



# Federal Register

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## Part III

### Commodity Futures Trading Commission

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17 CFR Part 1

### Securities and Exchange Commission

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17 CFR Part 240

Further Definition of “Swap Dealer,”  
“Security-Based Swap Dealer,” “Major  
Swap Participant,” “Major Security-Based  
Swap Participant” and “Eligible Contract  
Participant”; Proposed Rule

**COMMODITY FUTURES TRADING COMMISSION****17 CFR Part 1**

RIN 3038-AD06

**SECURITIES AND EXCHANGE COMMISSION****17 CFR Part 240**

[Release No. 34-63452; 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"**

**AGENCY:** Commodity Futures Trading Commission; Securities and Exchange Commission.

**ACTION:** Joint proposed rule; proposed interpretations.

**SUMMARY:** In accordance with Section 712(d)(1) of 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, are proposing rules and interpretative guidance under the Commodity Exchange Act ("CEA"), 7 U.S.C. 1 *et seq.*, and the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. 78a *et seq.*, to further define the terms "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant," and "eligible contract participant."

**DATES:** Submit comments on or before February 22, 2011.

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

CFTC:

- *Agency Web site*, via its Comments Online process: <http://comments.cftc.gov>. Follow the instructions for submitting comments through the Web site.

- *Mail*: David A. Stawick, Secretary, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581.

- *Hand Delivery/Courier*: Same as mail above.

- *Federal eRulemaking Portal*: Comments also may be submitted at <http://www.regulations.gov>. Follow the instructions for submitting comments.

"Definitions" must be in the subject field of responses submitted via e-mail, and clearly indicated on written submissions. All comments must be submitted in English, or if not, accompanied by an English translation. All comments provided in any electronic form or on paper will be published on the CFTC Web site, without review and without removal of personally identifying information. All comments are subject to the CFTC Privacy Policy.

**SEC***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](mailto:rule-comments@sec.gov). Please include File Number S7-39-10 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 S7-39-10. 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 Web site (<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for Web site 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 a.m. and 3 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:**

CFTC: Mark Fajfar, Assistant General Counsel, at 202-418-6636, [mfajfar@cftc.gov](mailto:mfajfar@cftc.gov), Julian E. Hammar, Assistant General Counsel, at 202-418-5118, [jhammar@cftc.gov](mailto:jhammar@cftc.gov), or David E. Aron, Counsel, at 202-418-6621, [daron@cftc.gov](mailto:daron@cftc.gov), Office of General Counsel, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581; SEC: Joshua Kans, Senior Special Counsel, Jeffrey Dinwoodie, Attorney Advisor, or Richard Grant, 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.<sup>1</sup> Title VII of the Dodd-Frank Act<sup>2</sup> established a comprehensive new regulatory framework for swaps and security-based swaps. The legislation was enacted, among other reasons, to reduce risk, increase transparency, and promote market integrity within the financial system, including by: (1) Providing for the registration and comprehensive regulation of swap dealers, security-based swap dealers, major swap participants and major security-based swap participants; (2) imposing clearing and trade execution requirements on swaps and security-based swaps, subject to certain exceptions; (3) creating rigorous recordkeeping and real-time reporting regimes; and (4) enhancing the rulemaking and enforcement authorities of the Commissions with respect to, among others, all registered entities and intermediaries subject to the Commissions' oversight.

More specifically, the Dodd-Frank Act provides that the CFTC will regulate "swaps," and the SEC will regulate "security-based swaps." The Dodd-Frank Act also adds to the CEA and Exchange Act definitions of the terms "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant," and "eligible contract participant." These terms are defined in Sections 721 and 761 of the Dodd-Frank Act and, with respect to the term "eligible contract participant," in Section 1a(18) of the CEA,<sup>3</sup> as re-designated and amended by Section 721 of the Dodd-Frank Act.

Section 712(d)(1) of the Dodd-Frank Act provides that the CFTC and the SEC, in consultation with the Board of Governors of the Federal Reserve System, shall jointly further define the terms "swap," "security-based swap," "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant," "eligible contract participant," and "security-based swap agreement."

<sup>1</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 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>.

<sup>2</sup> Pursuant to Section 701 of the Dodd-Frank Act, Title VII may be cited as the "Wall Street Transparency and Accountability Act of 2010."

<sup>3</sup> See 7 U.S.C. 1a(18).

Further, 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,” and Section 761(b) of the Dodd-Frank Act permits the SEC to adopt a rule to further define the terms “security-based swap,” “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 of the Dodd-Frank Act.<sup>4</sup>

In light of the requirements in the Dodd-Frank Act noted above, the CFTC and the SEC issued a joint Advance Notice of Proposed Rulemaking (“ANPRM”) on August 13, 2010, requesting public comment regarding the definitions of “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” in Title VII of the Dodd-Frank Act.<sup>5</sup> The Commissions reviewed more than 80 comments in response to the ANPRM. The Commissions also informally solicited comments on the definitions on their respective Web sites.<sup>6</sup> In addition, the staffs of the CFTC and the SEC have met with many market participants and other interested parties to discuss the definitions.<sup>7</sup>

In this release, the Commissions propose to further define “swap dealer,” “security-based swap dealer,” “major swap participant,” “major security-based swap participant” and “eligible contract participant,” and propose related rules, and also discuss certain factors that are relevant to market participants when determining their status with respect to the defined terms. In developing these proposals, the Commissions have been mindful that the markets for swaps and security-based swaps are evolving, and that the rules that we adopt will, as intended by the Dodd-Frank Act,

significantly affect those markets. The rules not only will help determine which entities will be subject to comprehensive regulation of their swap and security-based swap activities, but may also cause certain entities to modify their activities to avoid being subject to the regulations. As a result, we are aware of the importance of crafting these rules carefully to maximize the benefits of the regulation imposed by the Dodd-Frank Act, and to do so in a way that is flexible enough to respond to market developments. While we preliminarily believe that these proposals, if adopted, would appropriately effect the intent of the Dodd-Frank Act, we are very interested in commenters’ views as to whether we have achieved this purpose, and, if not, how to improve these proposals.<sup>8</sup>

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

The Dodd-Frank Act defines the terms “swap dealer” and “security-based swap dealer” in terms of whether a person engages in certain types of activities involving swaps or security-based swaps.<sup>9</sup> Persons that meet either of those definitions are subject to statutory requirements related to, among other things, registration, margin, capital and business conduct.<sup>10</sup>

The two definitions in general encompass persons that engage in any of the following types of activity:

<sup>8</sup> In addition, we recognize that the appropriateness of these proposals also should be considered in light of the substantive requirements that will be applicable to dealers and major participants, including capital, margin and business conduct requirements, which are the subject of separate rulemakings. For example, whether the definition of a major participant is too broad or too narrow may well depend in part on the substantive requirements applicable to such entities, and whether those substantive requirements are themselves appropriate may in turn depend in part on the scope of the major participant definition. We therefore encourage comments that take into account the interplay between the proposed definitions and these substantive requirements.

<sup>9</sup> See Section 721 of the Dodd-Frank Act (defining “swap dealer” in new Section 1a(49) of the CEA, 7 U.S.C. 1a(49)) and Section 761 of the Dodd-Frank Act (defining “security-based swap dealer” in new Section 3(a)(71) of the Exchange Act, 15 U.S.C. 78c(a)(71)).

<sup>10</sup> The Dodd-Frank Act excludes from the Exchange Act definition of “dealer” persons who engage in security-based swap transactions 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 are a type of security, persons who act as brokers in connection with security-based swaps must, absent an 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.

(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

(iv) Engaging in activity causing oneself to be commonly known in the trade as a dealer or market maker in swaps or security-based swaps.<sup>11</sup>

The definitions are disjunctive, in that a person that engages in any of the enumerated dealing activities is a swap dealer or security-based swap dealer even if the person does not engage in any of the other enumerated activities.

The definitions, in contrast, do not include a person that enters into swaps or security-based swaps “for such person’s own account, either individually or in a fiduciary capacity, but not as a part of a regular business.”<sup>12</sup> The Dodd-Frank Act also instructs the Commissions to exempt from designation as a dealer an entity 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.”<sup>13</sup> 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.”<sup>14</sup>

The definitions also provide that a person may be designated as a dealer for one or more types, classes or categories of swaps, security-based swaps, or activities without being designated a dealer for other types, classes or categories or activities.<sup>15</sup>

The Commissions are proposing rules to further define certain aspects of the meaning of “swap dealer” and “security-based swap dealer,” and are providing guidance on how the Commissions propose to interpret these terms. This release specifically addresses: (A) The types of activities that would cause a person to be a swap dealer or security-based swap dealer, including differences in how those two definitions should be applied; (B) the statutory provisions requiring the Commissions to exempt persons from the dealer

<sup>11</sup> See CEA section 1a(49)(A); Exchange Act section 3(a)(71)(A).

<sup>12</sup> See CEA section 1a(49)(C); Exchange Act section 3(a)(71)(C).

<sup>13</sup> See CEA section 1a(49)(D); Exchange Act section 3(a)(71)(D).

<sup>14</sup> CEA section 1a(49)(A).

<sup>15</sup> See CEA section 1a(49)(B); Exchange Act section 3(a)(71)(B).

<sup>4</sup> The definitions of the terms “swap,” “security-based swap,” and “security-based swap agreement,” and regulations regarding mixed swaps are the subject of a separate rulemaking by the Commissions.

<sup>5</sup> See Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act, Exchange Act Rel. No. 34-62717, 75 FR 51429 (Aug. 20, 2010). The comment period for the ANPRM closed on September 20, 2010.

<sup>6</sup> Comments were solicited by the CFTC at [http://www.cftc.gov/LawRegulation/DoddFrankAct/OTC\\_2\\_Definitions.html](http://www.cftc.gov/LawRegulation/DoddFrankAct/OTC_2_Definitions.html) and the SEC at <http://www.sec.gov/spotlight/regreformcomments.shtml/>.

<sup>7</sup> The views expressed in the comments in response to the ANPRM, in response to the Commissions’ informal solicitation, and at such meetings are collectively referred to as the views of “commenters.”

definitions in connection with *de minimis* activity; (C) the exception from the “swap dealer” definition in connection with loans by insured depository institutions; (D) the possibility that a person may be considered a dealer for some types, classes or categories of swaps, security-based swaps, or activities but not others; and (E) certain interpretative issues that arise in particular situations. The Commissions request comment on all aspects of the proposals, including the particular points noted in the discussion below.

#### A. Swap and Security-Based Swap Dealing Activity

##### 1. Comments Regarding Dealing Activities

Commenters provided numerous examples of conduct they viewed as dealing activities—as well as conduct they did not view as dealing activities. For example, many of the commenters stated that dealers provide “bid/ask” or “two-way” prices for swaps on a regular basis, or regularly participate in both sides of the swap market. Some commenters indicated that dealers perform an intermediary function. Other commenters stated that a person holds itself out as a dealer if it consistently and systematically markets itself as a swap dealer to third parties. Some commenters described market makers in the swap markets as persons that stand ready to buy or sell swaps at all times, are open to doing swaps business on both sides of a market, or make bids to buy and offers to sell swaps or a type of swap at all times. Commenters stated that a person should be included in the definition of dealer if its sole or dominant line of business is swaps activity. One commenter urged the Commissions to adopt a swap association’s definition of a primary member as the definition of dealer.

Some commenters stated that the definition of dealer should be read narrowly. For example, some commenters suggested that the market maker concept should not encompass persons that provide occasional quotes or that do not make bids or offers consistently or at all times. Another commenter stated that a willingness to buy or sell a swap or security-based swap at a particular time does not constitute market making absent the creating of a two-way market. One commenter suggested that solely acting as a market maker should not cause a person to be a dealer, since firms may have commercial purposes for offering two-way trades. Another commenter stated that an entity that “holds itself

out” as a dealer should qualify as a swap dealer only if it “consistently and systematically markets itself as a dealer to third-parties.”<sup>16</sup>

Many commenters called for the exclusion of particular types of persons from the definition of swap dealer or security-based swap dealer. Several commenters maintained that commercial end-users of swaps or security-based swaps that enter into swaps or security-based swaps to hedge or mitigate commercial risk should be excluded from the definitions. Another commenter stated the definitions should exclude persons who use swaps or security-based swaps for bona fide hedging. Other commenters indicated that cooperatives that enter into swaps in connection with the business of their members should be excluded. Commenters also stated that if all of a person’s swaps are cleared on an exchange or derivatives clearing organization, the person should not be deemed to be a dealer. One commenter stated competitive power suppliers should be excluded, and another stated that the dealer definition should not apply to futures commission merchants that act economically like brokers.

Commenters, particularly those in the securities industry, urged the Commissions to interpret the definitions of swap dealer and security-based swap dealer consistently with precedent that distinguishes between dealers in securities and traders in securities. However, one commenter also noted that some concepts from the securities and commodities laws may not easily be applied to these markets.

##### 2. Application of the Core Tests to “Swap Dealers” and “Security-Based Swap Dealers”

The Dodd-Frank Act defines the terms “swap dealer” and “security-based swap dealer” in a functional manner, encompassing how a person holds itself out in the market, the nature of the conduct engaged in by the person, and how the market perceives the person’s activities. This suggests that the definitions should not be interpreted in a constrained or overly technical manner. Rigid standards would not provide the necessary flexibility to respond to evolution in the ways that dealers enter into swaps and security-based swaps. The different types of swap and security-based swap markets

are diverse, and there does not appear to be a single set of criteria that can be determinative in all markets.

At the same time, we note that there may be certain distinguishing characteristics of swap dealers and security-based swap dealers, including that:

- Dealers tend to accommodate demand for swaps and security-based swaps from other parties;
- Dealers are generally available to enter into swaps or security-based swaps to facilitate other parties’ interest in entering into those instruments;
- Dealers tend not to request that other parties propose the terms of swaps or security-based swaps; rather, dealers tend to enter into those instruments on their own standard terms or on terms they arrange in response to other parties’ 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.

We also recognize that the principles relevant to identifying dealing activity involving swaps can differ from comparable principles associated with security-based swaps. These differences are due, in part, to differences in how those instruments are used. For example, because security-based swaps may be used to hedge or gain economic exposure to underlying securities (while recognizing distinctions between securities-based swaps and other types of securities, as discussed below), there is a basis to build upon the same principles that are presently used to identify dealers for other types of securities. Accordingly, we separately address how the core tests would apply to swap dealers and to security-based swap dealers.

##### a. Application to Swap Dealers

The definition of swap dealer should be informed by the differences between swaps, on the one hand, and securities and commodities, on the other. Transactions in cash market securities and commodities generally involve purchases and sales of tangible or intangible property. Swaps, in contrast, are notional contracts requiring the performance of agreed terms by each party.<sup>17</sup> Thus, many of the concepts cited by commenters, such as whether a person buys and sells swaps or makes a two-sided market in swaps or trades within a bid/offer spread, cannot

<sup>16</sup> See letter from Eric Dennison, Sr. Vice President and General Counsel, Stephanie Miller, Assistant General Counsel—Commodities, and Bill Hellinghausen, Director of Regulatory Affairs, EDF Trading, dated September 20, 2010 (distinguishing transactions that the commenter enters into as part of energy management services).

<sup>17</sup> As discussed below, however (*see* note 42, *infra*), the Dodd-Frank Act amended the Exchange Act definitions of “buy,” “purchase,” “sale” and “sell” to apply to particular actions involving security-based swaps.

necessarily be applied to all types of swaps to determine if the person is a swap dealer. We understand that market participants do use this terminology colloquially to describe the process of entering into a swap. For example, a person seeking a fixed/floating interest rate swap may inquire as to the fixed rates, spread above the floating rate and other payments that another person would require in order to enter into a swap. But, while these persons may discuss bids, offers, prices and so forth, the parties are negotiating the terms of a contract, they are not negotiating the price at which they will transfer ownership of tangible or intangible property. Accordingly, these concepts are not determinative of whether a person is a “swap dealer.”

Instead, persons who are swap dealers may be identified by the functional role they fulfill in the swap markets. As noted above, swap dealers tend to accommodate demand and to be available to enter into swaps to facilitate other parties’ interest in swaps (although swap dealers may also advance their own investment and liquidity objectives by entering into such swaps). In addition, swap dealers can often be identified by their relationships with counterparties. 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, non-dealers tend to enter into swaps with swap dealers more often than with other non-dealers.<sup>18</sup> The Commissions can most efficiently achieve the purposes underlying Title VII of the Dodd-Frank Act—to reduce risk and to enhance operational standards and fair dealing in the swap markets—by focusing their attention on those persons whose function is to serve as the points of connection in those markets. The definition of swap dealer, construed functionally in the manner set forth above, will help to identify those persons.

Clause (A)(iii) of the statutory definition of swap dealer, which includes any person that “regularly enters into swaps with counterparties as an ordinary course of business for its own account,”<sup>19</sup> has been the subject of

<sup>18</sup> Some of the commenters appeared to suggest that significant parts of the swap markets operate without the involvement of swap dealers. We believe that this analysis is likely incorrect, and that the parties that fulfill the function of dealers should be identified and are likely to be swap dealers.

<sup>19</sup> We interpret this reference to a person entering into swaps “with counterparties \* \* \* for its own account” to refer to a person entering into a swap as a principal, and not as an agent. A person who

significant uncertainty among commenters. The commenters point out that its literal terms could encompass many parties who regularly enter into swaps without engaging in any form of swap dealing activity. In this regard, clause (A)(iii) of the definition should be read in combination with the express exception in subparagraph (C) of the swap dealer definition, which excludes “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.” Thus, the difference between the inclusion in clause (A)(iii) and the exclusion in subparagraph (C) is whether or not the person enters into swaps as a part of, or as an ordinary course of, a “regular business.”<sup>20</sup> We believe 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. Conversely, persons who do not fulfill this function should not be deemed to enter into swaps as part of a “regular business” and are not likely to be swap dealers.

In sum, to determine if a person is a swap dealer, we would consider that person’s activities in relation to the other parties with which it interacts in the swap markets. If the person is available to accommodate demand for swaps from other parties, tends to propose terms, or tends to engage in the other activities discussed above, then the person is likely to be a swap dealer. Persons that rarely engage in such activities are less likely to be deemed swap dealers.

We request comment on this interpretive approach for identifying whether a person is a swap dealer.

#### b. Application to Security-Based Swap Dealers

The definition of “security-based swap dealer” has parallels to the definition of “dealer” under the Exchange Act.<sup>21</sup> In addition, security-

entered into swaps as an agent for customers (*i.e.*, for the customers’ accounts) would be required to register as either a Futures Commission Merchant, Introducing Broker, Commodity Pool Operator or Commodity Trading Advisor, depending on the nature of the person’s activity.

<sup>20</sup> The definition of “security-based swap dealer” is structured similarly, and should be interpreted similarly.

<sup>21</sup> The Exchange Act in relevant part defines “dealer” to mean “any person engaged in the business of buying and selling securities (not including security-based swaps, other than security-based swaps with or for persons that are not eligible contract participants) for such person’s own account through a broker or otherwise,” but with an exception for “a person that buys or sells securities

based swaps may be used to hedge risks associated with the ownership of certain other types of securities,<sup>22</sup> and security-based swaps may be used to gain economic exposure akin to ownership of certain other types of securities.<sup>23</sup> As a result, the SEC would consider the same factors that are relevant to determining whether a person is a “dealer” under the Exchange Act as also generally relevant to the analysis of whether a person is a security-based swap dealer.

The Exchange Act has been interpreted to distinguish between “dealers” and “traders.” In this context, 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).<sup>24</sup>

Other non-exclusive factors that are relevant for distinguishing between dealers and non-dealers can include the receipt of customer property and the furnishing of incidental advice in connection with transactions.

The markets involving security-based swaps are distinguishable in certain respects from markets involving cash market securities—particularly with regard to the concepts of “inventory” (which generally appears inapplicable in this context)<sup>25</sup> and “regular place of business.” For example, the suggestion that dealers are more likely to operate at a “regular place of business” than traders should not be construed in a way that ignores the reality of how the security-based swap markets operate (or that

(not including security-based swaps, other than security-based swaps with or for persons that are not eligible contract participants) for such person’s own account, either individually or in a fiduciary capacity, but not as a part of a regular business.” Exchange Act sections 3(a)(5)(A) and (B), 15 U.S.C. 78c(a)(5)(A) and (B), as amended by Section 761(a)(1) of the Dodd-Frank Act.

<sup>22</sup> For example, an entity that owns a particular security may use a security-based swap to hedge the risks of that security. Conversely, an entity may seek to offset exposure involving a security-based swap by using another security as a hedge.

<sup>23</sup> For example, an entity may enter into a security-based swap to gain economic exposure akin to a long or short position in a stock or bond, without having to engage in a cash market transaction for that instrument.

<sup>24</sup> Securities Exchange Act Release No. 47364 (Feb. 13, 2003) (footnotes omitted).

<sup>25</sup> In particular, an analysis that considers dealers to differ from traders in part because dealers have regular turnover in “inventory” appears not to apply in the context of security-based swaps, given that those instruments are created by contract between two market counterparties, rather than reflecting financial rights issued by third-parties.

ignores evolution in dealing practices involving other types of securities). Dealers may use a variety of methods to communicate their availability to enter into security-based swaps with other market participants. The dealer-trader distinction should not be applied to the security-based swap markets without taking those distinctions into account.<sup>26</sup> Even in light of those differences, however, we believe that the dealer-trader distinction provides an important analytical tool to assist in determining whether a person is a “security-based swap dealer.”

Commenters have raised concerns that the ambit of the security-based swap dealer definition could encompass end-users that use security-based swaps for hedging their business risks. Deeming those entities to be security-based swap dealers due to their hedging activities could discourage their use of hedging transactions or subject them to a regulatory framework that was not intended to address their businesses and could subject them to unnecessary costs. Under the dealer-trader distinction, however, we would expect entities that use security-based swaps to hedge their business risks, absent other activity, likely would not be dealers.<sup>27</sup> Also, as discussed below, both the “security-based swap dealer” definition and the dealer-trader distinction in part turn on whether a person holds itself out as a dealer.

We request comment on the application of the dealer-trader distinction as part of the analysis of whether a person is a security-based swap dealer.

<sup>26</sup> The definition of “security-based swap dealer,” unlike the Exchange Act’s definition of “dealer,” does not specifically refer to “buying” and “selling.” We do not believe that this language difference is significant, however, 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 Dodd-Frank Act sections 761(a)(3), (4) (amending Exchange Act sections 3(a)(13), (14)).

<sup>27</sup> Of course, if a person’s other activities satisfy the definition of security-based swap dealer, it must comply with the applicable requirements with regard to all of its security-based swap activities, absent an order to the contrary, as discussed below. Also, as discussed below, we would expect end-users to use security-based swaps for hedging purposes less commonly than they use swaps for hedging purposes.

#### c. Issues Common to Both Definitions

##### i. Holding Oneself Out as, and Being Commonly Known in the Trade as, a Swap Dealer or Security-Based Swap Dealer

As noted above, the application of these definitions to persons that “hold themselves out” as dealers or that are “commonly known in the trade” as dealers highlights the need for a functional interpretation of the dealer definitions. We believe that factors that may reasonably indicate that a person is holding itself out as a dealer or is commonly known in the trade as a dealer may include (but are not limited to) the following:

- 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 Web site) 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.

Notably, holding oneself out as a security-based swap dealer would likely encompass a situation in which a person that is a “dealer” in another type of security enters into a security-based swap with a customer.<sup>28</sup> Another example of holding oneself out as a security-based swap dealer would likely be an entity expressing its availability to provide liquidity to counterparties that seek to enter into security-based swaps, regardless of the “direction” of the transaction or across a broad spectrum of risks (e.g., credit default swaps related to a variety of issuers).

The determination of who is commonly known in the trade as a swap

<sup>28</sup> For example, if a person that is a dealer in securities that are not security-based swaps enters into a security-based swap transaction with one of its cash market customers, the person would appear to be engaged in security-based swap dealing activity with that customer. In that circumstance, the customer reasonably would be expected to view the person as a dealer for purposes of the security-based swap, making the applicable business conduct requirements particularly important.

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 an entity is known as a dealer by persons without that experience and knowledge.

##### ii. Making a Market in Swaps or Security-Based Swaps

A number of commenters suggested that the market making component of the definitions should apply only to persons that quote a two-sided market consistently or at all times. Some commenters also suggested that a person’s willingness to buy or to sell a swap or security-based swap at any particular time should not be deemed to be market making activity. While continuous two-sided quotations and a willingness to stand ready to buy and sell a security are important indicators of market making in the equities markets,<sup>29</sup> these indicia may not be appropriate in the context of the swap or security-based swap markets, given that parties do not enter into many types of swaps or security-based swaps on a continuous basis, and that parties may use a variety of methods for communicating their willingness to enter into swaps or security-based swaps. Any analysis that would impute to the definitions a “continuous” activity requirement may cause certain persons that engage in non-continuous dealing activities not to be regulated as swap dealers or security-based swap dealers. We have not identified anything in the statutory text or legislative history of the Dodd-Frank Act to suggest that Congress intended such a result.

##### iii. No Predominance Test

Although some commenters suggested that a person should be a swap dealer or security-based swap dealer only if such activity is the person’s sole or predominant business, the statutory definition does not contain a predominance test or otherwise depend upon the level of the person’s dealing activity, other than the *de minimis* exception discussed below. A predominance standard would not

<sup>29</sup> See Exchange Act Release No. 58875 (Oct. 14, 2008), 73 FR 61690 (Oct. 17, 2008) (“Although determining whether or not a market maker is engaged in bona-fide market making would depend on the facts and circumstances of the particular activity, factors that indicate a market maker is engaged in bona-fide market making activities may include, for example, whether the market maker incurs any economic or market risk with respect to the securities (e.g., by putting their own capital at risk to provide continuous two-sided quotes in markets).”).

provide a workable test of dealer status because many of the parties that are commonly acknowledged as swap or security-based swap dealers also engage in other businesses that often outweigh their swap or security-based swap dealing business in terms of transaction volume or other measures. 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 or security-based swap dealer.<sup>30</sup>

#### iv. Application of the Definition to New Types of Swaps and New Activities

The Commissions intend to apply the definitions of swap dealer and security-based swap dealer flexibly when the development of innovative business models is accompanied by new types of dealer activity. As discussed above, the Commissions generally intend to follow a “facts-and-circumstances” approach with respect to identifying dealing activities. The dealer definitions must be flexible enough to cover appropriate persons as the swap markets evolve.

#### v. Request for Comment

The Commissions request comment on these interpretations of holding oneself out as a dealer and being commonly known in the trade as a dealer, as well as the lack of a predominance test, and the application of the definitions to new types of swaps and new activities. Commenters particularly are requested to address the relevance, to the dealer analysis, of activities such as an entity’s membership in a swap execution facility (“SEF”) or a security-based SEF, or use of facilities that may not be SEFs or security-based SEFs. Are there factors that would lead entities to become members of SEFs that would not make membership relevant to the dealer analysis? Commenters also are requested to generally address how the dealer analysis should appropriately apply the requirements applicable to dealers (e.g., capital, margin and business conduct requirements) to the entities that should be subject to those requirements. In addition, commenters are requested to address how the dealer definitions should be applied to entities such as, for example, Federal home loan banks subject to restrictions limiting their dealing activities to particular types of counterparties. Finally,

<sup>30</sup> As one example, a non-financial company that engages in both swap dealing and other commercial activities would fall within the definition of swap dealer because of its swap dealing activities, notwithstanding that it also engages in other commercial activities.

commenters are requested to address whether additional guidance is advisable to help identify dealer activity and to promote effective enforcement of the requirements applicable to swap dealers and security-based swap dealers.

#### 3. Designation of a Person as a Swap Dealer

The Dodd-Frank Act has amended the CEA and the Exchange Act to require a person that meets either of the definitions to register as a swap dealer and/or security-based swap dealer,<sup>31</sup> and the Commissions are proposing separate rules regarding this registration requirement. In connection with the registration requirement, market participants are in a position to assess their activities to determine whether they function in the manner described in the definitions. In addition, the Commissions have the authority to take enforcement actions in response to a dealer’s failure to register. In determining whether a person meets the applicable definitions, the Commissions may use information from other regulators, swap data repositories, registered clearing agencies, derivatives clearing organizations and other sources.

#### 4. Application of the Swap Dealer Definition to Agricultural Commodities

Section 723(c)(3)(B) of the Dodd-Frank Act provides that swaps in agricultural commodities shall be subject to such terms and conditions as the CFTC may prescribe. In a separate rulemaking, the CFTC has proposed a definition of the term “agricultural commodity.”<sup>32</sup> Acting under the authority in Section 723(c)(3)(B), the CFTC may develop particular terms and conditions for the interpretation of the swap dealer definition when it is applied to dealing in swaps in agricultural commodities. Any such terms and conditions would not be applicable to the definition of security-based swap dealer. The CFTC requests 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. The CFTC may consider any comments on this topic for both the definition of swap dealer and also for any rulemaking regarding swaps in agricultural commodities.

<sup>31</sup> See CEA section 4s(a)–(b); Exchange Act section 15F(a)–(b).

<sup>32</sup> See 75 FR 65586 (Oct. 26, 2010).

#### B. De Minimis Exemption to the Definitions

The Dodd-Frank Act requires that the Commissions exempt, from designation as a “swap dealer” or “security-based swap dealer,” a person who “engages in a *de minimis* quantity of [swap or security-based swap] dealing in connection with transactions with or on behalf of its customers.”<sup>33</sup> The statutory definitions do not require that the Commissions fix a specific level of swap activity that will be considered *de minimis*, but instead require that the Commissions “promulgate regulations to establish factors with respect to the making of this determination to exempt.”

#### 1. Comments Regarding the De Minimis Exemption

Some commenters asserted that the *de minimis* exemption should be linked to systemic risk concerns, stating that persons engaged in dealing activities that do not pose systemic risk should be able to take advantage of the exemption. Other commenters suggested that a person’s dealing activities should be considered *de minimis* if they do not pose undue risks to the person. Commenters also expressed the view that the application of the exemption should be based on quantitative criteria.

#### 2. Proposed Rule Regarding the De Minimis Exemption

The Commissions preliminarily believe that the “*de minimis*” exemption 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.<sup>34</sup> In other words, the exemption should apply only when an entity’s dealing activity is so minimal that applying dealer regulations to the entity would not be warranted.

We thus preliminarily do not agree with those commenters that argued that

<sup>33</sup> See CEA section 1a(49)(D); Exchange Act section 3(a)(71)(D).

<sup>34</sup> The Title VII requirements applicable to swap and security-based swap dealers include, for example: requirements that dealers conform to regulatory standards relating to the confirmation, processing, netting, documentation and valuation of swaps and security-based swaps (CEA section 4s(i), Exchange Act section 15F(i)); requirements that dealers disclose, to regulators, information concerning terms and conditions of swaps or security-based swaps, as well as information concerning trading practices, financial integrity protections and other trading information (CEA section 4s(j)(3), Exchange Act section 15F(j)(3)); conflicts of interest provisions (CEA section 4s(j)(5), Exchange Act section 15F(j)(5)); and chief compliance officer requirements (CEA section 4s(k), Exchange Act section 15F(k)).



a *de minimis* quantity of dealing should be measured in relation to the level of the person's other activities (or other swap or security-based swap activities). Aside from the fact that the statute does not explicitly call for a relative test, such an approach would lead to the result that larger and more active companies, which presumably would be more able to influence the swap markets, would be more likely to qualify for the exemption than smaller and less active companies. Also, a relative test not only would require a means of measuring the person's dealing activities, but also would require a means of measuring the larger scope of activities to which its swap dealing or security-based swap dealing activities are to be compared, thus introducing unnecessary complexity to the exemption's application.

Our proposed factors for the *de minimis* exemption seek to focus the availability of the exemption toward entities for which registration would not be warranted from a regulatory point of view in light of the limited nature of their dealing activities. At the same time, we recognize that this focus does not appear to readily translate into objective criteria. Thus, while the proposed factors discussed below reflect our attempt to delimit the *de minimis* exemption appropriately, we recognize that a range of alternative approaches may be reasonable, and we are particularly interested in commenters' suggestions as to the appropriate factors.

The first proposed factor is that the aggregate effective notional amount, measured on a gross basis, of swaps or security-based swaps that an entity enters into over the prior 12 months in connection with its dealing activities<sup>35</sup> could not exceed \$100 million.<sup>36</sup> We understand that in general the notional size of a small swap or security-based swap is \$5 million or less, and this

<sup>35</sup> The *de minimis* exemption specifically places limits on a person's dealing activity involving swaps or security-based swaps. Thus, these limits would not apply to swap or security-based swap activity that does not itself constitute dealing activity, such as activity in which a person hedges or mitigates a commercial risk of its business that is unrelated to a dealing business (*i.e.*, as discussed above, when the person did not accommodate demand from the other party, respond to the other party's interest in swaps or security-based swaps, solicit the other party, propose economic terms, intermediate between parties, provide liquidity, or engage in other dealing activities). See part II.A.2, *supra*.

<sup>36</sup> See proposed CEA rule 1.3(ppp)(4)(ii); proposed Exchange Act rule 3a71-2(a). To the extent that the stated notional amount of a swap or security-based swap is leveraged or enhanced by its structure, the calculation shall be based on the effective notional amount of the swap or security-based swap rather than on its stated notional amount.

proposed threshold would reflect 20 instruments of that size. Given the customer protection issues raised by swaps and security-based swaps—including the risks that counterparties may not fully appreciate when entering into swaps or security-based swaps—we believe that this notional amount reflects a reasonable limit for identifying those entities that engage in a *de minimis* level of dealing activity.<sup>37</sup> This standard would measure an entity's quantity of dealing on a gross basis (without consideration of the market risk offsets associated with combining long and short positions) to reflect the entity's overall amount of dealing activity. Similarly, the proposed notional threshold would not account for the amount of collateral held by or provided by the entity, nor other risk mitigating factors, in determining whether it engages in a *de minimis* quantity of dealing, given that dealer status focuses on an entity's absolute level of activity, and is not directly based on the risks that an entity poses or faces.<sup>38</sup>

In addition, the aggregate effective notional amount of such swaps or security-based swaps, in which the person's counterparty is a "special entity" (as that term is defined in CEA Section 4s(h)(2)(C) and Exchange Act Section 15F(h)(2)(C)),<sup>39</sup> that an entity enters into over the prior 12 months could not exceed \$25 million.<sup>40</sup> The Dodd-Frank Act provided special protections to special entities in connection with swaps and security-based swaps, and we preliminarily believe that this lower proposed threshold reasonably reflects the special protections afforded to those entities.

In addition, to take advantage of the *de minimis* exemption, the proposed rule would provide that the entity could not have entered into swaps or security-based swaps (as applicable) as a dealer with more than 15 counterparties, other than security-based swap dealers, over the prior 12 months.<sup>41</sup> The

<sup>37</sup> We preliminarily believe that activity above this amount would be sufficient to warrant dealer registration to bring about the benefits of such registration.

<sup>38</sup> Also, allowing offsets for collateral would result in a *de minimis* standard that could encompass positions of virtually unlimited size.

<sup>39</sup> The term "special entity" encompasses: 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.

<sup>40</sup> See proposed CEA rule 1.3(ppp)(4)(ii); proposed Exchange Act rule 3a71-2(b).

<sup>41</sup> See proposed CEA rule 1.3(ppp)(4)(iii); proposed Exchange Act rule 3a71-2(c). That these tests measure the entity's activities over the prior

Commissions preliminarily believe that an entity that enters into swaps or security-based swaps, in a dealer capacity, with a larger number of counterparties should be registered to help achieve Title VII's orderly market goals, and thus cannot be said to engage in a *de minimis* quantity of dealing (even if the aggregate effective notional amount of the swaps or security-based swaps is less than the thresholds noted above).<sup>42</sup> For purposes of determining the number of counterparties, we preliminarily believe that counterparties who are members of an affiliated group would generally count as one counterparty, given that the purpose of the limit is to measure the scope of dealer's interaction with separate counterparties.<sup>43</sup>

Finally, the proposed rule would provide that, to take advantage of the *de minimis* exemption, the entity could not have entered into more than 20 swaps or security-based swaps (as applicable) as a dealer during the prior 12 months.<sup>44</sup> As is the case for the limitation on the number of counterparties, the Commissions preliminarily believe that an entity that enters into a larger number of swaps or security-based swaps, in a dealer capacity, would, if registered, help achieve Title VII's orderly market goals, and thus cannot be said to engage in a *de minimis* quantity of dealing. For these purposes, we would expect that each separate transaction the entity enters into under a swap or security-based swap master agreement in general would count as entering into a swap or security-based swap, but that an amendment of an existing swap or security-based swap in which the counterparty remained the same and the underlying item remained substantially the same would not count as a new swap or security based swap.<sup>45</sup>

12 months provides certainty. As of the end of each month, the entity will know whether it may qualify for the exemption during the following month.

<sup>42</sup> Similarly, because all the *de minimis* factors must be satisfied, a person who enters into only a single swap or security-based swap, as a swap dealer, with a single counterparty could not qualify for the *de minimis* exemption if that swap or security-based swap exceeds the effective notional amount threshold.

<sup>43</sup> For this purpose, an affiliated group would be defined as any group of entities that is under common control and that reports information or prepares its financial statements on a consolidated basis.

<sup>44</sup> See proposed CEA rule 1.3(ppp)(4)(iv); proposed Exchange Act rule 3a71-2(d).

<sup>45</sup> For these purposes only, an amendment to an existing swap or security-based swap would not need to be counted as a new swap or security-based swap if the underlying item is substantially the same as the original item. This may occur, for example, to reflect the effect of a corporate action such as a merger. An amendment would be counted as a new swap or security-based swap, however, to



The proposed rule would not distinguish between different types of swaps or security-based swaps into which entities may enter (e.g., rate swaps versus other commodity swaps, or credit default swaps versus equity swaps). The Commissions preliminarily do not believe that the ceiling for distinguishing *de minimis* dealing activities from other dealing activities appropriately turns upon the particular type of swap or security-based swap.<sup>46</sup>

The Commissions request comment on the proposed rule regarding the *de minimis* exemption. Commenters particularly are requested to address whether certain of the proposed factors should be modified or eliminated; for example, should the proposed \$100 million limit on annual notional swaps or security-based swaps entered into in a dealer capacity be raised or lowered to better implement the intended scope of the *de minimis* exemption—i.e., to exclude entities for which dealer regulation would not be warranted? Should we adopt different thresholds that would appropriately limit the exemption so it encompasses only those entities whose dealing activities are such that dealer regulation is not warranted? To what extent would certain entities be expected to reduce or otherwise adjust their dealing activity to fall within the scope of the *de minimis* exemption? Would there be any adverse implications for market participants if this happens? To what extent could the proposed factors potentially reduce dealing activity, and in doing so reduce the liquidity available in the swap or security-based swap market?

Commenters also are requested to address whether the rule should seek to identify only certain types of counterparties with which a person could engage in dealing activities under the exemption. We also particularly request comment on the proposed \$25 million notional threshold for dealer transactions with “special entities,” including whether that proposed threshold should be raised or lowered, and whether an entity that enters into dealing transactions with “special entities” should be able to take advantage of the exemption at all. In addition, we request comment on

the extent that the change in the underlying item modifies the economic risk reflected by the swap or security-based swap.

<sup>46</sup> The Exchange Act’s definition of “dealer” does not include a *de minimis* exemption. Thus, an entity that engages in dealing activity involving securities (other than security-based swaps with eligible contract participants) would be required to register as a “dealer” under the Exchange Act, and comply with the Exchange Act’s requirements applicable to dealers, absent some other exception or exemption from registration.

whether the proposed threshold for transactions with “special entities” would provide a disincentive to dealers entering into transactions with such entities.

Commenters further are requested to address whether the factors may appropriately account for the size of the swap or security-based swap activities compared to the size of the entity; how an entity’s swaps or security-based swaps with affiliated counterparties should be treated for purposes of the test; and whether the exemption’s factors should vary depending on the type of swap or security-based swap at issue.

In addition, commenters are requested to address the significance of the fact that the statutory *de minimis* exemption specifically references transactions with or on behalf of a customer. Does that mean the exemption was intended to specifically address dealing activity as an accommodation to an entity’s customers? If so, should the exemption be conditioned on the presence of an existing relationship between the entity and the counterparty that does not entail swap or security-based swap dealing activity, and if so, which types of relationships should be treated as creating a “customer” relationship?

Commenters also are requested to address whether the *de minimis* exemption should excuse an entity from having to comply with certain regulatory requirements imposed on swap dealers or security-based swap dealers, while also mandating compliance with other dealer requirements. In addition, commenters are requested to address whether, in lieu of the self-executing approach proposed here, the Commissions instead should require that entities which seek relief under this *de minimis* exemption must submit exemptive requests to the relevant agency for the agency’s consideration and action. Commenters further are requested to address whether the proposed notional threshold for the *de minimis* exception should be subject to a formula that permits automatic periodic adjustments to the threshold, such as to reflect changes in market size or in the size of typical contracts.

### C. Statutory Exclusion for Swaps in Connection With Originating a Loan

The “swap dealer” definition 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.”<sup>47</sup> This exclusion does not

appear in the definition of “security-based swap dealer.”

#### 1. Comments Regarding the Exclusion for Swaps in Connection With Loans

Three IDIs commented on this aspect of the definition, stating that the exclusion should encompass any swap entered into contemporaneously with a loan that is related to any of the borrower’s activities that affect the ability to repay the loan and can be hedged. Thus, in their view, the exclusion should cover exchange rate and physical commodity swaps in addition to interest rate swaps. The IDIs also said the exclusion should apply to amendments, restructurings and workouts of loans, and to lenders that act through a syndicate.

Another commenter expressed similar views, and also asked for clarification whether the exclusion applies to all aspects of the definition, or if it applies only to whether a person is commonly known in the trade as a swap dealer. The CFTC preliminarily believes the exclusion applies to all aspects of the swap dealer definition.

#### 2. Proposed Rule Regarding the Exclusion for Swaps in Connection With Loans

The CFTC preliminarily interprets the word “offer” in this exclusion to include scenarios where the IDI requires the customer to enter into a swap, or the customer asks the IDI to enter into a swap, specifically in connection with a loan made by that IDI. Also, the proposed rule provides that, in order to prevent evasion, the statutory exclusion does not apply where (i) The purpose of the swap is not linked to the financial terms of the loan; (ii) the IDI enters into a “sham” loan; or (iii) the purported “loan” is actually a synthetic loan such as a loan credit default swap or loan total return swap.

The proposed rule would apply the statutory exclusion only to swaps that are connected to the financial terms of the loan, such as, for example, its duration, interest rate, currency or principal amount. Although commenters urged that this exclusion be extended to other aspects of the lending relationship, we preliminarily believe that it would not be appropriate that this exclusion from the swap dealer definition encompass swaps that are connected to the borrower’s other business activities, even if the loan agreement requires that the borrower enter into such swaps or otherwise refers to them. We preliminarily believe that a broader reading of the exclusion could encompass all swap activity

<sup>47</sup> See CEA section 1a(49)(A).

between an IDI and its borrowers, which we do not think is intended.

The origination of commercial loans is a complex process, and the CFTC preliminarily believes that this exclusion should be available to all IDIs that are a source of funds to a borrower. For example, all IDIs that are part of a loan syndicate providing a loan to a borrower could claim this exclusion with respect to swaps entered into with the borrower that are connected to the financial terms of the loan. Similarly, the proposed exclusion could be claimed with respect to such swaps entered into by any IDI that participates in or obtains a participation in such loan by means of a transfer or otherwise.<sup>48</sup> Also, an IDI that is a source of funds for the refinancing of a loan (whether directly or through a syndicate, participation or otherwise) could claim the exclusion if it enters into a swap with the refinancing borrower.

We emphasize that this proposed exclusion, by its statutory terms, is available only to IDIs. 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.

In sum, the proposed exclusion may be claimed by a person that meets the following three conditions: (i) The person is an IDI; (ii) the person is the source of funds to a borrower in connection with a loan (either directly or through syndication, participation, refinancing or otherwise); and (iii) the person enters into a swap with the borrower that is connected to the financial terms of the loan (so long as the loan is not a sham or a synthetic loan).

The CFTC requests comment on the proposed rule relating to the statutory exclusion for swaps in connection with originating a loan, and in particular on whether this statutory exclusion should be extended beyond swaps that are connected to the financial terms of the loan, and if so, why. The CFTC also requests 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 should also apply to swaps entered into during part or all of the duration of the loan.

#### *D. Designation as a Dealer for Certain Types, Classes, or Categories of Swaps, Security-Based Swaps, or Activities*

The statutory definitions include a provision stating that a person may be designated as a dealer for one or more types, classes or categories of swaps, security-based swaps, or activities without being considered a swap dealer or security-based swap dealer for other types, classes or categories of swaps, security-based swaps, or activities. This provision is permissive and does not require the Commissions to designate persons as dealers for only a limited set of types, classes or categories of swaps, security-based swaps, or activities.

##### 1. Comments Regarding Limited Designation as a Swap Dealer or Security-Based Swap Dealer

One commenter stated that the Commissions should allow a person to register as a swap dealer or security-based swap dealer for only a limited set of types, classes or categories of swaps or security-based swaps. Another commenter expressed the view that a person designated as a swap dealer or security-based swap dealer should be designated as such for all types of swaps or security-based swaps, respectively.

##### 2. Proposed Rule Regarding Limited Designation as a Swap Dealer or Security-Based Swap Dealer

In general, the Commissions propose that a person that satisfies the definition of swap dealer or security-based swap dealer would be a dealer for all types, classes or categories of swaps or security-based swaps, or activities involving swaps or security-based swaps, in which the person engages.<sup>49</sup> Thus, the person would be subject to all regulatory requirements applicable to dealers for all swaps or security-based swaps into which it enters. We propose this approach because it may be difficult for swap dealers and security-based swap dealers to separate their dealing activities from their other activities involving swaps or security-based swaps.<sup>50</sup>

The proposed rule also states, however, that the Commissions may provide for a person to be designated as a swap dealer or security-based swap

dealer for only specified categories of swaps, security-based swaps, or activities, without being classified as a dealer for all categories.<sup>51</sup> This proposed rule would afford persons an opportunity to seek, on an appropriate showing, a limited designation based on facts and circumstances applicable to their particular activities. The Commissions anticipate that a swap dealer could seek a limited designation at the same time as, or at a later time subsequent to, the person's initial registration as a swap dealer.

The CFTC understands that there may potentially be non-financial entities, such as physical commodity firms, that conduct swap dealing activity through a division of the entity, and not a separately-incorporated subsidiary. In these instances, the entity's swap dealing activity would not be a core component of the entity's overall business. If this type of entity registered as a swap dealer, the CFTC anticipates that certain swap dealer requirements would apply to the swap dealing activities of the division, but not necessarily to the swap activities of other parts of the entity.

The Commissions request comment on the proposed rules regarding limited designation as a swap dealer or security-based swap dealer. Commenters particularly are requested to address the circumstances in which such limited purpose designations would be appropriate, the factors that the Commissions should consider when addressing such requests, and the type of information requestors should provide in support of their request. For example, would it be appropriate to grant such limited purpose designations only to entities that do not otherwise fall within the definition of a financial entity, and whose dealing activity is below a defined threshold of the entity's overall activity? At what level should the Commissions set such a threshold? Which of the requirements applicable to dealers should or should not apply to such entity's non-dealing activities in swaps and security-based swaps?

In addition, commenters are requested to address whether the Commissions should provide for limited purpose designations of swap dealers or security-based swap dealers through some other mechanism as an alternative to, or in

<sup>48</sup> The CFTC preliminarily believes that the proposed exclusion could be claimed by any IDI that participates in a loan through any means that involves a payment to a lender to take the place of that lender, including an "English style" participation.

<sup>49</sup> See proposed CEA rule 1.3(ppp)(3); proposed Exchange Act rule 3a71-1(c).

<sup>50</sup> For example, in order to efficiently impose the dealer requirements on only the person's dealing activities, it may be necessary for the person to have separate books and records and a separate compliance regime for its dealing activities.

<sup>51</sup> CEA section 1a(49)(B); Exchange Act section 3(a)(71)(B). As discussed below, the Commissions preliminarily believe that there are four major categories of swaps and two major categories of security-based swaps. See part IV.A, *infra*. The designation as a swap dealer or security-based swap dealer may, for example, be limited in terms of these categories or in terms of particular activities of the person.

addition to, case-by-case evaluations of individual applications. If so, what criteria and procedures would be appropriate for making limited purpose designations through this type of approach? Also, should the limited purpose designation apply on a provisional basis starting at the time that the entity makes an application for a limited purpose designation?

Finally, commenters also are asked to address whether such limited purpose designations should be conditioned in any way, such as by the provision of information of the type that would be required with respect to an entity's swaps or security-based swaps involving the particular category or activity for which they are not designated as a dealer.

#### E. Certain Interpretative Issues

##### 1. Affiliate Issues

We preliminarily believe that the word "person" in the swap dealer and security-based swap dealer definitions should be interpreted to mean that the designation applies with respect to a particular legal person. That is, for example, we would not view a trading desk or other discrete business unit that is not a separately organized legal person as a swap dealer; rather, the legal person of which it is a part would be the swap dealer. Also, an affiliated group of legal persons under common control could include more than one dealer. Within such a group, any legal person that engages in swap or security-based swap dealing activities would be a swap dealer or security-based swap dealer, as applicable.

In determining whether a particular legal person is a swap dealer or security-based swap dealer, we preliminarily believe it would be appropriate for the person to consider the economic reality of any swaps and security-based swaps it enters into with affiliates (*i.e.*, legal persons under common control with the person at issue), including whether those swaps and security-based swaps simply represent an allocation of risk within a corporate group.<sup>52</sup> Swaps and security-based 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

<sup>52</sup> Such swaps and security-based swaps should be considered in this way only for purposes of determining whether a particular person is a swap dealer or security-based swap dealer and does not necessarily apply in the context of the Exchange Act's general definition of "dealer." The swaps and security-based swaps, moreover, would continue to be subject to all laws and requirements applicable to such swaps and security-based swaps.

commonly known as a dealer. To the extent, however, that an entity seeks to use transactions between persons under common control to avoid one of the dealer definitions, the Commissions have the authority to prohibit practices designed to evade the requirements applicable to swap dealers and security-based swap dealers.<sup>53</sup>

The Commissions invite comment as to how the swap dealer and security-based swap dealer definitions should be applied to members of an affiliated group. Commenters particularly are invited to address how the Commissions should interpret common control for these purposes, and whether this interpretation should be limited to wholly-owned affiliates.

##### 2. Application to Particular Swap Markets

The swap markets are diverse and encompass a variety of situations in which parties enter into swaps with each other. We believe it is helpful to the understanding of the rule to discuss some of these situations, particularly those that have been raised by commenters, here. The situations discussed below include persons who enter into swaps as aggregators, as part of their participation in physical markets, or in connection with the generation and transmission of electricity. We invite comment as to what aspects of the parties' conduct in these situations should, or should not, be considered swap dealing activities, and whether the parties involved in these situations are swap dealers.

##### a. Aggregators

Commenters explained that some persons 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, or otherwise to make entering into such swaps more efficient. For example, certain cooperatives enter into swaps with smaller cooperatives, smaller businesses or their members in order to establish a position in a commodity that is large enough to be traded on a swap or futures market. Similarly, one smaller financial institution explained that it enters into swaps with counterparties whose swap positions would not be large enough to be of interest to larger financial

<sup>53</sup> See Dodd-Frank Act sections 721(b)(2), 761(b)(3). For example, it would not be permissible for an entity that provides liquidity on one side of the market to use affiliated entities to provide liquidity on the other side in an attempt to avoid having to register as a swap or security-based swap dealer.

institutions. This institution stated that it enters into offsetting swaps with larger financial institutions so that it is in a neutral position between the counterparties and the larger financial institutions.

The result of these arrangements is that such persons engage in activities that are similar in many respects to those of a swap dealer as set out in the definition—the person enters into swaps to accommodate demand from other parties, it enters into swaps with a relatively large number of non-dealers, and it holds itself out as willing to enter into swaps. 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, in particular, requests comment as to how the *de minimis* threshold would apply to such persons. If their activity would exceed the *de minimis* threshold set forth in the proposed rule, the Commissions request comment on the application of the swap dealer definition to their activity.

##### b. Physical Market Participants

The markets in physical commodities such as oil, natural gas, chemicals and metals are complex and varied. They involve a large number of market participants that, over time, have developed highly customized transactions and market practices that facilitate efficiencies in their market in unique ways. Some of these transactions would be encompassed by the statutory definition of "swap," and some participants in these markets engage in swap dealing activities that are above the proposed *de minimis* threshold. The Commissions invite comment as to any different or additional factors that should be considered in applying the swap dealer definition to participants in these markets.

##### c. Electricity Generation and Transmission

The use of swaps in the generation and transmission of electricity is highly complex because electricity cannot be stored and therefore is generated, transmitted and used on a continuous, real-time basis. Also, 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. Nevertheless, some participants engage in swap dealing activities as described above that are above the *de minimis* threshold set forth in the proposed rule. The Commissions invite 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 Commissions invite comment on whether there are special considerations, including without limitation special considerations arising from section 201(f) of the Federal Power Act, related to non-profit, public power systems such as rural electric cooperatives and entities operating as political subdivisions of a State, and the applicability of the exemptive authority in section 722(f) of the Dodd-Frank Act to address those considerations.

### III. Amendments to Definition of Eligible Contract Participant

#### A. Overview

The Commodity Futures Modernization Act of 2000 ("CFMA")<sup>54</sup> generally excluded or exempted transactions between eligible contract participants ("ECPs") from most provisions of the CEA.<sup>55</sup> Section 723(a)(1)(A) of the Dodd-Frank Act repeals those exclusions and exemptions. ECP status remains important, however, because Section 723(a)(2) of the Dodd-Frank Act renders it unlawful for a non-ECP to enter into a swap other than on, or subject to the rules of, a designated contract market ("DCM").<sup>56</sup> Section 763(e) of the Dodd-Frank Act also renders it unlawful for a non-ECP to enter into a security-based swap unless such transaction is effected on a national securities exchange registered pursuant to Section 6(b) of the Exchange Act.<sup>57</sup> In addition, Section 768(b) of the Dodd-Frank Act makes it

unlawful for a non-ECP to enter into a security-based swap unless a registration statement is in effect. While this means that non-ECPs cannot enter into swaps on SEFs or on a bilateral, off-exchange basis, it also opens swaps to non-ECPs, so long as the swaps are entered into on, or subject to the rules of, a DCM. Similarly, while non-ECPs cannot enter into security-based swaps unless the transaction is effected on a national securities exchange and the security-based swap has an effective registration statement, it also opens security-based swaps to non-ECPs.

Congress also amended<sup>58</sup> the ECP definition in Section 721(a)(9) of the Dodd-Frank Act by: (1) Raising a threshold that governmental entities may use to qualify as ECPs, in certain situations, from \$25 million in discretionary investments to \$50 million in such investments; and (2) replacing the "total asset" standard for individuals to qualify as ECPs with a discretionary investment standard.<sup>59</sup>

#### B. Commenters' Views

The ECP definition elicited comment from nine commenters. The comments ranged from requests not to increase the monetary thresholds for governmental employee benefit plans in certain instances to suggestions to dramatically raise them across the board, and from requests not to change the definition in a way that would limit the commenter's access to swaps to specific proposals to address such otherwise limited access.

In the Dodd-Frank Act, Congress addressed aspects of the ECP definition that it found to be of particular concern regarding governmental entities and individuals. Otherwise, though, persons who qualified for exclusions or exemptions to enter into bilateral, off-exchange swaps prior to the Dodd-Frank Act will still qualify to do so with respect to non-standardized swaps under the Dodd-Frank Act, with the exceptions discussed below. We have not identified any legislative history

suggesting that Congress intended the Commissions to undertake a wholesale revision of the ECP definition. Accordingly, the Commissions are limiting the further definition of the term ECP to the discrete issues discussed below.

#### C. New ECP categories

The CEA definition of ECP generally is comprised of regulated persons;<sup>60</sup> entities defined as ECPs based on a total asset test (e.g., a corporation, partnership, proprietorship, organization, trust, or other entity with total assets exceeding \$10 million)<sup>61</sup> or an alternative monetary test coupled with a non-monetary component (e.g., an entity with a net worth in excess of \$1 million and engaging in business-related hedging;<sup>62</sup> or certain employee benefit plans, the investment decisions of which are made by one of four enumerated types of regulated entities<sup>63</sup>); and certain governmental entities and individuals that meet defined thresholds.<sup>64</sup>

Persons in the new major swap participant, major security-based swap participant, swap dealer and security-based swap dealer categories are likely to be among the most active and largest users of swaps and security-based swaps. Accordingly, the Commissions propose to further define the term ECP to include these new categories, which will permit such persons to enter into swaps and security-based swaps on SEFs and on a bilateral basis (where otherwise permitted under the Dodd-Frank Act and regulations thereunder).

We seek comment on this proposed expansion of the ECP definition.

#### D. Relationship Between Retail Foreign Currency and ECP Status in the Context of a Commodity Pool

Prior to the Dodd-Frank Act, clause (A)(iv) of the ECP definition provided that a commodity pool was an ECP if the pool and its operator met certain requirements (i.e., the commodity pool has \$5 million in total assets and is operated by a commodity pool operator regulated under the CEA or subject to

<sup>54</sup> Public Law 106-554, 114 Stat. 2763 (Dec. 21, 2000).

<sup>55</sup> See CEA sections 2(d) (Excluded Derivative Transactions), 2(e) (Excluded Electronic Trading Facilities), 2(g) (Excluded Swap Transactions) and 2(h) (Legal Certainty for Certain Transactions in Exempt Commodities) (7 U.S.C. 2(d), (e), (g), (h)). The CFMA also excluded swap agreements from the definitions of "security" in Section 3(a)(10) of the Exchange Act and Section 2(a)(1) of the Securities Act. See Section 3A of the Exchange Act, 15 U.S.C. 78c-1, and Section 2A of the Securities Act, 15 U.S.C. 77b-1 (both of which have been modified by the Dodd-Frank Act). The CFMA, however, provided that the SEC had antifraud authority over security-based swap agreements.

<sup>56</sup> Section 723(a)(2) of the Dodd-Frank Act adds new subsection (e) to CEA section 2 (7 U.S.C. 2(e)). New CEA section 2(e) provides 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."

<sup>57</sup> Section 763(e) of the Dodd-Frank Act adds paragraph (l) to Exchange Act section 6. New Exchange section 6(l) provides 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)."

<sup>58</sup> The changes to the ECP definition made by the Dodd-Frank Act originated in the Administration's "White Paper" on financial regulatory reform. See Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation, available at [http://www.financialstability.gov/docs/regs/FinalReprot\\_web.pdf](http://www.financialstability.gov/docs/regs/FinalReprot_web.pdf), at 48-49 (June 17, 2009) ("Current law seeks to protect unsophisticated parties from entering into inappropriate derivatives transactions by limiting the types of counterparties that could participate in those markets. But the limits are not sufficiently stringent.")

<sup>59</sup> The monetary component of ECP status for individuals remains the same under the amended ECP definition: More than \$10 million (but now in discretionary investments, not in total assets), or \$5 million if the transactions for which ECP status is necessary are for risk management of an asset or liability the individual owns or incurs, or is reasonably likely to own or incur.

<sup>60</sup> CEA section 1a(18)(A)(i), (ii), (iii), (iv), (viii), (ix), (x) (7 U.S.C. 1a(18)(A)(i), (ii), (iii), (iv), (viii), (ix), (x)), as redesignated by Section 721(a)(9) of the Dodd-Frank Act.

<sup>61</sup> CEA section 1a(18)(A)(v)(I) (7 U.S.C. 1a(18)(A)(v)(I)), as redesignated by Section 721(a)(9) of the Dodd-Frank Act.

<sup>62</sup> CEA section 1a(18)(A)(v)(III) (7 U.S.C. 1a(18)(A)(v)(III)), as redesignated by Section 721(a)(9) of the Dodd-Frank Act.

<sup>63</sup> CEA section 1a(18)(A)(vi) (7 U.S.C. 1a(18)(A)(vi)), as redesignated by Section 721(a)(9) of the Dodd-Frank Act.

<sup>64</sup> CEA sections 1a(18)(A)(vii) and (xi) (7 U.S.C. 1a(18)(A)(vii) and (xi)), as redesignated by Section 721(a)(9) of the Dodd-Frank Act.

foreign regulation), regardless of whether each pool participant was itself an ECP.<sup>65</sup> Section 741(b)(10) of the Dodd-Frank Act amended clause (A)(iv) of the ECP definition to provide that a commodity pool engaging in retail foreign currency transactions of the type described in CEA sections 2(c)(2)(B) or 2(c)(2)(C);<sup>66</sup> “retail forex” and such pools, “Retail Forex Pools”) no longer qualifies as an ECP for those purposes if any participant in the pool is not independently an ECP. The Commissions believe 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. Clause (A)(v) of the ECP definition applies to business entities irrespective of their form of organization (*i.e.*, corporations, partnerships, proprietorships, organizations, trusts and other entities), and contains a \$1 million net worth test where such an entity “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.”<sup>67</sup>

The Commissions believe that permitting Retail Forex Pools with one or more non-ECP participants to achieve ECP status by relying on clause (A)(v) of the ECP definition would frustrate the intent of Congress in denying ECP status to Retail Forex Pools under clause (A)(iv). Consequently, the Commissions propose to further define the term ECP to preclude a Retail Forex Pool with one or more non-ECP participants from qualifying as an ECP by relying on clause (A)(v) of the ECP definition if such Retail Forex Pool is not an ECP due to the language added to clause (A)(iv) of the ECP definition by section 741(b)(10) of the Dodd-Frank Act (*i.e.*, because the pool contains one or more non-ECP participants). Because commodity pools can be structured in various ways and can have one or more feeder funds and/or pools, many with

their own participants, the Commissions propose to preclude a Retail Forex Pool from being an ECP pursuant to clause (A)(iv) of the ECP definition if there is a non-ECP participant at any investment level (*e.g.*, a participant in the pool itself (a direct participant), an investor or participant in a fund or pool that invests in the pool in question (an indirect participant), an investor or participant in a fund or pool that invests in that investor fund or pool (also an indirect participant), *etc.*).

Similarly, the Commissions believe that 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. The Commissions are of the view 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. Therefore, the Commissions propose to further define the term ECP to prevent such an entity from qualifying as an ECP pursuant to clause (A)(v) of the ECP definition.

#### E. Request for comment

The Commissions request comment on all aspects of the proposed amendments to the definition of “eligible contract participant.” Are the proposed interpretations with respect to Retail Forex Pools and other commodity pools appropriate? Do entities described in the various enumerated ECP categories (other than commodity pools) rely on clause (A)(v) to qualify as ECPs? If so, should an entity that would be described in one of the clauses of paragraph (A) of the ECP definition, but cannot satisfy the conditions prescribed in that clause, be prohibited from relying on clause (A)(v) of the ECP definition?

In addition, should the Commissions further narrow any or all of the ECP categories? Why or why not? If so, what additional conditions would be appropriate? Should the Commissions define the term “discretionary basis,” as requested by one commenter, either solely for purposes of clause (A)(vii) or clause (A)(xi), or for both clauses? Alternatively, should the Commissions add any additional categories of ECPs, such as the following categories suggested by commenters: 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? If so, which ones and why?

#### IV. Definitions of “Major Swap Participant” and “Major Security-Based Swap Participant”

The definitions of “major swap participant” and “major security-based swap participant” (also jointly referred to as the “major participant” definitions) respectively focus on the market impacts and risks associated with an entity’s swap and security-based swap positions. In this respect, the major participant definitions differ from the definitions of “swap dealer” and “security-based swap dealer,” which focus on an entity’s activities and account for the amount or significance of those activities only in the context of the *de minimis* exception.

Despite those differences in focus, persons that meet the major participant definitions in large part must follow the same statutory requirements that apply to swap dealers and security-based swap dealers.<sup>68</sup> 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.<sup>69</sup>

The major participant definitions are similar in their key provisions, although one exception, as discussed below, is available only in connection with the “major swap participant” definition. Both major participant definitions encompass persons that satisfy any of three alternative tests:<sup>70</sup>

- The first test encompasses persons that maintain a “substantial position” in any of the “major” categories of swaps or security-based swaps, as those categories are determined by the CFTC

<sup>68</sup> 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).

<sup>69</sup> 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 definition and risk was highlighted during the Congressional debate on the statute. See 156 Cong. Rec. S5907 (daily ed. July 15, 2010) (dialogue between Senators Hagen and Lincoln, discussing how the goal of the major participant definition 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”).

<sup>70</sup> Also, neither major participant definition encompasses an entity that meets the respective swap dealer or security-based swap dealer definition. See CEA section 1a(33)(A); Exchange Act section 3(a)(67)(A)(i).

<sup>65</sup> CEA section 1a(12)(A)(iv) (7 U.S.C. 1a(12)(A)(iv)).

<sup>66</sup> 7 U.S.C. 2(c)(2)(B) and (C). See generally “Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries,” 75 FR 55410 (Final Rule; Sept. 10, 2010) (discussing the new CFTC retail forex regulatory regime); “Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries,” 75 FR 3282 (Proposed Rule; Jan. 20, 2010) (providing historical background on the regulation of retail forex transactions).

<sup>67</sup> CEA section 1a(18)(A)(v) (7 U.S.C. 1a(18)(A)(v)), as redesignated by Section 721(a)(9) of the Dodd-Frank Act.

or SEC as applicable. This test excludes both “positions held for hedging or mitigating commercial risk,” and positions maintained by or contracts held by any employee benefit plan (as defined in paragraphs (3) and (32) of section 3 of ERISA (29 U.S.C. 1002)) for the primary purpose of hedging or mitigating risks directly associated with the operation of the plan.<sup>71</sup>

- The second 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 United States banking system or financial markets.”<sup>72</sup>

- The third test encompasses any “financial entity” that 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” and that maintains a “substantial position” in swaps or security-based swaps for any of the “major” categories of swaps or security-based swaps.<sup>73</sup>

The statute directs the CFTC or the SEC to define “substantial position” for the respective definition at the threshold that it determines to be “prudent for the effective monitoring, management, and oversight of entities that are systemically important or can significantly impact the financial system of the United States.” The definitions further provide that when defining “substantial position,” the CFTC or SEC “shall consider the person’s relative position in uncleared as opposed to cleared [swaps or security-based swaps] and may take into consideration the value and quality of collateral held against counterparty exposures.”<sup>74</sup>

Both major participant definitions provide that a person may be designated as a major participant for one or more categories of swaps or security-based swaps without being classified as a major participant for all classes of swaps or security-based swaps.<sup>75</sup>

Finally, the definition of “major swap participant”—but not the definition of “major security-based swap participant”—includes an exception for any “entity 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 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.”<sup>76</sup>

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 appropriately account for those differences.

The Commissions are proposing rules to further define the “major swap participant” and “major security-based swap participant” definitions, by specifically addressing: (a) The “major” categories of swaps or securities-based swaps; (b) the meaning of “substantial position”; (c) the meaning of “hedging or mitigating commercial risk”; (d) the meaning of “substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets”; and (e) the meanings of “financial entity” and “highly leveraged.” We also are proposing rules to specify the use of a daily average methodology for identifying whether a person meets one of the major participant definitions, provide for a reevaluation period for certain entities that exceed the relevant daily average by a small amount, and provide for a minimum length of time before a person may no longer be deemed a major participant.

We further propose that the CFTC or SEC may limit an entity’s designation as a major participant to only certain types, classes or categories of swaps or security-based swaps. We also address certain additional interpretive issues that commenters have raised. Finally, while the Commissions also are not proposing any exclusions from the major participant definitions, we are soliciting comment as to whether certain types of entities should be excluded from the definitions’ application.<sup>77</sup>

<sup>76</sup> See CEA section 1a(33)(D).

<sup>77</sup> In light of the significant and novel issues raised by the major participant definitions, the Commissions recognize the importance of monitoring the swap and security-based swap markets following adoption of major participant rules. This will help us evaluate whether the rules appropriately reflect how market participants use these instruments, and will help us consider the impact of market evolution and the ways in which market participants may change their practices in response to the rules, so we may identify potential improvements to the rules or other actions to

#### A. “Major” Categories of Swaps and Securities-Based Swaps

The first and third tests of the statutory major participant definitions encompass entities that have a substantial position in a “major” category of swaps or security-based swaps. The Commissions are responsible for designating these “major” categories.<sup>78</sup>

The Commissions propose to designate “major” categories of swaps and security-based swaps in a manner that reflects the risk profiles of these various instruments and the different purposes for which end-users make use of the various instruments. We preliminarily believe that it is important not to parse these “major” categories so finely as to base the “substantial position” thresholds on unduly narrow risks that would reduce those thresholds’ effectiveness as risk measures. The “major” categories will apply only for purposes of the major participant definitions and are not necessarily determinative with respect to any other provision of the Dodd-Frank Act or the regulations adopted thereunder.

##### 1. Major Categories of Swaps

We propose to designate four “major” categories of swaps for purposes of the “major swap participant” definition. The four categories are rate swaps, credit swaps, equity swaps and other commodity swaps.<sup>79</sup> The first category 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, inflation rates or other monetary rates. The second category would encompass any swap that is primarily based on instruments of indebtedness, including but not limited to any swap primarily based on one or more indices related to debt instruments, or any swap that is an index credit default swap or total return

enhance enforcement of major participant regulation.

<sup>78</sup> See CEA section 1a(33)(A)(i), (iii); Exchange Act section 3(a)(67)(a)(2)(i), (iii). One commenter suggested that we determine these categories by reference to the types of instruments specifically listed in the statutory definition of “swap.” See Northwestern Mutual letter (suggesting that, for regulatory consistency, each type of swap listed in the definition and options on each of those swaps should be considered to be an individual major category). The statutory definition of “swap” lists 22 different types of swaps.

<sup>79</sup> See proposed CEA rule 1.3(rrr). For the avoidance of doubt, the term “swap” as it is used in the definitions of the major swap categories in rule 1.3(rrr) has the meaning set forth in section 1a(47) of the CEA and the rules promulgated thereunder.

<sup>71</sup> See CEA section 1a(33)(A)(i); Exchange Act section 3(a)(67)(A)(ii)(I).

<sup>72</sup> See CEA section 1a(33)(A)(ii); Exchange Act section 3(a)(67)(A)(ii)(II).

<sup>73</sup> See CEA section 1a(33)(A)(iii); Exchange Act section 3(a)(67)(A)(iii)(III).

<sup>74</sup> See CEA Section 1a(33)(B); Exchange Act section 3(a)(67)(B).

<sup>75</sup> See CEA section 1a(33)(C); Exchange Act section 3(a)(67)(C).

swap on one or more indices of debt instruments. The third category would encompass any swap that is primarily based on equity securities, such as any swap primarily based on one or more indices of equity securities, or any total return swap on one or more equity indices. The fourth category would encompass any swap not included in any of the first three categories. This fourth category 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.<sup>80</sup>

The four major categories of swaps are intended to cover all swaps. Each swap would be in the category that most closely describes the primary item underlying the swap. If a swap is based on more than one underlying item of different types, the swap would be in the category that describes the underlying item that is likely to have the most significant effect on the economic return of the swap. The proposed categories are consistent with market statistics that distinguish between these general types of swaps, as well as market infrastructures that have been established for these types of swaps.

We request comment on this proposed method of allocating swaps among “major” categories. Commenters particularly are asked to address whether there are any types of swaps that would have unclear status under this proposal, as well as whether all swaps instead should be placed into a single “major” category for purposes of the “major swap participant” definition, or whether there should be additional “major” categories of swaps. Commenters are also asked to address whether the rate swap category should be divided into two separate categories—one for swaps based on rates of exchange between different currencies, and another for swaps based on interest rates, inflation rates and other monetary rates—and if so, in which category cross-currency rate swaps should be included. Also, should the major swap category for other commodity swaps be divided into two separate categories—one for swaps based on agricultural commodities, and another for swaps based on all other

commodities not included in the other categories?

## 2. Major Categories of Security-Based Swaps

We propose to designate two “major” categories of security-based swaps for purposes of the “major security-based swap definition.” 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 swap, debt index swap, or credit spread.<sup>81</sup> The second category would encompass any other security-based swaps not included in the first category; this category would include, for example, equity swaps.<sup>82</sup>

The proposed categories reflect the fact that entities that transact in security-based swaps for non-speculative purposes would be expected to use the respective instruments for different purposes. For example, swaps based on instruments of indebtedness, such as credit derivatives, can be used to hedge the risks associated with the default of a counterparty or debt obligation. Equity swaps can be used, among other ways, to hedge the risks associated with equity ownership or gain synthetic exposure to equities.<sup>83</sup> The proposed categories also are consistent with market statistics that currently distinguish between those general types of security-based swaps, as well as market infrastructures, including separate trade warehouses, that have been established for credit default swaps and equity swaps.

We request comment on this proposed method of allocating security-based swaps between two “major” categories. In particular, we request comment on whether there are any types of security-based swaps that would have unclear status under this proposal, as well as whether all security-based swaps instead should be placed into a single “major” category for purposes of the “major security-based swap participant” definition, or whether there should be

additional “major” categories of security-based swaps.

## B. “Substantial Position”

As noted above, the Commissions are required to define the term “substantial position” as a threshold that is “prudent for the effective monitoring, management, and oversight of entities that are systemically important or can significantly impact the financial system of the United States.”<sup>84</sup> This raises two fundamental issues: (i) What types of measures should be used to identify the risks posed by an entity’s swap or security-based swap positions; and (ii) for each of those measures, how much risk should be required to evidence a “substantial position”?

### 1. Commenters’ Views

Commenters have expressed diverse views as to what should constitute a substantial position. A number of commenters suggested the use of a test based on the current uncollateralized mark-to-market exposure posed by an entity’s swap or security-based swap positions, after taking bilateral netting agreements into account. Two commenters suggested specific dollar amounts of uncollateralized exposure to use as the substantial position threshold.<sup>85</sup> Several commenters expressed the view that positions subject to central clearing should be entirely excluded from the analysis, or at least should be discounted for purposes of the analysis.<sup>86</sup>

Some commenters opposed using the notional amount of swap or security-based swap positions to set the threshold, stating that the notional amount is not indicative of the risks associated with a position. Some commenters similarly opposed using measures of swap or security-based swap volume to set the threshold,

<sup>84</sup> See CEA section 1a(33)(B); Exchange Act section 3(a)(67)(B).

<sup>85</sup> See letter from Timothy W. Cameron, Esq., Managing Director, SIFMA Asset Management Group, dated September 20, 2010 (“SIFMA AMG letter”) (suggesting a standard of \$2.5 billion average exposure in any calendar quarter based on the entity’s entire portfolio of swaps and security-based swaps, other than foreign exchange swaps and forwards); letter from Gus Sauter, Chief Investment Officer, Vanguard, dated September 20, 2010 (“Vanguard letter”) (suggesting that the applicable threshold be \$500 million in uncollateralized exposure for any single major swap category or \$1 billion aggregate exposure across all major categories).

<sup>86</sup> See letter from Jennifer J. Kalb, Associate General Counsel, Metropolitan Life Insurance Company, dated September 20, 2010 (“MetLife letter”) (suggesting that cleared trades be subject to a lesser “charge” for purposes of the substantial position calculation, or be excluded entirely).

<sup>80</sup> The term “commodity” as defined in Section 1a(9) of the CEA, 7 U.S.C. 1a(9), and CFTC Rule § 1.3(e), 17 CFR 1.3(e) includes interest rates, foreign exchange rates, and equity and debt indices as well as physical commodities. Thus, the fourth category of swaps is entitled “other commodity swaps” because it includes any swap not included in the other three categories.

<sup>81</sup> This category does not encompass a security-based swap that is based on an instrument of indebtedness solely in connection with the swap’s financing leg.

<sup>82</sup> See proposed Exchange Act rule 3a67–2.

<sup>83</sup> At the same time, we note that the distinctions between these proposed “major” categories of “security-based swaps” arguably are less significant than the distinctions among the proposed major categories of “swaps” (such as, for example, the distinction between other commodity swaps and rate swaps).



contending that the number of trades does not reflect risk.<sup>87</sup>

A few commenters addressed the possibility that the threshold could take into account the potential future risks associated with a position, in addition to the risks associated with uncollateralized current exposure.<sup>88</sup> Some commenters suggested that the threshold take into account the potential riskiness of the particular type of instrument at issue. Some commenters maintained that the threshold should take into account the number of counterparties an entity has, the size of an entity's positions compared to the size of the market, the size of an entity's swap or security-based swap positions compared to the entity's ability to absorb losses of that magnitude, or the financial strength of an entity's counterparties. Several commenters stated that the threshold should be based on an average measure over time, so that short-term spikes in measures such as exposure would not by themselves cause an entity to meet the major participant definitions. Some commenters suggested that the substantial position threshold should reflect an amount of "systemic risk."<sup>89</sup>

<sup>87</sup> *But see* letter from Christopher A. Klem, Ropes & Gray, dated September 2, 2010 (test should account for frequency of trading and frequency of trading with non-dealers).

<sup>88</sup> *See* letter from Andrew Baker, Chief Executive Officer, Alternative Investment Management Association, dated September 24, 2010 ("AIMA letter") (discussing possible methods of estimating the maximum risk of loss related to positions); letter from Warren Davis, Of Counsel, Sutherland Asbill & Brennan LLP on behalf of the Federal Home Loan Banks, dated September 20, 2010 (in addressing "substantial counterparty exposure" test, noting the possibility of accounting for the potential exposure of a portfolio).

<sup>89</sup> *See* letter from Edward J. Rosen, Cleary Gottlieb Steen & Hamilton LLP, dated September 21, 2010 ("Cleary letter") (suggesting that the threshold should be akin to the amount that is required for a non-financial entity to be designated as systemically important under Title I of the Dodd-Frank Act).

Section 113 of the Dodd-Frank Act provides that the Financial Stability Oversight Council ("FSOC") may determine that a non-bank financial company shall be supervised by the Federal Reserve Board, subject to prudential standards, 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." In making that determination, the FSOC is to consider: Leverage; off-balance sheet exposures; transactions and relationships with other significant non-bank financial companies and bank holding companies; importance as a source of credit and liquidity; extent to which assets are managed rather than owned; the nature, scope, size, scale, concentration, interconnectedness and mix of activities; presence of a primary financial regulator; assets and liabilities; and any other appropriate risk-related factors.

## 2. Proposed Substantial Position Thresholds

The Commissions recognize that it is important for the substantial position thresholds to be set using objective numerical criteria. Objective criteria should permit regulators, market participants and entities that may be subject to the regulations to readily evaluate whether swap or security-based swap positions meet the thresholds, and should promote the predictable application and enforcement of the requirements governing major participants.

In determining the substantial position thresholds—in light of what is "prudent for the effective monitoring, management, and oversight" of entities that are systemically important or can significantly impact the U.S. financial system—the Commissions are mindful that tests based on *current uncollateralized* exposure and tests based on *potential future* exposure both have respective advantages and disadvantages. We thus are proposing tests that would account for both types of exposure.

A test that focuses solely on the current uncollateralized exposure associated with an entity's swap and security-based swap positions should provide a reasonable measure of the theoretical amount of potential risk that an entity would pose to its counterparties if the entity currently were to default.<sup>90</sup> Such a test also should be relatively clear-cut for market entities to implement, and would be based on calculations that we expect that market entities would perform as a matter of course.

At the same time, a focus solely on current uncollateralized exposure could be overly narrow by failing 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. Because exposure can change significantly over short periods of time, and a swap or security-based swap position that may pose large potential exposures nonetheless would often have a mark-to-market exposure of zero at inception, an entity's positions may already pose significant risk to counterparties and to the market even before its uncollateralized mark-to-market exposure increases up to the applicable threshold. A test that focuses solely on current uncollateralized

exposure thus would not appear to be sufficient to satisfy the systemic importance standard required by the statute.

Tests based on measures of potential future exposure—which would address an estimate of how much the value of a swap or security-based swap might change against an entity over the remaining life of the contract—could address the gap left by a current uncollateralized exposure test. Potential future exposure tests, however, would reflect only an estimate of that type of risk, and would only be as effective as the factors used by the test.

While we have considered several other types of tests that could be used to determine the substantial position threshold, we preliminarily do not believe that the advantages of those tests justify their disadvantages. For example, while a threshold based on the number of an entity's counterparties could help identify highly interconnected entities (a factor that some have argued is important for identifying an entity's systemic risk), it also has been argued that a large number of counterparties could mean that the losses associated with that entity's default would be divided and absorbed by many counterparties without broader market effects.<sup>91</sup> While a threshold that is based on an entity's financial strength would help account for the possibility of an entity's default as well as the effects of such a default, it would not address swap-related risks to the market that are not directly linked to the entity's default. In other words, an entity that has large out-of-the-money swap or security-based swap positions and faces a margin call may cause significant price movements in the swaps or security-based swaps and in the related reference entities or assets if the entity chooses to unwind its positions, even if the entity itself does not appear to present a large threat of default. These movements may be exacerbated if other entities have similar positions.

Moreover, although substantial position thresholds based on the financial strength of an entity's counterparties would help measure the potential that an entity's default would have a broader impact, such thresholds could result in disparate results between two entities with identical positions,

<sup>91</sup> *See* AIMA letter ("An entity that has only a small number of counterparties may only affect a small number of entities directly, should it fail, but the impact could be significant if the position is large and the counterparty is a systemically important entity. A diversified exposure to multiple entities could affect more entities but is likely to be smaller and thus shares the losses in the industry and having less systemic impact.").

<sup>90</sup> In practice, however, this measure may underestimate the amount of risk that an entity poses to its counterparties, given that it may take multiple days to liquidate a defaulting entity's swap or security-based swap positions, during which time prices may move against the defaulting entity.

and also could encourage concentration of exposure or potential future exposure within a few counterparties. While tests that are based on the volume of an entity's swaps or security-based swaps may be helpful in identifying significant swap or security-based swap activity, such tests would not directly be germane to the current or potential future exposure posed by an entity's swap and security-based swap positions. Finally, while we have considered the feasibility of tests that take specific contract features into account (e.g., triggers that require the payment of mark-to-market margin if an entity's credit rating is lowered), we preliminarily believe that simpler tests of exposure can more efficiently identify the risks associated with particular swap or security-based swap positions.

After considering these alternatives, the Commissions are proposing two tests to define "substantial position." One test would focus exclusively on an entity's current uncollateralized exposure; the other would supplement a current uncollateralized exposure measure with an additional measure that estimates potential future exposure. A position that satisfies either test would be a "substantial position."

The Commissions, however, request comment on whether it would be appropriate to use other types of approaches for determining whether an entity has a substantial position—as an alternative to, or in addition to, the two proposed tests.

#### a. Proposed Current Exposure Test

The proposed first substantial position test, which would focus solely on current uncollateralized exposure, in general would set the substantial position threshold by reference to the sum of the uncollateralized current exposure, obtained by marking-to-market using industry standard practices, arising from each of the person's positions with negative value in each of the applicable "major" category of swaps or security-based swaps (other than positions excluded from consideration, such as positions for the purpose of "hedging or mitigating commercial risk").<sup>92</sup>

<sup>92</sup> See proposed CEA rule 1.3(sss)(2); proposed Exchange Act rule 3a67-3(b)(1). In other words, the test would measure the portion of the exposure that is not offset by the posting of collateral. If a position was collateralized only partially, the value of the collateral posted would be offset against the total exposure, and the test would measure the residual part of the exposure. 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.

A person would apply this proposed substantial position test on a major category-by-major category basis, examining its positions with each counterparty with which the person has swaps or security-based swaps in the particular category. 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 (subject to the netting provisions described below) in that major category by marking-to-market using industry standard practices, and deduct from that amount the aggregate value of the collateral the person has posted with respect to the swap or security-based swap positions. 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 the applicable major category.<sup>93</sup>

The proposed test would not prescribe any particular methodology for measuring current exposure or the value of collateral posted,<sup>94</sup> and instead would provide that the method should be consistent with counterparty practices and industry practices generally.<sup>95</sup>

As noted above, the statutory definitions require us to consider the presence of central clearing in setting the substantial position threshold. This test would account for the risk-mitigating effects of central clearing in that centrally cleared swaps and security-based swaps are subject to mark-to-market margining that would largely eliminate the uncollateralized exposure associated with a position, effectively resulting in cleared positions being excluded from the analysis.

<sup>93</sup> See proposed CEA rule 1.3(sss)(2); proposed Exchange Act rule 3a67-3(b)(2).

<sup>94</sup> Depending on the particular circumstances of the swap or security-based swap, such 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.

<sup>95</sup> Consistent with industry practices, we would expect that entities may value exposure based on measures that take into account the amounts that would be payable if the transaction were terminated. Also, to the extent the valuation of collateral posted in connection with swaps or security-based swaps is subject to other rules or regulations, we would expect that the valuation of collateral for purposes of the major participant calculations would be consistent with those applicable rules.

At the same time, we recognize that there can be disputes or uncertainty as to an entity's exposure in connection with swap and security-based swap positions, and as to the valuation of the collateral it has posted in connection with those positions. In some circumstances this could lead to uncertainty as to whether the entity is a major participant. As addressed below, we are requesting comment as to the potential significance of these issues, and as to whether we should set forth additional guidance or mandate the use of specific standards with respect to these valuations.

This proposed test would account for the risk mitigating effects of netting agreements<sup>96</sup> by permitting an entity to calculate its exposure on a net basis, by applying the terms of master netting agreements entered into between the entity and a single counterparty.<sup>97</sup> When calculating the net exposure the entity may take into account offsetting positions with that particular counterparty involving swaps, security-based swaps and securities financing transactions (consisting of securities lending and borrowing, securities margin lending and repurchase and reverse repurchase agreements) to the extent that is consistent with the offsets provided by the master netting agreement.<sup>98</sup>

The Commissions preliminarily believe that this approach is appropriate because it avoids identifying a position's exposure as being "uncollateralized" when there is no current counterparty risk associated with it due to offsets under a netting agreement with the counterparty.<sup>99</sup> In

Also, it is important to recognize that 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, our proposed rules would not be relevant for other purposes, such as in the context of capital and margin requirements.

<sup>96</sup> Section 362(b)(17) of the United States Bankruptcy Code generally provides derivatives contracts with a safe harbor from the Bankruptcy Code's automatic stay, thus allowing parties to these contracts to enforce their contractual rights, including those associated with netting and offsets, even after a counterparty has filed for bankruptcy.

In addition, Section 210(c)(8)(A) of the Dodd-Frank Act reaffirms the enforceability of netting and offset provisions in certain derivatives contracts with insolvent counterparties that have been placed under the receivership of the Federal Deposit Insurance Corporation ("FDIC"). However, the Dodd-Frank Act also places certain limitations on the timing by which netting rights may be exercised when the FDIC has been appointed as the receiver of an insolvent counterparty. See Dodd-Frank Act section 210(c)(10)(B).

<sup>97</sup> To the extent that the two counterparties maintain multiple netting agreements (e.g., separate agreements for dollar-denominated and euro-denominated instruments), the calculation would account only for the netting permitted under the netting agreement that is relevant to the swap or security-based swap at issue.

<sup>98</sup> See proposed CEA rule 1.3(sss)(2)(iii)(A); proposed Exchange Act rule 3a67-3(b)(3)(A). As is the case for the proposed rules on valuation, 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.

<sup>99</sup> If, for example, an entity was \$X out of the money in connection with a security-based swap, but was \$X in the money with the same counterparty in connection with a swap, there would be no economic need for the entities to exchange collateral in connection with those offsetting positions. A test that fails to account for

calculating current uncollateralized exposure, however, the entity may not take into account the market risk offsets associated with holding positions with multiple counterparties.<sup>100</sup> Also, the entity may not “double count” any offset or collateral—once any item of collateral or any position with positive value has been applied against current exposure, the same item cannot be applied for purposes of this test against any other exposure.

The proposal to permit this type of netting, however, raises questions as to how an entity’s net out-of-the-money exposure with a counterparty, and the collateral posted with respect to its positions with the counterparty, should be allocated among swap positions, security-based swap positions and other positions specified in the rule.<sup>101</sup> In particular, when an entity has not fully collateralized its net current exposure to a particular counterparty with which it has a netting agreement, there may be questions regarding how to attribute the net out-of-the-money positions and associated collateral to its swap or security-based swap positions. We preliminarily believe that an entity that has net uncollateralized exposure to a counterparty should, for purposes of the test, allocate that net uncollateralized exposure *pro rata* in a manner that reflects the exposure associated with each of its out-of-the-money swap positions, security-based swap positions and non-swap positions.<sup>102</sup> This allocation would be intended to cause the measure of uncollateralized exposure connected with swaps or security-based swaps for purposes of the test to reasonably reflect the relative contribution of those instruments to an

this netting of exposure could lead the entities to engage in needless offsetting exchanges of collateral.

<sup>100</sup> See proposed CEA rule 1.3(sss)(2)(iii)(C); proposed Exchange Act rule 3a67–3(b)(2)(iii). While recognizing that offsetting positions of that type would reduce the market risk facing the entity, the offsets would not be expected to directly mitigate the risks that the entity’s counterparties would face if the entity were to default.

<sup>101</sup> This issue does not arise to the extent that an entity’s net positions with a counterparty are fully collateralized.

<sup>102</sup> In other words, if an entity’s out-of-the-money rate swap positions have \$W exposure, its out-of-the-money other commodity swap positions have \$X exposure, its out-of-the-money security-based swap positions have \$Y exposure, and its other out-of-the-money positions covered by that netting agreement have \$Z exposure, fractions of the collateral equal to  $W/(W+X+Y+Z)$  should be allocated to the rate swap positions,  $X/(W+X+Y+Z)$  to the other commodity swap positions and  $Y/(W+X+Y+Z)$  to the security-based swap positions. A similar process should be used for allocating net out-of-the-money exposure across the categories of swaps and security-based swaps that have out-of-the-money exposure when one or more categories are in-the-money.

entity’s total overall uncollateralized exposure.

For purposes of the definition of “major swap participant,” the Commissions are proposing to set the current uncollateralized exposure threshold at a daily average of \$1 billion in the applicable major category of swaps, except that the threshold for the rate swap category would be a daily average of \$3 billion. For purposes of the definition of “major security-based swap participant,” this threshold would be based on a daily average of \$1 billion in the applicable major category of security-based swaps.<sup>103</sup> We preliminarily believe that these proposed thresholds are appropriate for identifying entities that, through their swap and security-based swap activities, have a significant potential to pose the systemic importance or risks to the U.S. financial system that the major participant definition and associated statutory requirements were intended to address, but we also recognize that it is possible that the appropriate threshold should be higher or lower. In proposing these specific thresholds, we have sought to take into account several factors: (i) The ability of the financial system to absorb losses of a particular size;<sup>104</sup> (ii) the appropriateness of setting “prudent” thresholds that are materially below the level that could cause significant losses to the financial system as 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;<sup>105</sup> and (iii) the need to account for the possibility that multiple market participants may fail close in time, rather than focusing narrowly on the potential impact of a single participant’s default.<sup>106</sup> Based on these factors, we

<sup>103</sup> See proposed CEA rule 1.3(sss)(1); proposed Exchange Act rule 3a67–3(a)(1).

<sup>104</sup> In this regard, the Commissions preliminarily believe that the “Tier 1” capital of major dealer banks provides relevant information about the ability of the financial system to absorb losses of a particular size. We note that, among U.S. banks that are dealers in credit derivatives, the six largest banks account for the vast majority of dealing activities. We understand that the most liquid “Tier 1” regulatory capital for those six banks ranges from \$14 billion to \$113 billion.

<sup>105</sup> In other words, the proposed thresholds are intended to be low enough to provide for the appropriately early regulation of an entity whose swap or security-based swap positions have a reasonable potential of posing significant counterparty risks and risks to the market that stress the financial system, while being high enough that it would not unduly burden entities that are materially less likely to pose these types of risks.

<sup>106</sup> For example, the proposed \$1 billion threshold for swaps and security-based swaps would reflect a potential loss of \$3 billion if three large swap or security-based swap entities were to

preliminarily believe that the proposed substantial position thresholds would reasonably be expected to apply to entities that have the potential of satisfying the statutory criteria of systemic importance or significant impact to the U.S. financial system. As discussed below, however, we welcome comments on the appropriateness of the proposed threshold.

These proposed thresholds would be evaluated by reference to a calculation of the mean of an entity’s uncollateralized exposure measured at the close of each business day, beginning on the first business day of each calendar quarter and continuing through the last business day of that quarter.<sup>107</sup> In this regard, the Commissions have taken into account commenters’ concerns that an entity’s exposure should not be evaluated based on a single point in time, as short-term market fluctuations may not fairly reflect the risks of the entity’s positions. The use of a daily average approach should help address commenters’ concerns about the impact of short-term price fluctuations, and also help preclude the possibility that an entity may seek to use short-term transactions to distort the measure of exposure.

The Commissions request comment on the proposed current uncollateralized exposure test. Commenters particularly are requested to address whether the proposed threshold amounts of current uncollateralized exposure are appropriate, and, if not, what alternative higher or lower threshold amounts would appropriately identify entities that pose the types of risks that the definition was intended to address. In this regard, commenters specifically are requested to address whether bank Tier 1 capital provides a good indicative reference of the ability of major dealers to absorb losses of a particular size, or whether alternative reference points for the analysis (*e.g.*, the size of the swap market or security-based swap market) would also be applied. Commenters are requested to address whether uncollateralized mark-to-market exposure is the appropriate way to measure current exposure, and if not, what alternative approach is more appropriate, and why. Commenters also are requested to address whether the

fail close in time. That \$3 billion could represent a significant impairment of the ability of some major dealers to absorb losses, as reflected by their Tier 1 capital.

We also are mindful of the views expressed by the two commenters that suggested particular dollar values for the threshold. See note 85, *supra*.

<sup>107</sup> See proposed CEA rule 1.3(sss)(4); proposed Exchange Act rule 3a67–3(d).

proposed thresholds reasonably address the need to set the threshold at a prudent level so as to avoid the possibility that the substantial position test would encompass entities only after they pose significant risks to the market, whether the proposed thresholds reasonably address the possibility that multiple market entities could fail close in time, and whether the proposed thresholds reasonably address the fact that swap or security-based swap activities would comprise only part of the risks to the market posed by an entity. To what extent would this proposed definition of “substantial position” have an effect on the activities of entities that potentially may be deemed to be major participants? What impact could these types of effects have on liquidity, on risk-taking or risk-reducing activities, or on other aspects of the relevant markets?

Also, more fundamentally, we request comment on whether the substantial position analysis also should encompass a test that does not account for the collateral posted in connection with an entity’s exposure, given that tests that account for the posting of collateral would not encompass entities that have very large swap or security-based swap positions that are fully collateralized (either by the posting of bilateral collateral or by virtue of central clearing). In that light, should the analysis seek to capture entities that have very large positions in light of potential market disruptions such entities could cause, regardless of whether the positions are collateralized?

Commenters further are requested to address whether such thresholds should also account for entities that have large in-the-money positions that may indicate their potential significance to the market. In this regard, commenters also are asked to address whether the thresholds should specifically address entities with large in-the-money positions that lead them to receive large amounts of collateral posted by their counterparties, particularly to the extent that such collateralized in-the-money positions could later turn and lead the entity to incur losses.

In addition, commenters are requested to address whether and how it would be appropriate to adjust the threshold amounts over time, including whether these proposed current uncollateralized exposure thresholds should periodically be adjusted by formula to reflect changes in the ability of the market to absorb losses over time, or changes in other criteria over time. Commenters further are requested to address whether the test will be practical for potential major participants to use. Moreover,

commenters are requested to address whether the proposed current exposure test should be modified to account for the risks associated with the expected time lag between an entity’s default and the liquidation of its swap or security-based swap positions.

Commenters also are requested to address whether we should set forth additional guidance or mandate the use of specific standards with respect to the measure of exposure or valuing collateral posted, or should specify particular procedures in the event of valuation disputes. What particular industry standard documentation and other methodologies could be used to measure exposure and value collateral? Also, how could regulatory requirements applicable to the valuation of collateral be relevant to the valuation of collateral for purposes of the major participant definitions?

Commenters are invited to address whether the rule should provide that, in measuring their current uncollateralized exposure, entities must value collateral in a way that is at least as conservative as such collateral would be valued according to applicable haircuts or other adjustments dictated by applicable regulations. Commenters further are requested to address whether the test should exclude certain types of collateral that cannot readily be valued. Also, commenters are requested to address whether the proposed method of evaluation—the mean of an entity’s uncollateralized exposure measures at the close of each business day, beginning on the first business day of each calendar quarter and continuing through the last business day of that quarter—would be unduly burdensome or potentially subject to gaming or evasion.

Should the proposed approach for measuring uncollateralized current exposure be amended or supplemented, such as by establishing requirements for how exposure should be measured or collateral should be valued in certain circumstances (e.g., requiring the valuation of certain types of collateral to be conservative during times of rapid price changes in the relevant asset class)? Should current exposure and collateral be required to be valued in accordance with US generally accepted accounting principles? Would measurement according to such principles differ in any respects from measurement under the proposal, and, if so, how?

In addition, commenters are requested to address the proposed netting provisions of this test, including: whether the proposed test would reasonably permit the measure of

uncollateralized exposure to account for bilateral netting agreements; whether additional types of positions should be included within the netting provisions; whether the proposal appropriately takes into account the netting of exposures and collateral involving positions in financial instruments other than swaps, security-based swaps and securities financing transactions and if so, whether any limitations to such offsetting would be necessary or appropriate; whether the netting provisions should accommodate offsetting positions involving the net equity balance in an entity’s securities account (e.g., free credit balances, other credit balances, and fully paid securities), and if so, whether any limitations to such offsetting would be necessary or appropriate; whether the netting provisions should accommodate offsets for exposures, or collateral connected with the positions that an entity has with the affiliate of a counterparty; and whether the proposed method of allocating the uncollateralized portion of exposures among the different types of financial instruments that are all subject to a single netting agreement is appropriate.

Commenters also are requested to address whether the proposed current uncollateralized exposure test would pose significant monitoring burdens upon entities that have swap or security-based swap positions that are significant enough to potentially meet the current uncollateralized exposure threshold. Should we provide guidance as to policies and procedures that such an entity should be able to follow to demonstrate that it does not meet the applicable thresholds?

#### b. Proposed Current Exposure Plus Potential Future Exposure test

The second proposed test would account both for current uncollateralized exposure (as discussed above) and for the potential future exposure associated with swap or security-based swap positions in the applicable “major” category of swaps or security-based swaps. This additional test would allow the major participant analysis to take into account estimates of how the value of an entity’s swap or security-based swap positions may move against the entity over time.

The potential future exposure portion of this proposed test would be based on 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 to certain adjustments. Bank capital standards also

make use of this type of test,<sup>108</sup> and this proposal builds upon those standards but modifies them to focus on the risk that an entity poses to its counterparties (rather than on the risk that counterparties pose to an entity). In doing so, this proposal seeks to use a test that can be implemented by a range of market participants, and that can be expected to lead to reproducible results across market participants with identical swap or security-based swap portfolios, rather than relying on alternative tests (e.g., value at risk measures or stress testing methodologies) that may be costly for market participants to implement and that would not be expected to lead to reproducible results across participants.

The exposure measures in general would be based on the total notional principal amount of those positions, adjusted by certain risk factors that reflect the type of swap or security-based swap at issue and the duration of the position.<sup>109</sup> For positions in which

<sup>108</sup> See 12 CFR part 3, app. C, section 32 (Office of the Comptroller of the Currency bank capital standards).

<sup>109</sup> For example, consistent with the bank standards, the multiplier for equity swaps would range from 0.06 for equity swaps of one year or less to 0.10 for equity swaps with a maturity of more than five years. See proposed Exchange Act rule 3a67-3(c)(2)(i)(A). For security-based swaps based on the credit of a reference entity, the multiplier would be 0.1.

The current bank capital standards contain a distinction based on whether the credit derivative is on "investment grade" or "non-investment grade" reference entities, providing a 0.1 multiplier for the former and a lower 0.05 multiplier for the latter. We preliminarily do not believe that a test that distinguishes among reference entities by reference to their credit ratings would be appropriate for purposes of these definitions, particularly in light of the fact that the Dodd-Frank Act mandates the substitution of credit ratings with other standards of creditworthiness in U.S. regulations. See Dodd-Frank Act section 939A.

The multipliers in part will be a function of the remaining maturity of the swap or security-based swap. If the swap or security-based swap, however, is structured such that on specified dates the outstanding exposure is settled and the terms are reset so the market value is zero, the remaining maturity would equal the time until the next reset date.

Although we recognize that these risk multipliers may suggest a lower than expected volatility of credit or equity derivatives of that duration, this may be offset by the fact that the proposed calculations of potential future exposure do not directly account for portfolio netting or collateral updates that could mitigate future exposure. We preliminarily believe that the use of these thresholds (and proposed related calculations) for purposes of identifying major participants are consistent with similar bank capital standards and are therefore suitable for use as an estimate of potential future exposure. We are also cognizant that requiring a more complete calculation of potential future exposure may be costly and burdensome for participants, especially those who would otherwise not meet the thresholds for major swap or security-based swap participant and would not have systems in place to perform a more complete calculation.

the stated notional amount is leveraged or enhanced by the particular structure, this calculation would be based on the position's effective notional amount.<sup>110</sup>

At the same time, the proposed measures would contain adjustments for certain types of positions that pose relatively lower potential risks.<sup>111</sup> In addition, the general risk-adjusted notional measures of potential future exposure would be reduced to reflect the risk mitigation effects of master netting agreements, in a manner consistent with bank capital standards.<sup>112</sup>

The proposed measures of potential future exposure would contain further downward adjustments to account for

<sup>110</sup> See proposed CEA rule 1.3(sss)(3)(ii); proposed Exchange Act rule 3a67-3(c)(2)(i)(B). For purposes of this rule, 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 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.

<sup>111</sup> The analysis would exclude swap or security-based swap positions that constitute the purchase of an option, such that the person has no additional payment obligations under the position, as well as other positions on which the person has prepaid or otherwise satisfied all of its payment obligations. See proposed Exchange Act rule 3a67-3(c)(2)(i)(C).

For similar reasons, the potential outward exposure associated with a position by which a person buys credit protection using a credit default swap would be capped at the net present value of the unpaid premiums. See proposed CEA rule 1.3(sss)(3)(ii)(A)(4); proposed Exchange Act rule 3a67-3(c)(2)(i)(D).

<sup>112</sup> In particular, for swaps or security-based swaps subject to master netting agreements the potential exposure associated with the person's swap or security-based swaps with each counterparty would equal a weighted average of the potential exposure in the applicable "major" category of swaps or security-based swaps with a particular counterparty as calculated without reference to netting, and that amount reduced by the ratio of net current replacement cost to gross current replacement cost of all swap and security-based swap positions with that counterparty, consistent with the following equation:  $P_{Net} = 0.4 \times P_{Gross} + 0.6 \times NGR \times P_{Gross}$ .

Under this formula,  $P_{Net}$  is the potential exposure in the applicable "major" category of swaps or security-based swaps adjusted for bilateral netting;  $P_{Gross}$  is the potential exposure in that category without adjustment for bilateral netting; and  $NGR$  is the ratio of net current replacement cost to gross current replacement cost. See proposed CEA rule 1.3(sss)(3)(ii)(B); proposed Exchange Act rule 3a67-3(c)(2)(ii).

The "NGR" ratio is intended to serve as a type of proxy for the impact of netting on potential future exposure, but does not serve as a precise indicator of future changes in net exposure relative to gross exposure, as the ratio and potential exposure can be influenced by many idiosyncratic properties of individual portfolios. See Basle Committee on Banking Supervision, "The Treatment of the Credit Risk Associated with Certain Off-Balance-Sheet Items" (July 1994).

the risk mitigation effects of central clearing and mark-to-market margining. In particular, if the swap or security-based swap positions are cleared by a registered clearing agency or subject to daily mark-to-market margining,<sup>113</sup> the measures of potential future exposure would further be adjusted to equal twenty percent of the potential future exposure calculated using the methodology described above.<sup>114</sup> The Commissions preliminarily believe that a significant downward adjustment would be appropriate because clearing and daily mark-to-market margining would be expected to reduce the potential future risks posed by an entity's swap or security-based swap positions. Also, it is appropriate to incentivize the use of central clearing and daily mark-to-market margining as practices for helping to control risks. We are not proposing to entirely eliminate such cleared and margined positions from the analysis of potential future exposure, however, because clearing may not entirely eliminate the risks posed by an entity's potential default,<sup>115</sup> and daily mark-to-market margining would not eliminate the risks associated with large intra-day price movements. While the proposed amount of the adjustment seeks to balance these

<sup>113</sup> For these purposes, a swap or security-based swap would 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 exposure (after taking into account any other positions addressed by a netting agreement between the parties). If a person is permitted to maintain an uncollateralized "threshold" amount under the agreement, that amount (regardless of actual exposure) would be considered current uncollateralized exposure for purposes of the test. Also, if the agreement provides for a minimum transfer amount in excess of \$1 million, the entirety of that amount would be considered current uncollateralized exposure. See proposed CEA rule 1.3(sss)(3)(iii)(B); proposed Exchange Act rule 3a67-3(c)(3)(ii).

In this way, the measure of potential future exposure would reflect for the risk mitigating benefits of daily margining, while specifically accounting for industry practices that limit those benefits. Of course, to take advantage of this adjustment it is not enough to the agreement to provide for daily mark-to-market margining—the parties must actually follow that practice.

<sup>114</sup> See proposed CEA rule 1.3(sss)(3)(iii)(A); proposed Exchange Act rule 3a67-3(c)(3).

<sup>115</sup> For example, the 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 the customer's positions in the event of a dealer's default). As a result, central clearing may not eliminate the counterparty risk that the customer poses to the dealer. Even then, however, required mark-to-market margining should help control that risk, and central clearing thus would be expected to reduce the likelihood that an entity's default would lead to broader market impacts.

competing factors, we recognize that alternative higher or lower downward adjustments may also be appropriate.

For purposes of the “major swap participant” definition, the substantial position threshold would be \$2 billion in daily average current uncollateralized exposure plus aggregate potential outward exposure in the applicable major swap category, except that the threshold for the rate swap category would be a daily average of \$6 billion. For purposes of the “major security-based swap participant” definition, the substantial position threshold would be \$2 billion in daily average current uncollateralized exposure plus aggregate potential outward exposure in any major security-based swap category.<sup>116</sup> These proposed amounts reflect the same factors discussed above in the context of the current uncollateralized exposure test,<sup>117</sup> but are raised to reflect the fact that potential future exposure is a measure of potential risk over time, and hence is less likely to pose a direct, immediate impact on the markets than current measures of uncollateralized exposure. We recognize that alternative risk thresholds may also be appropriate, and we welcome comment on potential alternatives.

In light of the amount of this threshold and the underlying risk adjustments, we preliminarily do not believe that an entity would need to calculate its potential future exposure for purposes of the test unless the entity has large notional positions. For example, in light of the proposed risk adjustment of 0.10 for credit derivatives, an entity that does not have any uncollateralized current exposure would have to have notional positions of at least \$20 billion to potentially meet the \$2 billion threshold, even before accounting for the discounts associated with netting agreements. If those swaps or security-based swaps are cleared or subject to mark-to-market margining, the additional 20 percent risk adjustment would mean that the entity without current uncollateralized exposure would have to have cleared notional positions of at least \$100 billion to possibly meet that threshold.<sup>118</sup>

The Commissions request comment on this proposed use of a current exposure plus potential future exposure test to determine the substantial

position threshold. Commenters particularly are requested to address the appropriateness of using potential exposure risk adjustments derived from bank capital rules; and the appropriateness of using bank capital methodologies for addressing positions subject to netting agreements. Also, should this test be supplemented by a test that accounts for the notional amount of an entity’s swap or security-based swap positions without risk-adjustments, to focus on entities that have very large swap or security-based swap positions?

Commenters are requested to address whether the proposed threshold amounts for the proposed current exposure plus potential future exposure test are appropriate, and if not, what alternative threshold amounts would be more appropriate, and why. In addition, commenters are requested to address the proposed method of discounting the potential future exposure associated with cleared positions or positions subject to daily mark-to-market margining to equal 20 percent of what the measure of potential future exposure would be otherwise. Would a larger or smaller discount be appropriate? Is there data available that may assist with reaching the appropriate discount factor? Also, in that regard, should both sets of discounts be equal, or should cleared positions be subject to more of a discount than uncleared positions subject to daily mark-to-market margining? Commenters also are invited to address whether the proposed discounts for cleared positions or positions that are marked-to-market would make it unnecessary or duplicative for this test separately to account for netting agreements. Also, if an entity currently has posted excess collateral in connection with a position, should the amount of that current overcollateralization be deducted from its measure of potential future exposure?

Commenters also are requested to address whether the proposed test in connection with purchases of credit protection—which would cap the measure of exposure at the net present value of unpaid premiums—would raise problems in implementation, and whether we should propose any particular discount rate to be used in conducting the calculation (and, if so, what discount rate should be appropriate). Also, should the measure of potential future exposure in connection with purchases of credit protection and options also account for collateral that a counterparty has posted in connection with an entity’s in-the-money positions, given that such

collateralized in-the-money positions could later turn and cause losses to an entity? In addition, for positions that represent the sale of options on swaps or security-based swaps, would the effective notional amount of the option for purposes of the calculation properly be deemed to be the notional amount of the underlying instrument (or should the notional amount of the option vary based on the link between the changes in the value of the option and changes in the value of the underlying), and would the duration of the option properly be deemed to be the sum of the duration of the option and the duration of the underlying swap or security-based swap?

Commenters also are requested to address whether the risk adjustment for credit derivatives should reflect the riskiness of the underlying reference entity, and, if so, how should that be accomplished in a way that does not rely on the use of credit ratings.

The proposed test of potential future exposure is based in part on the application of fixed multipliers to the notional amounts, or effective notional amounts, of swaps and security-based swaps. In this regard, commenters are invited to discuss whether there are alternative tests that would be more effective to determine potential future exposure or otherwise to supplement an uncollateralized current exposure test, and whether such alternative tests may be more effectively developed in the near future, when additional data regarding swap and security-based swap positions are likely to be available. In particular, commenters are requested to identify any tests based on non-proprietary risk models that could be uniformly applied by all potential major participants to measure potential future exposure. Commenters who propose alternative tests are asked to address how the tests would provide consistent results across different types of swaps and security-based swaps, including customized instruments, in the different major categories. Commenters are also invited to address, on the other hand, whether a single test based on uncollateralized current exposure (*i.e.*, without any test of potential future exposure) would be adequate for identifying entities whose swap or security-based swap positions pose a relatively high degree of risk to counterparties and to the markets. In addition, commenters are invited to identify any tests or thresholds below which a party would be deemed not to be a major swap participant, without needing to calculate the exposure tests set forth in the proposed rule.

<sup>116</sup> See proposed Exchange Act rule 3a67–3(a)(2).

<sup>117</sup> See notes 103 to 106, *supra*, and accompanying text.

<sup>118</sup> Based on these thresholds, we preliminarily believe that only relatively few entities would regularly have to perform these potential future exposure calculations with regard to their security-based swaps. See notes 181 and 182, *infra*, and accompanying text.

Commenters further are requested to address whether and how it would be appropriate to adjust the threshold amounts over time, including whether these proposed thresholds should periodically be adjusted by formula to reflect changes in the ability of the market to absorb losses over time, or changes in other criteria over time. In addition, commenters are requested to address whether the proposed use of a daily average measure for purposes of this test would be burdensome for potential major participants to implement, and, if so, how often should potential participants have to measure these amounts. Commenters also are requested to address whether any such tests should seek to reflect the maximum level of exposure associated with a position, rather than risk-adjusted estimates of exposure proposed here.

In addition, commenters are requested to address whether this proposed test would pose significant monitoring burdens upon entities that have swap or security-based swap positions that are significant enough to potentially meet the combined current uncollateralized exposure and potential future exposure test. Should we provide guidance as to policies and procedures that such an entity should be able to follow to be able to demonstrate that it does not meet the applicable thresholds?

### C. "Hedging or Mitigating Commercial Risk"

The first test of the major participant definitions excludes positions held for "hedging or mitigating commercial risk" from the substantial position analysis.<sup>119</sup>

Commenters took the position that this exclusion from the major participant definitions should encompass a variety of uses of swaps and security-based swaps to hedge risks faced by non-financial entities.<sup>120</sup> Some commenters also suggested that the exclusion should be interpreted to address risks such as "balance sheet risk," the "risk of under-diversification," and hedges undertaken on a portfolio basis. Some commenters favored interpreting this exclusion to permit its use by insurers and banks. One commenter emphasized the need to avoid taking interpretations that would encourage commercial entities not to

manage risks that they otherwise would manage.<sup>121</sup> Commenters also took the position that the addition of the word "mitigating" was intended to expand the exclusion beyond what would have been encompassed had only the term "hedging" been used.<sup>122</sup>

#### 1. Proposed Interpretation

In interpreting the meaning of "hedging or mitigating commercial risk" for purposes of the first test of the major participant definitions, the Commissions first note that virtually identical language is found in the Dodd-Frank provisions granting an exception from the mandatory clearing requirement to non-financial entities that are using swaps or security-based swaps to hedge or mitigate commercial risk.<sup>123</sup> Because Congress used virtually identical language in both instances, the Commissions intend to interpret the phrase "hedging or mitigating commercial risk" with respect to the participant definitions in the same manner as the phrase "hedge or mitigate commercial risk" in the exception from the mandatory clearing requirement.<sup>124</sup> The Commissions also note that although only non-financial entities that

<sup>121</sup> See Cleary letter (also urging inclusion of "all risks" arising in connection with a company's business activities, including risks incidental to a company's ordinary course of business).

<sup>122</sup> See MetLife letter (addition of mitigation "plainly indicates that this exclusion intends an expansive definition of hedging and can also encompass non-speculative derivatives positions used to manage economic risk, including potentially diversification and synthetic asset strategies, such as the conservative 'replication' strategy permitted under State insurance laws"); letter from Joanne R. Medero, Managing Director, BlackRock, dated September 20, 2010 (addressing the parallel context of the exclusion for ERISA plan positions).

<sup>123</sup> 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"). The definition of commercial risk here is for purposes of only the major participant definitions and, to the extent the interpretation is similar, for purposes of the end-user exception from the mandatory clearing requirement. The concept of commercial risk may be interpreted differently for other purposes under the CEA and the Exchange Act.

<sup>124</sup> There is a technical difference in the way those provisions use the concept of hedging and mitigating commercial risk—in that the major participant definitions specifically refer to "positions held for hedging and mitigating commercial risk" while the end-user exception refers to a counterparty that "is using [swaps or security-based swaps] to hedge or mitigate commercial risk." That difference is consistent with the different language used in the two places (particularly the use of "substantial position" in the major participant definitions) and we do not see a reason why the use of the term in the context of the major participant definitions should be construed differently than its use in the comparable clearing exception.

are using 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 major participant test. Accordingly, with respect to the first major participant test, it appears that positions established to hedge or mitigate commercial risk may qualify for the exclusion, regardless of the nature of the entity—*i.e.*, whether a financial entity (including a bank) or a non-financial entity.<sup>125</sup>

In general, we are premising the proposed exclusion on the principle that swaps or security-based swaps necessary to the conduct or management of a person's commercial activities should not be included in the calculation of a person's substantial position.<sup>126</sup> In this regard, the Commissions preliminarily believe that whether an activity is commercial should not be determined solely by the person's organizational status as a for-profit company, a non-profit organization or a governmental entity. Rather, the determinative factor should be whether the underlying activity to which the swap relates is commercial in nature.<sup>127</sup>

<sup>125</sup> 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.

Also, had the statute 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 to include an additional provision in the statute generally restricting the availability of the clearing exception to non-financial entities.

<sup>126</sup> The scope of the proposed exclusion is based on our understanding that when a swap or security-based swap is used to hedge an entity's commercial activities, the gains or losses associated with the swap or security-based swap itself will be offset by losses or gains in the entity's commercial activities, and hence the risks posed by the swap or security-based swap to counterparties or the industry generally will be mitigated.

<sup>127</sup> We do not concur with the suggestion that the use of the word "mitigating" within the major participant definitions was intended to mean something significantly more than hedging. Other provisions of the Dodd-Frank Act appear to use the terms "hedging" and "mitigating" interchangeably; for example, certain provisions of the Dodd-Frank Act refer to "risk-mitigating hedging activities." See Dodd-Frank Act section 619 (adding Section 13 to the Bank Holding Company Act of 1956); Dodd-Frank Act section 619 (adding Section 27B to the Securities Act of 1933). Title VII also refers to "[h]edging and other similar risk mitigating activities." Dodd-Frank Act section 716(d)(1).

<sup>119</sup> See CEA section 1a(33)(A)(i)(I); Exchange Act section 3(a)(67)(A)(i)(I).

<sup>120</sup> See, *e.g.*, letter from Coalition for Derivatives End-Users, dated September 20, 2010 (discussing, *inter alia*, a supplier's use of credit derivatives in connection with a cash receivable, and a company's use of equity derivatives in connection with a stock repurchase program).



a. Proposed Exclusion in the “Major Swap Participant” Definition

As a general matter, the CFTC preliminarily believes 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 person’s overall hedging and risk mitigation strategies. At the same time, the swap position could not be held for a purpose that is in the nature of speculation, investing or trading. Although the line between speculation, investing or trading, on the one hand, and hedging, on the other, can at times be difficult to discern, the statute nonetheless requires such determinations.<sup>128</sup> The CFTC expects that a person’s overall hedging and risk management strategies will help inform whether or not a particular position is properly considered to hedge or mitigate commercial risk. Although the definition includes swaps that are recognized as hedges for accounting purposes or as bona fide hedging for purposes of an exemption from position limits under the CEA, the swaps included within the proposed exclusion are not limited to those categories. Rather, the proposal covers swaps hedging or mitigating any of a person’s business risks, regardless of their status under accounting guidelines or the bona fide hedging exemption.

The CFTC invites comment on whether swaps qualifying for the hedging or risk mitigation exclusion should be limited to swaps where the underlying hedged item is a non-financial commodity. Commenters may also address whether swaps subject to this exception should hedge or mitigate commercial risk on a single risk or an aggregate risk basis, and on a single entity or a consolidated basis. The CFTC also invites comment on whether risks such as the foreign exchange, currency, or interest rate risk relating to offshore

<sup>128</sup> We preliminarily believe that swap positions that are held for the purpose of speculation or trading are, for example, those positions that are held primarily to take an outright view on the direction of the market, including positions held for short term resale, or to obtain arbitrage profits. Swap positions that hedge other positions that themselves are held for the purpose of speculation or trading are also speculative or trading positions.

We preliminarily believe that swap positions that are held for the purpose of investing are, for example, those positions that are held primarily to obtain an appreciation in value of the swap position itself, without regard to using the swap to hedge an underlying risk. In contrast, a swap position related to a non-swap investment (such as the purchase of an asset that a commercial enterprise will use to produce income or otherwise advance its commercial interests) may be a hedging position if it otherwise qualifies for the definition of hedging or mitigating commercial risk.

affiliates, should be covered; whether industry-specific rules on hedging, or rules that apply only to certain categories of commodity or asset classes are appropriate at this time; whether swaps facilitating asset optimization or dynamic hedging should be included; and whether hedge effectiveness should be addressed. Commenters are requested to discuss both the policy and legal bases underlying their comments.

b. Proposed Exclusion in the “Major Security-Based Swap Participant” Definition

The proposed meaning of “hedging or mitigating commercial risk” for purposes of the “major security-based swap participant” definition 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 they arise from the potential change in the value of assets, liabilities and services connected with the ordinary course of business of the enterprise.<sup>129</sup> This standard is intended to exclude from the first major participant test security-based swaps that pose limited risk to the market and to counterparties because the positions would be substantially related to offsetting risks from an entity’s commercial operations.<sup>130</sup> The security-based swaps included within the proposed rule would not be limited to those recognized as hedges for accounting purposes; rather, the proposal has been drafted to cover security-based swaps used in the broader range of transactions commonly referred to as economic hedges,

<sup>129</sup> See proposed Exchange Act rule 3a67–4(a). The concept of “economically appropriate” already is found in rules under the CEA pertaining to the definition of “bona fide hedging” for purposes of an exemption from position limits. See CEA rule 1.3(z). In the context of the definition of “major security-based swap participant,” we may take into account existing interpretations of that term under the CEA, but only to the extent that such interpretations would appropriately be applied to the use of security-based swaps for hedging.

The SEC preliminarily plans 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. The SEC also preliminarily believes 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 cannot reflect over-hedging that could reasonably have a speculative effect) and it should not introduce any basis risk or other new types of risk (other than the counterparty risk that is attendant to all security-based swaps) more than reasonably necessary to manage the identified risk.

<sup>130</sup> These hedging positions would include activities, such as the management of receivables, that arise out of the ordinary course of an entity’s commercial operations, including activities that are incidental to those operations.

regardless of their status under accounting guidelines.

At the same time, the security-based swap position could not be held for a purpose that is in the nature of speculation or trading.<sup>131</sup> In addition, the 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 as defined by the rule or CEA rule 1.3(tt).<sup>132</sup>

We look forward to commenters’ views on whether the proposed standard strikes an appropriate balance in determining which positions may be excluded for purposes of the first major participant test. We recognize that there are other reasonable views as to what positions may appropriately be considered to be for the purposes of hedging or mitigating commercial risk. We also recognize the importance of providing as clear guidance as possible as to what is or is not a hedging position for these purposes.

The proposal also would condition 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 positions.<sup>133</sup> These activities are intended to help ensure that positions excluded for purposes of the

<sup>131</sup> See proposed Exchange Act rule 3a67–4(b)(1). For these purposes, we preliminarily believe that security-based swap positions that are held for the purpose of speculation or trading are those positions that are held intentionally 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, as well as security-based swap positions that hedge other positions that themselves are held for the purpose of speculation or trading. Thus, for example, positions that would be part of a “trading book” of an entity such as a bank would not constitute hedging positions that may be excluded for purposes of the first major participant test.

<sup>132</sup> See proposed Exchange Act rule 3a67–4(b)(2).

<sup>133</sup> See proposed Exchange Act rule 3a67–4(a)(3). The proposal particularly would require the person to: identify and document the risks that are being reduced by the security-based swap position; establish and document a method of assessing the effectiveness of the security-based swap as a hedge; and regularly assess the effectiveness of the security-based swap as a hedge.

We expect that market participants that have security-based swap activities significant enough that they may be major participants would already engage in risk assessment activities for their hedging positions, either formally or informally, and thus we do not believe that the proposed requirements would disrupt existing business practices. Instead, the proposal is intended to create standards that will allow market participants to confirm their compliance with the rule by formalizing risk assessment activities that should already be part of an effective hedging program.

first major participant test would not extend to positions that are not entered into to reduce or hedge commercial risks, or that at a later time no longer substantially serve to reduce or mitigate such risks.<sup>134</sup>

We preliminarily believe that this proposed approach would facilitate the following types of security-based swap positions:

- 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;<sup>135</sup>

- Positions established to manage the 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 CEA rule 1.3(ttt));

- 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 those positions.

## 2. Request for Comments

We request comment on the proposed definition of "hedging or mitigating commercial risk" for purposes of both the "major swap participant" and the "major security-based swap participant" definitions. Commenters particularly are requested to address whether the proposed definitions would adequately limit the types of swaps or security-based swaps that are encompassed by the definition, such that the definitions do not encompass positions that serve speculative, trading or other non-hedging purposes. In this regard, do the proposed definitions appropriately exclude from the scope of the definition swaps and security-based swaps that would be less likely to pose risks to counterparties and the market, by virtue of gains or losses on those swaps being offset by losses or gains associated with an entity's commercial operations? Commenters further are requested to address whether the proposed "economically appropriate" standard would effectively limit the positions encompassed by the definition. If not, what alternative standards (e.g., standards derived from accounting principles) would more effectively identify hedging positions and distinguish those from positions held for other purposes? In that regard, is the concept of "economically appropriate" well-understood, and, if not, is there another concept that would more effectively delimit the nature of the relationship between the swap or security-based swap position and the risk being hedged or mitigated? Also, in the context of the definition of this term for purposes of security-based swaps, should existing interpretive guidance pertaining to the concept of "economically appropriate" with respect to the CEA's bona fide hedging exemption for position limits be considered, and, if so, to what extent?

We further request comment on possible alternative approaches to the test identifying positions entered into for the purpose of hedging or mitigating commercial risk. For example, should the test require the entity excluding a position to have a reasonable basis to believe, and to actually believe, that the excluded swap would be a "highly effective," "reasonably effective" or "economically appropriate" hedge of a

specified commercial risk? Should the test be generally identical to the proposed test, but with the substitution of the phrase "highly effective" or "reasonably effective" (or another standard) for "economically appropriate"? Should the test be based on accounting principles for hedging treatment (i.e., a quantitative test requiring the hedge to be within a certain band of effectiveness)?

Commenters also are requested to address the proposed restrictions on positions in the nature of speculation or trading. Is it appropriate not to permit any speculative or trading positions from being deemed for the purpose of hedging or mitigating commercial risk? What would be the impact of such an interpretation on an entity's risk mitigation practices? Also, is the dividing line between speculative and trading positions on the one hand, and positions eligible to be considered to be hedging positions on the other hand, sufficiently clear? Is such a line appropriately based on whether the position is intended to be held for the short-term versus long-term intent? Would some alternative criteria be preferable in terms of setting forth objective standards for identifying risk reducing hedging positions and distinguishing them from other positions? Also, would additional standards or other guidance be appropriate to help ensure that positions used in connection with speculative or trading purposes do not fall within the definition?

We further request comment on the proposal that a swap or security-based swap would not fall within the definition of "hedging or mitigating commercial risk" if it is held to hedge or mitigate the risk of another swap or security-based swap, unless that other position itself is held for the purpose of hedging or mitigating commercial risk. One consequence of this approach might be that a particular swap or security-based swap hedging a particular type of risk would be included or excluded based solely on whether that risk arises from another swap or security-based swap or from a different type of transaction.<sup>136</sup> Is this the appropriate approach? What would be the consequences of this approach for

<sup>134</sup> This condition does not mandate that an entity follow a particular set of procedures to take advantage of the exclusion. We would expect that an entity that already engages in these types of risk assessment procedures in connection with its existing business activities to be able to rely on those procedures to satisfy the condition. These conditions also could be satisfied by the entity's use of a third-party to assist with these risk assessment activities.

<sup>135</sup> The references here to customers and counterparties do not include swap or security-based swap counterparties.

<sup>136</sup> For example, under this proposal an entity may exclude from the first major participant test a security-based swap used to manage the credit risk posed by a customer's default in connection with financing that an entity provides to that customer. The entity may not exclude an identical security-based swap, however, if that security-based swap is used to hedge the credit risk associated with a second swap or security-based swap that itself is not for the purpose of hedging or mitigating commercial risk.

different types of entities? How would the proposed approach affect the risk management practices of entities that are close to the proposed threshold? Is it appropriate to include both positions within the major participant calculations? If this general approach in the proposed rule were adopted, should there be any exceptions to the approach? What alternative approaches might be considered? For example, would it be appropriate to exclude a swap or security-based swap that hedges another swap or security-based swap from the calculation? What would be the advantages and disadvantages of this approach?

Moreover, commenters are requested to address whether the definition should encompass a quantitative test that would limit the total value of swaps and security-based swaps that an entity may include under this rule to be no more than the total value of underlying risk identified by such entity. If so, what measurement should be used for determining an entity's total value of swaps and security-based swaps and total value of underlying risk, and what methods or procedures should entities be required to follow when calculating and comparing the two values?

In addition, commenters are requested to address whether the proposed procedural requirements, in the context of this definition for purposes of the "major security-based swap participant" analysis, are appropriate. In this regard, commenters are requested to discuss whether there are any advantages or disadvantages to providing more specific procedural requirements; whether the proposed procedural requirements will alter business practices to the extent that a transition period is necessary before they are implemented; and whether specific guidance is required to address how the proposed procedural requirements will affect existing positions. In addition, commenters are requested to address whether the proposed procedural requirements should include a requirement to quantify the underlying risk and the effectiveness of the hedge, and whether such quantitative assessments would impose significant systems costs or other costs. Also, should an assessment of hedging effectiveness be required at all, in light of the costs that may be associated with such a requirement?

More generally, would the proposed standards for identifying positions for the purpose of hedging or mitigating commercial risk suffice to allow a person holding a security-based swap position to identify and document the commercial risks that are being hedged

or mitigated by that position, and if not, what additional requirements are needed? Should additional guidance be provided regarding whether components of risks (in assets, liabilities or services) or whether risks in portfolios (of assets, liabilities or services) may be identified as the commercial risks that are being hedged or mitigated by the position, and, if so, which components? Also, should additional guidance be provided with respect to the form of documentation or the elements of the hedging relationship that should be documented, and, if so, which elements? Moreover, if a swap or security-based swap that was hedging at inception were no longer to serve a hedging purpose over time, should it no longer fall within the definition of hedging or mitigating commercial risk?

In addition, should the rule specify the frequency with which an entity should assess the effectiveness of the hedge? Also, should we provide additional guidance on the acceptable methods of assessing effectiveness? Is a qualitative assessment adequate to assess effectiveness or should a quantitative assessment also be required? Should the rule establish a level of offset between the position and the hedged risk, below which the position would not be considered to be effective at reducing risk, and, if so, what is the level of offset (or range of levels) below which the position should not be considered to be effective? Are there methods for assessing effectiveness that should not be permitted for these purposes?

Commenters also are requested to address whether the proposal also should encompass certain activities in which an entity hedges an affiliate's risks.

We further request comment on how the definition should apply to hedging activities by financial entities. Commenters particularly are invited to address whether financial entities should be able to rely on this exclusion, or whether financial entities should face special limits in the context of this exclusion. Commenters further are requested to address how the proposed provisions excluding positions in the nature of speculation or trading from the definition would apply to activities by banks, including permissible trading activities by banks, and, in particular, whether it is appropriate to exclude positions that are part of an entity's "trading book."

Commenters also are requested to address the application of the proposal to registered investment companies, including whether additional guidance would be appropriate with respect to

which uses of security-based swaps by registered investment companies would fall within the exclusion.

#### D. "Substantial Counterparty Exposure"

The second test of the major participant definitions addresses entities whose swaps and 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."<sup>137</sup> Unlike the first test of the major participant definitions, this test does not focus on positions in a "major" category of swaps or security-based swaps. Also, unlike the first test, this test does not explicitly exclude hedging positions or certain ERISA plan positions from the analysis.

Some commenters suggested that the second major participant definition test should be interpreted in a manner similar to the first test. Many commenters stated that the analysis should also reflect netting agreements and the posting of collateral. Some commenters stated that the test should exclude hedging positions, and cleared positions.

We preliminarily believe that the second major participant definition test's focus on the counterparty risk associated with an entity's swap or security-based swap positions is similar enough to the "substantial position" risks embedded in the first test that the second test appropriately takes into account the same measures of current uncollateralized exposure and potential future exposure that are used in our proposal for the first test. For the second test, however, the thresholds must focus on the entirety of an entity's swap positions or security-based swap positions, rather than on positions in any specific "major" category. In addition, this second test does not explicitly account for positions for hedging commercial risk or ERISA positions.

Accordingly, these proposed calculations of substantial counterparty exposure would be performed in largely the same way as the calculation of substantial position in the first major participant definition tests, except that the amounts would be calculated by reference to all of the person's swap or security-based swap positions, rather than by reference to a specific "major" category of such positions.<sup>138</sup>

For purposes of the "major swap participant" definition, the CFTC

<sup>137</sup> See CEA section 1a(33)(A)(ii); Exchange Act section 3(a)(67)(A)(ii)(II).

<sup>138</sup> See proposed CEA rule 1.3(uuu)(2); proposed Exchange Act rule 3a67-5(b)(1).

proposes that the second major participant definition test be satisfied by a current uncollateralized exposure of \$5 billion, or a combined current uncollateralized exposure and potential future exposure of \$8 billion, across the entirety of an entity's swap positions.<sup>139</sup> For purposes of the "major security-based swap participant" definition, the SEC proposes that the second test be satisfied by a current uncollateralized exposure of \$2 billion, or a combined current uncollateralized exposure and potential future exposure of \$4 billion, across the entirety of an entity's security-based swap positions.<sup>140</sup> We look forward to commenters' views as to whether alternative thresholds would be more appropriate to achieve the statutory goals.

These proposed thresholds in part are based on the same factors that underpin the proposed "substantial position" thresholds.<sup>141</sup> The proposed thresholds, however, also reflect the fact that this test must account for an entity's positions across four major swap categories or two major security-based swap categories.<sup>142</sup> These proposed thresholds, moreover, have further been raised to reflect the fact that this second test (unlike the first major participant test) encompasses certain hedging positions that, in general, we would expect to pose fewer risks to counterparties and to the markets as a whole than positions that are not for purposes of hedging.

We request comment on this proposal. Commenters particularly are requested to address whether the proposed use of current uncollateralized exposure and potential future exposure tests (including the parts of those tests that account for positions that are cleared or subject to mark-to-market margining) are appropriate, and whether the proposed thresholds are set at an appropriate level. Should the thresholds be higher or lower? If so, what alternative threshold amounts would be more appropriate, and why? Commenters also are requested to address whether the test should exclude commercial risk and ERISA hedging positions, on the grounds that those hedging positions may not raise the same degree of risk to counterparties as other swap or security-based swap positions. Comments are also requested on whether the test of

substantial counterparty exposure, given its focus on the systemic risks arising from the entirety of a person's portfolio, should include a measure to take into account the person's combined swap positions and security-based swap positions.

#### E. "Financial Entity" and "Highly Leveraged"

The third test of the major participant definitions addresses any "financial entity," other than one subject to capital requirements established by an appropriate Federal banking agency,<sup>143</sup> that is "highly leveraged relative to the amount of capital" the entity holds, and that maintains a substantial position in a "major" category of swaps or security-based swaps. This test does not permit an exclusion for positions held for hedging.

As discussed below, we are proposing specific definitions of the terms "financial entity" and "highly leveraged." In addition, we request comment on whether we should include additional regulators within the proposed interpretation of what is an appropriate Federal banking agency.

#### 1. Meaning of "financial entity"

While the third major participant definition test does not explicitly define "financial entity," Title VII of the Dodd-Frank Act defines "financial entity" in the context of the end-user exception from mandatory clearing (an exception that generally is not available to those entities).<sup>144</sup> Some commenters have pointed out that using that definition here would produce circular results.<sup>145</sup>

We preliminarily do not believe there is a basis to define "financial entity" for purposes of the major participant definitions in a way that materially differs from the definition used in the end-user exception from mandatory clearing. Using the same basic definition also would appear to be consistent with the statute's intent to treat non-financial end-users differently than financial entities. Accordingly, other than

<sup>143</sup> Sections 721 and 761 of the Dodd-Frank Act add a definition of the term "appropriate Federal banking agency" in sections 1a and 3(a) of the CEA and the Exchange Act, respectively, 7 U.S.C. 1a(2), 15 U.S.C. 78c(a)(72). The Commissions propose to refer to those statutory definitions for purposes of the rules.

<sup>144</sup> See CEA section 2(h)(7)(C)(i); Exchange Act section 3C(g)(3)(A).

<sup>145</sup> See Cleary letter (also addressing status of broker-dealers and futures commission merchants as part of the analysis).

The circularity would result because, for purposes of the end-user clearing exception, "financial entity" is defined to include swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants.

technical changes to avoid circularity, we propose to use the same definition in the major participant definitions.<sup>146</sup>

Commenters are requested to address our proposed definition of "financial entity."

#### 2. Meaning of "Highly Leveraged"

Some commenters have stated that the term "highly leveraged" should be interpreted by looking at the leverage associated with other firms in an entity's line of business, rather than by applying an across-the-board measure of leverage.<sup>147</sup> One commenter suggested that higher leverage may be warranted for entities with a smaller capital base, and another commenter suggested that we look at analogous banking regulations rather than creating a new regime for measuring leverage. Some commenters suggested ways of addressing specific items for purposes of determining leverage.<sup>148</sup>

The Commissions recognize that traditional balance sheet measures of leverage have limitations as tools for

<sup>146</sup> See proposed CEA rule 1.3(vv)(1); proposed Exchange Act rule 3a67-6(a). To avoid circularity, the meaning of "financial entity" for purposes of the "major swap participant" definition would not encompass any "swap dealer" or "major swap participant" (but would encompass "security-based swap dealers" and "major security-based swap participants"). The meaning of "financial entity" for purposes of the "major security-based swap participant" definition would not encompass any "security-based swap dealer" or "major security-based swap participant (but would encompass "swap dealers" and "major swap participants"). For both definitions, "financial entity" 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 the Employee Retirement Income Security Act of 1974; 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).

<sup>147</sup> See letter from Robert Pickel, Executive Vice Chairman, International Swaps and Derivatives Association, Inc., dated September 20, 2010 (suggesting that "leverage ratio limits to which banks and other regulated entities are subject would be unsuitably low for other enterprises"); letter from Steve Martinie, Assistant General Counsel and Assistant Secretary, The Northwestern Mutual Life Insurance Company, dated September 20, 2010 ("Northwestern Mutual letter") (suggesting that financial firms require less cushion than other entities because financial firms are able to match their assets and liabilities more closely).

<sup>148</sup> See Northwestern Mutual letter (suggesting that the Commissions recognize that liabilities such as bank deposits and insurance policy reserves are not leverage); Vanguard letter (suggesting that leverage should relate to debt financing and should not encompass potential leveraging effects posed by derivatives); SIFMA AMG letter (suggesting that the Commissions take into account the difference between non-recourse and recourse obligations, the difference between notional amounts payable and actual payable obligations, and the difference between actual financial obligations and leverage embedded in a derivative that affects returns but does not result in a payment obligation).

<sup>139</sup> See proposed CEA rule 1.3(uuu)(1).

<sup>140</sup> See proposed Exchange Act rule 3a67-5(a).

<sup>141</sup> See notes 103 to 106 and 117, *supra*, and accompanying text.

<sup>142</sup> Thus, these proposed thresholds in part would account for an entity 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 either.

evaluating an entity's ability to meet its obligations. In part this is because such measures of leverage do not directly account for the potential risks posed by specific instruments on the balance sheet, or financial instruments that are held off of an entity's balance sheet (as may be the case with an entity's swap and security-based swap positions). At the same time, we preliminarily do not believe that it is necessary to use more complex measures of risk-adjusted leverage here, particularly given that the third test in the major participant definitions already addresses those types of risks by considering whether an entity has a substantial position in a major category of swaps or security-based swaps. We are also mindful of the costs that entities would face if forced to undertake a complex risk-adjusted leverage calculation, especially for entities that would not already be performing this type of analysis.<sup>149</sup> Additionally, we preliminarily do not believe that it is necessary for the leverage standard to account for the degree of leverage associated with different types of financial entities.

Although the third test of the major participant definitions does not define "highly leveraged," we note that Congress addressed the issue of leverage in Title I of the Dodd-Frank Act. There, Congress provided that the Board of Governors of the Federal Reserve System 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 of Governors, 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."<sup>150</sup>

This requirement in Title I suggests potential alternative approaches to the definition of "highly leveraged" for purposes of the major participant definitions. On the one hand, the 15 to 1 limit may represent an upper limit of acceptable leverage, indicating that the limit for the major participant definitions should be lower so as to create a buffer between entities at that upper limit and entities that are not highly leveraged. On the other hand, the Title I requirement, which applies only when the entity in question poses a "grave threat" to financial stability, may indicate that the 15 to 1 leverage ratio is also the appropriate test of whether an entity poses the systemic risk concerns implicated by the major participant definitions.

For these reasons, we propose two possible definitions of the point at which an entity would be "highly leveraged"—either an entity would be "highly leveraged" if the ratio of its total liabilities to equity is in excess of 8 to 1, or an entity would be "highly leveraged" if the ratio of its total liabilities to equity is in excess of 15 to 1. In either case, the determination would be measured at the close of business on the last business day of the applicable fiscal quarter. To promote consistent application of this leverage test, 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.<sup>151</sup> All other entities would calculate the value of total liabilities and equity consistent with the proper application of U.S. generally accepted accounting principles.

We believe that the 15 to 1 ratio could be consistent with the use of that ratio in Title I, which, as noted above, provides that the 15 to 1 leverage ratio would be applied to a bank holding company or nonbank financial company subject to Title I as a maximum only if it is determined that the company poses a "grave threat" to financial stability. Commenters are requested to address whether the proposed 15 to 1 standard used in Title I suggests that a standard higher than 15 to 1 should be used here, given that the Title I standard is applicable only to large entities that also pose a "grave threat" to financial

stability and thus may suggest that a higher standard is appropriate for entities that do not pose the same degree of threat. Alternatively, the 8 to 1 ratio could be consistent with the exemption in the third test of the major participant definitions for financial institutions that are subject to capital requirements set by the Federal banking agencies, as it is possible that financial institutions were specifically excluded from the third test based on the presumption that they generally are highly leveraged, and hence would have been covered by the third test if they were not expressly exempted. Based on our analysis of financial statements it appears that those institutions generally have leverage ratios of approximately 10 to 1, which may suggest that the "highly leveraged" threshold would have to be lower for those institutions to be potentially subject to the third test. Such an approach would help to ensure that the third test of the major participant definition applies to financial entities that are not subject to capital requirements set by the Federal banking agencies, but that have leverage ratios similar to institutions that are subject to those requirements.

The Commissions request comment on the proposed alternative definitions of "highly leveraged." Commenters particularly are requested to specifically address the relative merits of the proposed alternative 8 to 1 and 15 to 1 standards, as well as other standards that they believe would be appropriate for these purposes.<sup>152</sup>

Commenters further are requested to address whether a risk-adjusted leverage ratio should be used, and, if so, how the ratio should be calculated (including whether particular items should be included or excluded when making this calculation), and whether a risk-adjusted leverage ratio could be developed relying on measures already

<sup>149</sup> The Basel Committee on Banking Supervision recently proposed one method for calculating risk-adjusted leverage in its Consultative Document entitled: "Strengthening the resilience of the banking sector" (Dec. 2009). This proposal would create a new leverage ratio based on a comparison of capital to total exposure. Total exposure for these purposes would be measured by, among other things, including the notional value of all written credit protection, severely limiting the recognition given to netting, and calculating the risks associated with off-balance sheet derivatives transactions, as measured by the current exposure method for calculating future risks outlined in Basel II. The Consultative Document drew over 150 comments from the international financial community, which included both those in support of, and those that questioned the inclusion of a risk-adjusted leverage ratio within the Basel framework. The Basel Committee on Banking Supervision expects to deliver a full package of reforms by the end of 2010, based on the Consultative Document released in December 2009 and comments received thereon.

<sup>150</sup> See Dodd-Frank Act section 165(j)(1).

<sup>151</sup> These entities would include those that submit periodic reports on a voluntary basis to the SEC, as well as those that are required to file periodic reports with the SEC.

<sup>152</sup> In this regard, we recognize that under Exchange Act rule 15c3-1, 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% of its net capital (*i.e.*, a 15 to 1 aggregate indebtedness to net capital ratio). 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% of their net capital (*i.e.*, a 12 to 1 aggregate indebtedness to net capital ratio). We recognize that these measures, however, reflect a different ratio of total liabilities to equity; for example, the calculation of aggregate indebtedness in rule 15c3-1 excludes certain liabilities, and the calculation of net capital includes certain subordinated debt—meaning that these measures would respectively be equivalent to ratios higher than 15:1 or 12:1 when converted to a balance sheet ratio of liabilities to equity such as that used under the proposed rule.

calculated by entities as a matter of course.<sup>153</sup> Commenters further are requested to address whether the leverage ratio should be revised to require that the amount of potential future exposure (as outlined in the “substantial position” discussion above) be combined with total liabilities before such number is compared to equity for purposes of calculating the ratio, and, if so, whether the proposed ratios would still be appropriate; whether the rule should more specifically address issues as to how certain types of positions or liabilities should be accounted for when calculating leverage; whether the proposed timing of the measurement—the close of business on the last business day of the applicable fiscal quarter—would be potentially subject to gaming or evasion; and whether the rule text should particularly prescribe how separate categories of entities calculate leverage.

#### *F. Implementation Standard, Reevaluation Period and Minimum Duration of Status*

While the analysis of whether an entity is a major participant is backward looking, an entity that meets the criteria for being a major participant is required to register with the CFTC and/or the SEC, and comply with the requirements applicable to major participants. We recognize that these entities will need time to complete their applications for registration and to come into compliance with the applicable requirements. We thus propose that an unregistered entity that meets the major participant criteria as a result of its swap or security-based swap activities in a fiscal quarter would not be deemed to be a major participant until the earlier of the date on which it submits a complete application for registration pursuant to CEA Section 4s(b) or Exchange Act Section 15F(b), or two months after the end of that quarter.<sup>154</sup> We preliminarily believe that this would provide entities with an appropriate amount of time to apply for registration and, with the time between the submission of an application and the effectiveness of the registration, to comply with the requirements applicable to major participants, without permitting undue delay.

<sup>153</sup> For example, would adjustments akin to those discussed above in the context of broker-dealer net capital provide a more useful measure of leverage for these purposes?

<sup>154</sup> See proposed CEA rule 1.3(qqq)(4)(i); proposed Exchange Act rule 3a67-7(a). The Commissions are proposing separate rules regarding the registration requirements and processes for major participants.

We also propose to provide a reevaluation for entities that meet one or more of the applicable major participant thresholds, but only by a modest amount.<sup>155</sup> In particular, an unregistered entity that has met these criteria as a result of its swap or security-based swap activities in a fiscal quarter, but without exceeding any applicable threshold by more than twenty percent, would not immediately be subject to the timing requirements discussed above. Instead, that entity would become subject to those requirements if the entity exceeded any of the applicable daily average thresholds in the next fiscal quarter.<sup>156</sup> We preliminarily believe this type of reevaluation period would avoid applying the major participant requirements to entities that meet the major participant criteria for only a short time due to unusual activity.

In addition, we propose that any entity that is deemed to be a major participant would retain that status until such time that it does not exceed any of the applicable thresholds for four consecutive quarters after the entity becomes registered.<sup>157</sup> Commentators raised concerns about the possibility of entities moving in and out of the status on a rapid basis,<sup>158</sup> and we believe that this proposal appropriately addresses that concern in a way that would help promote the predictable application and enforcement of the requirements governing major participants.

The Commissions request comment on these proposals. Commenters particularly are requested to address: Whether two months is an adequate amount of time for entities that have met the criteria to submit an application for registration; whether there is an adequate amount of time to make the necessary internal changes to come into compliance with the requirements applicable to major participants before being subject to those requirements as a result of a registration becoming effective; whether twenty percent is the appropriate threshold for applicability

<sup>155</sup> Commenters raised concerns over an entity qualifying as a major participant due to an unusual event. See, e.g., letter from American Benefits Council and Committee on the Investment of Employee Benefit Assets, dated September 20, 2010 (stating that quirky volatility may affect the determinations).

<sup>156</sup> See proposed CEA rule 1.3(qqq)(4)(ii); proposed Exchange Act rules 3a67-7(b).

<sup>157</sup> See proposed CEA rule 1.3(qqq)(5); proposed Exchange Act rules 3a67-7(c)(1).

<sup>158</sup> See Vanguard letter (suggesting that entities should remain in the status after qualification for an extended defined period such as one calendar year); AIMA letter (noting that recategorization of entities could be disruptive for entities' business models and could be administratively burdensome for the Commissions).

of the reevaluation period; whether there would be any risks arising from delaying registration as a major participant for an entity that exceeds the thresholds, but qualifies for the reevaluation period; and whether four consecutive quarters of not meeting the criteria for major participant status after registration is granted is the appropriate amount of time that a major participant should be required to stay in the status.

In addition, we request comment on the appropriateness of the proposed reevaluation period. Commenters particularly are requested to address whether it is likely that unusual market conditions could cause an entity to exceed the proposed thresholds over the course of a quarter (based on a daily average) without generally raising the types of risks that the thresholds were intended to identify. Also, should the use of the reevaluation period be conditioned on requiring any entity relying on the reevaluation period to make a representation, or otherwise demonstrate, that it exceeded the threshold due to a one-time extraordinary event, and that it will be below the threshold at the next time of measurement?

#### *G. Limited Purpose Designations*

In general, a person that meets the definition of major participant will be considered to be a major participant with respect to all categories of swaps or security-based swaps, as applicable, and with regard to all activities involving those instruments.<sup>159</sup> As discussed above, however, the statutory definitions provide that a person may be designated as a major participant for one or more categories of swaps or security-based swaps without being classified as a major participant for all categories.<sup>160</sup> Thus, as with the definitions of “swap dealer” and “security-based swap dealer,” we propose to provide that major participants who engage in significant activity with respect to only certain types, classes or categories of swaps or security-based swaps may apply for relief with respect to other types of swaps or security-based swaps from certain of the requirements that are applicable to major participants. The Commissions anticipate that a major participant could seek a limited designation at the same time as, or at a later time subsequent to, the person's initial registration as a major participant. Because of the variety of situations in which major participants

<sup>159</sup> See proposed CEA rule 1.3(qqq)(2); proposed Exchange Act rule 3a67-1(c).

<sup>160</sup> CEA section 1a(33)(C); Exchange Act section 3(a)(67)(C).

may enter into swaps or security-based swaps, it is difficult to set out at this time the conditions, if any, which would allow a person to be designated as a major participant with respect to only certain types, classes or categories of swaps or security-based swaps.

The Commissions request comment on the proposed rules regarding limited designation as a major participant. Commenters particularly are requested to address the circumstances in which such limited purpose designations would be appropriate, and to address the factors that the Commissions should consider when addressing such requests, and the type of information requestors should provide in support of their request. Commenters also are asked to address whether such limited purpose designations should be conditioned in any way, such as by the provision of information of the type that would be required with respect to an entity's swaps or security-based swaps involving the particular category or activity for which they are not designated as a major participant.

#### H. Additional Interpretive Issues

Commenters have raised additional issues related to the major participant definitions.

##### 1. Exclusion for ERISA Plan Positions

As discussed above, the first test of the major participant definitions excludes from the analysis "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 ERISA (29 U.S.C. 1002) for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan." Some commenters suggested that the exclusion should encompass activities such as portfolio rebalancing and diversification, and gaining exposure to alternative asset classes, and that this type of exclusion also should apply to certain other types of entities.<sup>161</sup>

We preliminarily do not believe that it is necessary to propose a rule to further define the scope of this exclusion. In this regard, we note that this ERISA plan exclusion, unlike the other exclusion in the first major participant test, is not limited to "commercial" risk, which may be construed to mean that hedging by

ERISA plans should be broadly excluded.

While the Commissions are not proposing to make this type of exclusion available to additional types of entities, we request comment on whether we should do so. If so, what type of entities should receive this type of exclusion, and why do the concerns that led to the enactment of the major participant requirements in the Dodd-Frank Act not apply to such entities?

##### 2. Application of Major Participant Definitions to Managed Accounts

Some commenters have stated that asset managers and investment advisers should not be deemed to be major participants by virtue of the swap and security-based swap positions held by the accounts they manage. These commenters have emphasized that asset managers and investment advisers are separate legal entities from the accounts that they administer, the accounts themselves are the counterparties to the swaps and security-based swaps, and managers and advisers do not maintain capital to support the trades of their clients. One commenter also expressed the view that the positions of individual accounts under the advisement of a single asset manager should not be aggregated for the purpose of the major participant definitions because different accounts managed by an asset manager may use the same positions for different purposes.<sup>162</sup>

Preliminarily, we do not believe that the major participant definitions should be construed to aggregate the accounts managed by asset managers or investment advisers to determine if the asset manager or investment adviser itself is a major participant. The major participant definitions apply to the entities that actually "maintain" substantial positions in swaps and security-based swaps or that have swaps or security-based swaps that create substantial counterparty exposure. The Commissions have the authority to adopt anti-evasion rules to address the possibility that persons who enter into swaps and security-based swaps may attempt to allocate the swaps and security-based swaps among different accounts (thereby attempting to treat

such other accounts as the entity that has entered into the swaps or security-based swaps) for the purpose of evading the regulations applicable to major participants.<sup>163</sup> In addition, we note that since the major participant definitions focus on the entity that enters into swaps or security-based swaps, all of the managed positions of which a person is the beneficial owner are to be aggregated (along with such beneficial owner's other positions) for purposes of determining whether such beneficial owner is a major participant.<sup>164</sup>

The Commissions request comment on the application of the major participant definitions to managed accounts. Commenters particularly are requested to address: whether additional guidance is necessary to address issues relating to the application of the major participant definition to managed accounts; whether there are areas of potential abuse, and if so, what they may be. Commenters further are requested to address whether the Commissions should adopt anti-evasion rules to address areas of potential abuse, and if so, how such rules should be crafted.

In addition, commenters are requested to discuss any implementation concerns that may arise if the beneficial owner of a managed account meets one of the major participant definitions; for example, would the beneficial owner face any impediments in terms of identifying whether it falls within the major participant definitions? Also, what implementation issues would arise with respect to applying the major participant definitions to managed accounts and/or their beneficial owners if the accounts' advisers or managers are not subject to regulation as major participants?

##### 3. Application of Major Participant Definitions to Positions of Affiliated Entities

The issues discussed above with regard to managed accounts also are related to the separate issue of whether the major participant tests should, in some circumstances, aggregate the swap and security-based swap positions of entities that are affiliated. Absent that type of aggregation, an entity could seek to evade major participant status by allocating swap or security-based swap

<sup>162</sup> In addition, a colloquy on the Senate floor addressed the status of managed accounts for purposes of the major participant definitions, particularly focusing on whether the analysis should "look at the aggregate positions of funds managed by asset managers or at the individual fund level?" In response, it was stated that, "[a]s a general rule, the CFTC and the SEC should look at each entity on an individual basis when determining its status as a major swap participant." See 156 Cong. Rec. S5907 (daily ed. July 15, 2010) (colloquy between Senators Hagan and Lincoln).

<sup>163</sup> See Dodd-Frank Act sections 721(b)(2), 761(b)(3).

<sup>164</sup> This guidance relates only to the application of the major participant definitions to managed accounts. It is not intended to apply to the treatment of managed accounts with respect to any other rules promulgated by the CFTC or SEC to implement Title VII of the Dodd-Frank Act or to any other applicable rules or requirements.

<sup>161</sup> See Cleary letter (addressing welfare plans or entities holding assets of such plans, such as voluntary employee beneficiary associations, employer group trusts or bank-maintained collective trusts); see also letter from Jane Hamblen, State of Wisconsin Investment Board, dated September 20, 2010.



positions among a number of affiliated entities.

In situations in which a parent is the majority owner of a subsidiary entity, we preliminarily believe that the major participant tests may appropriately aggregate the subsidiary's swaps or security-based swaps at the parent for purposes of the substantial position analyses.<sup>165</sup> Attributing those positions to a parent appears consistent with the concepts of "substantial position" and "substantial counterparty exposure," given that the parent would effectively be the beneficiary of the transaction. In those circumstances, however, there still may be questions as to whether the requirements applicable to major participants—*e.g.*, capital, margin and business conduct—should be placed upon the parent or the subsidiary. We recognize that it may be appropriate at times to apply such requirements upon the subsidiary to the extent that the subsidiary is acting on behalf of the parent.<sup>166</sup>

Commenters particularly are invited to discuss when it would be appropriate to apply the major participant definitions to entities that are the majority owner of subsidiaries that enter into swaps or security-based swaps, or whether attribution of a subsidiary's security-based swap positions is generally inappropriate. Also, to the extent this type of attribution is appropriate, to what extent should the subsidiary retain responsibilities for complying with the capital, margin, business conduct and other requirements applicable to major participants?

Commenters further are requested to address whether the swaps or security-based swaps of corporate subsidiaries in some circumstances should be attributed to an entity that itself is not the majority owner of the direct counterparty to a swap or security-based swap. Moreover, should this type of attribution apply when one entity controls another entity, and, if so, how should the concept of control be defined for these purposes? In addition, commenters are requested to address whether, as an alternative approach, this type of attribution would be appropriate specifically when a parent provides guarantees on behalf of its subsidiaries,

<sup>165</sup> Arguably, the basis for this type of attribution would be even stronger if the parent wholly owns the subsidiary. An attribution rule that only addresses 100 percent ownership situations, however, may readily be susceptible to gaming if the parent were to sell a very small interest in the subsidiary to another party.

<sup>166</sup> It may also be appropriate to address these issues in connection with the rule proposals addressing the substantive requirements applicable to major participants.

or third parties provide guarantees on behalf of unaffiliated entities.

Commenters further are requested to address any issues that would arise with regard to the effective implementation of the requirements applicable to major participants in the context of this type of attributions.

#### 4. Application of Major Participant Definitions to Inter-Affiliate Swaps and Security-Based Swaps

Several commenters have suggested that swaps and security-based swaps between affiliated counterparties should not be considered within the analysis of whether an entity's swap or security-based swap positions cause it to be a major participant. Such inter-affiliate swaps and security-based swaps may be used to achieve various operational and internal efficiency objectives.

The Commissions preliminarily believe that when a person analyzes its swap or security-based swap positions under the major participant definitions, it would be appropriate for the person to consider the economic reality of any swaps or security-based swaps it enters into with wholly owned affiliates, including whether the swaps and security-based swaps simply represent an allocation of risk within a corporate group.<sup>167</sup> Such swaps and 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. As discussed above in the context of managed accounts, however, an entity would not be able to evade the requirements applicable to major participants by allocating among multiple affiliates swap or security-based swap positions of which it is the beneficial owner.

The Commissions request comment on the treatment of inter-affiliate swaps and security-based swaps between wholly-owned affiliates of the same corporate parent in connection with the major participant definitions.

Commenters also are requested to address whether similar interpretations should apply to swaps and security-based swaps between entities within a consolidated group as determined in accordance with U.S. generally accepted accounting principles. Commenters further are requested to discuss whether the major participant definition should be interpreted to encompass an entity

<sup>167</sup> Such swaps and security-based swaps should be considered in this way only for purposes of determining whether a particular person is a major participant. The swaps and security-based swaps would continue to be subject to all laws and requirements applicable to such swaps and security-based swaps.

(including an affiliate of the named counterparty to the swap or security-based swap) that provides a guarantee of the named counterparty's obligations, either in the form of a guarantee or through some other form of credit support whereby the guarantor agrees to satisfy margin obligations of the named counterparty and/or periodic payment obligations of the named counterparty.

#### 5. Legacy Portfolios

Some commenters have stated that certain entities that maintain legacy portfolios of credit default swaps that previously had been entered into in connection with the activities of monoline insurers and "credit derivative product companies" should not be considered major participants. The commenters argued that these entities would be unable to comply with the capital and margin requirements applicable to major participants, and that regulation as major participants is unnecessary given that the entities are not writing any additional swaps or security-based swaps.

We request comment on whether the rules further defining major swap participant and major security-based swap participant should exclude such entities from the major participant definition if their swap and security-based swap positions are limited to those types of legacy positions. The exclusion from the definition could be conditional, and any such excluded entity would be required to provide the Commissions with position information of the type that registered major participants would be required to provide. We invite comment on any other conditions that might be appropriate to an exclusion of such legacy portfolios from the major participant definitions.

#### 6. Potential Exclusions

Some commenters stated that the major participant definitions should not be interpreted to apply to entities such as investment companies,<sup>168</sup> ERISA plans, registered broker-dealers and/or registered futures commission

<sup>168</sup> See letter from Karrie McMillan, General Counsel, Investment Company Institute, dated September 20, 2010 (registered investment companies should be excluded from the major participant (and dealer) definitions, or else the terms of the definitions should be interpreted to clarify that mutual funds generally will not be major participants).

merchants,<sup>169</sup> and long-term investors such as sovereign wealth funds.<sup>170</sup>

These comments, and the rationale behind the comments, raise the issue of whether we should exclude, conditionally or unconditionally, certain types of entities from the major participant definitions, on the grounds that such entities do not present the risks that underpin the major participant definitions and/or to avoid duplication of existing regulation. While we are not proposing any such exclusions, we request comment as to whether we should exclude certain types of entities, including those noted above, as well as to entities subject to bank capital rules, State-regulated insurers, private and State pension plans, and registered derivatives clearing organizations or clearing agencies.

Commenters particularly are requested to address whether such exclusions are necessary and appropriate in light of the proposed rules that would be applicable to major participants, whether any conditions would be appropriate for such exclusions, and whether modifying those proposed rules would more effectively address these issues than granting specific exclusions from the major participant definitions for specific types of entities. Commenters also are particularly requested to discuss whether banks should be excluded from the major participant definitions because of the regulation to which they already are subject. Commenters also are requested to discuss whether registered investment companies should be excluded from the major participant definitions because of the regulations to which they already are subject, and whether registered investment companies would be able to comply with capital and margin requirements applicable to major participants.

Commenters also particularly are requested to address whether sovereign wealth funds or other entities linked to foreign governments should be excluded

from the major participant definitions, particularly in light of the provisions of the Dodd-Frank Act governing its territorial reach, and whether the answer in part should be determined based on whether the entity's obligations are backed by the full faith and credit of the foreign government.

#### **V. 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 requires that agencies consider whether the rules they propose will have a significant economic impact on a substantial number of small entities and, if so, provide a regulatory flexibility analysis respecting the impact.<sup>171</sup> The 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.

##### *B. Paperwork Reduction Act*

The proposed rule will not impose any new recordkeeping or information collection requirements, or other collections of information that require approval of the Office of Management and Budget under the Paperwork Reduction Act.<sup>172</sup> The CFTC invites public comment on the accuracy of its estimate that no additional recordkeeping or information collection requirements or changes to existing collection requirements would result from the rules proposed herein.

##### *C. Cost-Benefit Analysis*

Section 15(a) of the CEA<sup>173</sup> requires the CFTC to consider the costs and benefits of its actions before issuing a rulemaking under the CEA. By its terms, Section 15(a) does not require the CFTC to quantify the costs and benefits of a rule or to determine whether the benefits of the rulemaking outweigh its costs; rather, it requires that the CFTC “consider” the costs and benefits of its actions. Section 15(a) further specifies that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (1) Protection of market participants and

the public; (2) efficiency, competitiveness, and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. The CFTC may in its discretion give greater weight to any one of the five enumerated areas and could in its discretion determine that, notwithstanding its costs, a particular rule is necessary or appropriate to protect the public interest or to effectuate any of the provisions or accomplish any of the purposes of the CEA.

##### 1. Summary of Proposed Requirements

The proposed regulations would further define the terms “swap dealer,” “eligible contract participant,” “major swap participant,” and related terms, including “substantial position” and “substantial counterparty exposure.” The proposed regulations regarding eligible contract participants are clarifying changes that are not expected to have substantive effects on market participants. The proposed regulations further defining swap dealer and major swap participant are significant because any entity determined to be a swap dealer or major swap participant would be subject to registration, margin, capital, and business conduct requirements set forth in the Dodd-Frank Act, as those requirements are implemented in rules proposed or to be proposed by the CFTC. Those requirements will likely lead to compliance costs, capital holding costs, and margin posting costs, which have been or will be addressed in the CFTC's proposals to implement those requirements. On the other hand, those requirements will likely lead to benefits in the form of increased market transparency, reduced counterparty risk and a lower incidence of systemic crises and other market failures. This discussion concerns the costs and benefits arising from the proposed definitional tests themselves, in terms of the burden on market participants to determine how the proposed definitions apply, and the benefits arising from the specificity of the proposals.

##### 2. Proposed Regulations Regarding “Eligible Contract Participant”

The proposal regarding “eligible contract participant” would provide that swap dealers and major swap participants would qualify as eligible contract participants. The CFTC believes this proposal is in line with the expectations of market participants and would impose virtually no costs while providing the benefit of greater certainty. The proposal would also

<sup>169</sup> See letter from The Swaps & Derivatives Marketing Ass'n, dated September 20, 2010 (certain hedged positions of broker-dealers and futures commission merchants with customers should not be considered as part of the substantial position analysis); Cleary letter (registered and well-capitalized broker-dealers and futures commission merchants should not fall within the scope of the third major participant test).

<sup>170</sup> See letter from Lee Ming Chua, General Counsel, Government of Singapore Investment Corp., dated September 20, 2010 (stating that the major participant definitions were not intended to apply to long-term financial investors); see also letter from Richard M. Whiting, The Financial Services Roundtable, dated September 20, 2010 (major participant definitions should exclude firms that solely act as investors).

<sup>171</sup> 5 U.S.C. 601 *et seq.*

<sup>172</sup> 44 U.S.C. 3501 *et seq.*

<sup>173</sup> 7 U.S.C. 19(a).

provide that certain commodity pools could not qualify as eligible contract participants under certain provisions specified in the proposal. The CFTC believes that this proposal clarifies the interpretation of this aspect of the eligible contract participant definition and would prevent the commodity pools from using a provision of the definition that was not intended to apply to the commodity pools. Thus, while the proposal would potentially impose some costs on the commodity pools that could no longer rely on certain provisions of the definition, benefits would arise from preventing the misinterpretation of the definition.

### 3. Proposed Regulations Regarding "Swap Dealer"

The proposal regarding "swap dealer" would further define the term by providing that any person that engages in specified activities is a swap dealer. The proposal describes these activities qualitatively and in relatively general terms that apply in the same way to all parts of the swap markets. With regard to the *de minimis* exemption from the definition, the proposal sets out bright-line quantitative tests to determine if a person's swap dealing activity is *de minimis*. For the exclusion of swaps in connection with originating a loan by an insured depository institution, the proposal describes the scope of the exclusion qualitatively in terms that depend primarily on the terms of the swaps that would be eligible for the exclusion and the identity of the parties to the swap. Also, the proposal includes a voluntary process by which a swap dealer may request that the CFTC limit the swap dealer designation to certain aspects of the person's activity.

#### a. Costs

The costs to a market participant from the proposed regulations further defining "swap dealer" would arise primarily from its need to review its activities and determine, as a qualitative matter, whether its activities are of the type described in the proposal. As its activities change from time to time, it would be necessary to repeat this review, and ongoing compliance costs may arise if the market participant determines that it should adapt its activities so as to not be encompassed by the definition. Because the proposed regulations are qualitative and on relatively general terms, there may be multiple interpretations of the general criteria by market participants. A market participant whose activities fall within the realm of those described in the proposal may have to incur the costs of a more focused review to determine

whether or not it is encompassed by the definition.

The proposal regarding the *de minimis* exemption, on the other hand, would impose lower costs because of the precise, quantitative nature of the proposed exemption. A market participant would incur only the cost of determining the applicable quantities, such as notional value, number of swaps, number of counterparties, and so forth set out in the proposal. The CFTC believes that relatively few market participants would have to determine whether the *de minimis* exemption applies to their activities, and there would be only a low number of instances where application of the quantitative tests would be uncertain. Similarly, the CFTC believes that insured depository institutions would incur relatively low costs to apply the proposed exclusion of swaps in connection with originating loans because the proposed criteria relate to matters in which the institution is directly involved.

Last, the costs of the voluntary process for a request for a limited designation as a swap dealer are difficult to predict because they would depend on the complexity of the person making the request and the particular factors that are relevant to the limited designation. The CFTC believes that the person making the request would have broad discretion in determining how to do so and thereby could control the costs of the request to some extent.

#### b. Benefits

The benefits of the proposed regulations further defining "swap dealer" include that they set out a single set of criteria to be applied by all market participants. Thus, the proposed regulations create a level playing field that permits all market participants to determine, on an equal basis, which activities would potentially lead to designation as a swap dealer. The proposed regulations are set out in plain language terms that may be understood and applied by all market participants without relying on the technical expertise that may be required to implement more elaborate tests. The CFTC believes that the proposal can be fairly applied by substantially all market participants who could potentially be swap dealers.

Regarding the proposals regarding the *de minimis* exemption and the exclusion of swaps in connection with the origination of loans, benefits arise from the relatively specific, quantitative nature of the proposals. Since these proposals are expected to be applied by relatively few market participants in

limited situations, more detailed regulations are appropriate. The CFTC believes that these detailed criteria will permit market participants to make a relatively quick and low-cost determination of whether the exemption or exclusion apply. The proposal for requests for a limited swap dealer designation provides the benefit of flexibility to allow each market participant making this request to determine how to do so.

### 4. Proposed Regulations Regarding "Major Swap Participant"

The proposal regarding "major swap participant" would further define the term by setting out quantitative thresholds against which a market participant would compare its swap activities to determine whether it is encompassed by the definition. The proposal would require that potential major swap participants 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 proposal includes a general, qualitative definition of the swaps that may be excluded from the comparison because they are used to "hedge or mitigate commercial risk." Like the swap dealer proposal, there is a voluntary process by which a major swap participant may request that the CFTC limit the major swap participant designation to certain aspects of the person's activity.

#### a. Costs

The costs to a market participant from the proposed regulations further defining "major swap participant" would arise primarily from its need to analyze its swaps and determine whether it has a "substantial position" or "substantial counterparty exposure" as defined in the proposal. The proposed rule defines potential future exposure by a factor of the dollar notional value of the swap. The Commission also considered market-based tests of potential future exposure such as margin requirements or other valuations of the outstanding position. The Commission decided in favor of a more easily implementable test rather than market-based criteria for potential future exposure, given that daily variation in market prices is captured by the current exposure calculation. The CFTC believes that because the proposed quantitative thresholds are high, only very few market participants would have to conduct a detailed analysis to determine whether they are encompassed by the proposed

definition. The cost of the detailed analysis would vary for each market participant, depending on the particular characteristics of its swaps. Similarly, the costs to a market participant of determining whether it uses swaps to hedge or mitigate commercial risk would depend on how the market participant uses swaps. It is possible that for some market participants with complex positions in swaps, the costs of the analysis could be relatively high.

As is the case for the similar proposal regarding swap dealers, the costs of the voluntary process for a request for a limited designation as a major swap participant are difficult to predict because they would depend on the complexity of the particular case. The CFTC believes that the person making the request would have broad discretion in determining how to do so and thereby could control the costs of the request to some extent.

#### b. Benefits

The benefits of the proposed regulations further defining “major swap participant” include that they set out a quantitative, bright-line test that can be applied at a relatively low cost. Also, the definition of “hedging or mitigating commercial risk” is stated in general terms that may be flexibly applied by potential major swap participants. In preparing this proposal, the CFTC considered other methods of defining “major swap participant,” including multi-factor analyses, stress tests and adversary processes. The CFTC believes that these other methods would impose significantly higher costs for both the market participants that would have to apply them and for the CFTC (and, indirectly, the taxpayer), without providing additional benefits. The costs would result primarily from the need to retain qualified experts who would devote significant time and other resources to a detailed analysis of multiple aspects of the potential major swap participant’s swap positions. The benefits that could justify more costly proposals include reductions in arbitrary differences in results and greater consistency and predictability. However, other potential methods of further defining “major swap participant” do not appear likely to provide such benefits to an extent that would justify the higher costs.

#### 5. Request for Comment

The CFTC invites public comment on its cost-benefit considerations. Commenters are also invited to submit any data or other information that they may have quantifying or qualifying the

costs and benefits of the proposed rules with their comments.

#### D. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 (“SBREFA”) <sup>174</sup> the CFTC must advise the Office of Management and Budget as to whether the proposed rules constitute a “major” rule. Under SBREFA, a rule is considered “major” where, if adopted, it results or is likely to result in: (1) An annual effect on the economy of \$100 million or more (either in the form of an increase or a decrease); (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effect on competition, investment or innovation. If a rule is “major,” its effectiveness will generally be delayed for 60 days pending Congressional review. We do not believe that any of the proposed rules, in their current form, would constitute a major rule.

We request comment on the potential impact of the proposed rules on the economy on an annual basis, on the costs or prices for consumers or individual industries, and on competition, investment or innovation. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

#### VI. Administrative Law Matters—Exchange Act Rules (Definitions of “Security-Based Swap Dealer” and “Major Security-Based Swap Participant”)

##### A. Paperwork Reduction Act Analysis

Certain provisions of the proposed rules may impose new “collection of information” requirements within the meaning of the Paperwork Reduction Act of 1995 (“PRA”).<sup>175</sup> The SEC has submitted them to the Office of Management and Budget (“OMB”) for review in accordance with 44 U.S.C. 3507 and 5 CFR 1320.11. The title of the new collection of information is “Procedural Requirements Associated with the Definition of ‘Hedging or Mitigating Commercial Risk.’” An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. OMB has not yet assigned a control number to the new collection of information.

<sup>174</sup> Public Law 104–121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

<sup>175</sup> 44 U.S.C. 3501 *et seq.*

#### 1. Summary of Collection of Information

Proposed Exchange Act rule 3a67–4 would define the term “hedging or mitigating commercial risk.”<sup>176</sup> Security-based swap positions that meet this proposed definition would be excluded from the “substantial position” analysis under the first test of the proposed definition of major security-based swap participant.

For a security-based swap position to be held for the purpose of hedging or mitigating commercial risk under proposed rule 3a67–4, the person holding the position must satisfy several conditions, including the following:

- (i) The person must identify and document the risks that are being reduced by the security-based swap position;
- (ii) The person must establish and document a method of assessing the effectiveness of the security-based swaps as a hedge; and
- (iii) The person must regularly assess the effectiveness of the security-based swap as a hedge.

#### 2. Proposed Use of Information

The collections of information in proposed rule 3a67–4 are designed to help prevent abuse of the exclusion and to help ensure that the exclusion is only available to those entities that are engaged in legitimate hedging or risk mitigating activities.

#### 3. Respondents

The collections of information in proposed rule 3a67–4 would apply to those entities seeking to exclude the security-based swap positions held for hedging or mitigating commercial risk from the substantial position calculation. As discussed below in Section VI.B.4., based on the current market, we estimate that approximately 10 entities have security-based swap positions of a magnitude that they could potentially reach the major security-based swap participant thresholds. Accordingly, we estimate that approximately 10 entities would seek to avail themselves of the exclusion from

<sup>176</sup> As noted previously, the concept of “hedging or mitigating commercial risk” also is found in the statutory provisions granting an exception to end-users from the mandatory clearing requirement in connection with swaps and security-based swaps. 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”). If the proposed rule 3a67–4 definition of “hedging or mitigating commercial risk” is used any future SEC rulemakings, including rulemaking with respect to the end-user exception, any necessary discussion of administrative law matters relating to the use of proposed rule 3a67–4 will be provided at that time.

the substantial position calculation for security-based swap positions held for hedging or mitigating commercial risk.

#### 4. Total Annual Reporting and Recordkeeping Burden

We do not anticipate that the proposed collection of information in proposed rule 3a67-4 would cause the estimated 10 entities to incur any new costs. We believe that only highly sophisticated market participants would potentially meet the proposed thresholds for the major security-based swap participant designation and thus have a need to take advantage of the exclusion for positions held for hedging or mitigating commercial risk (and be required to meet the attendant collection requirements). We understand from our staff's discussions with industry participants that the entities that have security-based swap positions and exposures of this magnitude currently create and maintain the documentation proposed to be required in rule 3a67-4, as part of their ordinary course business and risk management practices.<sup>177</sup> Thus, we do not believe that any new burdens or costs will be imposed on the approximately 10 entities that may seek to use the exclusion. We therefore estimate the total annual reporting and recordkeeping burden associated with proposed rule 3a67-4 to be minimal.

#### 5. Collection of Information is Mandatory

The collections of information in proposed rule 3a67-4 would be mandatory for those entities seeking to exclude positions they hold for hedging or mitigating commercial risk from the substantial position calculation.

#### 6. Confidentiality

There is no proposed requirement that the collections of information in proposed rule 3a67-4 be provided to the SEC or a third party on a regular, ordinary course basis. In a situation

<sup>177</sup> Some entities follow these types of procedures so that their hedging transactions will qualify for hedge accounting treatment under generally accepted accounting principles, which requires procedures similar to those in proposed rule 3a67-4. Hedging relationships involving security-based swaps that qualify for the hedging or mitigating commercial risk exception in the proposed rule are not limited to those recognized as hedges for accounting purposes. We believe that all of the estimated 10 entities that have security-based swap positions of a magnitude that they could potentially be deemed to be major security-based swap participants already identify and document their risk management activities (including their security-based swap positions used to hedge or mitigate commercial risks) and assess the effectiveness of those activities as a matter of their ordinary business practice—even if they are not seeking hedge accounting treatment.

where the SEC has obtained the information, the SEC would consider requests for confidential treatment on a case-by-case basis.

#### 7. Record Retention Period

Proposed rule 3a67-4 does not contain a specific record retention requirement. Nonetheless, we would expect the approximately 10 entities that may seek to use the exclusion for positions held for hedging or mitigating commercial risk to maintain the records they create in connection with the exclusion. Because we understand from our staff's discussions with industry participants that the entities that have security-based swap positions and exposures of this magnitude currently create and maintain the documentation proposed to be required in rule 3a67-4, as part of their ordinary course business and risk management practices, we do not expect any new burdens or costs will be imposed to maintain the records.

#### 8. Request for Comments

The SEC invites comments on these estimates. Pursuant to 44 U.S.C. 3506(c)(2)(B), the SEC requests comments in order to: (a) Evaluate whether the collection of information is necessary for the proper performance of our functions, including whether the information will have practical utility; (b) evaluate the accuracy of our estimate of the burden of the collection of information; (c) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (d) evaluate whether there are ways to minimize the burden of the collection of information on those who respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should also send a copy of their comments to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090, with reference to File No. S7-39-10. Requests for materials submitted to OMB by the SEC with regard to this collection of information should be in writing, with reference to File No. S7-39-10, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 100 F Street, NE., Washington, DC 20549-1090. As OMB is required to

make a decision concerning the collections of information between 30 and 60 days after publication, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

#### B. Consideration of Benefits and Costs

##### 1. Introduction

The Dodd-Frank Act added definitions of "security-based swap dealer" and "major security-based swap participant" to the Exchange Act in conjunction with other provisions that require entities meeting either of those definitions to register with the SEC and to be subject to capital, margin, business conduct and certain other requirements. Consistent with the direction of the Dodd-Frank Act, the SEC is proposing rules to further define "major security-based swap participant" along with additional terms used in that definition. The SEC also is proposing rules to further define "security-based swap dealer" and to set forth factors for determining the availability of the *de minimis* exception from that definition. We believe that these proposed rules are consistent with the purposes of the Dodd-Frank Act, and, as appropriate, set forth objective standards to facilitate market participants' compliance with the amendments that the Dodd-Frank Act made to the Exchange Act. Market participants, however, may incur costs associated with certain of these proposed rules.

The SEC believes that there would be two categories of potential costs. First, there would be costs associated with the regulatory requirements that would apply to a "security-based swap dealer" or a "major security-based swap participant" (e.g., the registration, margin, capital, and business conduct requirements that would be imposed on security-based swap dealers and major security-based swap participants). While the specific costs and benefits associated with these regulatory requirements are being addressed in the SEC's proposals to implement those requirements, we recognize that the costs and benefits of these proposed definitions are directly linked to the costs and benefits of the requirements applicable to dealers and major participants. We welcome comment on the costs and benefits of these proposed definitions in that broader context.

Second, there may be costs that entities incur in determining whether they qualify as a "security-based swap dealer" or a "major security-based swap participant" under the proposed definitional rules. These costs, along

with the benefits associated with the proposed rules, are discussed below.

## 2. Proposed Exchange Act rule 3a67-1—Definition of “Major Security-Based Swap Participant”

Proposed Exchange Act rule 3a67-1 would largely restate the statutory definition of “major security-based swap participant,” to consolidate the definition and related interpretations for ease of reference.

A person that meets the definition of major security-based swap participant generally will be subject to the requirements applicable to major security-based swap participants without regard to the purpose for which it enters into a security-based swap, and without regard to the particular category of security-based swap.<sup>178</sup> However, the statutory definitions provide that a person may be designated as a major security-based swap participant for one or more categories of security-based swaps or for particular activities without being classified as a major security-based swap participant for all categories or activities.<sup>179</sup> Proposed rule 3a67-1 would provide that a major security-based swap participant that engages in significant activity with respect to only certain types, classes or categories of security-based swaps or only in connection with specified activities, could obtain relief with respect to other types of security-based swaps from certain of the requirements that are applicable to major security-based swap participants. The rule would have the benefit of implementing the statutory provision and providing that major security-based swap participants may obtain relief from the SEC. A person that seeks to be considered to be a major security-based swap participant only with respect to one category of security-based swaps, or only with respect to certain activities, would be expected to incur costs in connection with requesting an order from the SEC. However, any such costs would be voluntarily incurred by any person seeking to take advantage of that limited designation, and thus we preliminarily do believe that those costs would be attributable to the statute and not to this rule.

## 3. Proposed Exchange Act Rule 3a67-2—“Major” Categories of Security-Based Swaps

Proposed Exchange Act rule 3a67-2 would fulfill Congress’s mandate that

<sup>178</sup> The specific costs associated with these regulatory requirements will be addressed in the SEC’s proposals to implement those requirements.

<sup>179</sup> See Exchange Act section 3(a)(67)(C).

the SEC designate “major” categories of security-based swaps by setting forth two such “major” categories—one consisting of credit derivatives and the other consisting of equity-swaps and other security-based swaps. We believe that these proposed categories would have the benefit of being consistent with the different ways in which those products are used, as well as market statistics and current market infrastructures (particularly the separate trade warehouses for credit default swaps and equity swaps). Although, as discussed below, this categorization is relevant to the “substantial position” tests of the “major security-based swap participant” definition, we believe that the categorization itself would not impose any costs on market participants. While the categorization may affect the costs that market participants will incur from particular statutory and regulatory requirements applicable to major security-based swap participants,<sup>180</sup> those costs are being addressed in our proposals to implement those requirements.

## 4. Proposed Exchange Act Rule 3a76-3—Definition of “Substantial Position”

Proposed Exchange Act rule 3a76-3 would define the term “substantial position,” which is used in the first and third tests of the definition of “major security-based swap participant.” The Dodd-Frank Act requires the SEC to define this term. We have proposed two tests for identifying the presence of a substantial position—one test based on a daily average measure of uncollateralized mark-to-market exposure, and one based on a daily average measure of combined uncollateralized mark-to-market exposure and potential future exposure. Both of these daily measures would be calculated and averaged over a calendar quarter.

We believe that this proposed definition would have the benefit of providing objective criteria that reasonably would measure the risks associated with security-based swap positions, and reflect the counterparty risk and risk to the market factors that are embedded within the “major security-based swap participant” definition. We also believe that the proposed use of objective numerical criteria for the substantial position thresholds would promote the

<sup>180</sup> For example, distinguishing between categories of security-based swaps may cause some entities to incur additional costs to calculate their major security-based swap participant status with respect to each category. Similarly, categorization may affect whether an entity ultimately qualifies as a major security-based swap participant.

predictable application and enforcement of the requirements governing major security-based swap participants by permitting market participants to readily evaluate whether their security-based swap positions meet the thresholds.

The first “substantial position” test would encompass entities that have a daily average uncollateralized mark-to-market exposure of \$1 billion in a major category of security-based swaps. The second “substantial position” test would encompass entities that have a daily average combined uncollateralized mark-to-market exposure and potential future exposure of \$2 billion. Potential future exposure would be measured, consistent with bank capital rules, largely by multiplying notional positions by risk factors. Additional adjustments would reflect netting agreements, the presence of central clearing and the presence of daily mark-to-market margining practices.

As previously noted, there will be costs associated with the registration, margin, capital, business conduct, and other requirements that will be imposed on major security-based swap participants. Those costs are being addressed in the SEC’s rule proposals to implement those requirements. We also believe that there will be costs incurred by entities in determining whether they meet the definition of major security-based swap participant. These costs are discussed below.

Based on the current over-the-counter derivatives market, we estimate that no more than 10 entities that are not otherwise security-based swap dealers would have either uncollateralized mark-to-market positions<sup>181</sup> or

<sup>181</sup> We believe that an estimate of an entity’s mark-to-market exposure associated with its security-based swap positions can be derived from the level of an entity’s notional positions. We recognize that the ratio of exposure to notional amount will vary by market participant and by position. We understand that mark-to-market exposures associated with credit derivative positions on average are equal to approximately three percent of an entity’s level of notional positions in credit derivatives. This estimate is based on second quarter 2010 U.S. bank market statistics involving credit derivatives, given that banks have credit derivative positions with gross positive fair value (which would equate to negative fair value for the banks’ counterparties) of \$403 billion, compared to total notional credit derivative positions of \$13.9 trillion. See Office of the Comptroller of the Currency, “OCC’s Quarterly Report on Bank Trading and Derivatives Activities” (Second Quarter 2010) at 4 & Table 12. This data suggests that, on average, an entity would need to have notional credit derivative positions of roughly \$33 billion to meet our proposed threshold for the first substantial position test, \$1 billion in mark-to-market exposure.

We understand, based on our staff’s discussions with industry, that approximately 39 entities have

combined uncollateralized current exposure and potential future exposure of a magnitude<sup>182</sup> that may rise close enough to the levels of our proposed thresholds to necessitate monitoring to determine whether they meet those thresholds. Additionally, we preliminarily believe that all of these approximately 10 entities currently maintain highly sophisticated financial operations in order to achieve the large security-based swap positions necessitating their use of the tests.

We expect the costs associated with the proposed substantial position tests to be modest for these entities. We understand that the entities that have this magnitude of security-based swap positions already monitor and collect all of the data necessary for the proposed substantial position tests. Preliminarily, we understand that these entities already use automated systems to gauge their positions and exposures and assist in their risk management. Accordingly, we estimate that each of the entities would incur a one-time programming cost,<sup>183</sup> as well as ongoing costs

credit default swap notional positions of roughly \$33 billion or above. We understand that the large majority of those entities are banks or hedge funds (which we would expect to fully collateralize their positions with dealers as a matter of course). We further understand 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. See OCC's Quarterly Report on Bank Trading and Derivatives Activities (second quarter 2010) at 6. Therefore, it is not clear if any entities would have uncollateralized credit default swap positions near the proposed first substantial position threshold of \$1 billion uncollateralized outward exposure.

<sup>182</sup> The proposed risk multiplier of 0.1 for credit derivatives would require an entity to have a notional position of \$20 billion in credit derivatives to reach the proposed \$2 billion potential future exposure threshold (even before accounting for netting adjustments). The proposed additional multiplier of 0.2 for security-based swaps cleared by a registered clearing agency or subject to daily mark-to-market margining would mean that an entity with credit derivative positions that are cleared or subject to daily mark-to-market margining would need a notional position in credit derivatives of at least \$100 billion to potentially reach the proposed \$2 billion potential future exposure threshold. In this example, we are assuming an uncollateralized outward exposure of zero.

We understand, based on our staff's discussions with industry, that there are approximately 10 non-dealer entities that have a notional position in credit derivatives of over \$50 billion.

<sup>183</sup> For each of the entities, we estimate that the initial programming would require the following levels of work from a Compliance Attorney, Compliance Manager, Programmer Analyst, Senior Internal Auditor, and Chief Financial Officer. The estimated contributions are as follows: approximately 2 hours of work from a Compliance Attorney to advise the entity's compliance department on the legal requirements associated with the proposed tests; approximately 8 hours of work from a Compliance Manager to assist a Programmer Analyst in making the necessary changes to the entity's existing automated system

associated with the continuing use and monitoring of the testing.<sup>184</sup> We estimate that the one-time programming cost would be approximately \$13,444 per entity, and \$134,440 for all entities.<sup>185</sup> We estimate that the annual ongoing costs would be approximately \$7,260 per entity, and \$72,600 for all entities.<sup>186</sup>

#### 5. Proposed Exchange Act Rule 3a67-4—Definition of "Hedging or Mitigating Commercial Risk"

Proposed Exchange Act rule 3a67-4 would define the term "hedging or mitigating commercial risk." Security-based swap positions that meet that definition are excluded from the "substantial position" analysis under the

and to oversee and manage the entire programming process; approximately 40 hours of work from a Programmer Analyst to make the necessary programming changes to the existing automated system and to test the system; approximately 8 hours of work from a Senior Internal Auditor to perform quality assurance to ensure that the automated system is properly performing the proposed tests; and approximately 3 hours of work from the entity's Chief Financial Officer to monitor the process. We estimate that the hourly wage of a Compliance Attorney, Compliance Manager, Programmer Analyst, Senior Internal Auditor, and Chief Financial Officer would be approximately \$291, \$294, \$190, \$195, and \$450, respectively. The \$291/hour figure for a Compliance Attorney, the \$294/hour figure for a Compliance Manager, the \$190/hour figure for a Programmer Analyst, and the \$195/hour figure for a Senior Internal Auditor are from SIFMA's Management & Professional Earnings in the Securities Industry 2009, 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. The \$450/hour figure for a Chief Financial Officer is from <http://www.payscale.com>, 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. See <http://www.payscale.com> (last visited Nov. 1, 2010).

<sup>184</sup> We anticipate that each entity would incur ongoing monitoring costs to evaluate their test results and to ensure that the tests are properly run. We estimate that each entity would have a Senior Internal Auditor spend approximately 4 hours each quarter (or a total of 16 hours annually) to perform this quality assurance. We also estimate that each entity would need a Compliance Attorney, a Compliance Manager, and its Chief Financial Officer to each spend approximately 1 hour each quarter (or a total of 4 hours annually) to monitor the entity's test results and the entity's status under the proposed rule.

<sup>185</sup> The estimated one-time programming cost of approximately \$13,444 per entity and \$134,440 for all entities was calculated as follows: (Compliance Attorney at \$291 per hour for 2 hours) + (Compliance Manager at \$294 per hour for 8 hours) + (Programmer Analyst at \$190 per hour for 40 hours) + (Senior Internal Auditor at \$195 per hour for 8 hours) + (Chief Financial Officer at \$450 per hour for 3 hours) × (10 entities) = \$134,440.

<sup>186</sup> The estimated ongoing monitoring cost of approximately \$7,260 per year per entity and \$72,600 per year for all entities was calculated as follows: (Senior Internal Auditor at \$195 per hour for 16 hours) (Compliance Attorney at \$291 per hour for 4 hours) + (Compliance Manager at \$294 per hour for 4 hours) + (Chief Financial Officer at \$450 per hour for 4 hours) × (10 entities) = \$72,600.

first test of the major participant definition. The proposed rule is intended to be objective and promote the predictable application and enforcement of the requirements governing major security-based swap participants.

For a security-based swap position to be held for the purpose of hedging or mitigating commercial risk under proposed Exchange Act rule 3a67-4, the person holding the position must satisfy certain conditions:

(i) The person must identify and document the risks that are being reduced by the security-based swap position;

(ii) The person must establish and document a method of assessing the effectiveness of the security-based swap as a hedge; and

(iii) The person must regularly assess the effectiveness of the security-based swap as a hedge.

Proposed rule 3a67-4 would affect whether an entity will meet the definition of major security-based swap participant. The specific costs associated with these regulatory requirements are being addressed in the SEC's proposals to implement those requirements.

While we expect that there could be some potential costs associated with the procedural requirements of proposed rule 3a67-4, as described in Section VI.B.4., *supra*, we expect only highly sophisticated entities to hold security-based swap positions of a magnitude that would require use of the proposed tests. Thus, we do not anticipate that these proposed procedural requirements would cause market participants to incur costs that they do not incur already as a matter of their ordinary business and risk management practices. Accordingly, we do not expect that the proposed definition of "hedging or mitigating commercial risk" would impose any costs on the potentially affected entities beyond those already regularly incurred by these entities as a matter of course.

#### 6. Proposed Exchange Act Rule 3a67-5—Definition of "Substantial Counterparty Exposure That Could Have Serious Adverse Effects on The Financial Stability of The United States Banking System or Financial Markets"

Proposed Exchange Act rule 3a67-5 would define "substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets," a term that comprises part of the second test of the "major security-based swap participant" definition. This proposed rule would



parallel the “substantial position” analysis discussed above, but would examine an entity’s security-based swap positions as a whole (rather than focusing on a particular “major” category), and would not exclude certain hedging positions. Consistent with this broader scope, and the proposal that there be two “major” categories of security-based swaps, the thresholds used in this test would be two times the comparable “substantial position” thresholds. We believe that this approach reasonably would measure the counterparty exposure associated with the entirety of an entity’s security-based swap positions, consistent with the risk factors in the “major security-based swap participant” definition. Additionally, we believe that the proposed definition would provide objective criteria and promote the predictable application and enforcement of the requirements governing major security-based swap participants by permitting market participants to readily evaluate whether their security-based swap positions meet the proposed thresholds.

We believe that the same approximately 10 entities would calculate their substantial counterparty exposure under this rule as would undertake the substantial position calculation under proposed rule 3a67–3. Given that the threshold for this proposed rule is derived from the calculations of substantial position that would be mandated by proposed rule 3a67–3, we do not anticipate that it would create any costs outside of those already covered in the discussion of the estimated costs associated with the proposed definition of substantial position.

#### 7. Proposed Exchange Act Rule 3a67–6—Definitions of “Financial Entity” and “Highly Leveraged”

Proposed Exchange Act rule 3a67–6 would define the terms “financial entity” and “highly leveraged,” both of which are used in the third test of the “major security-based swap participant” definition. The proposed definition of “financial entity” would be consistent with the use of that term in the Title VII exception from mandatory clearing for end-users of security-based swaps (subject to limited technical changes). One of the two alternative proposed definitions of “highly leveraged” would be consistent with a standard used in Title I of the Dodd-Frank Act, while the other alternative is based on an understanding of typical leverage ratios for certain financial entities. We believe that these proposed alternative standards would apply reasonable

objective criteria to implement and further define the third test. Additionally, we believe that the proposed use of these objective definitions and numerical criteria would promote the predictable application and enforcement of the requirements governing major security-based swap participants by permitting market participants to readily evaluate whether they meet the threshold for major security-based swap participant status.

We do not believe that the proposed definition of “financial entity” would impose any significant costs on market entities, given the objective nature of the definition. We also do not believe that the proposed definition of “highly leveraged”—a balance sheet test that would be based on the ratio of an entity’s liabilities and equity, and that, in the case of entities subject to public reporting requirements, could be derived from financial statements filed with the SEC—would impose any significant costs on entities that have security-based swap positions large enough to potentially meet the “substantial position” requirement that is part of the third test.

#### 8. Proposed Exchange Act Rule 3a67–7—Timing Requirements, Reevaluation Period and Termination of Status

Proposed Exchange Act rule 3a67–7 would set forth methods for specifying when an entity that satisfies the tests specified within the definition of “major security-based swap participant” would be deemed to meet that definition. The proposed rule also would address the termination of an entity’s status as a major security-based swap participant. We believe that the proposed rule would set forth pragmatic standards for permitting entities that have security-based swap positions that require registration to go through the registration process, and to terminate their status when appropriate. We believe that this proposed rule would impose no direct costs on market entities.<sup>187</sup>

#### 9. Proposed Exchange Act Rule 3a71–1—Definition of “Security-Based Swap Dealer”

Proposed Exchange Act rule 3a71–1 largely would restate the statutory definition of “security-based swap dealer,” to consolidate the definition and related interpretations for market

participants’ ease of reference. We are not proposing to further define the four specific tests set forth in the “security-based swap dealer” definition. However, our release contains interpretive language that would have the benefit of providing additional legal certainty to market participants. While market participants would incur certain costs to analyze whether their security-based swap activities cause them to be on the “dealer” side of the dealer-trader distinction (which would require them to register with the SEC and comply with the other requirements applicable to security-based swap dealers unless they can take advantage of the *de minimis* exception), these costs would be incurred because of the statutory change, rather than due to proposed rule 3a71–1. The Dodd-Frank Act determined that persons that engage in dealing activities involving security-based swaps should be subject to comprehensive regulation, and any such analytic costs arise from Congress’s determination to amend the Exchange Act.<sup>188</sup>

#### 10. Proposed Exchange Act Rule 3a71–2—*de Minimis* Exception

Proposed Exchange Act rule 3a71–2 would set forth factors for determining whether a person that otherwise would be a security-based swap dealer can take advantage of the *de minimis* exception. The Dodd-Frank Act directed the SEC to promulgate these factors.<sup>189</sup> The proposed factors would account for an entity’s annual notional security-based swap positions in a dealing capacity, its total notional security-based swap positions in a dealing capacity when the counterparty is a “special entity,”<sup>190</sup> and its total number of counterparties and security-based swaps as a dealer. We believe that these factors appropriately would focus on dealing activities that do not warrant an entity’s regulation as a security-based swap dealer. We also believe that these objective numerical criteria for the *de minimis* exception would promote the predictable application and enforcement of the *de minimis* exception from security-based swap dealer status.

In general, we would expect a person that enters into security-based swaps in a dealing capacity would, as a matter of course, be aware of the notional amount

<sup>188</sup> Based on our staff’s discussions with industry, we estimate that approximately 50 entities may be required to register as security-based swap dealers following implementation of these proposed rules. The specific costs associated with these regulatory requirements will be addressed in the SEC’s proposals to implement those requirements.

<sup>189</sup> See Section 761(a)(6) of the Dodd-Frank Act.

<sup>190</sup> See Section 15F(h)(2)(C) of the Exchange Act.

<sup>187</sup> As noted above, we recognize that major security-based swap participants will incur costs associated with the registration and termination of registration processes. These costs will be addressed in the SEC rule’s proposals to implement those requirements.

of those positions, whether a particular counterparty is a “special entity,” and the total number of counterparties and security-based swaps it has in a dealer capacity. As a result, we believe that there would be no new costs incurred by entities in assessing the availability of the *de minimis* exception. Moreover, any costs associated with ensuring that a person can take advantage of the *de minimis* exception would be voluntarily incurred by entities that engage in dealing activities that seek to take advantage of the exception.

#### 11. Request for Comments

The SEC requests comment on these estimated benefits and costs. Commenters particularly are requested to address: the accuracy of our estimate that there would be approximately 10 entities in the market (that would not otherwise be security-based swap dealers) that would have security-based swap positions of a magnitude that may rise close enough to the levels of our proposed thresholds to necessitate monitoring to determine whether they meet those thresholds; the accuracy of our estimate that there would be approximately 50 entities in the market that may be required to register as security-based swap dealers following implementation of the proposed rules; the accuracy of our estimates of the costs associated with entities performing the proposed substantial position tests; whether the entities that have security-based swap positions that are significant enough to potentially meet one or more of the tests in the “major security-based swap participant” definition would, as a matter of course, already have the data necessary to perform the two proposed substantial position tests, and if not, what additional data would they need and how much time and expense would gathering that data require; whether these same entities would, as a matter of course, already comply with the proposed procedural requirements associated with the exclusion for positions that are for the purpose of “hedging or mitigating commercial risk;” and whether entities would change their behavior to avoid meeting the proposed definitions of “security-based swap dealer” or “major security-based swap participant,” and if so, what, if any, economic costs would be associated with such behavioral changes.

In addition, and more generally, we request comment on the costs and benefits of these proposed definitions in the broader context of the substantive rules, including capital, margin and business conduct rules, applicable to dealers and major participants.

Commenters particularly are requested to address whether the proposed scope of the dealer and major participant definitions are appropriate in light of the costs and benefits associated with those substantive rules.

#### C. 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 whether the action would promote efficiency, competition, and capital formation.<sup>191</sup> In addition, Section 23(a)(2) of the Exchange Act<sup>192</sup> 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 preliminarily do not believe that the proposed rules would result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. We are proposing rules to further define “major security-based swap participant,” along with several terms used in that definition. We are also proposing rules to further define “security-based swap dealer” and to set forth factors for determining the availability of the *de minimis* exception from that definition. We believe that the proposed rules are consistent with the purposes of Title VII of the Dodd-Frank Act, and, as appropriate, set forth objective standards to facilitate market participants’ compliance with the amendments that Title VII of the Dodd-Frank Act made to the Exchange Act. These amendments mandate that the SEC regulate major security-based swap participants and security-based swap dealers, which include some, but not all, entities that enter into security-based swaps. Although regulation of certain security-based swap market participants may result in competitive burdens to these entities when compared to unregulated security-based swap market participants, these burdens stem directly from Congress’s decision to impose regulation on a specified set of security-based swap market participants through the Dodd-Frank Act.

<sup>191</sup> 15 U.S.C. 78c(f).

<sup>192</sup> 15 U.S.C. 78w(a)(2).

While our decisions on how to further define the terms may have some effect on competition (*e.g.*, our determinations regarding the proposed definition of substantial position will affect whether entities qualify as major security-based swap participants), we preliminarily do not believe that our decisions would impose additional competitive burdens on entities outside of those that Congress previously imposed through its decision in Title VII of the Dodd-Frank Act to regulate and differentiate security-based swap market participants. Moreover, we believe that defining substantial position will help provide market participants with legal certainty regarding their need to register as major security-based swap participants and is necessary and appropriate to implement the purposes of regulating security-based swap dealers and major security-based swap participants.

We also preliminarily believe that the proposed rules would promote efficiency. We believe that the proposed rules would set forth clear objective standards to facilitate market participants’ compliance with the amendments that the Dodd-Frank Act made to the Exchange Act. Moreover, we believe that the proposed rules would promote the predictable application and enforcement of the Exchange Act. We also have considered what effect, if any, our proposed rules would have on capital formation. We preliminarily do not believe that our proposed rules would have a negative effect on capital formation.

The SEC requests comment on the effect of the proposed rules on efficiency, competition, and capital formation. Commenters are particularly requested to address whether entities would change their behavior to avoid meeting the proposed definitions of “security-based swap dealer” or “major security-based swap participant,” and if so, how. Commenters are also requested to address the effect, if any, that the proposed definitions of “substantial position,” “hedging or mitigating commercial risk,” “substantial counterparty exposure,” “financial entity,” or “highly leveraged,” or the proposed categories of security-based swaps would have on business decisions, trading behavior, transaction costs, or capital allocation. We also request comment on the effect, if any, that the proposed *de minimis* exception to the definition of security-based swap dealer would have on business decisions, trading behavior, transaction costs, or capital allocation, and if so, how. Commenters are particularly

encouraged to provide quantitative information to support their views.

#### D. Consideration of Impact on the Economy

For purposes of SBREFA, the SEC must advise the Office of Management and Budget as to whether the proposed rules constitute a “major” rule. Under SBREFA, a rule is considered “major” where, if adopted, it results or is likely to result in: (1) An annual effect on the economy of \$100 million or more (either in the form of an increase or a decrease); (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effect on competition, investment or innovation. If a rule is “major,” its effectiveness will generally be delayed for 60 days pending Congressional review. We do not believe that any of the proposed rules, in their current form, would constitute a major rule.

We request comment on the potential impact of the proposed rules on the economy on an annual basis, on the costs or prices for consumers or individual industries, and on competition, investment or innovation. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

#### E. Regulatory Flexibility Act Certification

The Regulatory Flexibility Act (“RFA”) <sup>193</sup> requires Federal agencies, in promulgating rules, to consider the impact of those rules on small entities. Section 603(a) <sup>194</sup> of the Administrative Procedure Act, <sup>195</sup> 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.” <sup>196</sup> 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. <sup>197</sup>

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, <sup>198</sup> 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 financial statements were prepared pursuant to Rule 17a-5(d) under the Exchange Act, <sup>199</sup> 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. <sup>200</sup> 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; <sup>201</sup> (ii) for entities engaged in non-depository credit intermediation and certain other activities, entities with \$7 million or less in annual receipts; <sup>202</sup> (iii) for entities engaged in financial investments and related activities, entities with \$7 million or less in annual receipts; <sup>203</sup> (iv) for insurance carriers and entities engaged in related activities, entities with \$7 million or less in annual receipts; <sup>204</sup> and (v) for funds, trusts, and other financial vehicles, entities with \$7 million or less in annual receipts. <sup>205</sup>

Based on feedback from industry participants about the security-based swap markets, the SEC preliminarily believes that entities that would qualify as security-based swap dealers and major security-based swap market participants, whether registered broker-dealers or not, exceed the thresholds defining “small entities” set out above. Thus, the SEC believes it is unlikely that the proposed rules would have a significant economic impact any small entity.

For the foregoing reasons, the SEC certifies that the proposed rules would not have a significant economic impact

on a substantial number of small entities for purposes of the RFA.

The SEC encourages written comments regarding this certification. The SEC requests that commenters describe the nature of any impact on small entities and provide empirical data to illustrate the extent of the impact.

## VII. Statutory Basis and Rule Text

### List of Subjects

#### 17 CFR Part 1

Definitions.

#### 17 CFR Part 240

Reporting and recordkeeping requirements, Securities.

### Commodity Futures Trading Commission

#### Text of Proposed Rules

For the reasons stated in this release, the CFTC is proposing to amend 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 by:

- a. Adding paragraph (m); and
- b. As proposed to be amended at 75 FR 63762, October 18, 2010, and 75 FR 77576, December 13, 2010, adding (ppp) through (vvv) to read as follows:

#### § 1.3 Definitions

\* \* \* \* \*

(m) *Eligible contract participant*. This term has the meaning set forth in Section 1a(18) of the Commodity Exchange Act, except that:

(1) A major swap participant, as defined in Section 1a(33) of the Commodity Exchange Act and § 1.3(qqq), is an eligible contract participant;

(2) A swap dealer, as defined in Section 1a(49) of the Commodity Exchange Act and § 1.3(ppp), 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 (15 U.S.C. 78c(a)(67)) 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

<sup>193</sup> 5 U.S.C. 601 *et seq.*

<sup>194</sup> 5 U.S.C. 603(a).

<sup>195</sup> 5 U.S.C. 551 *et seq.*

<sup>196</sup> 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).

<sup>197</sup> *See* 5 U.S.C. 605(b).

<sup>198</sup> *See* 17 CFR 240.0-10(a).

<sup>199</sup> *See* 17 CFR 240.17a-5(d).

<sup>200</sup> *See* 17 CFR 240.0-10(c).

<sup>201</sup> *See* 13 CFR 121.201 (Subsector 522).

<sup>202</sup> *See id.* at Subsector 522.

<sup>203</sup> *See id.* at Subsector 523.

<sup>204</sup> *See id.* at Subsector 524.

<sup>205</sup> *See id.* at Subsector 525.

Securities and Exchange Act of 1934 (15 U.S.C. 78c(a)(71)) and § 240.3a71-1 of this title, is an eligible contract participant;

(5) A commodity pool with one or more direct or indirect participants that is not an eligible contract participant is not an eligible contract participant for purposes of Sections 2(c)(2)(B)(vi) and 2(c)(2)(C)(vii) of the Commodity Exchange Act; and

(6) A commodity pool that does not have total assets exceeding \$5,000,000 or that is not operated by a person described in clause (A)(iv)(II) of Section 1a(18) of the Commodity Exchange Act is not an eligible contract participant pursuant to clause (A)(v) of such Section.

\* \* \* \* \*

(ppp) *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*. 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. A person may make such application to limit its designation at the same time as, or at a later time subsequent to, the person’s initial registration as a swap dealer.

(4) *De minimis exception*. A person shall not be deemed to be a swap dealer as a result of swap dealing activity involving counterparties that meets each of the following conditions:

(i) The swap positions connected with those activities into which the person enters over the course of the immediately preceding 12 months have an aggregate gross notional amount of no more than \$100 million, and have 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 Commodity Exchange Act). 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) The person has not entered into swaps in connection with those activities with more than 15 counterparties, other than swap dealers, over the course of the immediately preceding 12 months. In determining the number of counterparties, all counterparties that are members of a single group of persons under common control shall be considered to be a single counterparty.

(iii) The person has not entered into more than 20 swaps in connection with those activities over the course of the immediately preceding 12 months. For purposes of this paragraph, each transaction entered into under a master agreement for swaps shall constitute a distinct swap, but entering into an amendment of an existing swap in which the counterparty to such swap remains the same and the item underlying such swap remains substantially the same shall not constitute entering into a swap.

(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 such person is a swap dealer.

(i) A swap shall be considered to have been entered into in connection with originating a loan only if the rate, asset, liability or other notional item underlying such swap is, or is directly related to, a financial term of such loan. The financial terms of a loan include, without limitation, the loan’s duration, rate of interest, the currency or currencies in which it is made and its principal amount.

(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.

(qqq) *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 Commodity Exchange Act); 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 or specified activities of the person in connection with swaps, the Commission shall determine whether the person’s designation as a major swap participant shall be so limited. A person may make such application to limit its designation at the same time as, or at a later time subsequent to, 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 or two months after the end of that quarter.

(4) *Reevaluation period.*

Notwithstanding paragraph (qqq)(3) of this section, 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 immediately be subject to the timing requirements specified in paragraph (qqq)(3) of this section; but

(ii) That person will become subject 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.

(rrr) *Category of swaps; major swap category.* For purposes of Sections 1a(33) and 1a(49) of the Commodity Exchange Act and §§ 1.3(ppp) and 1.3(qqq), 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(rrr) has the meaning set forth in Section 1a(47) of the Commodity Exchange Act 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 Commodity Exchange Act, and any foreign exchange option.

(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, 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.

(sss) *Substantial position.* (1) *In general.* For purposes of Section 1a(33) of the Commodity Exchange Act and § 1.3(qqq), the term *substantial position* means swap positions, other than positions that are excluded from consideration, 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 a 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 the agreement. Calculation of net 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), to the extent these are consistent with the offsets permitted by the master netting agreement.

(B) Such adjustments may not take into account any offset associated with positions that the person has with separate counterparties.

(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 clearing agency or derivatives clearing organization, as calculated in accordance with paragraph (sss)(3)(ii); and

(B) The aggregate potential outward exposure for each of the person's swap positions in such major swap category that are subject to daily mark-to-market margining or are cleared by a registered clearing agency or derivatives clearing organization, as calculated in accordance with paragraph (sss)(3)(iii) of this section.

(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 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 clearing agency or a derivatives clearing organization, potential outward

exposure equals the total notional principal amount of those positions, adjusted by the following multipliers 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. 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.

TABLE TO § 1.3 (SSS)—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   |

(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 (sss)(3)(ii)(A)(1) of this section 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 (sss)(3)(ii)(A)(1) of this section shall exclude:

(i) Positions that constitute the purchase of an option, such that the person has no additional payment obligations under the position; and

(ii) Other positions for which the person has prepaid or otherwise satisfied all of its payment obligations.

(4) Adjustment for certain positions. Notwithstanding paragraph (sss)(3)(ii)(A)(1) of this section, 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 is capped at the net present value of the unpaid premiums.

(B) Adjustment for netting agreements. Notwithstanding paragraph (sss)(3)(ii)(A) of this section, 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 (sss)(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:

$$P_{Net} = 0.4 * P_{Gross} + 0.6 * NGR * P_{Gross}$$

**Note to paragraph (sss)(3)(ii)(B):**  $P_{Net}$  is the potential outward exposure, adjusted for bilateral netting, of the person’s swaps with a particular counterparty;  $P_{Gross}$  is that potential outward exposure without adjustment for bilateral netting; and NGR is the ratio of net current exposure to gross current exposure.

(iii) Calculation of potential outward exposure for swaps that are subject to daily mark-to-market margining or are cleared by a registered clearing agency or derivatives clearing organization. For positions in swaps that are subject to daily mark-to-market margining or cleared by a registered 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 (sss)(3)(ii) of this section multiplied by 0.2.

(B) For purposes of this calculation, 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. If the person is permitted by agreement to maintain a threshold for which it is not required to post collateral, the total amount of that threshold (regardless of the actual exposure at any time) shall be added to the person’s aggregate uncollateralized outward exposure for purposes of paragraph (sss)(1)(i)(B), (ii)(B), (iii)(B) or (iv)(B) of this section, as applicable. If the minimum transfer amount under the agreement is in excess of \$1 million, the entirety of the minimum transfer

amount shall be added to the person’s aggregate uncollateralized outward exposure for purposes of paragraph (sss)(1)(i)(B), (ii)(B), (iii)(B) or (iv)(B), as applicable.

(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.

(ttt) Hedging or mitigating commercial risk. For purposes of Section 1a(33) of the Commodity Exchange Act and § 1.3(qqq), a swap position shall be deemed to be 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, 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 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 Commodity Exchange Act; or

(iii) Qualifies for hedging treatment under Financial Accounting Standards Board Accounting Standards Codification Topic 815, Derivatives and Hedging (formerly known as Statement No. 133); and

(2) Such position is:

(i) Not held for a purpose that is in the nature of speculation, investing or trading;

(ii) Not held to hedge or mitigate the risk of another swap or securities-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.

(uuu) Substantial counterparty exposure. (1) *In general.* For purposes of Section 1a(33) of the Act and § 1.3(qqq), the phrase *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" have the same meaning as in § 1.3(sss), 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.

(vvv) *Financial entity; highly leveraged.* (1) For purposes of Section 1a(33) of the Commodity Exchange Act and § 1.3(qqq), 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 Commodity Exchange Act;

(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.

(2) For purposes of Section 1a(33) of the Commodity Exchange Act and § 1.3(qqq), the term "*highly leveraged*" means the existence of a ratio of an entity's total liabilities to equity in excess of [8 to 1 or 15 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.

#### 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 proposing to adopt 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 Proposed Rules

For the reasons stated in the preamble, the SEC is proposing to amend Title 17, Chapter II of the Code of the Federal Regulations 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, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 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; and 12 U.S.C. 5221(e)(3), unless otherwise noted.

\* \* \* \* \*

Sections 3a67-1 through 3a67-7 and sections 3a71-1 and 3a71-2 are also issued under Pub. L. 111-203, §§ 712, 761(b), 124 Stat. 1841 (2010).

\* \* \* \* \*

2. Add §§ 240.3a67-1 through 240.3a67-7 and §§ 240.3a71-1, 240.3a71-2 to read as follows:

\* \* \* \* \*

| Sec. | 240.3a67 | 1 | 240.3a67 | 2 | 240.3a67 | 3 | 240.3a67 | 4 | 240.3a67 | 5 | 240.3a67 | 6 | 240.3a67 | 7 | 240.3a71 | 1 | 240.3a71 | 2 |
|------|----------|---|----------|---|----------|---|----------|---|----------|---|----------|---|----------|---|----------|---|----------|---|
|      |          |   |          |   |          |   |          |   |          |   |          |   |          |   |          |   |          |   |
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|      |          |   |          |   |          |   |          |   |          |   |          |   |          |   |          |   |          |   |
|      |          |   |          |   |          |   |          |   |          |   |          |   |          |   |          |   |          |   |

#### § 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 or specified activities of the person in connection with security-based swaps.

**§ 240.3a67-2 Categories of Security-based Swaps.**

For purposes of sections 3(a)(67) and 3(a)(71) of the Act, 15 U.S.C. 78c(a)(67) and 78c(a)(71), 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) *Security-based credit derivatives.* 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 § 240.3a67-1 of this chapter, the term *substantial position* means security-based swap positions, other than positions that are excluded from consideration, 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. 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 a master netting agreement 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 the agreement. Calculation of net exposure may take into account offsetting positions entered into with that

particular counterparty involving security-based swaps (in any 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), to the extent these are consistent with the offsets permitted by the master netting agreement.

(ii) Such adjustments may not take into account any offset associated with positions that the person has with separate counterparties.

(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 not cleared by a registered clearing agency or 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 cleared by a registered 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 clearing agency or subject to daily mark-to-market margining.

(i) *General.* (A)(1) For positions in security-based swaps that are not cleared by a registered 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 "credit" or "equity" type, the "other" conversion factors are to be used:

| Residual maturity            | Credit | Equity | Other |
|------------------------------|--------|--------|-------|
| One year or less .....       | 0.10   | 0.06   | 0.10  |
| Over one to five years ..... | 0.10   | 0.08   | 0.12  |
| Over five years .....        | 0.10   | 0.10   | 0.15  |

(2) 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; and

(2) Other positions for which the person has prepaid or otherwise satisfied all of its payment obligations.

(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 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 that potential outward exposure without adjustment for bilateral netting; and  $NGR$  is the ratio of net current exposure to gross current exposure.

(3) Calculation of potential outward exposure for security-based swaps that are cleared by a registered clearing agency or subject to daily mark-to-market margining. For positions in security-based swaps that are cleared by a registered 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 0.2.

(ii) For purposes of this calculation, 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).

If the person is permitted by agreement to maintain a threshold for which it is not required to post collateral, the total amount of that threshold (regardless of the actual exposure at any time) shall be added to the person's aggregate uncollateralized outward exposure for purposes of paragraph (a)(2) of this section. If the minimum transfer amount under the agreement is in excess of \$1 million, 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) *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.

#### § 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 § 240.3a67-1 of this chapter, a security-based swap position shall be deemed to be held for the purpose of hedging or mitigating commercial risk when:

(a) Such position is economically appropriate to the reduction of risks that are associated with the present conduct and management of a commercial enterprise, or are reasonably expected to arise in the future conduct and management of the commercial enterprise, where such risks arise from:

(1) 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;

(2) 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

(3) 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;

(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(ttt); and

(c) The person holding the position satisfies the following additional conditions:

(1) The person identifies and documents the risks that are being reduced by the security-based swap position;

(2) The person establishes and documents a method of assessing the effectiveness of the security-based swap as a hedge; and

(3) The person regularly assesses the effectiveness of the security-based swap as a hedge.

#### § 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 § 240.3a67-1 of this chapter, 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 § 240.3a67-3 of this chapter, 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 Definitions of "Financial Entity" and "Highly Leveraged."

(a) For purposes of section 3(a)(67) of the Act, 15 U.S.C. 78c(a)(67), and § 240.3a67-1 of this chapter, 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) For purposes of section 3(a)(67) of the Act, 15 U.S.C. 78c(a)(67), and § 240.3a67-1 of this chapter, the term *highly leveraged* means the existence of a ratio of an entity's total liabilities to equity in excess of [8 to 1 or 15 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.

**§ 240.3a67-7 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 § 240.3a67-1 of this chapter 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 15 U.S.C. 78o-8 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 § 240.3a67-1 of this chapter 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 subject to the timing requirements specified in paragraph (a) of this section; but

(2) That person will become subject 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 § 240.3a67-1 of this chapter for four consecutive

fiscal quarters after the date on which the person becomes registered as a major security-based swap participant.

**§ 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 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 or specified activities of the person in connection with security-based swaps.

**§ 240.3a71-2 De minimis Exception.**

For purposes of section 3(a)(71) of the Act, 15 U.S.C. 78c(a)(71), and § 240.3a71-1 of this chapter, a person shall not be deemed to be a security-based swap dealer as a result of security-based swap dealing activity involving counterparties that meets each of the following conditions:

(a) *Notional amount of outstanding security-based swap positions.* The security-based swap positions connected with those activities into which the person enters over the course of the immediately preceding 12 months have an aggregate gross notional amount of no more than \$100 million and have an aggregate gross notional amount of no more than \$25 million with regard to security-based swaps in which the counterparty is a "special entity" (as that term is defined in 15 U.S.C. 78o-8). For purposes of this paragraph (a), 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) *No more than 15 counterparties.* The person does not enter into security-based swaps in connection with those activities with more than 15 counterparties, other than security-based swap dealers, over the course of the immediately preceding 12 months. In determining the number of counterparties, all counterparties that are members of a single affiliated group shall be considered to be a single counterparty.

(c) *No more than 20 security-based swaps.* The person has not entered into more than 20 security-based swaps in connection with those activities over the course of the immediately preceding 12 months. For purposes of this paragraph, each transaction entered into under a master agreement for security-based swaps shall constitute a distinct security-based swap, but entering into an amendment of an existing security-based swap in which the counterparty to such swap remains the same and the notional item underlying such security-based swap remains substantially the same shall not constitute entering into a security-based swap.

Dated: December 1, 2010.

By the Commodity Futures Trading Commission.

**David A. Stawick,**  
*Secretary.*

Dated: December 7, 2010.

By the Securities and Exchange Commission.

**Elizabeth M. Murphy,**  
*Secretary.*

**Additional Statement by the Commodity Futures Trading Commission Regarding the Joint Proposed Rule Entitled "Further Definition of 'Swap Dealer,' 'Security-Based Swap Dealer,' 'Major Swap Participant,' 'Major Security-Based Swap Participant,' and 'Eligible Contract Participant.'"**

On this matter, Chairman Gensler and Commissioners Dunn and Chilton voted in the affirmative; Commissioners Sommers and O'Malia voted in the negative.

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