Auction must be all-or-none. When a proposed solicited cross is entered into the Solicitation Auction, a broadcast message will be sent and Options Participants will be given an opportunity to enter responses with the prices and sizes at which they will be willing to participate in the execution of the agency order. At the end of the one second period for the entry of responses, the agency order will be automatically executed in full or cancelled. The agency order will be executed against the solicited order at the proposed execution price unless (1) there is sufficient size to execute the entire agency order at a better price or prices, or (2) there is a Public Customer order resting on the BOX Book at a price equal to or better than the proposed execution price within the depth of the BOX Book that would have traded with the agency order if the agency order had been submitted to the BOX Book instead of to the Solicitation Mechanism (Book Priority Public Customer Order). If there is sufficient size to execute the entire agency order at a better price or prices, the agency order will be executed at the improved price(s) and the Solicited Order will be cancelled. If there is not sufficient size to execute the entire agency order at a better price or prices, whether the agency order will be executed against the Solicited Order at the proposed execution price depends on whether there is one or more Book Priority Public Customer Order(s) on the BOX Book at the time of execution. If no such Book Priority public customer Orders are on the BOX Book at the time of execution, the agency order will be executed against the Solicited Order at the proposed execution price. However, if there is one or more Book Priority Public Customer Orders on the Book, then BOX will calculate whether sufficient size exists to execute the agency order at its proposed price. If there is sufficient size available on the BOX Book to execute the entire agency order at the proposed price, the agency order will be executed against the BOX Book. If there is not sufficient size available on the BOX Book to execute the entire agency order at the

It will be a violation of an Option Participant's duty of best execution to its customer if it were to cancel a Facilitation Order to avoid execution of the customer order at a better price that may be available on BOX.¹⁷⁸ Additionally, Options Participants may not use the Solicitation Auction to circumvent the limitations in Rule 7140 regarding Participants trading as principal with their customer orders.¹⁷⁹

The Commission believes that BOX Exchange's proposed display, execution, and priority rules are consistent with the Act. In particular, the Commission finds that the proposed rules are consistent with Section 6(b)(5) of the Act,¹⁸⁰ which, among other things, requires that the rules of a national securities exchange be designed to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest, and to not permit unfair discrimination between customers, issuers, or dealers. The Commission also finds that the proposed rules are consistent with Section 6(b)(8) of the Act,¹⁸¹ which requires that the rules of an exchange not impose any burden on competition that is not necessary or appropriate in

proposed price, the agency order and the solicited order will be cancelled and no executions will occur. See BOX Exchange Rule 7270(b)(2).

¹⁷⁸ See BOX Exchange IM-7270-1

¹⁷⁹ See BOX Exchange IM-7270-5. This may include, but is not limited to, Options Participants entering Solicitation Orders that are solicited from: (1) affiliated broker-dealers; or (2) broker-dealers with which the BOX Options Participant has an arrangement that allows the Options Participant to realize similar economic benefits from the solicited transaction as it would achieve by executing the customer order in whole or in part as principal. Further, any Solicited Orders entered by Options Participants to trade against Agency Orders may not be for the account of a BOX Market Maker that is assigned to the options class.

¹⁸⁰ 15 U.S.C. 78f(b)(5).

¹⁸¹ 15 U.S.C. 78f(b)(8).

furtherance of the purposes of the Act. The Commission notes that the trading rules of BOX Exchange are substantially similar to the current BOX trading rules, which were filed with and approved by the Commission (or otherwise became effective) pursuant to Section 19(b) of the Act. Thus, the Commission is making its findings regarding BOX Exchange's trading rules for the reasons set forth in the Commission approval orders relating to the current BOX trading rules.

2. Section 11 of the Act

Section 11(a)(1) of the Act¹⁸² prohibits a member of a national securities exchange from effecting transactions on that exchange for its own account, the account of an associated person, or an account over which it or its associated person exercises discretion (collectively, "covered accounts"), unless an exception applies. The Exchange has represented that it has analyzed its rules proposed hereunder, and believes that they are consistent with Section 11(a) of the Act and rules thereunder. For the reasons set forth below, the Commission believes that BOX Option Participants entering orders into the Trading Host, excluding those transactions effected through the PIP process, will satisfy the conditions of Rule 11a2-2(T). The Commission further believes that BOX Option Participants effecting transactions through the PIP process will satisfy the requirements of Section 11(a)(1)(G) of the Act, provided that BOX Option Participants comply with the requirements set forth in Rule 11a1-1(T) thereunder.

a. Rule 11a2-2(T)

Rule 11a2-2(T) under the Act,¹⁸³ known as the "effect versus execute" rule, provides exchange members with an exemption from the Section 11(a)(1) prohibition. Rule 11a2-2(T)

¹⁸² 15 U.S.C. 78k(a)(1).

¹⁸³ 17 CFR 240.11a2-2(T).

permits an exchange member, subject to certain conditions, to effect transactions for covered accounts by arranging for an unaffiliated member to execute the transactions on the exchange. To comply with Rule 11a2-2(T)'s conditions, a member: (1) may not be affiliated with the executing member; (2) must transmit the order from off the exchange floor; (3) may not participate in the execution of the transaction once it has been transmitted to the member performing the execution;¹⁸⁴ and (4) with respect to an account over which the member has investment discretion, neither the member nor its associated person may retain any compensation in connection with effecting the transaction except as provided in the Rule.

In a letter to the Commission,¹⁸⁵ BOX Exchange requested that the Commission concur with its conclusion that BOX Options Participants that enter orders into the Trading Host, excluding those transactions effected through the PIP process, satisfy the requirements of Rule 11a2-2(T). For the reasons set forth below, the Commission believes that BOX Option Participants entering orders into the Trading Host, excluding those transactions effected through the PIP process, will satisfy the conditions of Rule 11a2-2(T).

Rule 11a2-2(T)'s first condition is that the order be executed by an exchange member who is unaffiliated with the member initiating the order. The Commission has stated that the requirement is satisfied when automated exchange facilities, such as the Trading Host, are used, as long as the design of these systems ensures that members do not possess any special or unique trading advantages over non-members in handling their orders after transmitting them to the

¹⁸⁴ The member may, however, participate in clearing and settling the transaction. See Securities Exchange Act Release No. 14563 (March 14, 1978), 43 FR 11542 (March 17, 1978) (regarding the NYSE's Designated Order Turnaround System ("1978 Release")).

¹⁸⁵ See letter from Lisa Fall, President, BOX Exchange, to Elizabeth Murphy, Secretary, Commission, dated March 30, 2012 ("Exchange 11(a) Request Letter").

Exchange.¹⁸⁶ BOX Exchange has represented that the design of the trading platform ensures that no member has any special or unique trading advantage in the handling of its orders after transmitting its orders to BOX Exchange.¹⁸⁷ Based on the Exchange's representation, the Commission believes that the Trading Host satisfies this requirement.

Second, Rule 11a2-2(T) requires orders for covered accounts be transmitted from off the exchange floor. The Trading Host receives orders electronically through remote terminals or computer-to-computer interfaces. In the context of other automated trading systems, the Commission has found that the off-floor transmission requirement is met if a covered account order is transmitted from a remote location directly to an exchange's floor by electronic means.¹⁸⁸ Since the Trading Host receives all orders electronically through remote terminals or computer-to-computer interfaces, the Commission believes that the trading platform satisfies the off-floor

¹⁸⁶ In considering the operation of automated execution systems operated by an exchange, the Commission noted that while there is no independent executing exchange member, the execution of an order is automatic once it has been transmitted into each system. Because the design of these systems ensures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the exchange, the Commission has stated that executions obtained through these systems satisfy the independent execution requirement of Rule 11a2-2(T). *See* Securities Exchange Act Release No. 15533 (January 29, 1979), 44 FR 6084 (January 31, 1979) (regarding the American Stock Exchange ("Amex") Post Execution Reporting System, the Amex Switching System, the Intermarket Trading System, the Multiple Dealer Trading Facility of the Cincinnati Stock Exchange, the PCX Communications and Execution System, and the Philadelphia Stock Exchange ("Phlx") Automated Communications and Execution System ("1979 Release")).

¹⁸⁷ *See* Exchange 11(a) Request Letter, *supra* note 185.

¹⁸⁸ *See, e.g.,* Securities Exchange Act Release Nos. 59154 (December 23, 2008) 73 FR 80468 (December 31, 2008) (SR-BSE-2008-48) (order approving proposed rules of BX); 49068, *supra* note 6 (establishing, among other things, BOX as an options trading facility of BSE); 44983, *supra* note 130 (approving the PCX's use of the Archipelago Exchange as its equity trading facility); 29237 (May 24, 1991), 56 FR 24853 (May 31, 1991) (regarding NYSE's Off-Hours Trading Facility). *See* 1978 Release, *supra* note 184. *See* 1979 Release, *supra* note 186.

transmission requirement.

Third, Rule 11a2-2(T) requires that the member not participate in the execution of its order once it has been transmitted to the member performing the execution. BOX Exchange represented that at no time following the submission of an order is a member able to acquire control or influence over the result or timing of an order's execution.¹⁸⁹ According to BOX Exchange, the execution of a member's order is determined solely by what orders, bids, or offers are present in the Trading Host and where the order is ranked based on an established price-time priority matching algorithm at the time the BOX Options Participant submits the order and on the priority of those orders, bids and offers.¹⁹⁰ Accordingly, the Commission believes that a BOX Options Participant does not participate in the execution of an order submitted into the trading platform.

Fourth, in the case of a transaction effected for an account with respect to which the initiating member or an associated person thereof exercises investment discretion, neither the initiating member nor any associated person thereof may retain any compensation in connection with effecting the transaction, unless the person authorized to transact business for the account has expressly provided otherwise by written contract referring to Section 11(a) of the Act and

¹⁸⁹ See Exchange 11(a) Request Letter, supra note 185. The member may only cancel or modify the order, or modify the instructions for executing the order, but only from off the Exchange floor. The Commission has stated that the non-participation requirement is satisfied under such circumstances so long as such modifications or cancellations are also transmitted from off the floor. See 1978 Release, supra note 184 (stating that the "non-participation requirement does not prevent initiating members from canceling of modifying orders (or the instructions pursuant to which the initiating member wishes orders to be executed) after the orders have been transmitted to the executing member, provided that any such instructions are also transmitted from off the floor").

¹⁹⁰ See Exchange 11(a) Request Letter, supra note 185.

Rule 11a2-2(T).¹⁹¹ BOX Options Participants trading for covered accounts over which they exercise investment discretion must comply with this condition in order to rely on the rule's exemption.¹⁹²

b. Section 11(a)(1)(G) and Rule 11a1-1(T)

Section 11(a)(1)(G) of the Act provides an additional exemption from the general prohibition set forth in Section 11(a)(1) for any transaction for a member's own account, provided that: (i) such member is primarily engaged in certain underwriting, distribution, and other activities generally associated with broker-dealers and whose gross income is derived principally from such business and related activities; and (ii) the transaction is effected in compliance with the rules of the Commission, which, as a minimum, assure that the transaction is not inconsistent with the maintenance of fair and orderly markets and yields priority, parity, and precedence in execution to orders for the account of persons who are not members or associated with members of the exchange.¹⁹³ In addition, Rule 11a1-1(T) under the Act specifies that a transaction effected on a national securities exchange for the account of a member which meets the requirements of Section 11(a)(1)(G)(i) of the Act is deemed, in accordance with the requirements of Section 11(a)(1)(G)(ii), to be not inconsistent with the maintenance of fair and orderly.

¹⁹¹ 17 CFR 240.11a2-2(T)(a)(2)(iv). In addition, Rule 11a2-2(T)(d) requires a member or associated person authorized by written contract to retain compensation, in connection with effecting transactions for covered accounts over which such member or associated person thereof exercises investment discretion, to furnish at least annually to the person authorized to transact business for the account a statement setting forth the total amount of compensation retained by the member in connection with effecting transactions for the account during the period covered by the statement. See 17 CFR 240.11a2-2(T)(d). See also 1978 Release, supra note 184 (stating "[t]he contractual and disclosure requirements are designed to assure that accounts electing to permit transaction-related compensation do so only after deciding that such arrangements are suitable to their interests").

¹⁹² See Exchange 11(a) Request Letter, supra note 185.

¹⁹³ See 15 U.S.C. 78k(a)(1)(G).

markets and to yield priority, parity, and precedence in execution to orders for the account of non-members or persons associated with non-members of the exchange, if such transaction is effected in compliance with certain requirements.¹⁹⁴

The rules relating to the PIP process of the Trading Host prohibit any orders for the accounts of non-Market Maker BOX Options Participants to be executed prior to the execution of Public Customer Orders, both CPO and unrelated Customer Orders, and non-BOX Options Participant broker-dealer orders at the same price.¹⁹⁵ Because the rules will require BOX Options Participants that are not market makers¹⁹⁶ to yield priority in the PIP to all non-member orders, the Commission believes that the proposal with respect to transactions effected through the PIP process is consistent with the requirements in Section 11(a) of the Act and Rule 11a1-1(T) thereunder.¹⁹⁷ The Commission also reminds exchanges and their members, however, that, in addition to yielding priority to non-member orders at the same price, members must also meet

¹⁹⁴ Rule 11a1-1(T)(a)(1)-(3) provides that each of the following requirements must be met: (1) A member must disclose that a bid or offer for its account is for its account to any member with whom such bid or offer is placed or to whom it is communicated, and any member through whom that bid or offer is communicated must disclose to others participating in effecting the order that it is for the account of a member; (2) immediately before executing the order, a member (other than the specialist in such security) presenting any order for the account of a member on the exchange must clearly announce or otherwise indicate to the specialist and to other members then present for the trading in such security on the exchange that he is presenting an order for the account of a member; and (3) notwithstanding rules of priority, parity, and precedence otherwise applicable, any member presenting for execution a bid or offer for its own account or for the account of another member must grant priority to any bid or offer at the same price for the account of a person who is not, or is not associated with, a member, irrespective of the size of any such bid or offer or the time when entered. See 17 CFR 240.11a1-1(T)(a)(1)-(3).

¹⁹⁵ See BOX Rules, 7150(f)(4) and (g)(3)(i).

¹⁹⁶ Section 11(a)(1)(A) of the Act provides an exception to the general prohibition in Section 11(a) on an exchange member effecting transactions for its own account if such member is a dealer acting in the capacity of a market maker. See 15 U.S.C. 78k(a)(1)(A).

¹⁹⁷ See also Securities Exchange Act Release No. 49068, supra note 6.

the other requirements under Section 11(a)(1)(G) of the Act and Rule 11a1-1(T) thereunder (or satisfy the requirements of another exception) to effect transactions for their own accounts.

D. Other BOX Exchange Rules

1. BOX Options Participant Access

Membership on BOX Exchange will be available to any broker or dealer registered under Section 15 of the Act that meets the standards for membership set forth in the Rule 2000 Series of BOX Exchange's rules.¹⁹⁸ Access to the Trading Host will be available to persons that have applied and been approved by BOX Exchange as BOX Options Participants.¹⁹⁹ BOX Exchange will have two classes of BOX Options Participants: (1) OFPs, who can represent customer orders as agents and/or conduct proprietary trading; and (2) market makers. OFPs can transact business with public customers only if the OFPs are members of another registered national securities exchange or association.²⁰⁰

For a temporary 90-day period after the Commission's approval of BOX Exchange's Form 1 Application, an applicant that is an active member of FINRA or a registered national securities exchange and is a current or former BOX Options Participant of BOX trading facility will not be required to submit a full application for membership on the Exchange, but rather will only need

¹⁹⁸ See BOX Exchange Rule 2020(a); Form 1 Application, Exhibit L. To become or continue as a BOX Options Participant, a firm must: (1) have as the principal purpose of being a Participant the conduct of a securities business; (2) be a Clearing Participant or establish a clearing arrangement with a Clearing Participant; (3) meet the capital requirements of BOX Exchange or Rule 15c3-1 of the Act, whichever is greater; (4) demonstrate an ability to adhere to all applicable Exchange, Commission, Options Clearing Corporation and Federal Reserve Board policies, rules and regulations, including those concerning record-keeping, reporting, finance and trading procedures; and (5) be able to satisfactorily demonstrate reasonably adequate systems capability and capacity. See also BOX Exchange Rules 2000, 2010, 2020 and 10000 Series.

¹⁹⁹ See BOX Exchange Rule 2010. See also Form 1 Application, Exhibit L.

²⁰⁰ See BOX Exchange Rule 4000.

to complete a short-form waive-in membership application form.²⁰¹ This waive-in process is similar to arrangements that were in place temporarily at other SROs.²⁰² All other applicants (and after the 90-day period has ended, those that could have waived in through the expedited process) may apply for membership on the Exchange by submitting a full membership application to the Exchange.²⁰³ Applications for association with a BOX Options Participant shall be submitted to the Exchange on Form U-4 and such other forms as BOX Exchange may prescribe.²⁰⁴

A prospective BOX Options Participant must enter into a Participant Agreement, whereby it will, among other things, agree to abide by the Agreement, the Exchange Rules, and by all circulars, notices, directives or decisions adopted pursuant to or made in accordance with the Rules. Pursuant to BOX Exchange's rules, every applicant must have and maintain membership in another options exchange that is registered under the Act and that is not registered solely under Section 6(g) of the Act.²⁰⁵

The Exchange will receive and review all membership applications, and will provide to the applicant written notice of the Exchange's determination within 30 days after completion of its consideration of an application, specifying in the case of disapproval of an application the grounds thereof.²⁰⁶ The Exchange also will qualify associated persons of BOX Options

²⁰¹ See BOX Exchange Rules 2030. See also Form 1 Application, Exhibit L.

²⁰² See, e.g., Nasdaq Rule 1013(a)(5)(C) (containing a similar expedited waive-in membership process for members of FINRA).

²⁰³ See BOX Exchange Rule 2030.

²⁰⁴ See BOX Exchange IM-2040-6.

²⁰⁵ See BOX Exchange Rule 2010.

²⁰⁶ See BOX Exchange Rule 2000(b).

Participants.²⁰⁷ Once an applicant becomes a BOX Options Participant or a person associated with a BOX Options Participant, it must continue to satisfy all of the qualifications to be an options participant set forth in the BOX Exchange rules.²⁰⁸ When BOX Exchange has reason to believe that a BOX Options Participant or associated person fails to meet such qualifications, the Exchange may suspend or terminate such person's membership or association.²⁰⁹

The Commission finds that BOX Exchange's membership rules are consistent with Section 6 of the Act,²¹⁰ including Section 6(b)(2) of the Act²¹¹ in particular, which requires that a national securities exchange have rules that provide that any registered broker or dealer or natural person associated with such broker or dealer may become a member and any person may become associated with an exchange member. The Commission notes that pursuant to Section 6(c) of the Act,²¹² an exchange must deny membership to any person, other than a natural person, that is not a registered broker or dealer, any natural person that is not, or is not associated with, a registered broker or dealer, and registered broker-dealers that do not satisfy certain standards, such as financial responsibility or operational capacity. As a registered exchange, BOX Exchange must independently determine if an applicant satisfies the standards set forth in the Act, regardless of whether an applicant is a member of another SRO.²¹³

2. Linkage

²⁰⁷ Id. See also BOX Exchange Rule 2030.

²⁰⁸ See BOX Exchange Rule 2040.

²⁰⁹ See BOX Exchange Rule 2040.

²¹⁰ 15 U.S.C. 78f.

²¹¹ 15 U.S.C. 78f(b)(2).

²¹² 15 U.S.C. 78f(c).

²¹³ See, e.g., BATS Order, supra note 21, at 73 FR 49502; and Nasdaq Order, supra note 34, at 71 FR 3555.

The Exchange plans to become a participant in the Plan Relating to Options Order Protection and Locked/Crossed Markets or any successor plan ("Linkage Plan").²¹⁴ If admitted as a participant to the Plan, other plan participants would be able to send orders to the Trading Host in accordance with the terms of the plan as applied to the Exchange.

BOX Exchange rules include relevant definitions, establish the conditions pursuant to which members may enter orders in accordance with the Linkage Plan, impose obligations on the Exchange regarding how it must process incoming orders, establish a general standard that members and the Exchange should avoid trade-throughs, establish potential regulatory liability for members that engage in a pattern or practice of trading through other exchanges, and establish obligations with respect to locked and crossed markets.

The Commission believes that BOX Exchange has proposed rules that are designed to comply with the requirements of the Linkage Plan.²¹⁵ Further, before BOX Exchange can commence operations as an exchange, BOX Exchange must become a participant in the Linkage Plan.

3. Market Makers

a. Registration of Market Makers

A BOX Options Participant may register with BOX Exchange as a market maker by filing a written application with the Exchange, which will consider an applicant's market making ability and other factors it deems appropriate in determining whether to approve an applicant's

²¹⁴ See Form 1 Application, Exhibit E, Response 6. See also Securities Exchange Act Release No. 60405 (July 30, 2009), 74 FR 39362 (August 6, 2009) (File No. 4-546) (order approving the national market system Plan Relating to Options Order Protection and Locked/Crossed Markets Submitted by the Chicago Board Options Exchange, Incorporated ("CBOE"), ISE, The NASDAQ Stock Market LLC, NASDAQ OMX BX, Inc., NASDAQ OMX PHLX, Inc., NYSE Amex LLC, and NYSE Arca, Inc.).

²¹⁵ See BOX Exchange Rule 15000 Series.

registration.²¹⁶ To qualify for registration as a market maker, a BOX Options Participant must meet the requirements established in Rule 15c3-1(a)(6)(i) under the Act and the general requirements set forth in BOX Exchange Rule 8000.²¹⁷ All market makers will be designated as specialists on the Exchange for all purposes under the Act and rules thereunder.²¹⁸ BOX Exchange will not limit the number of qualifying entities that may become market makers.²¹⁹ The registration of a market maker may be suspended or terminated by the Exchange upon a determination that such market maker failed to properly perform as a market maker, comply with BOX Exchange rules, or acted in a manner inconsistent with the best interest of fair and orderly markets.²²⁰

The Commission finds that BOX Exchange's proposed market maker qualifications requirements are consistent with the Act. In particular, BOX Exchange's rules provide an objective process by which a BOX Options Participant can become a market maker on the BOX and provide for appropriate oversight by the Exchange to monitor for continued compliance by market makers with the terms of their application for such status and the BOX Exchange Rules.

²¹⁶ See BOX Exchange Rule 8000(b) and (c).

²¹⁷ See BOX Exchange Rule 8010.

²¹⁸ See BOX Exchange Rule 8000(a).

²¹⁹ See BOX Exchange Rule 8000(e). However, BOX Exchange may limit access to the System based on System constraints, capacity restrictions, or other factors relevant to protecting the integrity of the System, pending action required to address the issue of concern. To the extent that BOX Exchange places limitations on any Participant's access to the System, such limits shall be objectively determined and submitted to the Commission for approval pursuant to a rule change filed under Section 19(b) of the Act.

²²⁰ See BOX Exchange Rule 8000(d).

The Commission notes that BOX Exchange's proposed market maker registration requirements are similar to those of other options exchanges.²²¹

b. Market Maker Obligations

Pursuant to BOX Exchange rules, the transactions of a market maker in its market making capacity must constitute a course of dealings reasonably calculated to contribute to the maintenance of a fair and orderly market.²²² Among other things, a market maker must: (1) maintain a two-sided market on a continuous basis for options classes to which it is appointed at least 60% of the time that the classes are open for trading;²²³ (2) engage in dealings for its own account when there is a lack of price continuity, a temporary disparity between the supply of and demand for a particular option contract, or a temporary distortion of the price relationships between options contracts of the same class; (3) compete with other market makers; (4) update quotations in response to changed market conditions; (5) maintain active markets; and (6) make markets that will be honored for the number of contracts entered.²²⁴ In addition, market makers must maintain minimum net capital in accordance with Commission and BOX Exchange rules.²²⁵ Market makers also must maintain information barriers that are reasonably designed to prevent the misuse of material, non-public information.²²⁶

²²¹ See, e.g., Nasdaq Rules, Chapter VII, Sections 2 and 4; Chapter VI, Section 2 of the current BOX Rules; and ISE Rule 804.

²²² See BOX Exchange Rule 8040.

²²³ See BOX Exchange Rule 8050(e). These obligations will apply to all of the Market Maker's appointed classes collectively, rather than on a class-by-class basis.

²²⁴ See BOX Exchange Rule 8040.

²²⁵ See BOX Exchange Rule 8080.

²²⁶ See BOX Exchange Rule 8090.

If BOX Exchange finds any substantial or continued failure by a market maker to engage in a course of dealings as specified in Exchange Rule 8040, then such market maker will be subject to disciplinary action, suspension, or revocation of registration in one or more of the securities in which the market maker is registered.²²⁷

Market makers receive certain benefits for carrying out their responsibilities.²²⁸ For example, a broker-dealer or other lender may extend "good faith" credit to a member of a national securities exchange or registered broker-dealer to finance its activities as a market maker or specialist.²²⁹ In addition, market makers are excepted from the prohibition in Section 11(a) of the Act.²³⁰ The Commission believes that a market maker must have sufficient affirmative obligations, including the obligation to hold itself out as willing to buy and sell options for its own account on a regular or continuous basis, to justify this favorable treatment.²³¹

The Commission further believes that the rules of all U.S. options markets need not provide the same standards for market maker participation, so long as they impose affirmative obligations that are consistent with the Act.²³² The Commission believes that BOX Exchange's market maker participation requirements impose sufficient affirmative obligations on the Exchange's market makers and, accordingly, that BOX Exchange's requirements are consistent with the Act. In particular, the Act does not mandate a particular market model for exchanges,

²²⁷ See BOX Exchange Rule 8040(f).

²²⁸ See, e.g., NOM Approval Order, supra note 122 (discussing the benefits and obligations of market makers).

²²⁹ See 12 CFR 221.5 and 12 CFR 220.7; see also 17 CFR 240.15c3-1(a)(6) (capital requirements for market makers).

²³⁰ 15 U.S.C. 78k(a).

²³¹ See NOM Approval Order, supra note 122, at 73 FR 14526.

²³² See e.g., C2 Order, supra note 29 and NOM Approval Order, supra note 122.

and while market makers may become an important source of liquidity on BOX Exchange, they will likely not be the only source as BOX is designed to match buying and selling interest of all BOX Options Participants.

4. Discipline and Oversight of Members

As noted above, one prerequisite for Commission granting an exchange's application for registration is that a proposed exchange must be so organized and have the capacity to carry out the purposes of the Act. Specifically, an exchange must be able to enforce compliance by its members and persons associated with its members with federal securities laws and the rules of the exchange.²³³

BOX Exchange rules codify BOX Exchange's disciplinary jurisdiction over its members, thereby facilitating its ability to enforce its members' compliance with its rules and the federal securities laws.²³⁴ BOX Exchange's rules permit it to sanction members for violations of its rules and violations of the federal securities laws by, among other things, expelling or suspending members; limiting members' activities, functions, or operations; fining or censuring members; suspending or barring a person from being associated with a member; or any other appropriate sanction.²³⁵

BOX Exchange's disciplinary and oversight functions will be administered in accordance with Rule 12000 Series, which governs disciplinary actions. BOX Exchange regulatory staff

²³³ See 15 U.S.C. 78f(b)(1).

²³⁴ See BOX Exchange Rule 12000 Series.

²³⁵ Id.

will, among other things, investigate potential securities laws violations and initiate charges pursuant to BOX Exchange rules.²³⁶

Upon a finding by BOX Exchange's regulatory staff (and approved by the CRO) of probable cause of a violation within the disciplinary jurisdiction of the Exchange and that further proceedings are warranted,²³⁷ BOX Exchange will conduct a hearing on disciplinary matters before a professional hearing officer²³⁸ and two members of the Hearing Committee²³⁹ (the

²³⁶ See BOX Exchange Rule 12000 Series. As noted above, BOX Exchange has entered into a RSA with FINRA under which FINRA will perform certain regulatory functions on behalf of BOX Exchange. FINRA may perform some or all of the functions specified in the Rule 12000 Series. See also BOX Exchange Rule 12150 and IM-12150-1. FINRA will: assist BOX Exchange in conducting investigations of potential violations of BOX Exchange rules and/or federal securities laws related to activity on the Exchange; conduct examinations related to BOX Option Participants' conduct on BOX Exchange; assist BOX Exchange with disciplinary proceedings pursuant to BOX Exchange rules, including issuing charges and conducting hearings; and provide dispute resolution services to BOX Option Participants on behalf of BOX Exchange, including operation of the BOX Exchange's arbitration program. See *supra* notes 236 to 243 and accompanying text.

²³⁷ See BOX Exchange Rule 12040. If there is probable cause for finding a violation, the Exchange regulatory staff will prepare a statement of charges including the allegations and specifying the provisions of the Act and/or Exchange rules, regulations or policies thereunder alleged to have been violated by the BOX Options Participant or associated person. The CRO must approve the statement of charges.

²³⁸ See BOX Exchange Rule IM-12150-1. As noted above, BOX Exchange has entered into a RSA with FINRA to provide certain regulatory functions, including providing professional hearing officers. Under BOX Exchange Rule 12060(a), the professional hearing officer is designated as the Chairman of the Panel. Under BOX Exchange Rule 12060(e), the Panel Chairman has the sole responsibility to determine the time and place of all meetings of the Panel, and make all determinations with regard to procedural or evidentiary matters, as well as prescribe the time within which all documents, exhibits, briefs, stipulations, notices or other written materials must be filed where such is not specified in Exchange rules.

²³⁹ See BOX Exchange Bylaws Section 6.08. The Hearing Committee is not a BOX Exchange Board committee but is a separate committee of BOX Exchange. Promptly after the annual meeting of the BOX Exchange owners, the Chairman of the BOX Exchange Board will appoint a Hearing Committee composed of such number of BOX Options Participants and individuals who are not BOX Options Participants, as

'Panel').²⁴⁰ The BOX Options Participant (or associated person) or the Exchange regulatory staff may petition for review of the decision of the Panel by the BOX Exchange Board.²⁴¹ The review will be conducted by the BOX Exchange Board or a committee thereof composed of at least three Directors of the BOX Exchange Board (whose decision must be ratified by a majority of the BOX Exchange Board) and such decision will be final.²⁴² In addition, the BOX Exchange Board on its own motion may order review of a disciplinary decision.²⁴³

Appeals from any termination or suspension with regard to access to the Exchange will be instituted under, and governed by, the provisions in the Rule 13000 Series of the Exchange Rules. BOX Exchange Rule Series 13000 applies to persons economically aggrieved by any of the following Exchange actions including, but not limited to: (a) denial of an application to become a BOX Options Participant; (b) prohibiting a person from becoming associated with an

determined by the Chairman, none of whom shall be Directors. The Hearing Committee or any panel thereof shall include at least one officer, director or employee of a BOX Options Participant. The Hearing Committee shall have exclusive jurisdiction to conduct hearings on disciplinary proceedings brought by the Exchange against any BOX Options Participant, or any person employed by or associated with any BOX Options Participant for any alleged violation of the Act, the rules and regulations thereunder, the BOX Exchange Bylaws or the rules, or the interpretations and stated policies of the BOX Exchange Board.

²⁴⁰ See BOX Exchange Rule 12060. A Panel may make a determination without a hearing and may impose a penalty as to violations that the BOX Options Participant or associated person has admitted or has failed to answer or that otherwise do not appear to be in dispute. See BOX Exchange Rule 12080. A BOX Options Participant or associated person alleged to have committed a disciplinary violation may submit a written offer of settlement to the Panel, or CRO if a Panel is not yet been appointed, which the Panel or CRO may accept or reject. If the second offer of settlement is rejected (such decision is not subject to review), a hearing will proceed in accordance with BOX Exchange Rule 12060. See BOX Exchange Rule 12090.

²⁴¹ See BOX Exchange Rule 12100.

²⁴² See BOX Exchange Rule 12100.

²⁴³ Id.

BOX Options Participant; (c) limiting, suspending, or prohibiting a BOX Options Participant's activities, functions or operations on BOX Exchange; or (d) limiting or denial of access to services provided to a BOX Options Participant pursuant to BOX Exchange rules.²⁴⁴

Any person aggrieved by an action of the Exchange within the scope of the 13000 Rule Series may file a written application to be heard within thirty days²⁴⁵ after such action has been taken.²⁴⁶ Applications for hearing and review will be referred to the Hearing Committee, which will appoint a hearing panel of no less than three members of such committee.²⁴⁷ The decision of the hearing panel shall be made in writing and sent to the parties to the proceedings.²⁴⁸ The decision of the hearing panel made pursuant to the 13000 Rule Series becomes final thirty calendar days after issuance unless the applicant, the Chief Executive Officer of BOX Exchange or his designee, or the BOX Exchange Board on its own motion, petitions for review of the decision.²⁴⁹ The BOX Exchange Board, or a committee of the BOX Exchange Board, will have

²⁴⁴ See BOX Exchange Rule 13000. As noted above, BOX Exchange has entered into a RSA with FINRA under which FINRA will perform certain regulatory functions on behalf of BOX Exchange. FINRA may perform some or all of the functions specified in the Rule 13000 Series. See *supra* note 236. See also BOX Exchange Rule 13060.

²⁴⁵ An applicant may file for an extension of time as allowed by the Chairman of the Hearing Committee within thirty days of the Exchange action. An application for an extension will be ruled upon by the Chairman of the Hearing Committee, and his ruling will be given in writing. Rulings on applications for extensions of time are not subject to appeal. See BOX Exchange Rule 13000.

²⁴⁶ The application must include: (1) the action for which review is sought; (2) the specific reasons for the applicant's exception to such action; (3) the relief sought; and (4) whether the applicant intends to submit any documents, statements, arguments or other material in support of the application, with a description of any such materials. See BOX Exchange Rule 13010.

²⁴⁷ See BOX Exchange Rule 13020.

²⁴⁸ See BOX Exchange Rule 13030.

²⁴⁹ See BOX Exchange Rule 13040(a).

sole discretion to grant or deny either request.²⁵⁰ The review shall be conducted by the BOX Exchange Board or a committee of the BOX Exchange board composed of at least three directors.²⁵¹ The BOX Exchange Board or its designated committee may affirm, reverse or modify in whole or in part, the decision of the hearing panel.²⁵²

The Commission finds that BOX Exchange's proposed disciplinary and oversight rules and structure, as well as its proposed process for persons economically aggrieved by certain BOX Exchange actions, are consistent with the requirements of Sections 6(b)(6) and 6(b)(7) of the Act²⁵³ in that they provide fair procedures for the disciplining of members and persons associated with members. The Commission further finds that the proposed BOX Exchange rules are designed to provide the Exchange with the ability to comply, and with the authority to enforce compliance by its members and persons associated with its members, with the provisions of the Act, the rules and regulations thereunder, and the rules of BOX Exchange.²⁵⁴

5. Listing Requirements

BOX Exchange does not intend to offer original listings. Instead, BOX Exchange will list and trade only equity and index options that are listed on other national securities exchanges and cleared by the Options Clearing Corporation.²⁵⁵ The Commission finds that BOX

²⁵⁰ Id.

²⁵¹ See BOX Exchange Rule 13040(b).

²⁵² The decision of the BOX Exchange Board or its designated committee shall be in writing, shall be sent to the parties to the proceeding, and shall be final. See BOX Exchange Rule 13040(c).

²⁵³ 15 U.S.C. 78f(b)(6) and (b)(7), respectively.

²⁵⁴ See Section 6(b)(1) of the Act, 15 U.S.C. 78f(b)(1).

²⁵⁵ BOX Exchange's listing rules for the underlying securities and indices of the options to be traded are substantially similar to the rules of another exchange. See BOX Exchange Rule 5020 and ISE Rule 502.

Exchange's proposed initial and continued listing rules are consistent with the Act, including Section 6(b)(5), in that they are designed to protect investors and the public interest and to promote just and equitable principles of trade. The Commission notes that, before beginning operation, BOX Exchange will need to become a participant in the Plan for the Purpose of Developing and Implementing Procedures Designed to Facilitate the Listing and Trading of Standardized Options Submitted Pursuant to Section 11A(a)(3)(B) of the Act ('OLPP'). In addition, before beginning operation, BOX Exchange will need to become a participant in the Options Clearing Corporation.

III. Exemption from Section 19(b) of the Act With Regard to FINRA Rules Incorporated by Reference

BOX Exchange proposes to incorporate by reference certain FINRA rules.²⁵⁶ Thus, for certain BOX Exchange rules, BOX Options Participants will comply with a BOX Exchange rule by complying with the referenced FINRA rule.

In connection with the proposal to incorporate the FINRA rules by reference, BOX Exchange requested, pursuant to Rule 240.0-12 under the Act,²⁵⁷ an exemption under Section 36 of the Act from the rule filing requirements of Section 19(b) of the Act for changes to the BOX Exchange rules that are effected solely by virtue of a change to a cross-referenced FINRA rule.²⁵⁸ BOX Exchange proposes to incorporate by reference categories of rules, rather than individual rules within a category, that are not trading rules. BOX Exchange agrees to provide

²⁵⁶ Specifically, BOX Exchange proposes to incorporate by reference the following FINRA rules: Series 12000 (Code of Arbitration for Customer Disputes) and 13000 (Code of Arbitration Procedure for Industry Disputes), referenced in Exchange Rule 14000.

²⁵⁷ 17 CFR 240.0-12.

²⁵⁸ See letter from Lisa J. Fall, President, BOX Exchange, to Elizabeth M. Murphy, Secretary, Commission, dated March 30, 2012 ('Section 19(b) Exemption Request').

written notice to BOX Options Participants whenever FINRA proposes a change to a cross-referenced rule²⁵⁹ and whenever any such proposed changes are approved by the Commission or otherwise become effective.²⁶⁰

Using the authority under Section 36 of the Act, the Commission previously exempted certain SROs from the requirement to file proposed rule changes under Section 19(b) of the Act.²⁶¹ Each exempt SRO agreed to be governed by the incorporated rules, as amended from time to time, but is not required to file a separate proposed rule change with the Commission each time the SRO whose rules are incorporated by reference seeks to modify such rules. In addition, each exempt SRO incorporated by reference only regulatory rules, for example, margin, suitability, and arbitration rules, and not trading rules, and incorporated by reference whole categories of rules. Each exempt SRO had reasonable procedures in place to provide written notice to its members each time a change is proposed to the incorporated rules of another SRO in order to provide such members with notice of a proposed rule change that affects the members' interests, so that the members will have an opportunity to comment.

The Commission is granting BOX Exchange's request for exemption, pursuant to Section 36 of the Act, from the rule filing requirements of Section 19(b) of the Act with respect to the rules that BOX Exchange proposes to incorporate by reference. The exemption is conditioned upon BOX Exchange providing written notice to BOX Options Participants whenever FINRA

²⁵⁹ See *id.*

²⁶⁰ BOX Exchange will provide such notice through a posting on the same website location where BOX Exchange posts its own rule filings pursuant to Rule 19b-4 under the Act, within the required time frame. The website posting will include a link to the location on the FINRA website where FINRA's proposed rule change is posted. See *id.*

²⁶¹ See e.g., DirectEdge Exchanges Order and BATS Order, *supra* note 21, C2 Order, *supra* note 29, Nasdaq Order, *supra* note 34 and NOM Approval Order, *supra* note 122.

proposes to change an incorporated by reference rule. The Commission believes that the exemption is appropriate in the public interest and consistent, with the protection of investors because it will promote more efficient use of Commission and SROs resources by avoiding duplicative rule filings based on simultaneous changes to identical rule text sought by more than one SRO.

IV. Conclusion

IT IS ORDERED that the application of BOX Exchange for registration as a national securities exchange be, and it hereby is, granted.

IT IS FURTHERED ORDERED that operation of BOX Exchange is conditioned on the satisfaction of the requirements below:

A. Participation in National Market System Plans Relating to Options Trading. BOX Exchange must join: (1) The Plan for the Reporting of Consolidated Options Last Sale Reports and Quotation Information (Options Price Reporting Authority); (2) the OLPP; (3) the Linkage Plan; and (4) the Plan of the Options Regulatory Surveillance Authority.

B. Participation in Multiparty Rule 17d-2 Plans. BOX Exchange must become a party to the multiparty Rule 17d-2 agreements concerning options sales practice regulation and market surveillance.

C. Participation in the Options Clearing Corporation. BOX Exchange must become an Options Clearing Corporation participant exchange.

D. Participation in the Intermarket Surveillance Group. BOX Exchange must join the Intermarket Surveillance Group.

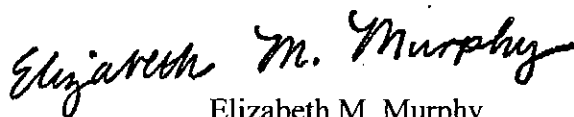
E. Effective Regulation. BOX Exchange must have, and represent in a letter to the staff in the Commission's Office of Compliance Inspections and Examinations that it has,

adequate procedures and programs in place to effectively regulate the BOX options trading facility.

F. Trade Processing and Exchange Systems. BOX Exchange must have, and represent in a letter to the staff in the Commission's Division of Trading and Markets that it has, adequate procedures and programs in place, as detailed in Commission Automation Policy Review guidelines, to effectively process trades and maintain the confidentiality, integrity, and availability of BOX Exchange's systems.²⁶²

IT IS FURTHER ORDERED, pursuant to Section 36 of the Act,²⁶³ that BOX Exchange shall be exempted from the rule filing requirements of Section 19(b) of the Act with respect to the FINRA rules that BOX Exchange proposes to incorporate by reference, subject to the conditions specified in this Order.

By the Commission.



Elizabeth M. Murphy
Secretary

²⁶² On November 16, 1989, the Commission published its first Automation Review Policy ("ARP I"), in which the Commission created a voluntary framework for SROs to establish comprehensive planning and assessment programs to determine systems capacity and vulnerability. On May 9, 1991, the Commission published its second Automation Review Policy ("ARP II") to clarify the types of review and reports expected from SROs. See Securities Exchange Act Release Nos. 27445 (November 16, 1989), 54 FR 48703 (November 24, 1989) and 29185 (May 9, 1991), 56 FR 22490 (May 15, 1991).

²⁶³ 15 U.S.C. 78mm.

*Chairman Schapiro
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 66879 / April 30, 2012

INVESTMENT ADVISERS ACT OF 1940
Release No. 3402 / April 30, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14859

In the Matter of

EDWARD D. PUTTICK, SR.,

Respondent.

ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS
PURSUANT TO SECTION 15(b) OF THE
SECURITIES EXCHANGE ACT OF 1934
AND SECTION 203(f) OF THE
INVESTMENT ADVISERS ACT OF 1940,
MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Edward D. Puttick, Sr. ("Respondent" or "Puttick").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these

proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934 and Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. From August 1991 through August 2006, Respondent was President of Advanced Planning Securities, Inc. ("Advanced Planning"), a broker-dealer that, during this period, was registered with the Commission pursuant to Section 15(b) of the Exchange Act. Puttick has been a registered representative with Waterford Investors Services, Inc., a broker-dealer and investment adviser registered with the Commission, from January 2, 2009 through the present. Puttick, age 72, resides in Setauket, New York.

2. On April 12, 2012, a final judgment was entered by consent against Puttick, permanently enjoining him from future violations of Sections 5(a) and 5(c) of the Securities Act of 1933, in the civil action entitled Securities and Exchange Commission v. Charles C. Slowey, Jr., et al., Civil Action Number 09 Civ. 4547 (LDW) (ETB), in the United States District Court for the Eastern District of New York.

3. The Commission's complaint alleges that from approximately March 2004 through August 2006, Puttick authorized registered representatives at Advanced Planning to sell interests in the Endeavor Real Estate Fund I, LLC, Endeavor Real Estate Fund II, LLC, Endeavor America Fund, LLC, and Windsor Lake Estates, LLC (collectively, the "Endeavor Funds"). There was no registration statement in effect for interests in the Endeavor Funds, and no exemption from the registration requirements applied to these interests.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Puttick's Offer.

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b) of the Exchange Act and Section 203(f) of the Exchange Act, that Respondent Puttick be, and hereby is:

- (a) suspended from association with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent for a period of twelve months, effective on the second Monday following entry of this Order; and
- (b) suspended from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock for a period of twelve months, effective on the second Monday following entry of this Order.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

2

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 66882 / April 30, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14860

In the Matter of

MICHAEL J. MCNERNEY,

Respondent.

ORDER OF SUSPENSION PURSUANT
TO RULE 102(e)(2) OF THE
COMMISSION'S RULES OF PRACTICE

I.

The Securities and Exchange Commission deems it appropriate to issue an order of forthwith suspension of Michael J. McNerney pursuant to Rule 102(e)(2) of the Commission's Rules of Practice [17 C.F.R. 200.102(e)(2)].¹

II.

The Commission finds that:

1. McNerney was an attorney admitted to practice in Florida.

2. On August 26, 2011, a judgment of conviction was entered against McNerney in *United States v. McNerney*, No. 08-CR-21158-CR-JORDAN, in the United States District Court for the Southern District of Florida, finding him guilty of one count of conspiracy to commit mail and wire fraud in violation of 18 U.S.C. § 371. McNerney's conduct was in connection with his representation of Mutual Benefits Corporation, a viatical services provider sued by the Commission for securities fraud in *Securities and Exchange Commission v. Mutual Benefits Corp., et al.*, No. 04-60573-CIV-MORENO (S.D. Fla.) (May 4, 2004).

¹ Rule 102(e)(2) provides in pertinent part: "Any...person who has been convicted of a felony or a misdemeanor involving moral turpitude shall be forthwith suspended from appearing or practicing before the Commission."

3. As a result of this conviction, McNerney was sentenced to 60 months imprisonment in a federal penitentiary and ordered to pay restitution in the amount of \$826,839,642.

III.

In view of the foregoing, the Commission finds that McNerney has been convicted of a felony within the meaning of Rule 102(e)(2) of the Commission's Rules of Practice.

Accordingly, it is ORDERED, that Michael J. McNerney is forthwith suspended from appearing or practicing before the Commission pursuant to Rule 102(e)(2) of the Commission's Rules of Practice.

By the Commission.

Elizabeth M. Murphy
Secretary


By: Jill M. Peterson
Assistant Secretary

*Commissioner Aguilar
Commissioner Gallagher
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Release No. 66876 / April 30, 2012

ADMINISTRATIVE PROCEEDING

File No. 3-14858

In the Matter of

LocatePlus Holdings Corporation

Respondent.

ORDER INSTITUTING
ADMINISTRATIVE
PROCEEDINGS AND NOTICE
OF HEARING PURSUANT TO
SECTION 12(j) OF THE
SECURITIES EXCHANGE ACT
OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondent LocatePlus Holdings Corporation, and any successor under Exchange Act Rules 12b-2 and 12g-3 or new corporate name, ("Respondent" or "LocatePlus").

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT

LocatePlus (CIK No. 0001160084) is a Delaware corporation located in Beverly, Massachusetts that provides online access to public record databases for investigative searches. LocatePlus has a class of securities that is registered with the Commission pursuant to Section 12(g) of the Exchange Act and is currently quoted under the symbol LPHCQ.PK on OTC Link operated by OTC Markets Group Inc. LocatePlus' fiscal year ends on December 31 and it files as a smaller reporting company. On October 14, 2010, the Commission filed a civil injunctive action against LocatePlus alleging violations of the antifraud, books and records, and periodic reporting provisions of the federal securities laws. That action remains pending. On June 17, 2011, LocatePlus filed a Form 8-K reporting that it and its subsidiaries had filed a voluntary petition under

Chapter 11 of the U.S. Bankruptcy Code in the U.S. Bankruptcy Court for the District of Massachusetts.

B. MATERIAL DEFICIENCIES AND DELINQUENT FILINGS

1. Respondent is delinquent in its periodic filings with the Commission. In particular, LocatePlus filed a materially deficient Form 10-K for the 2010 fiscal year, filed a materially deficient Form 8-K on May 3, 2011, and filed a materially deficient Form 10-Q for the first quarter of 2011. In addition, LocatePlus failed to file Forms 10-Q for the second and third quarters of 2011.

2. On April 14, 2011, LocatePlus filed a Form 10-K that contained financial statements for the fiscal year ended December 31, 2010. The financial statements contained in this Form 10-K are unaudited and the filing was materially deficient because Respondent's independent accountant issued a qualified audit opinion on those financial statements.

3. On May 3, 2011, LocatePlus filed a Form 8-K to report a change in its independent accountant. This filing was materially deficient because Respondent failed to address certain items required by Regulation S-K Item 304, which pertains to mandatory disclosures when reporting changes in and disagreements with accountants on accounting and financial disclosure. Specifically, LocatePlus did not provide any information in the Form 8-K concerning whether it had (i) any disagreements with its terminated accountant, (ii) any reportable events that had occurred between the date of its last audited financial statements and the date it terminated its prior accountant, or (iii) any consultations with its new independent accountants about any such disagreements with the prior accountants or any reportable events.

4. On May 6, 2011, LocatePlus filed a Form 10-Q to report its financial results for the first quarter of 2011 (the quarter ended March 31, 2011) that compared current financial results with those from fiscal 2010, which were unaudited. This filing was materially deficient because Respondent's independent accountant did not review the filing in conjunction with audited financial statements for the prior fiscal year.

5. To date, the deficiencies in the Form 10-K filed on April 14, 2011, Form 8-K filed on May 3, 2011, and Form 10-Q filed on May 6, 2011 have not been cured.

6. LocatePlus is delinquent in filing its other recent required periodic reports since the Form 10-Q for the quarter ended March 31, 2011.

7. Section 13(a) of the Exchange Act and the rules promulgated thereunder require issuers of securities registered pursuant to Section 12 of the Exchange Act to file with the Commission current and accurate information in periodic reports. Specifically, Rule 13a-1 requires issuers to file annual reports (Forms 10-K or 10-KSB), Rule 13a-11 requires issuers to file current reports (Form 8-K), and Rule 13a-13 requires issuers to file quarterly reports (Forms 10-Q or 10-QSB).

8. Section 13(a)(2) of the Exchange Act requires annual reports to be certified by independent public accountants if required by the rules and regulations of the Commission.

9. Rule 8-02 under Article 8 of Regulation S-X requires smaller reporting companies following the end of their fiscal year to file an audited balance sheet, and statements of income and cash flows.

10. Rule 8-03 under Article 8 of Regulation S-X requires smaller reporting companies to file interim financial statements with a balance sheet as of the end of the issuer's preceding fiscal year.

11. Items 304(a)(1)(iv) and 304(a)(1)(v) of Regulation S-K require a reporting company to disclose, when reporting a change in its independent accountant, whether there were any disagreements or reportable events for the two most recent fiscal years, or any subsequent interim period, before the termination of the prior independent accountant.

12. Item 304(a)(2) of Regulation S-K requires a reporting company to disclose, if it engaged a new independent accountant within the company's two most recent fiscal years, or any subsequent interim period, information about certain consultations with its newly-engaged accountants, including consultations about disagreements with the company's former accountants and reportable events..

13. As a result of its violation of Rules 8-02 and 8-03 of Article 8 of Regulation S-X and Items 304(a)(1)(iv), 304(a)(1)(v) and 304(a)(2) of Regulation S-K, Respondent failed to comply with Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11 and 13a-13 thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate for the protection of investors that public administrative proceedings be instituted to determine:

A. Whether the allegations contained in Section II are true and, in connection therewith, to afford the Respondent an opportunity to establish any defenses to such allegations; and

B. Whether it is necessary or appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of, each class of securities of the Respondent registered pursuant to Section 12 of the Exchange Act.

IV.

IT IS HEREBY ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and

place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice [17 C.F.R. § 201.110].

IT IS HEREBY FURTHER ORDERED that Respondent shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If Respondent fails to file the directed Answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default and the proceedings may be determined against it upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondent personally or by certified, registered, or Express Mail, or by other means of verifiable delivery.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 120 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice [17 C.F.R. § 201.360(a)(2)].

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

*Commissioner Aguilar
Commissioner Gallagher
not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

April 30, 2012

IN THE MATTER OF

LocatePlus Holdings Corporation

File No. 500-1

ORDER OF SUSPENSION
OF TRADING

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of LocatePlus Holdings Corporation ("LocatePlus") because it has not filed any periodic reports since the period ended March 31, 2011.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed company, and any equity securities of any entity purporting to succeed to this issuer. Therefore, it is ordered, pursuant to Section 12(k) of the Exchange Act, that trading in the securities of the above-listed company, and any equity securities of any entity purporting to succeed to this issuer, is suspended for the period from 9:30 a.m. EDT on April 30, 2012, through 11:59 p.m. EDT on May 11, 2012.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

44 of 44

