SIMPSON THACHER MEMORANDUM

# CFTC and SEC Adopt New Rules Further Defining "Major Swap Participant" and "Major Security-Based Swap Participant"

*May 3, 2012*

Pursuant to Section 712 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the Commodity Futures Trading Commission and the Securities and Exchange Commission (collectively, the "Commissions"), in consultation with the Board of Governors of the Federal Reserve System, have issued critical, final rules defining the terms "major swap participant" and "major security-based swap participant" (collectively, "major participants").[1] These new regulations establish a comprehensive testing methodology that swap and security-based swap counterparties must employ both to determine whether they will be subject to heightened regulation as a major participant and to establish whether they will be shielded from such requirements by a safe harbor. To the extent that an entity satisfies any of the three alternative major participant tests, it will generally become subject to additional statutory and regulatory requirements, encompassing margin, capital, business conduct, recordkeeping, and reporting. Because the CFTC rule and the SEC rule (collectively, the "final rules") are substantially similar in both substance and approach, this memo discusses the two rules concurrently, highlighting areas in which they differ.

## I. STATUTORY DEFINITION

Under the Dodd-Frank Act, the definition of major swap participant and major security-based swap participant captures persons who are not swap dealers or security-based swap dealers[2] and who fall into any one of the following three statutory categories:

1. A person who maintains a "substantial position" in swaps, or security-based swaps, in any of the major categories, *excluding* both positions held for "hedging or mitigating commercial risk", and positions maintained by qualifying employee benefit plans and governmental plans for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;

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[1] *See* CFTC and SEC, Release No. 34–66868, Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant" (2012). (the "Adopting Release"). The CFTC rules will be codified at 17 C.F.R. § 1.3(hhh) and the SEC rules at 17 C.F.R. 240.3a67.

[2] Although the final rules defining the terms "swap dealer" and "security-based swap dealer" are addressed in the same final rule, they are discussed in a separate memorandum, *available at*: http://www.stblaw.com/siteContent.cfm?contentID=4&itemID=80&focusID=1413.

2. A person 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; *or*

3. A person who is a "financial entity" that is "highly leveraged" relative to the amount of capital it holds and is not subject to capital requirements established by an appropriate Federal banking agency; and who maintains a "substantial position" in outstanding swaps or security-based swaps in any major swap or security-based swap category.[3]

The final rules further define the terms "substantial position", "hedging or mitigating commercial risk", "substantial counterparty exposure", "financial entity", and "highly leveraged", each of which are discussed in detail below.

## II. KEY RISK MEASUREMENT CONCEPTS: UNCOLLATERALIZED OUTWARD EXPOSURE AND POTENTIAL OUTWARD EXPOSURE

The final rules establish two key risk metrics which form the basis for each risk calculation under the three major participant tests. In contrast to the activities-based analysis that the Commissions established for swap dealers and security-based swap dealers, the major participant definitions focus on the potential market impacts and systemic risks associated with an entity's outstanding swap and security-based swap positions. Among other considerations, the final rules seek to identity those entities whose exposure to swaps and security-based swaps pose market risks that, in the view of the Commissions, warrant enhanced regulatory oversight and control. To identify these entities, the final rules adopt two quantitative measurements of the current and the potential default-related credit risk associated with swap and security-based swap positions —"uncollateralized outward exposure" and "potential outward exposure".

### A. Daily Calculations

Each of the major participant tests calls for the daily average aggregate uncollateralized outward exposure and/or the daily average aggregate potential outward exposure. This daily average is calculated by taking the arithmetic mean of the relevant exposure 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.[4]

### B. Uncollateralized Outward Exposure

Uncollateralized outward exposure measures the current amount of potential risk that an entity would pose to its counterparties if it were to default today. In general terms, the test requires an entity, on a counterparty-by-counterparty basis, to mark-to-market each of its swap and security-based swap positions with a negative value and to then offset those negative positions with the value of any posted collateral.[5] The aggregate uncollateralized outward exposure for a

[3] Sections 721(a)(16) and 761(a)(6) of the Dodd-Frank Act.
[4] *See* CFTC Regulation § 1.3(jjj)(4) and Exchange Act Rule 240.3a67–3(c)(3)(d).
[5] *See* CFTC Regulation § 1.3(jjj)(2) and Exchange Act Rule 240.3a67–3.

given category of swaps[6] or security-based swaps[7] is the sum of the negative uncollateralized amounts within that category. In-the-money positions, fully collateralized positions, and perfectly netted positions are effectively disregarded under this analysis.

*1. Master Netting Agreements*

For counterparties with master netting agreements in place, such as an ISDA Master Agreement, aggregate uncollateralized outward exposure is calculated on a net basis subject to the terms of the master netting agreement.[8] Pursuant to the final rules, permitted offsets include any position governed by a master netting agreement that is also subject to netting offsets under applicable bankruptcy law. In applying the netting provisions, the final rules require a *pro rata* allocation of the offset among the out-of-the-money positions subject to the master netting agreement in each swap and security-based swap category. Importantly, the netting may only occur on a counterparty-by-counterparty basis—netting across multiple counterparties is prohibited.

**C. Potential Outward Exposure**

The potential outward exposure metric is intended to be a measure of the potential risk that an entity's positions might pose in the future. Under the rules, this measure is calculated as a function of the notional value of an entity's outstanding swaps or security-based swaps multiplied by a risk factor, which is based on the classification and tenor of the position. If such positions are subject to a master netting agreement, they will be further reduced by a factor to take into account the netting offsets. Similarly, for those swaps or security-based swaps that are either cleared by a registered or exempt clearing agency, or subject to daily mark-to-market margining the potential outward exposure of such swaps or security based swaps is further reduced by an additional risk multiplier to reflect the reduced risk associated with cleared/mark-to-market margined positions.[9] The total aggregate potential outward exposure for an entity equals the sum of the potential outward exposure of the entity's swap, or security-based swap, positions pursuant to the calculations below.

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[6] The CFTC rule separates swaps into four major categories: rate swaps, which encompass any swap that is primarily based on one or more reference rates; credit swaps, which encompass any swap that is primarily based on instruments of indebtedness; equity swaps, which encompass any swap that is primarily based on equity securities, e.g., broad-based indices of equity securities; and other commodity swaps, which encompass any swap that is not a rate swap, credit swap, or equity swap. *See* CFTC Regulation § 1.3(jjj)(1).

[7] The SEC rule separates security-based swaps into two major categories: debt security-based swaps, which encompass any security-based swap that is based, in whole or in part, on one or more instruments of indebtedness, or on a credit event relating to one or more issuers or securities; and other security-based swaps, which encompass any security-based swap that is not a debt security-based swap. *See* Exchange Act Regulation 240.3a67–2.

[8] *See* CFTC Regulation § 1.3(jjj)(2)(iii), (iv) and Exchange Act Rule 240.3a67–3(b)(3), (4).

[9] *See* CFTC Regulation § 1.3(jjj)(3) and Exchange Act Rule 240.3a67–3(c).

1. *Swaps and Security-Based Swaps Not Subject to Clearing or Mark-to-Market Margining*

As indicated above, for positions in swaps or security-based swaps that are neither cleared by a registered or exempt clearing agency, nor subject to daily mark-to-market margining, the aggregate potential outward exposure is calculated by aggregating the product of: (i) the notional principal amount of the outstanding positions[10] multiplied by (ii) a risk factor based on the classification and the tenor of the position, on a position-by-position basis.[11]

| **Risk Factor Multiplier for Swaps** | | | |
|---|---|---|---|
| | **Maturity in 1 year or less** | **Maturity in 1 to 5 years** | **Maturity in more than 5 years** |
| Interest rate | 0.00 | 0.005 | 0.015 |
| Foreign exchange and gold | 0.01 | 0.05 | 0.075 |
| Precious metals (except for gold) | 0.07 | 0.07 | 0.08 |
| Other commodities | 0.10 | 0.12 | 0.15 |
| Credit | 0.10 | 0.10 | 0.10 |
| Equity | 0.06 | 0.08 | 0.10 |

| **Risk Factor Multiplier for Security-Based Swaps** | | | |
|---|---|---|---|
| | **Maturity in 1 year or less** | **Maturity in 1 to 5 years** | **Maturity in more than 5 years** |
| Debt | 0.10 | 0.10 | 0.10 |
| Equity and other | 0.06 | 0.08 | 0.10 |

For swaps or security-based swaps governed by a master netting agreement, the potential outward exposure is reduced on a counterparty-by-counterparty basis by multiplying the potential outward exposure by a factor ranging from 0.4 to 1.0 depending on the ratio of current net exposure over current gross exposure (absent netting) in the relevant major swap or major security-based swap category.

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[10] The total notional amount excludes positions such as options and other positions for which a party has prepaid or has otherwise satisfied in-full all of its payment obligations. Further, for those positions where the only future obligation is to pay fixed premium amounts—e.g., buying credit protection or an option that has remaining premium payments—the potential outward exposure is capped at the net present value of the unpaid premiums. Finally, if the stated notional amount is leveraged or enhanced by the structure of the transaction, then the notional amount included in the calculation must be the effective notional amount rather than the stated notional amount.

[11] *See* CFTC Regulation § 1.3(jjj)(3)(ii) and Exchange Act Rule 240.3a67–3(c)(2).

2. *Swaps and Security-Based Swaps Subject to Clearing or Mark-to-Market Margining*

For swap, or security-based swap, positions that are either cleared by a registered or exempt clearing agency, or subject to daily mark-to-market margining,[12] the calculation of potential outward exposure involves two steps.[13] The first step is to calculate the potential outward exposure as if the positions were not subject to clearing or mark-to-market margining, including risk-based adjustments (*see* above). The second step is to take such potential outward exposure and multiply it by one of the following additional risk multipliers: (i) 0.1 in the case of positions cleared by a registered or exempt clearing agency, and (ii) 0.2 in the case of positions subject to daily mark-to-market margining.

## III. TEST 1: MAINTAINS A SUBSTANTIAL POSITION IN SWAPS OR SECURITY-BASED SWAPS, FOR ANY OF THE MAJOR SWAP OR SECURITY-BASED SWAP CATEGORIES

Under both the CFTC and the SEC rules, the determination of whether an entity's swaps or security-based swaps meet the standard for a "substantial position" rests on the satisfaction of one of two alternative tests.[14] The first metric is the daily average aggregate uncollateralized outward exposure (*see* calculation methods above). The second metric is the daily average aggregate uncollateralized outward exposure plus the daily average aggregate potential outward exposure (*see* calculation methods above). The thresholds for each of the categories of swaps, and security-based swaps, are laid out in the table below. It is important to note that for this test, and this test only, a substantial position excludes both positions held for hedging or mitigating commercial risk, as well as positions maintained by qualifying employee benefit plans and governmental plans for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan. Each of these exclusions is discussed in further detail below.

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[12] A swap or security-based swap is subject to daily mark-to-market margining if the counterparties follow the daily practice of exchanging collateral to reflect changes in exposure. Importantly, the use of a threshold below which the entity is not required to post collateral will not disqualify the position from the daily mark-to-market margining risk adjustment. In such a case, the total amount of the threshold (less any initial margin posted) will be included in the calculation of the party's aggregate uncollateralized outward exposure, regardless of the actual exposure at any time. Similarly, if a swap, or security-based swap, position is subject to a minimum transfer amount which is greater than $1 million, the position may still be considered subject to daily mark-to-market margining, but the entirety of the minimum transfer amount will be added to the party's aggregate uncollateralized outward exposure, regardless of actual exposure at any time. Instead of adding the threshold and minimum transfer amounts, an entity may choose instead to forego applying the risk reduction multipliers.

[13] *See* CFTC Regulation § 1.3(jjj)(3)(iii) and Exchange Act Rule 240.3a67–3(c)(3).

[14] *See* CFTC Regulation § 1.3(jjj) and Exchange Act Rule 240.3a67–3.

| Substantial Position in Swaps and Security-Based Swaps | | |
|---|---|---|
| **Swap/Security-Based Swap Classification** | **Daily Average Aggregate Uncollateralized Outward Exposure** | **Daily Average Aggregate Uncollateralized Outward Exposure *plus* Daily Average Aggregate Potential Outward Exposure** |
| **Swaps** | | |
| Rate Swaps | $3 billion | $6 billion |
| Credit Swaps | $1 billion | $2 billion |
| Equity Swaps | $1 billion | $2 billion |
| Other Swaps | $1 billion | $2 billion |
| **Security-Based Swaps** | | |
| Debt Security-Based Swaps | $1 billion | $2 billion |
| Other Security-Based Swaps | $1 billion | $2 billion |

### A. Hedging or Mitigating Commercial Risk

The first test of the major participant definitions—and only the first—excludes swap and security-based swap positions held for hedging or mitigating commercial risk. Because counterparties use swaps and security-based swaps to mitigate risks in different ways, the CFTC and the SEC rules are not identical. Notwithstanding these differences, the Commissions take a similar approach with respect to the general availability of the exclusion. The Commissions agree that the exclusion is not dependent on organizational status and is available to financial entities and non-financial entities alike. In addition, the exclusion extends to both swaps and security-based swaps that hedge against financial or balance sheet risks. Moreover, under both rules, the scope of the exclusion is not limited to the mitigation of an entity's own risks. Instead, it extends to hedges against the risks of majority-owned affiliates, as long as the affiliate could have taken advantage of the exclusion itself. The differences between the Commissions with respect to the hedging exclusion are discussed below.

#### 1. *Hedging Exclusion for Swaps*

To qualify for the hedging exclusion under the CFTC's final rule,[15] a swap counterparty must demonstrate that the relevant position:

1. Is "economically appropriate" to the reduction of risks in the conduct and management of a commercial enterprise;
2. Qualifies as bona fide hedging for purposes of an exemption from position limits under the Commodity Exchange Act;[16] *or*
3. Qualifies for hedging treatment under:

[15] *See* CFTC Regulation § 1.3(kkk).
[16] *See* Position Limits for Futures and Swaps, 76 F.R. 71626 (Nov. 18, 2011).

i) Financial Accounting Standards Board Accounting Statements Codification Topic 815, Derivatives and Hedging; *or*

ii) Government Accounting Standards Board Statement 53, Accounting and Financial Reporting for Derivative Instruments.

In reviewing whether a swap is "economically appropriate" to the reduction of risks in the conduct and management of a commercial enterprise, the CFTC will examine the facts and circumstances as they existed when the entity claiming the exemption established the position. The final rule enumerates a list of specific risk mitigation practices that qualify for the exclusion.[17] This list is exhaustive, and a risk mitigation strategy that does not fall within one of the enumerated categories will not satisfy the economically appropriate analysis.

In addition to the three threshold tests above, an entity claiming the hedging exclusion must also establish that the swap position is:

1. Not held for a purpose that is in the nature of speculation, investing, or trading;[18] *and*

2. Not held to hedge or mitigate the risk of another swap or security-based swap position, *unless* that other position itself is held for the purpose of hedging or mitigating commercial risk.

*2. Hedging Exclusion for Security-Based Swaps*

For security-based swaps, the SEC has defined a position that is for hedging or mitigating commercial risk[19] as one which is:

1. Economically appropriate to the reduction of risks that are associated with the present conduct and management of a commercial enterprise (or of a majority-owned affiliate of

[17] These include scenarios where the risks arise from: (i) the potential change in the value of assets that a person owns, produces, manufacturers, processes or merchandises or reasonably anticipates owning, producing, manufacturing, processing or merchandising in the ordinary course of business of the enterprise; (ii) the potential change in the value of liabilities that a person has incurred or reasonably anticipates incurring in the ordinary course of business of the enterprise; (iii) the potential change in value of services that a person provides, purchases, or reasonably anticipates providing or purchasing in the ordinary course of business of the enterprise; (iv) the potential change in the value of assets, services, inputs, products, or commodities that a person owns, produces, manufacturers, 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; (v) any potential change in value related to any of the foregoing arising from interest, currency, or foreign exchange rate movements associated with such assets, liabilities, services, inputs, products, or commodities; or (vi) any fluctuation in interest, currency, or foreign exchange rate exposure arising from a person's current or anticipated assets or liabilities. CFTC Regulation § 1.3(kkk)(1)(i).

[18] Swaps that hedge against other positions held for speculation, investment, or trading fail to qualify for the hedging exemption. *See* Adopting Release at 310–11.

[19] *See* Exchange Act Rule 240.3a67–4.

the enterprise), or are reasonably expected to arise in the future conduct and management of the commercial enterprise; *and*

2. Such position is:
   a. not held for speculative or trading purposes, *and*

   b. not held to hedge or mitigate 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.

The SEC defines a position as economically appropriate to the reduction of risk associated with the conduct of a commercial enterprise where the risks arise from the potential change in the value of: (i) assets a person owns, produces, manufactures, processes, or merchandises in the ordinary course of business; (ii) liabilities that a person has incurred in the ordinary course of business; or (iii) services that person provides or purchases in the ordinary course of business. In each case, this analysis also applies to hedging risks associated with affiliates under common control with the enterprise.

The SEC's final rule provides a non-exclusive list of positions that may be considered for purposes of hedging or mitigating commercial risk, dependent on a facts and circumstances analysis of each such position.[20]

### B. Exclusion for Positions Held by Qualifying ERISA Plans

In addition to the hedging exclusion, the first major participant test also excludes swap and security-based swap positions maintained by certain employee benefit plans and governmental plans,[21] for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan.[22] According to the Commissions, this exemption is broader than the exclusion for hedging discussed above, because it is not limited to commercial risks or to

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[20] This list includes: (i) positions established to manage the risk posed by 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 future, or a supplier's commitment to provide the same; (ii) positions established to manage the default risk posed by a financial counterparty in connection with a separate transaction (including credit derivative, equity swap, other security-based swap, interest rate swap, commodity swap, FX swap or other swap, option, or future that is itself hedging for commercial risk); (iii) positions established to manage equity or market risk associated with certain employee compensation plans; (iv) positions established to manage equity market price risks in connection with certain business combinations, such as a merger or consolidation in which securities of a person are exchanged for securities of any other person, or a transfer of assets in exchange for securities; (v) positions established by a bank to manage counterparty risks in connection with loans; and (vi) positions established to close out or reduce any of the positions described above.

[21] For qualifying entities, *see* Paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974.

[22] *See* Adopting Release at 328–321.

positions that have a sole hedging purpose. Instead, the qualifying plan exclusion extends to *any* risk directly associated with the operation of the plan, and encompasses swap and security-based swap positions that have a secondary, non-hedging purpose.

A swap or security-based swap has a "primary purpose" of hedging or mitigating risk directly associated with the operation of a qualifying plan if the position was established to reduce disruptions or costs in connection with: (i) the anticipated inflows or outflows of plan assets, (ii) risks related to interest rates, and (iii) changes in portfolio management or strategies.

### C. Procedural Conditions

Although the final rules do not require entities to demonstrate the effectiveness of hedges, to retain specific documentation, or to employ periodic retesting to qualify for the hedging exemption,[23] the SEC provided interpretive guidance in the Adopting Release that it may be prudent for entities relying on the exemption to retain documents and records consistent with such procedures.[24] According to the SEC, in the event that an exemption is disputed, the existence of such records may help to establish the basis for the exclusion.

## IV. TEST 2: OUTSTANDING SWAPS OR SECURITY-BASED SWAPS CREATE SUBSTANTIAL COUNTERPARTY EXPOSURE THAT COULD HAVE SERIOUS ADVERSE EFFECTS ON THE FINANCIAL STATBILITY OF THE UNITED STATES BANKING SYSTEM OR FINANCIAL MARKETS

The second major participant test targets entities 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.[25] Unlike the substantial position analysis, the substantial counterparty exposure calculation is not limited to positions in a single swap or security-based swap category. Instead, the substantial counterparty exposure test aggregates all the swap and security-based swap positions of an entity.[26] Importantly, positions held for hedging or mitigating commercial risks as well as those held by qualifying employee benefit and governmental plans are *not* excluded from the substantial counterparty exposure analysis.[27] Consequently, the triggering thresholds are higher for this test than for those under the substantial position test.

Pursuant to the substantial counterparty exposure analysis, an entity will qualify as a major participant if it exceeds any of the following thresholds:

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[23] *See id.* at 310, 325.
[24] *See id.* at 324–25.
[25] *See* CFTC Regulation § 1.3(lll) and Exchange Act Rule 240.3a67–5.
[26] *See* CFTC Regulation § 1.3(lll)(2) and Exchange Act Rule 240.3a67–5(b).
[27] *See* Adopting Release at 335.

| Swaps or Security-Based Swaps Create Substantial Counterparty Exposure | | |
|---|---|---|
| | **Major Swap Participant** | **Major Security-Based Swap Participant** |
| **Daily Average Aggregate Uncollateralized Outward Exposure** | $5 billion, calculated by reference to all swap positions | $2 billion, calculated by reference to all security-based swap positions |
| **Daily Average Aggregate Uncollateralized Outward Exposure *plus* Daily Average Aggregate Potential Outward Exposure** | $8 billion, calculated by reference to all swap positions | $4 billion, calculated by reference to all security-based swap positions |

## V. TEST 3: HIGHLY LEVERAGED FINANCIAL ENTITIES WITH SUBSTANTIAL POSITIONS IN ANY MAJOR CATEGORY OF SWAPS OR SECUIRTY-BASED SWAPS

The third major participant test encompasses any person that is: (i) a "financial entity" that is "highly leveraged" relative to the amount of capital it holds (and is not subject to capital requirements established by an appropriate Federal banking agency) and (ii) maintains a "substantial position" in outstanding swaps in any major swap or security-based swap category.

### A. Financial Entity

To define the term "financial entity," the Commissions relied on the corresponding statutory language employed in the clearing exception in Title VII of the Dodd-Frank Act. Thus, with certain modifications to avoid circularity, a "financial entity" includes:[28]

1. Swap dealers and security-based swap dealers;
2. Major swap participants and major security-based swap participants;
3. Commodity pools;
4. Private funds;[29]
5. Employee benefit plans and governmental plans;[30] *and*
6. Persons predominately engaged in activities that are in the business of banking.[31]

[28] *See* CFTC Regulation 1.3(mmm)(1) and Exchange Act Rule 240.3a67–6.
[29] *See* section 202(a) of the Investments Advisors Act of 1940.
[30] *See* paragraphs (3) and (32) of Section 3 of Employee Retirement Income Security Act of 1974.

In addition, the SEC's final rule also includes a specific carveout for centralized hedging and treasury entities that would otherwise qualify as financial entities solely because they facilitate hedging activities by majority-owned affiliates that themselves are not financial entities. While the interpretive guidance provided by the Commissions in the Adopting Release discussed this exemption for both swaps and security-based swaps,[32] the carveout is not included in the CFTC's final rule.

### B. Highly-Leveraged

Under the third major participant test, an entity is highly-leveraged relative to the amount of capital it holds if its ratio of liabilities to equity exceeds 12 to 1.[33] According to the final rules, the liability and equity calculations must be made at the close of business on the last day of the applicable fiscal quarter and, generally, must be determined in accordance with GAAP. For qualifying employee benefit plans, the calculation may: (i) exclude obligations to pay benefits to plan participants from liabilities and (ii) substitute the total value of plan assets for equity.

### C. Substantial Position

If a financial entity is highly leveraged, it will be deemed a major participant if it maintains a "substantial position" in any major swap or security-based swap category. It is important to note that, though the triggering thresholds are the same as those established under the first substantial position test, the analysis for highly leveraged financial entities does *not* exclude positions held for hedging or those held by qualifying employee benefit plans and governmental plans.[34] As a result, a highly leveraged financial entity will be deemed to be a major participant if it exceeds any of the following thresholds:

| **Substantial Position in Swaps and Security-Based Swaps** | | |
|---|---|---|
| **Swap/Security-Based Swap Classification** | **Daily Average Aggregate Uncollateralized Outward Exposure** | **Daily Average Aggregate Uncollateralized Outward Exposure *plus* Daily Average Aggregate Potential Outward Exposure** |
| **Swaps** | | |
| Rate Swaps | $3 billion | $6 billion |
| Credit Swaps | $1 billion | $2 billion |
| Equity Swaps | $1 billion | $2 billion |
| Other Swaps | $1 billion | $2 billion |
| **Security-Based Swaps** | | |
| Debt Security-Based Swaps | $1 billion | $2 billion |
| Other Security-Based Swaps | $1 billion | $2 billion |

[31] *See* section 4(k) of the Bank Holding Company Act of 1956.
[32] *See* Adopting Release at 344.
[33] *See* CFTC Regulation § 1.3(mmm)(2) and Exchange Act Rule
[34] *See* Adopting Release at 337.

## VI. AFFILIATE TRANSACTIONS & MANAGED ACCOUNTS

### A. Affiliate Transactions

#### 1. *Inter-Affiliate Transaction Exclusion*

In an expansion from the wholly-owned affiliate exclusion contemplated by the proposed rules, the final rules exclude swaps and security-based swaps entered into between majority-owned affiliates from the major participant analysis.[35] According to the Commissions, positions between majority-owned affiliates typically apportion risk within a corporate group and thus fail to pose the potential for widespread market impact as those positions between unaffiliated entities. Under the final rules, counterparties will qualify as majority-owned affiliates if one of them directly or indirectly owns a majority interest in the other or a third party directly or indirectly owns a majority interest in both. A majority interest is defined as: (i) the right to vote or direct the vote of a majority of a class of voting securities of an entity, (ii) the power to sell or direct the sale of a majority of a class of voting securities of an entity, or (iii) the right to receive upon dissolution or the contribution of a majority of the capital of a partnership.

#### 2. *Attribution of Affiliate Positions*

In addition to the inter-affiliate exclusion, the interpretive guidance in the Adopting Release also clarifies that the Commissions will not, as a general matter, attribute the swap and security-based swaps of subsidiaries at the parent-level for purposes of the major participant analysis.[36] Instead, an entity's swaps and security-based swaps will only be attributable to a parent, other affiliate, or guarantor to the extent that the counterparty to the transaction has recourse to the parent, other affiliate, or guarantor. Even in situations where recourse is available, however, the Commissions will not attribute the positions if the parent or guarantor is already subject to capital regulation by the CFTC or the SEC,[37] or is a U.S. entity regulated as a bank in the United States.

In the event that an entity is deemed to be a major participant due to the attribution of affiliate positions as discussed in the preceding paragraph, the Commissions have provided interpretive guidance in the Adopting Release with respect to operational compliance.[38] For those requirements that are transaction-focused, such as certain business conduct standards and requirements related to trading records, documentation, and confirmations, the parent *may* delegate its compliance duties to the entities that are direct parties to the relevant transactions. By contrast, for entity-focused regulations, such as requirements related to registration, capital, risk management, supervision, and chief compliance officers, the parent *cannot* delegate its compliance duties. Importantly, under either scenario, the parent remains liable for any failure of the subsidiary to comply with the applicable CFTC and SEC rules.

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[35] *See* CFTC Regulation § 1.3(jjj)(5) and Exchange Act Rule 240.3a67–3(d).
[36] *See* Adopting Release at 357–59.
[37] For example, the parent is already registered as a: swap dealer, security-based swap dealer, major swap participant, major security-based swap participant, futures commission merchant, or broker-dealer.
[38] *See* Adopting Release at 358–59.

### B. Managed Accounts

The interpretive guidance in the Adopting Release exempts swap and security-based swap positions in client accounts from the major participant analysis for asset managers and investment advisers.[39] Similarly, swap and security-based swap positions will not be attributed to a beneficial owner in the absence of recourse against the beneficial owner.[40]

## VII. SAFE HARBORS

Regardless of a whether an entity would otherwise be a major swap participant or major security-based swap participant based on the analysis above, both the SEC and the CFTC rules provide safe harbors from major participant status if an entity meets one of the three tests below, each of which are based on measures of outward exposure.[41] For purposes of the safe harbor calculations, an entity's aggregate uncollateralized outward exposure for positions held with swap dealers, or security-based swap dealers, is equal to the exposure of such positions reported on the most recent reports of such dealer. Positions that are not reflected in any such dealer report are calculated according to the aggregate uncollateralized outward exposure analysis (*see* above). Further, for purposes of the safe harbor, total notional principal amounts are calculated without using risk reduction multipliers for clearing, mark-to-marking margining, or netting.

### A. Safe Harbor 1: Cap on uncollateralized exposure and notional positions.

To satisfy the first safe harbor: (i) the express term's of such entity's agreements relating to swaps, or security-based swaps, must at no time permit the entity to maintain a total uncollateralized exposure of more than $100 million to all swap, or security-based swap, counterparties, respectively, including any exposure resulting from threshold or minimum transfer amounts; *and* (ii) the entity must not maintain positions with an effective notional amount of more than (a) $2 billion in any major category of swaps, or security-based swaps, *or* (b) $4 billion in the aggregate across all categories of swaps, or all categories of security-based swaps, respectively.[42]

### B. Safe Harbor 2: Cap on uncollateralized exposure plus monthly calculation

To meet the second test: (i) the express term's of such entity's agreements relating to swaps, or security-based swaps must at no time permit the entity to maintain a total uncollateralized exposure of more than $200 million to all parties (with respect to swaps, or security-based swaps, respectively, as well as any other instruments by which the entity may have exposure), including any exposure resulting from threshold or minimum transfer amounts; *and* (ii) its aggregate uncollateralized outward exposure plus its aggregate potential outward exposure (in each case disregarding daily averaging) calculated at the end of each month produce thresholds of no more than: (1) $1 billion in aggregate uncollateralized outward exposure (excluding

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[39] *See id*. at 362.
[40] *See id*. at 632–63.
[41] *See* CFTC Regulation § 1.3(hhh)(6) and Exchange Act Rule 240.3a67–9.
[42] *See* CFTC Regulation § 1.3(hhh)(6)(i) and Exchange Act Rule 240.3a67–9(a)(1).

hedging activities for all entities other than highly leveraged financial entities not subject to capital requirements established by an appropriate Federal banking agency), plus aggregate potential outward exposure in any major category of swaps, or security-based swaps, respectively; *and* (2) $2 billion in aggregate uncollateralized outward exposure plus aggregate potential outward exposure (without excluding any positions) with regard to all of the entity's swap positions, or security-based swap positions, respectively.[43]

### C. Safe Harbor 3: Calculations based on certain information

The third test requires an entity to make calculations at the end of each month that meet either one of two prongs.[44] For the SEC rule, the first prong is that: (i) the entity's aggregate uncollateralized outward exposure with respect to its security-based swap positions is less than $500 million with respect to each of the major categories of security-based swaps, *and* (ii) the sum of (a) the entity's aggregate uncollateralized outward exposure with respect to its security-based swap positions in each major category, plus (b) the total notional principal amount of such positions in each category (adjusted by the risk multipliers on a position-by-position basis), is less than $1 billion with respect to each of the major security-based swap categories.[45] The first prong of the CFTC rule for swaps is similar except that the thresholds in (i) and (ii) above are instead: (i) $1.5 billion for rate swaps and $500 million for each other major swap category; and (ii) $3 billion for rate swaps and $1 billion for all other major swap categories.[46]

The thresholds for the second prong are (i) the entity's aggregate uncollateralized outward exposure with respect to its swap, or security-based swap, positions across all major categories of swaps, or security-based swaps, respectively, is less than $500 million; *and* (ii) the sum of (a) the entity's aggregate uncollateralized outward exposure with respect to its swap, or security-based swap, positions across all major categories of swaps, and security based swaps, respectively; plus (b) the product of the total effective notional principal amount of the entity's swap, or security-based swap, positions across all major categories multiplied by 0.15 with respect to swaps, or 0.10 with respect to security-based swaps, is less than $1 billion.[47]

## VIII. CAPTIVE FINANCE COMPANY EXCLUSION

In addition to the safe harbors described above, Title VII of the Dodd-Frank Act incorporates a specific exception from the major swap participant definition—and the major swap participant definition only—for entities whose primary business is providing financing and use derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposure, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more are manufactured by the parent company or another subsidiary of the parent company.[48] To qualify for this so-called "captive finance company exclusion," the CFTC's interpretive guidance in the Adopting Release requires an

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[43] *See* CFTC Regulation § 1.3(hhh)(6)(ii) and Exchange Act Rule 240.3a67–9(a)(2).
[44] *See* CFTC Regulation § 1.3(hhh)(6)(iii) and Exchange Act Rule 240.3a67–9(a)(3).
[45] *See* Exchange Act Rule 240.3a67–9(a)(3)(i)(A).
[46] *See* CFTC Regulation § 1.3(hhh)(6)(iii)(A).
[47] *See* CFTC Regulation § 1.3(hhh)(6)(iii)(B) and Exchange Act Rule 240.3a67–9(a)(iii)(B).
[48] Section 721(a)(33)(D) of the Dodd-Frank Act.

entity to provide financing for purchases from its parent company as a primary business—providing financing as a secondary or complementary activity is not sufficient.[49] The Commission has also clarified that qualifying financing activity includes the financing of service, labor, component parts, and attachments related to products produced by the parent.

## IX. IMPLEMENTATION STANDARD, RE-EVALUATION PERIOD, AND SCOPE OF DESIGNATION

### A. Implementation Standard and Re-evaluation Period

In the event that an entity satisfies any of the three major participant tests, it will not be deemed to be a major participant until the earlier of: (i) the date that it submits an application for registration as a major participant or (ii) two months after the end of the fiscal quarter in which it qualifies as a major participant.[50] Importantly, these provisions do not apply if the entity did not exceed the major participant thresholds by more than 20 percent.[51] In those situations, the timing provisions will not apply unless the entity exceeds any of the applicable thresholds in the next fiscal quarter. Once an entity attains major participant status, it will be a major participant until its swap and security-based swap positions do not exceed any of the applicable thresholds for four consecutive fiscal quarters.[52]

### B. Scope of Designation

If an entity qualifies as a major swap participant or major security-based swap participant, the Commissions will deem it to be a major participant with respect to all categories of swaps or security-based swaps, respectively, notwithstanding the category of swaps or security-based swaps that triggered its major participant status.[53] A major participant may, however, submit an application to the CFTC or the SEC, as appropriate, to limit its designation to a specified category of swaps or security-based swaps.[54] Importantly, the Commissions will not approve an application for limited designation unless the entity can demonstrate its ability comply, as a limited designee, with the statutory and the regulatory requirements applicable to major participants at both the transaction- and the entity-level.

## X. EFFECTIVE DATE AND REQUIRED REGISTRATION

The major participant definitions become effective 60 days after publication in the *Federal Register*. Although the SEC has not yet issued final rules implementing the registration requirements and substantive regulations for major security-based swap participants, the CFTC *has* issued final rules imposing registration requirements and operational constraints on major swap participants. As a result, major security-based swap participants will not need to register

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[49] *See* Adopting Release at 373–74.
[50] *See* CFTC Regulation § 1.3(hhh)(3) and Exchange Act Rule 240.3a67–8(a).
[51] *See* CFTC Regulation § 1.3(hhh)(4) and Exchange Act Rule 240.3a67–8(b).
[52] *See* CFTC Regulation § 1.3(hhh)(5) and Exchange Act Rule 240.3a67–8(c).
[53] *See* CFTC Regulation § 1.3(hhh)(2) and Exchange Act Rule 240.3a67–1(b).
[54] *See* CFTC Regulation § 1.3(hhh)(2). The SEC plans to address the procedures to apply for a limited designation in a separate rulemaking. *See* Adopting Release at 385.

until the date provided by the SEC in the final registration rule. For major swap participants, existing CFTC rules require these entities to apply for registration with the Commission, via the National Futures Association, no later than the latest effective date of the final rule defining the term "swap".[55] Depending on when the CFTC adopts a final rule defining the term "swap," it is possible that once registered, major swap participants will immediately become subject to the panoply of final rules and regulations governing internal business conduct standards,[56] external business conduct standards,[57] and swap data recordkeeping and reporting.[58]

## XI. CONCLUSION

Under the final rules, *all* counterparties to swaps and security-based swaps are responsible for determining whether they satisfy the major participant tests. Given the scope of this substantial undertaking as well as the existence of substantive rules governing the conduct and business operations of major participants, it would be advisable to prepare for this exercise to ensure compliance once the final rules become effective.

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For more information about any of the foregoing, please contact a member of the Firm's Derivatives Group.

*This memorandum is for general information purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as our recent memoranda, can be obtained from our website, www.simpsonthacher.com.*



[55] *See* Registration of Swap Dealers and Major Swap Participants, 77 F.R. 2613 (Jan. 19, 2012); Performance of Registration Functions by National Futures Association With Respect to Swap Dealers and Major Swap Participants, 77 F.R. 2708 (Jan. 19, 2012).
[56] Swap Dealer and Major Swap Participant Recordkeeping and Reporting, Duties and Conflicts of Interest Policies and Procedures, 77 F.R. 20128 (Apr. 3, 2012).
[57] Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 F.R. 9734 (Feb. 17, 2012).
[58] Real-Time Public Reporting of Swap Transaction Data, 77 F.R. 1182 (Jan. 9, 2012); Swap Date Recordkeeping and Reporting Requirements, 77 F.R. 2136 (Jan. 13, 2012).

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