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NATIONAL ARCHIVES AND RECORDS ADMINISTRATION
LITTERA SCRIPTA MANET
1985

FEDERAL REGISTER

Vol. 77 Wednesday,
No. 100 May 23, 2012

Part II

Commodity Futures Trading Commission

17 CFR Part 1

Securities and Exchange Commission

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;'' Final Rules

COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 1

RIN 3038–AD06

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

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

RIN 3235–AK65

Further Definition of ''Swap Dealer,'' ''Security-Based Swap Dealer,'' ''Major Swap Participant,'' ''Major Security-Based Swap Participant'' and ''Eligible Contract Participant''

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

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

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

DATES: *Effective date.* The effective date for this joint final rule and joint interim final rule: July 23, 2012, except for CFTC regulations at 17 CFR 1.3(m)(5) and (6), which are effective December 31, 2012.

Comment date. The comment period for the interim final rule (CFTC regulation at 17 CFR 1.3(ggg)(6)(iii)) will close July 23, 2012.

Compliance date. Compliance with the element of the CFTC regulation at 17 CFR 1.3(m)(8)(iii) requiring that a commodity pool be formed by a registered CPO shall be required with respect to a commodity pool formed on or after December 31, 2012 for any person seeking to rely on such regulation; compliance with such element shall not be required with respect to a commodity pool formed prior to December 31, 2012.

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

SUPPLEMENTARY INFORMATION:

I. Background

On July 21, 2010, President Obama signed the Dodd-Frank Act into law.[1] Title VII of the Dodd-Frank Act established a statutory framework to reduce risk, increase transparency, and promote market integrity within the financial system by, among other things: (i) providing for the registration and regulation of swap dealers and major swap participants; (ii) imposing clearing and trade execution requirements on standardized derivative products; (iii) creating recordkeeping and real-time reporting regimes; and (iv) enhancing the Commissions' rulemaking and enforcement authorities with respect to all registered entities and intermediaries subject to the Commissions' oversight.

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

In December 2010, the Commissions proposed rules and interpretations to further define the meaning of the terms ''swap dealer,'' ''security-based swap dealer,'' ''major swap participant,'' ''major security-based swap participant,'' and ''eligible contract participant.''[4] The Commissions received approximately 968 written comments in response to the Proposing Release.[5] In addition, the Staffs of the Commissions participated in approximately 114 meetings with market participants and other members of the public about the Proposing Release,[6] and the Commissions held a

[1] *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*.

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

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

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

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

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

[5] Comment letters received in response to the Proposing Release may be found on the Commissions' Web sites at *http://comments.cftc.gov/PublicComments/CommentList.aspx?id=933* and at *http://www.sec.gov/comments/s7-39-10/s73910.shtml*.

[6] Summaries of these staff meetings may be found on the Commissions' Web sites at *http://*

Joint Public Roundtable on the proposed dealer and major participant definitions.[7] After considering the comments received, the Commissions are adopting final rules and interpretations to further define these terms.

II. Definitions of ''Swap Dealer'' and ''Security-Based Swap Dealer''

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

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

(i) Holding oneself out as a dealer in swaps or security-based swaps,

(ii) making a market in swaps or security-based swaps,

(iii) regularly entering into swaps or security-based swaps with counterparties as an ordinary course of business for one's own account, or

(iv) engaging in any activity causing oneself to be commonly known in the trade as a dealer or market maker in swaps or security-based swaps.[10] These dealer activities are enumerated in the CEA and Exchange Act in the disjunctive, in that a person that engages in any one of these activities is a swap dealer under the CEA or security-based swap dealer under the Exchange Act, even if such person does not engage in one or more of the other identified activities.

At the same time, the statutory dealer definitions provide exceptions for a person that enters into swaps or security-based swaps for the person's own account, either individually or in a fiduciary capacity, but not as a part of a ''regular business.'' [11] The Dodd-Frank Act also instructs the Commissions to exempt from designation as a dealer a person that ''engages in a *de minimis* quantity of [swap or security-based swap] dealing in connection with transactions with or on behalf of its customers.'' [12] Moreover, the definition of ''swap dealer'' (but not the definition of ''security-based swap dealer'') provides that an insured depository institution is not to be considered a swap dealer ''to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer.'' [13] The statutory definitions further provide that a person may be designated as a dealer for one or more types, classes or categories of swaps or security-based swaps, or activities without being designated a dealer for other types, classes or categories or activities.[14]

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

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

A. General Considerations for the Dealer Analysis

1. Proposed Approach

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

www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF_2_Definitions/index.htm and *http://www.sec.gov/comments/s7-39-10/s73910.shtml#meetings*.

[7] A transcript of the roundtable discussion and public comments received with respect to the roundtable may be found on the CFTC's Web site at *http://www.cftc.gov/PressRoom/Events/opaevent_cftcsecstaff061611*.

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

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

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

In mid-2011, the SEC issued temporary exemptions under the Exchange Act in connection with the revision of the ''security'' definition to encompass security-based swaps. Among other aspects, these temporary exemptions extended to certain broker activities involving security-based swaps. *See* ''Order Granting Temporary Exemptions under the Securities Exchange Act of 1934 in Connection with the Pending Revision of the Definition of ''Security'' to Encompass Security-Based Swaps, and Request for Comment,'' Securities Exchange Act Release No. 64795 (Jul. 1, 2011), 76 FR 39927, 39939 (Jul. 7, 2011) (addressing availability of exemption to registration requirement for securities brokers).

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

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

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

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

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

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

[16] *See* proposed CFTC Regulation § 1.3(ggg)(4); proposed Exchange Act rule 3a71–2.

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

[18] *See* proposed CFTC Regulation § 1.3(ggg)(3); proposed Exchange Act rule 3a71–1(c).

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

swaps or security-based swaps upon request, or to create new types of swaps or security-based swaps at the dealer's own initiative.[20]

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

a. ''Swap Dealer'' Activity

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

In addition, the Proposing Release noted that the nature of swaps precludes importing concepts used to identify dealers in other areas. The Proposing Release explained that because swaps are typically not bought and sold, concepts such as whether a person buys and sells swaps, makes a two-sided market in swaps, or trades within a bid/offer spread cannot necessarily be used to determine if the person is a swap dealer, even if such concepts are useful in determining whether a person is a dealer in other financial instruments.[24]

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

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

The Proposing Release also noted that the swap markets are diverse and encompass a wide variety of situations in which parties enter into swaps with each other, and invited comment as to what aspects of the parties' activities in particular situations should, or should not, be considered swap dealing activities. Specifically, the Proposing Release invited comment regarding persons who enter into swaps: (i) As aggregators; (ii) as part of their participation in physical markets; or (iii) in connection with the generation and transmission of electricity.[27]

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

Second, the Proposing Release noted that the markets in physical commodities such as oil, natural gas, chemicals and metals have developed highly customized transactions, some of which would be encompassed by the statutory definition of the term ''swap,'' and that some participants in these markets engage in swap dealing activities that are above the proposed *de minimis* threshold. The CFTC invited comment as to any different or additional factors that should be considered in applying the swap dealer definition to participants in these markets.

Third, the Proposing Release noted a number of complexities that arise when applying the swap dealer definition in connection with the generation and transmission of electricity. In particular, the Proposing Release noted that additional complexity results because electricity is generated, transmitted and used on a continuous, real-time basis, and because the number and variety of participants in the electricity market is very large, and some electricity services are provided as a public good rather than for profit. The CFTC invited comment as to any different or additional factors that should be considered in applying the swap dealer definition to participants in the generation and transmission of electricity. Specifically, the CFTC invited comment on whether there are special considerations, including without limitation special considerations arising from section

[20] Proposing Release, 75 FR at 80176.

[21] *Id.*

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

[23] *See* Proposing Release, 75 FR at 80177.

[24] *See id.* at 80176–77.

[25] *See id.* at 80177.

[26] *See id.*

[27] *See id.* at 80183–84.

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

201(f) of the Federal Power Act,[29] related to not-for-profit power systems such as rural electric cooperatives and entities operating as political subdivisions of a state and on the applicability of the exemptive authority in section 722(f) of the Dodd-Frank Act to address those considerations.

b. ''Security-Based Swap Dealer'' Activity

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

c. Additional Principles Common to Both Definitions

i. ''Hold Themselves Out'' and ''Commonly Known in the Trade'' Tests

The Proposing Release identified the following non-exclusive list of factors as potentially indicating that a person meets the ''hold themselves out'' and ''commonly known in the trade'' tests of the statutory dealer definitions:

- Contacting potential counterparties to solicit interest in swaps or security-based swaps;
- Developing new types of swaps or security-based swaps (which may include financial products that contain swaps or security-based swaps) and informing potential counterparties of the availability of such swaps or security-based swaps and a willingness to enter into such swaps or security-based swaps with the potential counterparties;
- Membership in a swap association in a category reserved for dealers;
- Providing marketing materials (such as a 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.[33]

The Proposing Release further stated that the test for being ''commonly known in the trade'' as a swap dealer or security-based swap dealer may appropriately reflect, among other factors, the perspective of persons with substantial experience with and knowledge of the swap and security-based swap markets (regardless of whether a particular entity is known as a dealer by persons without that experience or knowledge). The Proposing Release also stated that holding oneself out as a security-based swap dealer likely would encompass a person who is a dealer in another type of security entering into a security-based swap with a customer, as well as a person expressing its availability to enter into security-based swaps, regardless of the direction of the transaction or across a broad spectrum of risks.[34]

ii. Market Making

In addressing the statutory definitions' ''making a market'' test, the Proposing Release noted that while continuous two-sided quotations and a willingness to buy and sell a security are important indicators of market making in the equities market, these indicia may not be appropriate in the swap and security-based swap markets. The proposal also noted that nothing in the statutory text or legislative history suggested the intent to impute a ''continuous'' activity requirement to the dealer definitions.[35]

iii. No Predominance Test

The Proposing Release further addressed whether a person should be a dealer only if that activity is the person's sole or predominant business, and took the view that such an approach was not consistent with the statutory definition. The Proposing Release rejected this as an unworkable test of dealer status because many parties that commonly are acknowledged as dealers also engage in other businesses that outweigh their swap or security-based swap dealing business in terms of transaction volume or other measures.[36]

iv. Application to New Types of Wwaps and New Activities

The Proposing Release noted that the Commissions intended to apply the dealer definitions flexibly when the development of innovative business models is accompanied by new types of dealer activity, following a facts-and-circumstances approach.[37]

2. Commenters' Views

Numerous commenters addressed the proposed rules and interpretations in connection with the ''swap dealer'' and ''security-based swap dealer'' definitions. Several commenters addressed principles that are common to the two dealer definitions, while a number of commenters also addressed interpretations in the Proposing Release that were specific to the ''swap dealer'' definition.

a. ''Hold Themselves Out'' and ''Commonly Known in the Trade'' Tests

Some commenters expressed the view that the persons that hold themselves out as or are commonly known as dealers are easy to identify.[38] In addressing the ''hold themselves out'' and ''commonly known'' criteria of the dealer definitions, commenters placed particular focus on whether only dealers engage in the activities cited by the

[29] 16 U.S.C. 824(f).

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

[31] The Proposing Release referred to the fact that the SEC previously has noted that the dealer-trader distinction: ''recognizes that dealers normally have a regular clientele, hold themselves out as buying or selling securities at a regular place of business, have a regular turnover of inventory (or participate in the sale or distribution of new issues, such as by acting as an underwriter), and generally provide liquidity services in transactions with investors (or, in the case of dealers who are market makers, for other professionals).'' Proposing Release, 75 FR at 80177 (*citing* Securities Exchange Act Release No. 47364 (Feb. 13, 2003) (footnotes omitted)). The Proposing Release further noted that other non-exclusive factors that are relevant for distinguishing between dealers and non-dealers can include receipt of customer property and the furnishing of incidental advice in connection with transactions. *See id.*

[32] *See* Proposing Release, 75 FR at 80177–78.

[33] *See id.* at 80178.

[34] *See id.*

[35] *See id.*

[36] *See id.* at 80178–79.

[37] *See id.* at 80179.

[38] *See* transcript of Joint CFTC–SEC Staff Roundtable Discussion on Proposed Dealer and Major Participant Definitions Under Dodd-Frank Act, June 16, 2011 (''Roundtable Transcript'') at 22–23 (remarks of Ron Filler, New York Law School), 50–51 (remarks of Ron Oppenheimer, Working Group of Commercial Energy Firms), 215 (remarks of Bella Sanevich, NISA Investment Advisors LLC).

Proposing Release, or whether those activities are common both to dealers and to other users of swaps and security-based swaps. Commenters particularly stated that end users contact potential counterparties,[39] develop new types of swaps or security-based swaps,[40] and propose terms or language for swap or security-based swap agreements.[41] One commenter further stated that identifying dealing activity based on whether a person develops new types of swaps or proposes swap terms would discourage innovation and the free negotiation of swaps.[42] Some commenters stated that merely responding to a request for proposals or quotations should not, in itself, constitute dealing.[43] Commenters also criticized the Proposing Release's suggestion that criteria for identifying dealing activity include membership in a dealer category of a trade association,[44] as well as providing marketing materials and offering a range of financial products.[45] Commenters also argued for more objective criteria for identifying persons ''commonly known'' as dealers.[46]

Conversely, one commenter said that three particular activities cited in the Proposing Release—membership in a swap association category reserved for dealers, providing marketing materials and expressing a willingness to offer a range of financial products—are indicative of holding oneself out as a dealer or being commonly known in the trade as a dealer, and should be codified in the final rule.[47] Another commenter suggested other factors, such as having a derivatives sales team, that should be treated as indicators of dealer activity.[48] Commenters also expressed the view that this aspect of the dealer definition should focus on whether a person solicits expressions of interest in swaps from a range of market participants,[49] and that end users of swaps can actively seek out and negotiate swaps without necessarily being swap dealers.[50]

b. Market Making

Several commenters generally requested that the Commissions provide more guidance as to which activities constitute making a market in swaps or security-based swaps.[51] Commenters also described various activities as indicating, or not indicating, market making activity. For example, two commenters expressed the view that market making is characterized by entering into swaps on one side of the market and then establishing offsetting positions on the other side of the market.[52] Other commenters equated market making to providing liquidity by regularly quoting bid and offer prices for swaps, and standing ready to enter into swaps.[53] One commenter stated that market making activity is indicated by a person consistently presenting itself as willing to take either side of a trade.[54] Two commenters said that market makers receive tangible benefits (such as reduced trading fees) in return for the obligation to transact when liquidity is required.[55]

In contrast, one commenter said the proposal correctly did not limit market making to consistently quoting a two-sided market, because to do so would insert a loophole into the definition.[56] Some commenters expressed the view that mere active participation in a market or entering into swaps on both sides of a market does not necessarily constitute market making.[57] Others said that occasionally quoting prices on both sides of the market is not market making when done to obtain information about the market or to mask one's view of the market.[58] One commenter stated that futures commission merchants (''FCMs'') and broker-dealers that facilitate customers' entering into swaps are not necessarily market makers.[59] Other commenters urged the Commissions to reject the view that market making requires continuous activity.[60]

A number of commenters addressed the issue of how the dealer definitions should treat swaps or security-based swaps entered into on a trading platform such as a designated contract market (''DCM''), national securities exchange, swap execution facility (''SEF''), or security-based SEF (collectively referred to herein as ''exchanges'').[61] Several stated that entering into swaps or security-based swaps on exchanges should not be considered in determining if a person is a dealer.[62] Some of these commenters emphasized the fact that parties would not know the identity of the counterparty to the swap executed on an exchange (*i.e.,* such swaps are ''anonymous''),[63] while other commenters said that such swaps do not constitute ''accommodating demand'' for swaps or ''facilitating interest'' in swaps.[64] Another commenter said that future means of executing swaps on exchanges are likely to be diverse, and it is premature to draw conclusions

[39] *See* letters from the Financial Services Roundtable (''FSR'') dated February 22, 2011 (''FSR I''), the International Swap Dealers Association (''ISDA'') dated February 22, 2011 (''ISDA I'') and the Midsize Bank Coalition of America (''Midsize Banks'').

[40] *See* letters from the Committee on Capital Markets Regulation (''CCMR'') dated February 22, 2011 (''CCMR I''), FSR I, ISDA I and Midsize Banks.

[41] *See* letters from the BG Americas & Global LNG (''BG LNG'') dated February 22, 2011 (''BG LNG I''), CCMR I, EDF Trading North America, LLC (''EDF Trading'') and The Gavilon Group, LLC (''Gavilon'') dated February 21, 2011 (''Gavilon II'').

[42] *See* letter from EDF Trading.

[43] *See* meeting with American Electric Power, Calpine Corporation (''Calpine''), Constellation, DC Energy LLC (''DC Energy''), Edison International (''Edison Int'l''), Exelon Corp., GenOn, Southern Company, Edison Electric Institute (''EEI'') and Electric Power Supply Association (''ESPA'') (collectively ''Electric Companies'') on April 13, 2011.

[44] *See* letter from ISDA I and joint letter from National Corn Growers Association (''NCGA'') and Natural Gas Supply Association (''NGSA'') (''NCGA/NGSA'') dated February 22, 2011 (''NCGA/NGSA I'').

[45] *See* letter from ISDA I.

[46] *See* letters from ISDA I and Peabody Energy Corporation (''Peabody'').

[47] *See* letter from FSR I.

[48] *See* meeting with Vitol, Inc. (''Vitol'') on February 16, 2011.

[49] *See* letter from Midsize Banks.

[50] *See* letter from EDF Trading.

[51] *See* joint letter from American Benefits Council and the Committee on Investment of Employee Benefits Assets (''ABC/CIEBA'') and letters from FSR I.

[52] *See* letters from DC Energy and FSR I.

[53] *See* letters from Edison Int'l, NextEra Energy Resources, LLC (''NextEra'') dated February 22, 2011 (''NextEra I'') and Vitol, and joint letter from American Electric Power, Edison Int'l, Exelon Corp., and Southern Company (''Utility Group'').

[54] *See* letter from ISDA I.

[55] *See* joint letter from EEI and EPSA (''EEI/EPSA'') and letter from Vitol.

[56] *See* letter from Americans for Financial Reform (''AFR'').

[57] *See* letters from ABC/CIEBA, Managed Funds Association (''MFA'') dated February 22, 2011 (''MFA I''), and Vitol.

[58] *See* letters from NextEra Iand Vitol.

[59] *See* letter from Newedge USA LLC (''Newedge''); *see also* Roundtable Transcript at 39 (remarks of Eric Chern, Chicago Trading Company).

[60] *See* letters from American Federation of State, County and Municipal Employees (''AFSCME''), and FSR I.

[61] While some of these commenters specially addressed this issue in the context of whether a person is a market maker in swaps, others more generally addressed the issue in terms of whether a person is a dealer. For clarity, all of those comments are being addressed in the market maker context.

[62] *See* letters from EEI/EPSA, International Energy Credit Association (''IECA–Credit'') dated February 22, 2011 (''IECA–Credit I''), and NextEra I, joint letter from Shell Trading (US) Company and Shell Energy North America (US), L.P. (''Shell Trading'') dated February 22, 2011 (''Shell Trading I''), and joint letter from Allston Trading, LLC, Atlantic Trading USA LLC, Bluefin Trading LLC, Chopper Trading LLC, DRW Holdings, LLC, Eagle Seven, LLC, Endeavor Trading, LLC, Geneva Trading USA, LLC, GETCO, Hard Eight Futures, LLC, HTG Capital Partners, IMC Financial Markets, Infinium Capital Management LLC, Kottke Associates, LLC, Liger Investments Limited, Marquette Partners, LP, Nico Holdings LLC, Optiver US, Quantlab Financial, LLC, RGM Advisors, LLC, Tibra Trading America LLC, Traditum Group LLC, WH Trading and XR Trading LLC (''Traders Coalition'').

[63] *See* letters from Shell Trading I and Traders Coalition.

[64] *See* letters from EEI/EPSA, IECA–Credit I, and NextEra I. For further discussion of this issue, *see* parts II.A.4 and II.A.5 below.

about how they should be treated in the dealer definitions.[65]

Two commenters asserted that firms that provide liquidity in cleared and exchange-executed swaps by actively participating in the market provide heterogeneity among liquidity providers and thereby disperse risk, and further stated that to regulate such persons as swap dealers subject to increased capital requirements would discourage their participation in the market and increase risk.[66]

One commenter expressed the view that the statutory definition uses dealing and market making interchangeably, and suggested that the analysis of whether a person acts as a dealer should be subsumed within the analysis of whether it acts as a market maker.[67]

c. Exception for Activities Not Part of a ''Regular Business''

Several commenters addressed the exception from the dealer definitions for swap or security-based swap activities that are not part of a ''regular business.'' Some commenters supported the Commissions' proposed interpretation in the context of the ''swap dealer'' definition and stated that this interpretation should be codified in the text of the final rule.[68]

Many commenters said that the activity of entering into swaps or security-based swaps should not be deemed to be a ''regular business,'' and thus not indicative of dealing activity, when the person's use of swaps or security-based swaps are ancillary to, or in connection with, a separate non-swap business that is the person's primary business.[69] Some commenters making this point said that when the person's primary business relates to physical commodities, the person's use of swaps relating to those commodities does not constitute a ''regular business.''[70] Other commenters stated that where a person enters into swaps to serve its own business needs, as opposed to serving the business needs of the counterparty, the person's use of swaps does not constitute a ''regular business.''[71] Other commenters said that the use of swaps to hedge the commercial risks of a business does not constitute a ''regular business'' of entering into swaps.[72] Some commenters also suggested that the ''regular business'' exclusion should be interpreted to mean ''regular swap dealing business'' or ''regular security-based swap dealing business'' to prevent the dealer definitions from capturing hedgers.[73]

On the other hand, two commenters said that the proposed interpretation was correct in the view that the test of whether a person has a ''regular business'' of entering into swaps does not necessarily depend on whether a person's swap activities are a predominant activity, because such an approach would allow a person to engage in a significant level of swap dealing activity without registering as a swap dealer simply because the person also has substantial activities in a non-swap business or businesses.[74]

Other commenters suggested that the types of swap activities that a person engages in are relevant to determining whether the person has a ''regular business'' of entering into swaps. One commenter stated that a person has a ''regular business'' of entering into swaps when the person has a primary business of accommodating demand or facilitating interest in swaps,[75] while others similarly emphasized that a ''regular business'' of entering into swaps is characterized by financial intermediation activities.[76] One commenter took the view that a person that enters into swaps primarily with financial intermediaries does not have a ''regular business'' of entering into swaps.[77]

Some commenters said that the final rule should clarify the point at which a person's episodic or occasional swap activities become a ''regular business'' of entering into swaps.[78] Others stated that the fact that a person enters into swaps frequently or with a large number of counterparties does not necessarily mean that the person has a ''regular business'' of entering into swaps.[79]

Commenters proposed specific tests for determining if a person has a ''regular business'' of entering into swaps. One commenter said the determination should look to whether a person enters into swaps to accommodate demand from other parties and to profit from a bid/ask spread on swaps (as opposed to swaps that are substitutes for physical transactions or positions and used by at least one party to hedge commercial risk), and consider specifically the volume, revenues and profits of such activities, the person's value at risk (VaR) and exposure from such activities, and its resources devoted to such activities.[80] Another commenter said that the determination should be based on the nature of the person's business, the person's business purpose for using swaps, and the person's method of executing swap transactions (*e.g.,* a person whose business primarily relates to physical commodities, who uses swaps to hedge commercial risk, and who executes swaps on an exchange would be less likely to have a ''regular business'' of entering into swaps).[81]

One commenter argued that the ''regular business'' exception should apply to all four of the dealer tests—not only the test for persons that regularly enters into swaps or security-based swaps as an ''ordinary course of business''—and further argued that the ''regular business'' exception should be linked to a ''two-way market'' base

[65] *See* letter from Metropolitan Life Insurance Company (''MetLife'').

[66] *See* letters from Newedge and Traders Coalition; Roundtable Transcript at 39 (remarks of Eric Chern, Chicago Trading Company).

[67] *See* letter from ISDA I.

[68] *See* letters from FSR I, MFA I and Midsize Banks.

[69] *See* Roundtable Transcript at 88 (remarks of Steve Walton, Bank of Oklahoma).

[70] *See* letters from Atmos Energy Corporation (''Atmos Energy''), Dominion Resources, Inc. (''Dominion Resources''), EDF Trading, Edison Int'l, EEI/EPSA, Gavilon II, Hess Corporation and its affiliates (''Hess''), Mississippi Public Utility Staff, NextEra I, National Milk Producers Federation (''NMPF''), Shell Trading I, Utility Group and Working Group of Commercial Energy Firms (''WGCEF'') on the swap dealer definition dated February 22, 2011 (''WGCEF I''), and meeting with Bunge on February 23, 2011.

[71] *See* letters from BT Pension Scheme Management Limited (''BTPS''), EDF Trading, EEI/EPSA and Vitol.

[72] *See* letters from American Petroleum Institute (''API'') dated February 22, 2011 (''API I''), Calpine, Coalition of Physical Energy Companies (''COPE'') dated February 22, 2011 (''COPE I''), Dominion Resources, EDF Trading, Edison Int'l and Peabody; *see also* Roundtable Transcript at 45 (remarks of Ed Prosser, Gavilon) and letter from Church Alliance. In addition, three commenters said that the interpretation of the provisions relating to a ''regular business'' in the Proposing Release is correct, because it will exclude from the definition of swap dealer those persons using swaps to hedge commercial risk. *See* letters from Air Transport Association of America, Inc. (''ATAA''), IECA–Credit I and joint letter from Petroleum Marketers Association of America and New England Fuel Institute.

[73] *See* letters from Church Alliance and Peabody.

[74] *See* letters from AFR and Better Markets, Inc. (''Better Markets'') dated February 22, 2011 (''Better Markets I'').

[75] *See* letter from IECA–Credit I.

[76] *See* letter from NextEra I and Shell Trading I. Another commenter disagreed with this approach, however, saying that a person who enters into swaps as an intermediary between smaller customers and larger financial institutions is not entering into swaps for its ''own account'' and therefore is not a swap dealer, but rather would be an FCM or introducing broker. *See* letter from MFX Solutions, Inc. (''MFX'') dated February 22, 2011 (''MFX I'').

[77] *See* letter from Traders Coalition.

[78] *See* letters from BG LNG I and WGCEF I.

[79] *See* letters from NCGA/NGSA I and Vitol. One of these commenters asked that the final rule clarify that simply because a person engages in swap activity exceeding the thresholds for the *de minimis* exception from the swap dealer definition does not necessarily mean that the person is engaged in a ''regular business'' of swap dealing. *See* letter from Vitol.

[80] *See* letter from NextEra I; *see also* letter from Hess (proposing similar criteria).

[81] *See* letter from Shell Trading I.

requirement to avoid commercial hedgers being encompassed by the dealer definitions.[82]

d. Other Dealer Issues

Commenters also addressed other issues in the Proposing Release, including: (i) Whether Congress intended that there be implicit preconditions to dealer status; (ii) whether the concepts of ''accommodating demand'' for swaps or security-based swaps or ''facilitating interest'' in swaps are useful in identifying dealers; and (iii) whether the interpretation of the dealer definitions should depend on pre-defined, objective criteria.

i. Preconditions

Several commenters said that the proposal is overbroad and would encompass persons that Congress did not intend to regulate as dealers.[83] Comments in this vein said that the statutory definition should be interpreted to require that persons meet certain criteria or engage in certain activity, not explicitly stated in the statute, to be covered by the swap dealer definition. For instance, some commenters said that a dealer is a person who enters into swaps or security-based swaps on either side of the market and who profits from fees for doing so, or from the spread between the terms of swaps on either side of the market.[84] Other commenters made a similar point, saying that swap dealers are those persons that intermediate between swap users on either side of the market.[85]

The commenters were not all in agreement on this, however. Several commenters (including some of those that said swap dealers enter into swaps on both sides of the market) also stated that there are a variety of situations in which a person's activity of contemporaneously entering into swaps on both sides of the market is not indicative of dealing activity.[86] One commenter said that it would not be appropriate to require that a person enter into swaps or security-based swaps on both sides of the market as a litmus test for dealer status, because to do so would create loopholes in the definition.[87] Two commenters also supported rejection of any interpretation that would limit the dealer definitions to encompass only those entities that solely or predominately act as dealers.[88]

In addition, commenters were particularly divided as to whether acting as an intermediary always is indicative of swap dealing, as some commenters said that a person is not a swap dealer when it simply stands between two parties by entering into offsetting swaps with each party.[89]

ii. ''Accommodating Demand'' and ''Facilitating Interest''

A number of commenters addressed the Proposing Release's view that a tendency to accommodate demand for swaps and a general availability to enter into swaps to facilitate other parties' interest in swaps (referred to here as ''accommodating demand'' and ''facilitating interest'') are characteristic of swap dealers. Some commenters stated that accommodating demand and facilitating interest would not be effective factors to identify swap dealers, particularly in bilateral negotiations where it is difficult to say which party is accommodating demand for swaps.[90] Other commenters said the activities of accommodating demand or facilitating interest are indicative of swap dealing only in certain circumstances, such as when they are not related to a person's commodity business,[91] or when done with the purpose of serving the needs of the other party to the swap.[92] Some commenters argued that the statement in the Proposing Release that swap dealers are likely involved in most or all significant parts of the swap markets is incorrect in the market for energy swaps. There, the commenters said, persons can find counterparties for swaps without the intermediation of a swap dealer, and swaps entered into directly by two end users are more frequent.[93]

Other commenters, though, said that the proposal's focus on accommodating demand and facilitating interest strikes the right balance and that the proposed approach is generally correct.[94] Another commenter did not object to including accommodating demand and facilitating risk as factors in the definition, but said that those factors should be applied flexibly.[95]

iii. Application of Objective Criteria, and Additional Factors

Some commenters, specifically addressing the CFTC's proposed interpretive approach to the ''swap dealer'' definition, said that the final rule should set out objective criteria that market participants could use to determine whether or not they are covered by the definition and therefore required to register as swap dealers.[96]

[82] *See* letter from ISDA dated I.

[83] *See, e.g.,* letters from BG LNG I, EDF Trading, ISDA I, NCGA/NGSA dated February 17, 2012 (''NCGA/NGSA II'') and WGCEF I, and joint letter from American Farm Bureau Federation, American Soybean Association, National Association of Wheat Growers, National Cattlemen's Beef Association, National Corn Growers Association, National Council of Farmer Cooperatives, National Grain and Feed Association, National Milk Producers Federation and National Pork Producers Council (''Farmers' Associations'').

[84] *See* letters from COPE I, Edison Int'l, Hess, ISDA I, Shell Trading I, Utility Group, Vitol and WGCEF I; *see also* Roundtable Transcript at 43–45 (remarks of Ed Prosser, Gavilon). However, other commenters questioned whether profiting from a bid/ask spread is a relevant test of dealer status, and emphasized that dealers are those persons who take risk by entering into swaps or security-based swaps on both sides of the market. *See* Roundtable Transcript at 21, 56 (remarks of Richard Ostrander, Morgan Stanley) and 43 (remarks of Russ Wasson, National Rural Electric Cooperative Association (''NRECA'')). Another commenter pointed out that it could be difficult to determine how a person is profiting from entering into swaps. *See* Roundtable Transcript at 42 (remarks of Michael Masters, Better Markets).

[85] *See* letters from API I, BG LNG I and NCGA/NGSA II.

[86] The examples cited were: entering into swaps on either side of a market depending on a firm's commercial purpose for entering each particular swap (*see* letters from the Industrial Energy Consumers of America (''IECA–Consumers'') and WGCEF I, and letter from the Not-For-Profit Electric End User Coalition (''NFPEEU''), consisting of NRECA, American Public Power Association (''APPA'') and Large Public Power Council (''LPPC''); *see also* Roundtable Transcript at 44 (remarks of Ed Prosser, Gavilon)); entering into swaps on both sides of an illiquid market for purposes of price discovery or to elicit bids and offers from other market participants (*see* letters from Hess, Vitol and WGCEF I); and entering into swaps on both sides of the market as part of an investment strategy (*see* letter from ABC/CIEBA).

[87] *See* letter from AFR.

[88] *See* letters from AFR and Better Markets I.

[89] *See* letters from BOKF, National Association (''BOK'') dated January 13, 2012 (''BOK V''), MFX I, Newedge and Northland Energy Trading LLC (''Northland Energy''); *see also* Roundtable Transcript at 48 (remarks of John Nicholas, Newedge). One commenter queried whether the final rule should clarify whether a customer relationship between the parties to a swap is necessary in order for the swap to be relevant in determining whether either of the parties is a swap dealer. *See* letter from Representative Scott Desjarlais (''Rep. Desjarlais'').

[90] *See* letters from NextEra I and Peabody and meeting with Vitol on February 15, 2011.

[91] *See* letter from Shell Trading I.

[92] *See* letters from IECA–Credit I, National Association of Insurance Commissioners (''NAIC''), Vitol and WGCEF I. One of these commenters also said that entering into a bespoke swap with a registered swap dealer, in which the swap dealer lays off risk, should not be viewed as accommodating demand or facilitating interest. *See* letter from Vitol.

[93] *See* letter from BG LNG I, NCGA/NGSA I, NFPEEU, NRG Energy, Inc. (''NRG Energy'') and WGCEF I and meeting with Vitol on February 16, 2011.

[94] *See* letters from AFR and MFX I.

[95] *See* letter from National Grain and Feed Association (''NGFA'') dated February 22, 2011 (''NGFA I'').

[96] *See* letters from BG LNG I, EEI/EPSA, Peabody, Rep. Desjarlais and Utility Group. Some commenters said that the CFTC's interpretive approach to the swap dealer definition should be codified in the text of the final rule. *See* letters from Alternative Investment Management Association Limited (''AIMA'') dated February 22, 2011 (''AIMA I'') and COPE I.

Others focused especially on statements in the Proposing Release to the effect that swap dealers are those persons who ''tend to'' engage in certain activities, and that persons who engage in certain activities are ''likely'' to be swap dealers, as being overly subjective and difficult to interpret.[97]

Certain commenters suggested specific objective criteria to use to identify swap dealers. One commenter said that swap dealing activity is characterized by more frequent use of swaps; having substantial staff and technological resources devoted to swaps; a larger portion of revenue and profit being derived from swap activity; and owning fewer physical assets related to the type of swaps entered into.[98] Another commenter said that to identify swap dealers, the CFTC should compare a person's revenue or profits generated by swap activity to its overall revenue or profits; compare a person's total business volume to the volume, VaR and exposure associated with the swap activity; compare a person's total business resources to the resources devoted to swap activity; and consider ownership or control of physical assets in the specific market or region to which the person's swap activity is tied.[99]

More generally, some commenters supported codification of more concrete tests in connection with the dealer definitions.[100] However, other commenters said that the use of bright line rules to determine whether a person is a dealer would be inappropriate given the dynamic nature of the swap and security-based swap markets. These commenters supported a facts and circumstances approach to the dealer definition as a better approach.[101] One commenter also raised issues about the sources of information that may be considered as part of a dealer determination.[102]

e. Application of Exchange Act ''Dealer-Trader'' distinction

i. Security-Based Swap Dealer Definition

A number of commenters supported the proposed use of the dealer-trader distinction under the Exchange Act to interpret the ''security-based swap dealer'' definition.[103] Two commenters, however, specifically opposed use of the distinction in the context of security-based swaps, arguing that use of the distinction would create confusion or would be inconsistent with the goal of improved transparency.[104]

ii. Swap Dealer Definition

Some commenters said that the CFTC should apply the dealer-trader distinction as it has been interpreted with respect to the definition of ''dealer'' under the Exchange Act to identify swap dealers.[105] Some commenters said that the applicable interpretations under the Exchange Act mean that swaps a person uses for proprietary trading (including for speculative purposes) should not be considered in determining if the person is a swap dealer because dealers enter into transactions in order to profit from spreads or fees regardless of their view of the market for the underlying item, whereas traders enter into transactions in order to take a view on the direction of the market or to obtain exposure to movements in the price of the underlying item.[106] Two commenters said that if the CFTC applied the distinction, traders should be subject to potential registration as major swap participants, and dealers should be subject to regulation as swap dealers.[107] Commenters acknowledged differences between the market for swaps and the market for securities, but said that the Exchange Act interpretations are still relevant.[108]

On the other hand, some commenters agreed with the CFTC's view not to apply Exchange Act interpretations to the definition of the term ''swap dealer.'' These commenters said that it is appropriate not to apply the interpretations under the Exchange Act to identify persons that meet the swap dealer definition under the CEA.[109]

e. Application to Particular Swap Markets

i. Aggregators

Certain commenters addressed persons who enter into swaps as aggregators, with most of those commenters discussing agricultural cooperatives. Commenters said that agricultural cooperatives that hedge their own risks or the risks of their members regarding agricultural commodities should be excluded from the swap dealer definition because Congress did not intend to treat agricultural cooperatives as swap dealers and because agricultural cooperatives are in effect an extension of their members.[110] Some commenters said that the agricultural cooperatives' use of swaps allows their members to hedge risks when the members' transactions are too small for (or otherwise not qualified for) the futures markets.[111]

Some commenters said that an exclusion from the swap dealer definition also should be available to private companies that serve as aggregators for swaps in agricultural commodities or otherwise offer swaps

[97] *See* letters from BG LNG I, Chesapeake Energy Corporation (''Chesapeake Energy''), COPE I, ISDA I, Vitol and WGCEF I. Some commenters focused on particular aspects of the swap dealer definition as requiring further detail, such as, for example, what it means to be ''commonly known in the trade'' as a swap dealer (*see* letter from Peabody) and the definition of market making (*see* letters from Midsize Banks and Peabody).

[98] *See* letter from Hess.

[99] *See* letter from NextEra I.

[100] *See, e.g.,* letters from EEI/EPSA, FSR I, ISDA I, NextEra I and WGCEF I.

[101] *See* letters from Better Markets I, Chris Barnard (''Barnard'') and Prof. Michael Greenberger, University of Maryland School of Law (''Greenberger'').

[102] *See* letter from ISDA I (stating that sources of information considered by the Commissions in determining dealer status should be revealed to the entity being evaluated).

[103] *See, e.g.,* letters from Coalition for Derivatives End-Users (''CDEU''), CCMR I, ISDA I and MetLife.

[104] *See* letters from AFR and AFSCME.

[105] Some of these commenters said that, since some provisions in the statutory swap dealer definition are similar to the definition of a ''dealer'' under the Exchange Act, Congress intended that the two definitions would be applied in the same way. *See* letters from API I, BG LNG I, CDEU, IECA–Consumers and WGCEF I. Others said that the CFTC should apply these interpretations because they have been effectively applied for a long time in the context of securities. *See* letters from CCMR I and MFA I.

[106] *See* letters from Gavilon II, and Next Era I, and meetings with Electric Companies on April 13, 2011 and WGCEF on April 28, 2011. Another commenter said the interpretations mean that dealers and traders can be distinguished by their activities: dealers hold themselves out as buying and selling on a regular basis, derive income from providing services in the chain of distribution, and profit from price spreads, while traders do not provide services or extend credit but, rather, profit from changes in the market value of underlying items. *See* letter from API I.

[107] *See* letters from EDF Trading and IECA–Consumers.

[108] *See* letters from API I, Gavilon I and IECA–Consumers.

[109] *See* letters from AFR and AFSCME; *see also* joint meeting with AFR and Better Markets on March 17, 2011 (dealer-trader distinction not helpful in identifying swap dealers because the transparency and operational robustness of the swap market is much lower than in the securities market). One commenter said the precedents should be applied only by the SEC to identify security-based swap dealers. *See* letter from NAIC.

[110] *See* letters from Dairy Farmers of America (''DFA''), Growmark, Land O'Lakes, Inc. (''Land O'Lakes'') dated February 22, 2011 (''Land O'Lakes II''), National Council of Farmer Cooperatives (''NCFC'') dated February 22, 2011 (''NCFC I'') and NMPF. One commenter also said that a subsidiary of an agricultural cooperative that enters into swaps with its parent cooperative, and the members of the parent cooperative, should be excluded from the swap dealer definition for the same reason. *See* meeting with Agrivisor. Another commenter said that an agricultural cooperative's swaps with farmers and other persons for risk management should be disregarded in determining if the cooperative is a swap dealer so long as the swaps relate to the marketing function of the cooperative, even if the swaps are not with members of the cooperative. *See* letter from NMPF.

[111] *See* letters from DFA and Growmark.

for agricultural risk management.[112] These commenters said that such an exclusion would reduce the costs and regulatory burdens imposed on such companies and therefore provide a broader choice of swap providers to farmers and other agricultural market participants, which they said would reduce risks.[113]

One commenter discussed a small energy firm that aggregates demand for swaps from small energy retailers and consumers. This commenter said that such aggregators should be excluded from the swap dealer definition because imposing the swap dealer regulations (which would be promulgated with large financial firms in mind) on such firms would increase costs for the aggregators, discourage the aggregators' offering of swaps, and thereby reduce choice and efficiency in the market.[114] Another commenter said that a firm that enters into swaps with microfinance lenders and offsetting swaps with commercial banks is akin to an introducing broker or FCM, and should be excluded from the swap dealer definition on the grounds that it does not enter into swaps on its own initiative, but rather to provide access to the swap markets to smaller counterparties.[115]

Another commenter said that there is no need for any special treatment of aggregators in the swap dealer definition. According to this commenter, the CFTC's guidance regarding the definition and the *de minimis* exception from the definition address the relevant issues properly and completely.[116]

ii. Physical Commodity Swaps

Commenters that discussed physical commodity swaps primarily focused on swaps related to energy commodities such as oil, natural gas and electricity. The commenters said that the market for these swaps is different from the market for swaps on interest rates and other financial commodities because, among other things, the swaps are used to mitigate price and delivery risks directly linked to a commercial enterprise; less swap activity flows through intermediaries; the markets for the underlying physical commodities are separately regulated; and the failure of a commodity market participant is not likely to impact financial markets as a whole.[117] Therefore, these commenters believe, the application of the swap dealer definition to participants in these physical commodity swap markets should be different from the application to participants in the financial commodity swap markets.[118] Some commenters said that imposing the costs of swap dealer regulation on participants in the markets for physical commodity swaps would discourage participation in the market, thereby reducing liquidity and increasing market concentration.[119]

iii. Electricity Swaps

Commenters on the use of swaps in connection with the generation and transmission of electricity addressed a variety of issues. First, commenters said that markets related to electricity are different from markets for other physical commodities in that electricity must be generated and transmitted at the time it is needed (it cannot be stored for future use); the overall demand for electricity is inelastic but demand at any particular time is subject to external variables, such as weather; the generation, transmission and use of electricity is widely dispersed and geographically specific; the markets are overseen by regulators such as state Public Utility Commissions, regional transmission organizations (''RTOs'') and the Federal Energy Regulatory Commission (''FERC''); and government mandates require continuous supply of electricity and treat electricity as a ''public good.'' [120] Commenters said that because of these differences, the use of swaps related to electricity is different from the use of swaps on other physical commodities in that electricity swaps: Are more highly customized to a particular place and time; are more likely to relate to a short time period or be more frequently entered into; typically can be tied to a specific generation, transmission or use of electricity; are more likely to be entered into directly by end-users rather than through dealers; are likely to be entered into by electricity companies on both sides of the market; and in many cases were subject to regulatory oversight prior to the Dodd-Frank Act.[121]

Commenters made various points regarding how swaps related to electricity should be treated for purposes of the swap dealer definition. A coalition of not-for-profit power utilities and electric cooperatives said that electricity cooperatives should be excluded from the swap dealer definition because they are non-profit entities that enter into swaps for the benefit of their members, they do not hold themselves out as swap dealers, they do not make markets, and their swaps are not necessarily reflective of market rates.[122] Other commenters said that swaps related to transactions on tariff schedules approved by FERC or the Electric Reliability Council of Texas should be disregarded in determining if a person is a swap dealer.[123] And, some commenters said that any special treatment of swaps related to electricity should apply not only to companies that generate, transmit or distribute electricity, but also to energy marketing companies that use swaps to benefit from price changes in the underlying energy commodities or to hedge related risks.[124]

On the other hand, some commenters acknowledged that a person who makes a market in swaps related to electricity by standing ready to enter into such swaps in order to profit from a bid/ask spread would be a swap dealer, even if the person was in the business of generating, transmitting or distributing

[112] *See* letters from Farmers' Associations, NGFA I and NMPF.

[113] *See id.*

[114] *See* letter from Northland Energy. This commenter defined an ''aggregator'' as a person who: (i) Enters into swaps predominantly in one direction with counterparties that are using swaps to establish bona fide hedges; and (ii) offsets risks associated with such swaps using regulated futures contracts or cleared swaps.

[115] *See* letter from MFX dated June 3, 2011 (''MFX II''). This commenter said that the exclusion should be available to a person who operates primarily on a not-for-profit basis and limits its swap activities to offering swaps to persons in underserved markets and offsetting such swaps, and who meets other requirements to limit the scope of the exclusion.

[116] *See* letter from Better Markets I.

[117] *See* letters from BG LNG I, Dominion Resources, National Energy Marketers Association (''NEM''), NFPEEU, Vitol and WGCEF I joint letter from Senator Debbie Stabenow and Representative Frank Lucas (many commercial end-users of swaps with inherent physical commodity price risk use swaps to hedge such risk and otherwise for their own trading objectives and not for the benefit of others) and meetings with Bunge on May 18, 2011 and Electric Companies on April 13, 2011.

[118] *See id.*

[119] *See* letters from Dominion Resources, NEM and NFPEEU.

[120] *See* letters from Edison Int'l, the staff of the FERC (''FERC Staff''), National Association of Regulatory Utility Commissioners (''NARUC''), NEM, NextEra I, NFPEEU and National Rural Utilities Cooperative Finance Corporation (''NRU CFC'') dated February 14, 2011 (''NRU CFC I''), joint letter from NRECA, APPA, LPPC, EEI and EPSA (''Electric Trade Associations'') and meetings with Electric Companies on April 13, 2011 and NFPEEU on January 29, 2011.

[121] *See* letters from Edison Int'l, EEI/EPSA, Electric Trade Associations, FERC Staff, NextEra I and NFPEEU and meeting with Electric Companies on April 13, 2011.

[122] *See* letter from NFPEEU. This commenter said the exclusion from the swap dealer definition should extend to persons acting as an operating or purchasing agent for other utilities in connection with energy infrastructure products, or otherwise entering into energy commodity swaps on behalf of other end users.

[123] *See* letters from EDF Trading, FERC Staff and NARUC.

[124] *See* letters from DC Energy, EDF Trading and EEI/EPSA.

electricity and owned physical facilities for that purpose.[125]

f. Suggested Exlusions From the Dealer Definitions

Several commenters took the view that the swap dealer and security-based swap dealer definitions should categorically exclude, or should be interpreted in a way that would be expected to exclude, a variety of types of persons or transactions. Commenters particularly suggested that the following categories of persons should be excluded from the dealer definitions: Agricultural cooperatives and electric cooperatives (as addressed above), employee benefit plans as defined in the Employee Retirement Income Security Act of 1974 (''ERISA''),[126] farm credit system institutions,[127] Federal Home Loan Banks,[128] insured depository institutions that limit their swap dealing activity to riskless principal transactions,[129] FCMs and broker-dealers that limit their swap dealing activity to riskless principal transactions,[130] financial guaranty insurers and their affiliates that do not enter into new swaps,[131] asset managers,[132] non-financial companies offering swaps related to their physical commodity business,[133] any person who enters into swaps or security-based swaps only with registered dealers and major participants,[134] persons that do not pose systemic risk,[135] hedge funds [136] and entities that enter into swaps or security-based swaps solely in a fiduciary capacity.[137]

Commenters also suggested that the dealer definitions categorically exclude, or should be interpreted to exclude, the following types of swaps and security-based swaps: Exchange-cleared swaps and security-based swaps,[138] options to make or receive delivery of physical commodities,[139] cash forward transactions with embedded swaps and book-out transactions,[140] swaps or security-based swaps that are used for hedging or mitigating commercial risk,[141] swaps entered into to profit from future changes in the price of the underlying commodity,[142] swaps or security-based swaps entered into as a fiduciary or agent for another person,[143] swaps or security-based swaps entered into for purposes of price discovery,[144] and, as noted above, swaps related to items that are covered by a tariff approved by FERC or the Electric Reliability Council of Texas.[145]

In contrast, some commenters opposed providing any categorical exclusions from the dealer definitions. One commenter stated that the definitions' focus on a person's activities—as opposed to whether that person falls within a particular category—is a better means of determining whether the person is a swap dealer.[146] Another commenter described the requested exclusions as attempts to achieve carve-outs that are not provided for in the statute.[147]

Lastly, several commenters addressed the extraterritorial application of the definitions of the terms ''swap dealer,'' ''security-based swap dealer,'' ''major swap participant,'' ''major security-based swap participant,'' and ''eligible contract participant.'' In general, the commenters addressed when and how the definitions should be applied to persons based outside the U.S. and how the definitions should take account of non-U.S. requirements that may be applicable to such persons.[148] The Commissions intend to separately address issues related to the application of these definitions to non-U.S. persons in the context of the application of Title VII to non-U.S. persons.

g. Cost-Benefit Issues and Hedging Deterrence

Several commenters emphasized the cost of being regulated as a dealer, and emphasized that an overbroad scope of the dealer definitions would impose significant unwarranted costs on entities contrary to the goals of the Dodd-Frank Act, and would deter the use of swaps and security-based swaps for hedging.[149] Some commenters also noted that impact of the provisions of section 716 of the Dodd-Frank Act on entities that are deemed to be swap

[125] *See* letter from EEI/EPSA and meeting with Electric Companies on April 13, 2011.

[126] *See* letter from ABC/CIEBA.

[127] *See* letter from Farm Credit Council dated February 22, 2011 (''Farm Credit Council I'').

[128] *See* letters from Credit Union National Association (''CUNA'') and Federal Home Loan Banks (''FHLB'') dated February 22, 2011 (''FHLB I'').

[129] *See* letter from BOK dated January 31, 2011 (''BOK I''); *but see* letter from Vitol at 7 (riskless principal transactions are a ''good model for true swap dealing activity'').

[130] *See* letter from Newedge.

[131] *See* letter from Association of Financial Guaranty Insurers (''AFGI'').

[132] *See* letter from BlackRock, Inc. (''BlackRock'') dated February 22, 2011 (''BlackRock I'').

[133] Commenters making this point varied in their phrasing of potential exclusions, and particularly suggested exclusions for: Agricultural firms offering swaps as risk management tools related to physical commodities (*see* letter from NGFA I); all firms, other than financial entities whose primary business is swap dealing (*see* letter from NEM); any person that uses swaps only to reduce price volatility, enters into a volume of swaps relating to any physical commodity that is less than the volume of its trading in that commodity, and is not making a market (*see* letter from Chesapeake Energy); or any person that limit its use of swaps to hedging or speculating (*see* letters from API I).

[134] *See* letter from ISDA I.

[135] *See* letters from NARUC and NCGA/NGSA I.

[136] *See* letter from MFA I.

[137] *See* letters from FSR dated February 22, 2011 and Midsize Banks.

[138] *See* letters from Commodity Markets Council (''CMC''), EEI/EPSA, IECA-Credit I, NextEra I, Shell Trading I, Utility Group and Vitol.

[139] *See* letters from NextEra I and WGCEF I. The commenters acknowledged that such options may or may not be included in the definition of ''swap.''

[140] *See* letter from CMC.

[141] *See, e.g.,* letters from Edison Int'l and WGCEF I and joint letter from Senator Stabenow and Representative Lucas (also saying that definition of ''hedging'' should be consistent with respect to the dealer and major participant definitions and the end-user exception from clearing).

[142] *See* letters from EEI/EPSA, NextEra I, Utility Group and WGCEF I.

[143] *See* letters from Midsize Banks, NFPEEU and FSR I.

[144] *See* letters from EEI/EPSA, Vitol and WGCEF I.

[145] *See* letters from EDF Trading, FERC Staff and NARUC.

[146] *See* letter from Better Markets I.

[147] *See* letter from AFSCME. Additional commenters emphasized the need for transparency about swaps and swap activities. *See* letters from Jason Cropping and BJ D'Milli.

[148] *See, e.g.,* letters from FSR I, Institute of International Bankers, ISDA I, Investment Management Association, Japan Financial Services Agency, Securities Industry and Financial Markets Association (''SIFMA'') dated February 3, 2011 (''SIFMA I''), and the World Bank Group, joint letter from the Autorité de contrôle prudential and the Autorité des marches financiers, joint letter from Bank of America Merrill Lynch, Barclays Capital, BNP Paribas S.A. (''BNP Paribas''), Citi, Crédit Agricole Corporate and Investment Bank, Credit Suisse Securities (USA), Deutsche Bank AG (''Deutsche Bank''), HSBC, Morgan Stanley, Nomura Securities International, Inc. (''Nomura Securities''), Société Générale and UBS Securities LLC (''Twelve Firms''), joint letter from the Bank of Tokyo-Mitsubishi UFJ, Ltd., Mizuho Corporate Bank, Ltd. and Sumitomo Mitsui Banking Corporation, and joint letter from Barclays Bank PLC, BNP Paribas, Credit Suisse AG, Deutsche Bank, HSBC, Nomura Securities, Rabobank Nederland, Royal Bank of Canada, the Royal Bank of Scotland Group pLc, Société Générale, the Toronto-Dominion Bank and UBS AG.

[149] *See* joint letter from Representatives Spencer Bachus and Frank Lucas at 2 (''Casting an overly-broad net in defining [dealer and major participant] could force some smaller participants to leave the marketplace as a result of increased costs, or eliminate certain types of contracts used for hedging. If either occurs, businesses will be left exposed to market volatility and the consequences will ultimately be felt by Americans in the form of increased consumer costs.'') and letters from ISDA Iat 7 (''The substantial additional burdens and costs of Dealer regulation must be reserved for those whose business it is to 'make the market,' that is, those who consistently both buy and sell. This is in accord with Dodd-Frank Act's market regulatory goals, as well as the legislation's obvious intent to preserve healthy growth and innovation in the U.S. swap markets.'' (footnote omitted)), Peabody at 2–3 (''Legal uncertainty over the application to end users of the significant regulatory requirements for [swap dealers] could lead end users to minimize their use of swaps in order to avoid the risk of being deemed to be [a swap dealer].''), and Church Alliance (stating that the risk of incurring the costs of dealer regulation would harm employee benefit plans by reducing their use of swaps and security-based swaps for hedging and risk mitigation).

dealers or security-based swap dealers.[150] Also, one commenter suggested that using a qualitative test for the dealer definition might increase costs due to regulatory uncertainty.[151]

One commenter specifically suggested that in considering the final rules, the Commissions should consider empirical data regarding the costs and benefits flowing from the rules and issue a second analysis of the costs and benefits of the rules for public comment,[152] while other commenters said that the consideration of cost and benefits should include the cumulative cost of interrelated regulatory burdens arising from all the rules proposed under the Dodd-Frank Act.[153] Other commenters said the Commissions should consider alternatives that would impose fewer costs.[154]

Another commenter said that the cost-benefit analyses in the Proposing Release may have understated the benefits of the proposed rules, because focusing on individual aspects of all the rules proposed under the Dodd-Frank Act prevents consideration of the full range of benefits that arise from the rules as a whole, in terms of providing greater financial stability, reducing systemic risk and avoiding the expense of assistance to financial institutions in the future.[155] This commenter said the consideration of benefits of the proposed rules should include the mitigated risk of a financial crisis.[156]

3. Final Rules and Interpretation—General Principles

Consistent with the Proposing Release, the final rules that define the terms ''swap dealer'' and ''security-based swap dealer'' closely follow the statutory definitions' four tests and exclusion for activities that are not part of a ''regular business.'' [157] In addition, this Adopting Release sets forth interpretive guidance regarding various elements of the final rules.

Because the definitions of the terms ''swap dealer'' in the CEA and ''security-based swap dealer'' in the Exchange Act are substantially similar, the rules further defining those terms and the accompanying interpretations in this Adopting Release reflect common underlying principles. At the same time, the interpretations regarding the application of the definitions differ in certain respects given the differences in the uses of and markets for swaps and security-based swaps.[158] For example, because security-based swaps may be used to hedge or gain economic exposure to underlying individual securities (while recognizing distinctions between security-based swaps and other types of securities, as discussed below), there is a basis to build upon the same principles that presently are used to identify dealers for other types of securities. These same principles, though instructive, may be inapplicable to swaps in certain circumstances or may be applied differently in the context of dealing activities involving commodity, interest rate, or other types of swaps.

For these reasons, we separately are addressing the interpretation of the ''swap dealer'' and ''security-based swap dealer'' definitions.

Also, as discussed below, the Commissions are directing their respective staffs to report separately regarding the rules being adopted in connection with the definition and related interpretations. These staff reports will help the Commissions evaluate the ''swap dealer'' and ''security-based swap dealer'' definitions in all respects, including whether new or revised tests or approaches would be appropriate for identifying swap dealers and security-based swap dealers.[159]

4. Final Rules and Interpretation—Definition of ''Swap Dealer''

The Dodd-Frank Act contains a comprehensive definition of the term ''swap dealer,'' based upon types of activities. As noted above, we are adopting a final rule under the CEA that, like the proposed rule, defines the term ''swap dealer'' using terms from the four statutory tests and the exclusion for swap activities that are not part of ''a regular business.'' [160] The final rule includes modifications from the proposed rule that are described below, including provisions stating that swaps entered into for hedging physical positions as defined in the rule, swaps between majority-owned affiliates, swaps entered into by a cooperative with its members, and certain swaps entered into by registered floor traders, are excluded from the swap dealer determination.[161] The Commissions, in consideration of comments received, are also making certain modifications to the interpretive guidance set out in the Proposing Release with respect to various elements of the statutory definition of the term ''swap dealer,'' as described below.

The determination of whether a person is covered by the statutory definition of the term ''swap dealer'' requires application of various provisions of the rule further defining that term, as well as the interpretive guidance in this Adopting Release, depending on the person's particular circumstances. We intend that the determination with respect to a particular person would proceed as follows.

The person would begin by applying the statutory definition, and the provisions of the rule which implement the four statutory tests and the exclusion for swap activities that are not part of ''a regular business,'' [162] in order to determine if the person is engaged in swap dealing activity. In that analysis, the person would apply the interpretive guidance described in this part II.A.4, which provides for consideration of the relevant facts and circumstances. As part of this consideration, the person would apply elements of the dealer-trader distinction, as appropriate, including as described in part II.A.4.a, below.

The rule provides that certain swaps are not considered in the determination of whether a person is a swap dealer.[163] In particular, swaps entered into by an insured depository institution with a customer in connection with originating a loan with that customer, [164] swaps

[150] *See* letters from American Bankers Association (''ABA'') dated November 3, 2011 (''ABA I''), BOK I, and ISDA I. Section 716 of the Dodd-Frank Act prohibits any ''swaps entity''—a term that encompasses swap dealers and security-based swap dealers—from receiving Federal assistance with respect to any swap, security-based swap, or other activity of the swaps entity.

[151] *See* letter from API I (stating that costs of regulatory uncertainty stem from the use of qualitative factors for identifying dealing, and from regulatory efforts to reach beyond ''true'' swap dealers); *see also* letter from Dominion Resources (the opportunity costs associated with regulatory uncertainty should be considered).

[152] *See* letter from WGCEF I.

[153] *See* letters from ABA I, NFPEEU and WGCEF dated December 20, 2011, enclosing a report prepared by NERA Economic Consulting (''NERA'') (''WGCEF VIII''); *see also* letter from NERA dated March 13, 2012.

[154] *See* letters from NextEra I (referring to alternative *de minimis* tests) and NFPEEU.

[155] *See* letter from Better Markets dated June 3, 2011 (''Better Markets II'').

[156] Better Markets cited estimates that the worldwide cost of the 2008 financial crisis in terms of lost output was between $60 trillion and $200 trillion, depending primarily on the long term persistence of the effects. *See* letter from Better Markets II.

[157] *See* CFTC Regulation § 1.3(ggg)(1), (2); Exchange Act rule 3a71–1(a), (b).

[158] Section 712(a)(7)(A) of the Dodd-Frank Act provides that in adopting rules and orders implementing Title VII, the Commissions shall treat functionally or economically similar products or entities in a similar manner. Section 712(a)(7)(B), though, provides that the Commissions need not act in an identical manner.

[159] *See* part V, *infra*.

[160] *See* CFTC Regulation § 1.3(ggg)(1), (2).

[161] *See* CFTC Regulation § 1.3(ggg)(6)(ii), (iii).

[162] *See* CFTC Regulation § 1.3(ggg)(1), (2).

[163] *See* CFTC Regulation § 1.3(ggg)(5), (6).

[164] *See* CFTC Regulation § 1.3(ggg)(5); *see also* part II.B, *infra*.

between majority-owned affiliates, [165] swaps entered into by a cooperative with its members,[166] swaps entered into for hedging physical positions as defined in the rule,[167] and certain swaps entered into by registered floor traders [168] are excluded from the swap dealer determination.

If, after completing this review (taking into account the applicable interpretive guidance and excluding any swaps as noted above), the person determines that it is engaged in swap dealing activity, the next step is to determine if the person is engaged in more than a *de minimis* quantity of swap dealing.[169] If so, the person is a swap dealer. When the person registers, it may apply to limit its designation as a swap dealer to specified categories of swaps or specified activities of the person in connection with swaps.[170]

In this part II.A.4., we provide interpretive guidance on the application of the ''swap dealer'' definition, modified from the Proposing Release as appropriate based on comments received. This guidance separately addresses the following: application of the dealer-trader framework; the ''holding out'' and ''commonly known'' criteria; market making; the not part of ''a regular business'' exception; the exclusion of swaps entered into for hedging physical positions as defined in the rule; and the overall interpretive approach to the definition.[171]

a. Use of the Dealer-Trader Distinction

We believe that the dealer-trader distinction [172]—which already forms a basis for identifying which persons fall within the longstanding Exchange Act definition of ''dealer''—in general provides an appropriate framework for interpreting the statutory definition of the term ''swap dealer.'' [173] While there are differences in the structure of those two statutory definitions,[174] we believe that their parallels—particularly their exclusions for activities that are ''not part of a regular business''—warrant analogous interpretive approaches for distinguishing dealers from non-dealers.[175] Thus, the dealer-trader distinction forms the basis for a framework that appropriately distinguishes between persons who should be regulated as swap dealers and those who should not. We also believe that the distinction affords an appropriate degree of flexibility to the analysis, and that it would not be appropriate to seek to codify the distinction in rule text.

The Commissions recognize that the dealer-trader distinction needs to be adapted to apply to swap activities in light of the special characteristics of swaps and the differences between the ''dealer'' definition, on the one hand, and the ''swap dealer'' definition, on the other. Relevant differences between the swap market and the markets for securities (other than security-based swaps) include:

• *Level of activity*—Swap markets are marked by less activity than markets involving certain types of securities (while recognizing that some debt and equity securities are not actively traded). This suggests that in the swap context, concepts of ''regularity'' should account for a participant's level of activity in the market relative to the total size of the market.

• *No separate issuer*—Each counterparty to a swap in essence is the ''issuer'' of that instrument; in contrast, dealers in cash market securities generally transact in securities issued by another party. This distinction suggests that the concept of maintaining an ''inventory'' of securities is inapposite in the context of swaps. Moreover, this distinction—along with the fact that the ''swap dealer'' definition lacks the conjunctive ''buying *and* selling'' language of the ''dealer'' definition—suggests that concepts of two-sided markets at times would be less relevant for identifying swap dealers than they would be for identifying dealers.[176]

• *Predominance of over-the-counter and non-standardized instruments*—Swaps an thus far are not significantly traded on exchanges or other trading systems, in contrast to some cash market securities (while recognizing that many cash market securities also are not significantly traded on those systems).[177] These attributes—along with the lack of ''buying *and* selling'' language in the swap dealer definition, as noted above—suggest that concepts of what it means to make a market need to be construed flexibly in the contexts of the swap markets.

• *Mutuality of obligations and significance to ''customer'' relationship*—In contrast to a secondary market transaction involving equity or debt securities, in which the completion of a purchase or sale transaction can be expected to terminate the mutual obligations of the parties to the transaction, the parties to a swap often will have an ongoing obligation to exchange cash flows over the life of the agreement. In light of this attribute, some market participants have expressed the view that they have ''counterparties'' rather than ''customers'' in the context of their swap activities.

In applying the dealer-trader distinction, it also is necessary to apply

[165] *See* CFTC Regulation § 1.3(ggg)(6)(i); *see also* part II.C, *infra.*

[166] *See* CFTC Regulation § 1.3(ggg)(6)(ii); *see also* part II.C, *infra.*

[167] *See* CFTC Regulation § 1.3(ggg)(6)(iii); *see also* part II.B.4.e, *infra.*

[168] *See* CFTC Regulation § 1.3(ggg)(6)(iv); *see also* part II.B.4.f, *infra.*

[169] *See* CFTC Regulation § 1.3(ggg)(4); *see also* part II.D, *infra.*

[170] *See* CFTC Regulation § 1.3(ggg)(3); *see also* part II.E, *infra.*

[171] The Commissions note that interpretations of the applicability of the dealer-trader distinction to the ''swap dealer'' definition under the CEA do not affect existing, or future, interpretations of the dealer-trader distinction under the Exchange Act.

[172] *See* note 31, *supra.* The principles embedded within the ''dealer-trader distinction'' are also applicable to distinguishing dealers from non-dealers such as hedgers or investors. *See* note 250, *infra.*

[173] The Commissions note that interpretations of the applicability of the dealer-trader distinction to the ''swap dealer'' definition under the CEA do not affect existing, or future, interpretations of the dealer-trader distinction under the Exchange Act.

[174] For example, while the ''dealer'' definition encompasses certain persons in the business of ''buying and selling'' securities, the ''swap dealer'' definition does not address either ''buying'' or ''selling.'' We also note that the ''dealer'' definition requires the conjunctive ''buying *and* selling''—which connotes a degree of offsetting two-sided activity. In contrast, the swap dealer definition (particularly the ''regularly enters into'' swaps language of the definition's third prong) lacks that conjunctive terminology.

[175] In the Proposing Release, the CFTC did not propose to use principles from the dealer-trader distinction to interpret the definition of the term ''swap dealer,'' instead proposing an interpretive approach that focused on, among other things, a person's functional role in the swap markets and its relationships with swap counterparties. *See* Proposing Release, 75 FR at 80177. There was, however, some overlap in practice between the factors identified in the Proposing Release relating to a swap dealer's functional role and relationships and the principles of the dealer-trader distinction that were proposed to be applied to identify security-based swap dealers. Moreover, the changes to the interpretive approach to the swap dealer definition that we are adopting here and discussed in this part II.A.4 are in many respects similar to the principles of the dealer-trader distinction. We also acknowledge the commenters who asked for additional guidance regarding the application of the definitions. *See, e.g.,* letters from Gavilon II, Peabody and the Utility Group, and meeting with CDEU on April 7, 2011.

Thus, while the incorporation of the dealer-trader distinction in the interpretation of the term ''swap dealer'' constitutes a change from the Proposing Release, this is simply reflective of the other changes to the CFTC's interpretive approach that we are adopting for the final rule and the overlap between the factors relating to a swap dealer's functional role and counterparty relationships and the principles of the dealer-trader distinction.

[176] The analysis also should account for the fact that a party to a swap can use other derivatives or cash market instruments to hedge the risks associated with the swap position, meaning that two-way trading is not necessary to maintain a flat risk book.

[177] Even though we expect trading of swaps on exchanges following the implementation of Title VII, we expect there to remain a significant amount of over-the-counter activity involving swaps.

the statutory provisions that will govern swap dealers in an effective and logical way. Those statutory provisions added by the Dodd-Frank Act advance financial responsibility (*e.g.,* the ability to satisfy obligations, and the maintenance of counterparties' funds and assets) associated with swap dealers' activities,[178] other counterparty protections,[179] and the promotion of market efficiency and transparency.[180] As a whole, the relevant statutory provisions suggest that we should interpret the ''swap dealer'' definition to identify those persons for which regulation is warranted either: (i) Due to the nature of their interactions with counterparties; or (ii) to promote market stability and transparency, in light of the role those persons occupy within the swap and security-based swap markets.

There are several aspects of our interpretive approach to the swap dealer definition that are particularly similar to the dealer-trader distinction as it will be applied to determine if a person is a security-based swap dealer. In particular, the following activities, which are indicative of dealing activity in the application of the dealer-trader distinction,[181] similarly are indicative that a person is acting as a swap dealer:[182] (i) Providing liquidity by accommodating demand for or facilitating interest in the instrument (swaps, in this case), holding oneself out as willing to enter into swaps (independent of whether another party has already expressed interest), or being known in the industry as being available to accommodate demand for swaps; (ii) advising a counterparty as to how to use swaps to meet the counterparty's hedging goals, or structuring swaps on behalf of a counterparty; (iii) having a regular clientele and actively advertising or soliciting clients in connection with swaps;[183] (iv) acting in a market maker capacity on an organized exchange or trading system for swaps;[184] and (v) helping to set the prices offered in the market (such as by acting as a market maker) rather than taking those prices, although the fact that a person regularly takes the market price for its swaps does not foreclose the possibility that the person may be a swap dealer.

The Commissions further note that the following elements of the interpretive approach to the swap dealer definition are also generally consistent with the dealer-trader distinction as it will be applied to determine if a person is a security-based swap dealer: (i) A willingness to enter into swaps on either side of the market is not a prerequisite to swap dealer status; (ii) the swap dealer analysis does not turn on whether a person's swap dealing activity constitutes that person's sole or predominant business; (iii) a customer relationship is not a prerequisite to swap dealer status; and (iv) in general, entering into a swap for the purpose of hedging, absent other activity, is unlikely to be indicative of dealing. Last, under the interpretive approach to the definition of both the terms ''swap dealer'' and ''security-based swap dealer,'' whether a person is acting as a dealer will turn upon the relevant facts and circumstances, as informed by the interpretive guidance set forth in this Adopting Release.

At the same time, the Commissions recognize that the dealer-trader distinction is not static, but rather has evolved over time through interpretive materials. The Commissions expect the dealer-trader distinction to evolve over time with respect to swaps independently of its evolution over time with respect to securities or security-based swaps. Prior interpretations and future developments in the law regarding securities or security-based swaps may inform the interpretation of the swap dealer definition, but will not be dispositive in identifying dealers in the swap markets.[185]

b. Indicia of Holding Oneself Out as a Dealer in Swaps or Being Commonly Known in the Trade as a Dealer in Swaps

The final rule further defining the term ''swap dealer'' includes the provisions in the proposed rule which incorporate the statutory requirements that the term includes a person that is holding itself out as a dealer in swaps or is engaging in any activity causing it to be commonly known in the trade as a dealer or market maker in swaps.[186]

We continue to believe that the Proposing Release appropriately identifies a number of factors as indicia of ''hold[ing] itself out as a dealer in swaps'' and ''engag[ing] in any activity causing [itself] to be commonly known in the trade as a dealer or market maker in swaps.''[187] In our view, those factors thus are relevant to determining if a person is a swap dealer. For example, regarding the proposed factor of ''membership in a swap association in a category reserved for dealers,'' we note that the bylaws of the International Swaps and Derivatives Association (''ISDA'') provide that any business organization that:

> Directly or through an affiliate, as part of its business (whether for its own account or as agent), deals in derivatives shall be eligible for election to membership in the Association as a Primary Member, provided that no person or entity shall be eligible for membership as a Primary Member if such person or entity participates in derivatives transactions solely for the purpose of risk hedging or asset or liability management.[188]

We believe that in circumstances such as this, where a category of association

[178] *E.g.,* capital and margin requirements (CEA section 4s(e)), and requirements for segregation of collateral (CEA sections 4d(f), 4s(l)).

[179] *E.g.,* requirements with respect to business conduct when transacting with special entities (CEA sections 4s(h)(2), 4s(h)(4), 4s(h)(5)); disclosure requirements (CEA section 4s(h)(3)(B)); requirements for fair and balanced communications (CEA section 4s(h)(3)(D)); other requirements related to the public interest and investor protection (CEA section 4s(h)(3)(D)); and conflict of interest provisions (CEA section 4s(j)(5)).

[180] *E.g.,* reporting and recordkeeping requirements (CEA section 4s(f)); daily trading records requirements (CEA section 4s(g)); regulatory standards related to the confirmation, processing, netting, documentation and valuation of security-based swaps (CEA section 4s(i)); position limit monitoring requirements (CEA section 4s(j)(1)); risk management procedure requirements (CEA section 4s(j)(2)); and requirements related to the disclosure of information to regulators (CEA section 4s(j)(3)).

[181] *See generally* part II.A.5, *infra.*

[182] To clarify, the activities listed in the text are indicative of acting as a swap dealer. Engaging in one or more of these activities is not a prerequisite to a person being covered by the swap dealer definition.

[183] As with the interpretation of the dealer-trader distinction with respect to securities, a nomenclature distinction between ''counterparties'' and ''customers'' is not significant for purposes of applying the dealer-trader distinction to swap activities. Contractual provisions related to nomenclature, such as a provision stating that no ''customer'' relationship is present, would not be significant if the reality of the situation is different. *See* note 271, *infra,* and accompanying text.

[184] As with the dealer-trader distinction as it has been interpreted under the Exchange Act with respect to securities (and as noted below in the discussion of the ''makes a market in swaps'' prong of the swap dealer definition), the presence of an organized exchange or trading system is not a prerequisite to being a market maker for purposes of the swap dealer definition, nor is acting as a market maker a prerequisite to being a swap dealer.

[185] In interpreting the term ''swap dealer,'' we intend to consider, but do not formally adopt, the body of court decisions, SEC releases, and SEC staff no-action letters that have interpreted the dealer-trader distinction.

[186] *See* CFTC Regulation § 1.3(ggg)(1)(i) and (iv).

[187] These factors are as follows: Contacting potential counterparties to solicit interest; developing new types of swaps or security-based swaps and informing potential counterparties of their availability and of the person's willingness to enter into the swap or security-based swap; membership in a swap association in a category reserved for dealers; providing marketing materials describing the type of swaps or security-based swaps the party is willing to enter into; and generally expressing a willingness to offer or provide a range of products or services that include swaps or security-based swaps. *See* Proposing Release, 75 FR at 80178.

[188] *See* By-laws of ISDA at 3, available at: *https://www.isdadocs.org/membership.* The Commissions note that the Primary Members of ISDA are not limited to only financial firms.

membership requires that a person deal in derivatives and not limit its participation in derivative transactions to solely risk hedging, membership in the category is an indicator of swap dealer status.[189]

We take note, however, of the comments that these activities may be insufficient to establish that a person is a swap dealer. In particular, we generally agree with commenters that many commercial end users of swaps do, from time to time, actively seek out and negotiate swaps. Yet, based on the applicable facts and circumstances, these end users do not necessarily fall within the definition of a swap dealer solely because they actively seek out and negotiate swaps from time to time.

The activities described in the Proposing Release as indicia of holding oneself out as a swap dealer or engaging in any activity causing oneself to be commonly known as a swap dealer should not be considered in a vacuum, but should instead be considered in the context of all the activities of the swap participant. While the activities listed in the Proposing Release are indicators that a person is holding itself out or is commonly known as a swap dealer, these are factors to be considered in the analysis. They are not *per se* conclusive, and could be countered by other factors indicating that the person is not a swap dealer.[190] Because of the flexibility—including the consideration of applicable facts and circumstances—needed for such an analysis, we do not believe that it is appropriate to codify this guidance in rule text, as suggested by some commenters.

c. Market Making

The final rule defining ''swap dealer'' includes the provision from the proposed rule which incorporates the statutory requirement that this term include a person that ''makes a market in swaps.'' [191]

We have considered the comments suggesting various descriptions of activities that should and should not be deemed to be market making in swaps for purposes of this rule. In consideration of these comments, we clarify that making a market in swaps is appropriately described as routinely standing ready to enter into swaps at the request or demand of a counterparty. In this regard, ''routinely'' means that the person must do so more frequently than occasionally, but there is no requirement that the person do so continuously.[192]

It is appropriate, in response to comments asking for further guidance regarding what activities constitute making a market in swaps, to describe some of the activities indicative of whether a person is routinely standing ready to enter into swaps at the request or demand of a counterparty. Such activities include routinely: (i) Quoting bid or offer prices, rates or other financial terms for swaps on an exchange; (ii) responding to requests made directly, or indirectly through an interdealer broker, by potential counterparties for bid or offer prices, rates or other similar terms for bilaterally negotiated swaps; (iii) placing limit orders for swaps; or (iv) receiving compensation for acting in a market maker capacity on an organized exchange or trading system for swaps.[193] These examples are not exhaustive, and other activities also may be indicative of making a market in swaps if the person engaging in them routinely stands ready to enter into swaps as principal at the request or demand of a counterparty.

In determining whether a person's routine presence in the market constitutes market making under these four factors, the dealer-trader interpretative framework may be usefully applied.[194] Under the dealer-trader distinction, seeking to profit by providing liquidity to the market is an indication of dealer activity.[195] Thus, in applying these four factors, it is useful to consider whether the person is seeking, through presence in the market, compensation for providing liquidity, compensation through spreads or fees, or other compensation not attributable to changes in the value of the swaps it enters into.[196] If not, such activity would not be indicative of market making.

Some commenters suggested that, in order to be a market maker in swaps, a person must make a two-way market in swaps.[197] Nonetheless, it is possible for a person making a one-way market in swaps to be a maker of a market in swaps and, therefore, within the swap dealer definition. This may be true, for example, where a person routinely

[189] However, while such membership is an indicator of swap dealer status, a person holding such membership could nonetheless be excluded by other provisions of the definition of the term ''swap dealer.'' For example, an insured depository institution that limits its activity to offering swaps in connection with the origination of loans, as discussed below in part II.B, would not be covered by the definition simply because it holds such membership.

[190] The statutory definition of the term ''swap dealer'' contains four separate clauses, or ''prongs,'' joined by the disjunctive ''or,'' the ordinary meaning of which is that the prongs are stated as alternative types of swap dealer. Accordingly, where an assessment of all the activities of a swap participant demonstrates that the person is not holding itself out as a swap dealer or engaging in any activity that causes it to be commonly known as a swap dealer, that person may, nonetheless, be a swap dealer based on the market making or regular business prongs of the swap dealer definition, discussed below. The Commissions note, however, that as discussed below in part II.A.4.g, the CFTC's overall interpretive guidance, including guidance regarding the dealer-trader framework, applies to identify swap dealers under all four prongs of the statutory ''swap dealer'' definition.

[191] *See* CFTC Regulation § 1.3(ggg)(1)(ii). Because the statutory swap dealer definition contains four disjunctive prongs, the CFTC does not agree with a commenter (*see* letter from ISDA I) who asserted that status as a market maker in swaps is a prerequisite to a person being a swap dealer.

[192] A person that occasionally, or less than routinely, enters into a swap at the request of a counterparty is not a maker of a market in swaps, and therefore is not a swap dealer on that basis. However, we reiterate, as stated in the Proposing Release, that since many types of swaps are not entered into on a continuous basis, it is not necessary that a person enter into swaps at the request or demand of counterparties on a continuous basis in order for the person to be a market maker in swaps and, therefore, a swap dealer.

[193] In addition, section 619 of the Dodd-Frank Act (the ''Volcker Rule'') generally prohibits banking entities from engaging in proprietary trading, but contains an exception for certain market making-related activities. The Commissions have proposed an approach to the Volcker Rule under which a person could seek to avoid the Volcker Rule in connection with swap activities by asserting the availability of that market making exception. *See* SEC, Board, Office of the Comptroller of the Currency (''OCC''), and Federal Deposit Insurance Corporation (''FDIC''), Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Proposed Rule, 76 FR 68846 (Nov. 7, 2011); CFTC, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Proposed Rule, 77 FR 8332 (Feb. 14, 2012). Under this approach, such a person would likely also be required to register as a swap dealer (unless the person is excluded from the swap dealer definition, such as by the exclusion of certain swaps entered into in connection with the origination of a loan). The SEC has proposed to adopt the same approach with respect to the interplay of the Volcker Rule and the definition of the term ''security-based swap dealer.'' *See* note 272, *infra.*

[194] We recognize that routine presence in the swap market is not necessarily indicative of making a market in swaps. For example, persons may be routinely present in the market in order to engage in swaps for purposes of hedging, to advance their investment objectives, or to engage in proprietary trading.

[195] *See* note 265, *infra,* and accompanying text.

[196] In this case, the spread from which a person profits may be between two or more swaps, or it may be between a swap and another position or financial instrument. In contrast, entering into swaps in order to obtain compensation attributable to changes in the value of the swaps is indicative of using swaps for a hedging, investment or trading purpose.

[197] *See* letters cited in notes 52 to 58, *supra.* Although swaps are notional contracts requiring the performance of agreed upon terms by each party, it is possible to describe swap users in practical terms as being on either ''side'' of a market. For example, for many swaps the party paying a fixed amount is on one ''side'' of the market and the party paying a floating amount is on the other ''side.''

stands ready to enter into swaps on a particular side of the market—say, routinely bidding for floating exposures on a swap trading platform—while entering into transactions on the other side of the market in other instruments (such as futures contracts). The relevant indicator of market maker status is the willingness of the person to routinely stand ready to enter into swaps at the request or demand of a counterparty (as opposed to entering into swaps to accommodate one's own demand or desire to participate in a particular market), be it on one or both sides of the market, and then to enter into offsetting positions, either in the swap market or in other markets.

The Commissions disagree with the commenters who said that swaps executed on an exchange should not be considered in determining if a person is a market maker in swaps and thus a swap dealer.[198] First, the statutory definition of the term ''swap dealer'' makes no distinction between swaps executed on an exchange and swaps that are not, suggesting that the same protections should apply regardless of the method of executing the swap. Second, from the perspective of an end user seeking to execute a swap on an exchange, the important consideration under our analysis is whether a market maker is ready to enter into swaps, not whether the market maker is aware of the counterparty's identity. A market maker in swaps routinely stands ready to enter into swaps at the request or demand of a counterparty, regardless of whether the counterparty and the market maker meet on a disclosed basis through bilateral negotiations or anonymously through an exchange.[199] Similarly, the issue of whether a person is a registered FCM or broker-dealer is not necessarily relevant to whether the person is a maker of a market in swaps, if the person is routinely standing ready to enter into swaps at the request or demand of a counterparty. Third, we believe it would be inappropriate to disregard swaps executed on exchanges in order, as some commenters suggested,[200] to encourage market participants to use, or to provide liquidity to, exchanges. Finally, variety of exchanges, markets, and other facilities for the execution of swaps are likely to evolve in response to the requirements of the Dodd-Frank Act, and there is no basis for any bright-line rule excluding swaps executed on an exchange, given the impossibility of obtaining information about how market participants will interact and execute swaps in the future, after the requirements under the Dodd-Frank Act are fully in effect. For all these reasons, we have determined that it is inappropriate to restrict the ''making a market in swaps'' prong of the swap dealer definition (*i.e.,* routinely standing ready to enter into swaps at the request or demand of a counterparty) to swaps that are not executed on an exchange.[201]

d. Exception for Activities Not Part of ''a Regular Business''

The final rule includes the provisions in the proposed rule that incorporate the provisions of the statutory definition regarding activities that are not part of ''a regular business'' of entering into swaps. One provision states that the term ''swap dealer'' includes a person that ''regularly enters into swaps with counterparties as an ordinary course of business for its own account''; the other provision states that the term ''swap dealer'' does not include a person that ''enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business.'' [202]

The Commissions continue to believe, as stated in the Proposing Release, that the phrases ''ordinary course of business'' and ''a regular business'' are, for purposes of the definition of ''swap dealer'' essentially synonymous. In this context, we interpret these phrases to focus on activities of a person that are usual and normal in the person's course of business and identifiable as a swap dealing business. It is not necessarily relevant whether the person conducts its swap-related activities in a dedicated subsidiary, division, department or trading desk, or whether such activities are a person's ''primary'' business or an ''ancillary'' business, so long as the person's swap dealing business is identifiable.[203]

We have taken into consideration comments seeking additional guidance regarding the types and levels of activities that constitute having ''a regular business'' of entering into swaps.[204] In this regard, any one of the following activities would generally constitute both entering into swaps ''as an ordinary course of business'' and ''as a part of a regular business'': [205] (i) Entering into swaps with the purpose of satisfying the business or risk management needs of the counterparty (as opposed to entering into swaps to accommodate one's own demand or desire to participate in a particular market); (ii) maintaining a separate profit and loss statement reflecting the results of swap activity or treating swap activity as a separate profit center; or (iii) having staff and resources allocated to dealer-type activities with counterparties, including activities relating to credit analysis, customer onboarding, document negotiation, confirmation generation, requests for novations and amendments, exposure monitoring and collateral calls, covenant monitoring, and reconciliation.[206]

[198] *See, e.g.,* letters cited in note 62, *supra.*

[199] As discussed above, in many cases routine presence in the swap market, without more, would not constitute market making activity. Nevertheless, the CFTC will, in connection with promulgation of final rules relating to capital requirements for swap dealers and major swap participants, consider institution of reduced capital requirements for entities or individuals that fall within the swap dealer definition and that execute swaps only on exchanges, using only proprietary funds. Similarly, the CFTC also will consider the applicability to such entities or individuals of the other requirements imposed on swap dealers (*e.g.,* internal business conduct standards, external business conduct standards with counterparties), and may adjust those swap dealer requirements as appropriate.

[200] *See, e.g.,* letters cited in note 66, *supra.* Since the structures of the markets on which swaps will be executed are still in development, and market obligations have not been established, there is little support for comments asserting that market makers should be defined as only those persons who receive benefits from the market (such as reduced trading fees) in return for the obligation to transact when the market requires liquidity.

[201] By contrast, it may be appropriate, over time, to tailor the specific requirements imposed on swap dealers depending on the facility on which the swap dealer executes swaps. For example, the application of certain business conduct requirements may vary depending on how the swap is executed, and it may be appropriate, as the swap markets evolve, to consider adjusting certain of those requirements for swaps that are executed on an exchange or through particular modes of execution.

[202] Final CFTC Regulation § 1.3(ggg)(2) is modified from the proposal to include the word ''a'' before the words ''regular business,'' to conform the text of the rule to the text of the statute. *See* CEA section 1a(49)(C), 7 U.S.C. 1a(49)(C).

As stated in the Proposing Release, we interpret the reference in the definition of the term ''swap dealer'' to a person entering into swaps ''with counterparties * * * for its own account'' to refer to a person who enters into a swap as a principal, and not as an agent. A person who enters into swaps as an agent for customers (*i.e.,* for the customers' accounts) would be required to register as either an FCM, introducing broker, commodity pool operator or commodity trading advisor, depending on the nature of the person's activity.

[203] We recognize, as noted by one commenter (*see* letter from ISDA I), that the ''regular business'' exclusion is not limited solely to the ''ordinary course of business'' test of the swap dealer definition. Our interpretations of the other three tests are, and should be read to be, consistent with the exclusion of activities that are not part of a regular business.

[204] *See, e.g.,* letters from BG LNG I, COPE I, IECA–Credit I, Shell Trading I, WGCEF I and Vitol (stating that the proposed approach was overly subjective and requesting guidance as to the specific activities that are covered by the statutory definition).

[205] These activities are inconsistent with entering into a swap to hedge a physical position as defined in § 1.3(ggg)(6)(iii). As discussed below, such hedging is not dealing activity.

[206] The three indicators of being engaged in ''a regular business'' of entering into swaps described

The Commissions see merit in the comments saying that ''a regular business'' of entering into swaps can be characterized by entering into swaps to satisfy the business or risk management needs of the other party to the swap, and so incorporate this element into our interpretation of the rule.[207] Also, an objective indicator of a person being engaged in ''a regular business'' of entering into swaps is when the person accounts for the results of its swap activities separately, by maintaining a separate profit and loss statement for those activities or treating them as a separate profit center. Our interpretation incorporates this indicator of activity that is ''a regular business'' of entering into swaps.

Other comments suggesting specific criteria to identify ''a regular business'' also were helpful. We agree with commenters[208] that ''a regular business'' of entering into swaps can be characterized by having staff and resources allocated to the types of activities in which swap dealers must engage with their counterparties, such as those noted above (*e.g.,* credit analysis, confirmation generation, collateral calls, and covenant monitoring). However, we understand that some end users of swaps engage in some of these activities and, in certain circumstances, may have staff and resources available for these activities. Therefore, this element of the definition should be applied in a reasonable manner, taking all appropriate circumstances into account. This element does not depend on whether a specific amount or percentage of expenses or employee time are related to these swap activities. Instead, it is appropriate to objectively examine a person's use of staff and resources related to swap activities. Using staff and resources to a significant extent in conducting credit analysis, opening and monitoring accounts and the other activities noted above, is an indication that the person is engaged in ''a regular business'' of entering into swaps.

Regarding the commenters' assertion that the activity of entering into swaps in connection with a person's physical commodity business cannot constitute ''a regular business'' of the person, we believe that while in most cases this is not dealing activity,[209] a *per se* exclusion of this type is not appropriate because it is possible that in some circumstances a person might enter into swaps that are connected to a physical commodity business but also serve market functions characteristic of the functions served by swap dealers. Also, again, the statutory definition does not contain any such exclusion, but rather includes any person who ''regularly enters into swaps with counterparties as an ordinary course of business for its own account,'' without regard to the person's particular type of business.

Consistent with the statutory definition, we interpret ''a regular business'' of entering into swaps in a manner that applies equally to all market participants that engage in the activities set forth in the statutory definition. This will ensure that all participants in the swap markets are regulated in a fair and consistent manner, regardless of whether their underlying business is primarily physical or financial in nature.[210]

Finally, as noted above, the manner in which persons negotiate, execute and use swaps is likely to evolve in response to the requirements of the Dodd-Frank Act and the other forces that will shape the swap markets going forward. For this reason, it would be inappropriate to craft per se exclusions from the swap dealer definition at a time when the only available information about the use of swaps relates to the period prior to implementation of the Dodd-Frank Act.[211]

e. Interim Final Rule Excluding Swaps Entered Into for Hedging Physical Positions

We note that some commenters said that swaps used to hedge or mitigate commercial risks should not be considered in determining whether a person is a swap dealer.[212] We understand that swaps are used to hedge risks in numerous and varied ways, and we expect that the number of persons covered by the definition will be very small in comparison to the thousands of persons that use swaps for hedging.

In terms of the statutory definition of the term ''swap dealer,'' the CFTC notes as an initial matter that there is no specific provision addressing hedging activity. Thus, the statutory definition leaves the treatment of hedging swaps to the CFTC's discretion; it neither precludes consideration of a swap's hedging purpose, nor does it require an absolute exclusion of all swaps used for hedging.[213]

In general, entering into a swap for the purpose of hedging is inconsistent with swap dealing.[214] The practical

here are set forth in the alternative. Any one of these indicators may be sufficient, based on a facts and circumstances analysis, to reach a conclusion that an entity is engaged in ''a regular business'' of entering into swaps.

[207] This element of the interpretation reflects our agreement with those commenters who said that ''a regular business'' of entering into swaps is characterized by having a business of accommodating demand or facilitating interest in swaps (*see* letter from IECA–Credit I), and those commenters who said that ''a regular business'' does not encompass the use of swaps to serve a person's own business needs, as opposed to serving the business needs of the counterparty (*see* letters cited in note 71, *supra*).

[208] *See* letters cited in note 80, *supra.*

[209] *See* CFTC Regulation § 1.3(ggg)(6)(iii) (swaps entered into for hedging physical positions as defined in the rule are not considered in the determination of whether a person is a swap dealer).

[210] Regulation of firms engaged in an underlying physical business is also consistent with regulatory practices outside the U.S. For example, non-financial entities register with the Financial Services Authority in the U.K. as ''Oil Market Participants'' and ''Energy Market Participants.'' *See* Financial Services Authority Handbook EMPS and OMPS, available at *http://fsahandbook.info/FSA/html/handbook.*

[211] For the same reasons, we do not believe it would be appropriate, in determining whether a person has a ''regular business'' of entering into swaps, to consider whether a person engages in activities normally associated with financial institutions, as some commenters suggested. *See* letters cited in note 76, *supra.*

[212] *See, e.g.,* letters cited in note 72, *supra.*

[213] In this regard, the statutory definition of the term ''swap dealer'' stands in contrast to the statutory definition of the term ''major swap participant'' which, as discussed further below, explicitly provides that positions in swaps held for hedging or mitigating commercial risk are to be excluded in certain parts of that definition. *See* CEA section 1a(33)(A)(i)(1), 7 U.S.C. 1a(33)(A)(i)(1). The absence of any explicit requirement in the ''swap dealer'' definition to exclude swaps held for hedging or mitigating commercial risk does not support the view that Congress intended to categorically exclude all swaps that may serve as hedges in determining whether a person is covered by the definition.

Similarly, the absence of any limitation in the statutory definition of the term ''swap dealer'' to financial entities, when such limitation is included elsewhere in Title VII, indicates that no such limitation applies to the swap dealer definition. CEA section 2(h)(7), 7 U.S.C. 2(h)(7), specifically limits the application of the clearing mandate, in certain circumstances, to only ''financial entities.'' That section also provides a detailed definition of the term ''financial entity.'' *See* CEA section 2(h)(7)(C), 7 U.S.C. 2(h)(7)(C). That such a limitation is included in this section, but not in the swap dealer definition, does not support the view that the statutory definition of the term ''swap dealer'' should encompass only financial entities.

[214] For example, under the dealer-trader distinction, the Commissions would expect persons that use security-based swaps to hedge their business risks, absent other activity, likely would not be dealers. *See* part II.A.5.b, *infra.* Under the CFTC's interpretive guidance, making a market in swaps is appropriately described as routinely standing ready to enter into swaps at the request or demand of a counterparty, and the indicia of swap dealing as a ''regular business'' include entering into swaps to satisfy the business or risk management needs of the counterparty. Entering into swaps for the purpose of hedging one's own risks generally would not be indicative of this form of swap activity. *See also, e.g.,* joint letter from Senator Stabenow and Representative Lucas (the

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difficulty lies in determining when a person has entered into a swap for the purpose of hedging, as opposed to other purposes for entering into swaps, such as accommodating demand for swaps or as part of making a market in swaps, and in distinguishing a swap with a hedging purpose from a swap with a hedging consequence. In view of these uncertainties, the CFTC believes it is appropriate to adopt an interim final rule that draws upon the principles of bona fide hedging that the CFTC has long applied to identify when a financial instrument is used for hedging purposes, and excludes from the swap dealer analysis swaps entered into for the purpose of hedging physical positions that meet the requirements of the rule.

Specifically, the CFTC is adopting as an interim final rule CFTC Regulation § 1.3(ggg)(6)(iii), which provides that the determination of whether a person is a swap dealer will not consider a swap that the person enters into, if:

(i) The person enters into the swap for the purpose of offsetting or mitigating the person's price risks that arise from the potential change in the value of one or several (a) assets that the person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising; (b) liabilities that the person owns or anticipates incurring; or (c) services that the person provides, purchases, or anticipates providing or purchasing;

(ii) the swap represents a substitute for transactions made or to be made or positions taken or to be taken by the person at a later time in a physical marketing channel;

(iii) the swap is economically appropriate to the reduction of the person's risks in the conduct and management of a commercial enterprise;

(iv) the swap is entered into in accordance with sound commercial practices; and

(v) the person does not enter into the swap in connection with activity structured to evade designation as a swap dealer.[215]

Thus, although the CFTC is not incorporating the bona fide hedging provisions of the CFTC's position limits rule here, the exclusion from the swap dealer analysis draws upon language in the CFTC's definition of bona fide hedging.[216] For example, the exclusion expressly includes swaps hedging price risks arising from the potential change in value of existing or anticipated assets, liabilities, or services, if the hedger has an exposure to physical price risk. And, as in the bona fide hedging rule, the exclusion utilizes the word ''several'' to reflect that there is no requirement that swaps hedge risk on a one-to-one transactional basis in order to be excluded, but rather they may hedge on a portfolio basis.[217] For these reasons, swaps that qualify as enumerated hedging transactions and positions are examples of the types of physical commodity swaps that are excluded from the swap dealer analysis if the rule's requirements are met.[218]

This provision in the final rule is consistent with our overall interpretive approach to the definition of the term ''swap dealer.'' The interpretations of the statutory dealer definitions by both Commissions focus on a person's activities in relation to its counterparties and other market participants.[219] As noted above, for example, one indicator that a person enters into swaps as part of ''a regular business'' is that the person does so to satisfy the business or risk management needs of the counterparty. This aspect of the swap dealer analysis turns on the accommodation of a counterparty's needs or demands. If a person enters into swaps for the purpose of hedging a physical position as defined in CFTC Regulation § 1.3(ggg)(6)(iii), by contrast, then the swap can be identified as not having been entered into for the purpose of accommodating the counterparty's needs or demands.[220] Also, a person's activity of seeking out swap counterparties in order to hedge a physical position as defined in the rule generally would not warrant regulations to promote market stability and transparency or to serve the other purposes of dealer regulation.[221]

At the same time, however, there may be circumstances where a person's activity of entering into swaps is encompassed by the statutory definition of the term ''swap dealer,'' notwithstanding that the swaps have the effect of hedging or mitigating the person's commercial risk.[222] Although these swaps could, in theory, be excluded from the swap dealer analysis, we believe that a broader, *per se* exclusion for all swaps that hedge or mitigate commercial risk is

final rule should distinguish using swaps for hedging from swap dealing).

[215] *See* CFTC Regulation § 1.3(ggg)(6)(iii). All five requirements set forth in the regulation must be met with respect to the swap, in order for the swap to be excluded from the swap dealer determination by the regulation.

[216] *See* CFTC Regulation § 151.5(a)(1). The definition of bona fide hedging in CFTC Regulation § 1.3(z), which applies for excluded commodities, is not relevant here, because it does not contain the requirement that the swap represents a substitute for a transaction made or to be made or a position taken or to be taken in a physical marketing channel, as required by CFTC Regulation § 1.3(ggg)(6)(iii)(B). We believe that this requirement is an important aspect of how principles from the bona fide hedging definition are useful in identifying swaps that are entered into for the purpose of hedging as opposed to other purposes.

[217] *See* CFTC, Position Limits for Futures and Swaps; Final Rule, 76 FR 71626, 71649 (Nov. 18, 2011).

[218] The swaps that qualify as enumerated hedging transactions and positions are those listed in CFTC Regulation § 151.5(a)(2) and appendix B to part 151. These examples are illustrative of the types of ''assets,'' ''liabilities,'' and ''services'' contemplated in CFTC Regulation § 1.3(ggg)(6)(iii), because the price risk arising from changes in their value could be offset or mitigated with a swap that represents a substitute for transactions made or to be made or positions taken or to be taken by the person at a later time in a physical marketing channel. To be clear, notwithstanding that a swap does not fit precisely within such examples, it may still satisfy CFTC Regulation § 1.3(ggg)(6)(iii).

Regarding commenters' queries about dynamic hedging, which one commenter described as the ability to modify the hedging structure related to physical assets or positions when relevant pricing relationships applicable to that asset change (*see* joint letter from WGCEF and CMC), we note that qualification as bona fide hedging has never been understood to require that hedges, once entered into, must remain static. We expect that entites would move to update their hedges periodically when pricing relationships or other market factors applicable to the hedge change.

[219] *See* parts II.A.4.e and II.A.5.a, *infra.* For example, the conclusion that a person's relationship with its counterparties can lead to associated obligations is consistent with the ''shingle theory,'' which implies a duty of fair dealing when a person hangs out its shingle to do business. *See* note 260, *infra.*

[220] In this way, the exclusion from the swap dealer analysis of swaps hedging physical positions as defined in CFTC Regulation § 1.3(ggg)(6)(iii) is similar to the exclusions, discussed below, of swaps between affiliates and swaps between a cooperative and its members. *See* CFTC Regulation § 1.3(ggg)(6)(i)(ii); *see also* part II.C, *infra.* However, to the extent a person engages in dealing activities involving swaps, the presence of offsetting positions that hedge those dealing activities would not excuse the requirement that the person register as a swap dealer.

[221] Thus, the CFTC's interpretation of the swap dealer definition in this regard draws upon principles in the dealer-trader distinction. *See* part II.A.4.a. Additional authority for CFTC Regulation § 1.3(ggg)(6)(iii) is provided by subparagraph (B) of the swap dealer definition. This subparagraph provides that a person ''may be designated as a swap dealer for a single type or single class or category of swap or activities and considered not to be a swap dealer for other types, classes, or categories of swaps or activities.'' CEA Section 1a(49)(B), 7 U.S.C. 1a(49)(B). It thereby authorizes a review of a person's various activities with respect to swaps, and a determination that some of the person's activities are covered by a designation as a swap dealer, while other of the person's activities are not. Thus, a person who enters into some swaps for hedging physical positions as defined in CFTC Regulation § 1.3(ggg)(6)(iii), and also enters into other swaps in connection with activities covered by the swap dealer definition, could be designated as a swap dealer only for the latter activities.

[222] For example, ''pay floating/receive fixed'' swaps entered into by a swap dealer with long exposure to the floating side of a market would have the effect of hedging the dealer's exposure.

inappropriate for the swap dealer definition.

First, the hedging exclusion that we are adopting is in the nature of a safe harbor; *i.e.,* it describes activity that will not be considered swap dealing activity. As such, the CFTC believes that it is appropriate that the interim final rule not be cast broadly.[223] This does not mean that other types of hedging activity that do not meet the requirements of the interim final rule are necessarily swap dealing activity. Rather, such hedging activity is to be considered in light of all other relevant facts and circumstances to determine whether the person is engaging in activity (*e.g.,* accommodating demand for swaps, making a market for swaps, etc.) that makes the person a swap dealer.

Second, the usefulness of an exclusion of all swaps that hedge or mitigate commercial risk for certain aspects of the major swap participant definition [224] is not a reason to use the same exclusion in the swap dealer definition, since the swap dealer definition serves a different function. The definition of the term ''major swap participant,'' which applies only to persons who are not swap dealers,[225] is premised on the prior identification, by the swap dealer definition, of persons who accommodate demand for swaps, make a market in swaps, or otherwise engage in swap dealing activity. The major swap participant definition performs the subsequent function of identifying persons that are not swap dealers, but hold swap positions that create an especially high level of risk that could significantly impact the U.S. financial system.[226] Only for this subsequent function is it appropriate to apply the broader exclusion of swaps held for the purpose of hedging or mitigating commercial risk.[227]

The CFTC believes that since the over-the-counter swap markets have operated largely without regulatory oversight and encompass swaps used for a wide variety of commercial purposes, no method has yet been developed to reliably distinguish, through a *per se* rule, between: (i) Swaps that are entered into for the purpose of hedging or mitigating commercial risk; and (ii) swaps that are entered into for the purpose of accommodating the counterparty's needs or demands or otherwise constitute swap dealing activity, but which also have a hedging consequence.[228] In contrast, the CFTC notes that it has set forth and modified standards for bona fide hedging transactions and granted exemptions in compliance with such standards for decades.[229] These historically-developed standards form the basis of the interim final rule excluding from the swap dealer analysis certain swaps that hedge the risks associated with a physical position.

The exclusion in CFTC Regulation § 1.3(ggg)(6)(iii) depends not on the effect or consequences of the swap, but on whether the purpose for which a person enters into a swap is to hedge a physical position as defined in the rule. If so, then the swap is excluded from the dealer analysis because using swaps for that purpose is inconsistent with, and is not, dealing activity.[230] On the other hand, if, at the time the swap is entered into, the person's purpose for entering into the swap is not as defined in CFTC regulation § 1.3(ggg)(6)(iii), or if it is unclear whether the swap is for such purpose, then the fact that the swap hedges the person's exposure in some regard does not preclude consideration of that swap in the dealer analysis.[231] In this latter case, all relevant facts and circumstances regarding the swap and the person's activity with respect to the swap would be relevant in the determination of whether the person is a swap dealer.[232]

We believe that, based on the CFTC's experience in applying bona fide hedging principles with respect to swaps hedging risks related to physical positions, the exclusion in CFTC Regulation § 1.3(ggg)(6)(iii) at this time is the best means of providing certainty to market participants regarding which swaps may be disregarded in the dealer analysis. However, commenters presented a range of views as to the exclusions from the dealer analysis that may be appropriate in this regard.[233] Accordingly, the CFTC is implementing this exclusion on an interim rule basis and is seeking comments on all aspects of the interim rule, including any adjustments that may be appropriate in the rule or accompanying interpretive guidance.

The CFTC also seeks comments on whether a different approach to swaps entered into for the purpose of hedging risk is appropriate to implement the statutory definition of the term ''swap dealer.''

For example, the CFTC invites commenters to address whether any exclusion of hedging swaps from the swap dealer analysis is appropriate, and if so, how swaps that are entered into for purposes of hedging may be identified and distinguished from other swaps. Commenters are encouraged to address whether it is relevant to distinguish swaps entered into for purposes of hedging from swaps that have a consequential result of hedging, and if so, how such swaps may be distinguished. Also, commenters may address whether the exclusion should be limited to swaps hedging risks related to physical positions or extended to encompass swaps hedging financial risks or other types of risks.

Commenters should address whether the exclusion in CFTC Regulation § 1.3(ggg)(6)(iii) should be consistent with the exclusion in CFTC Regulation § 1.3(kkk). If so, why, and if not, why not? If the two exclusions should be consistent, does consistency require that that exclusions be identical, or would there be variations in application of the two exclusions? Are there market participants whose swap positions would be classified as held for the purpose of hedging or mitigating commercial risk under CFTC Regulation

[223] While we recognize that a rule delineating the swap activities that do not constitute swap dealing would simplify and make more certain, at least in some contexts, the application of the swap dealer definition, there are also reasons for caution in incorporating a categorical exclusion for hedging.

[224] *See* part IV.C, *infra.*

[225] *See* CEA § 1a(33)(A)(i), 7 U.S.C. 1a(33)(A)(i).

[226] *See* CEA § 1a(33)(B), 7 U.S.C. 1a(33)(B).

[227] We do not believe that the differences between the exclusion in the major participant definitions for swaps held for the purpose of hedging or mitigating commercial risk and the exclusion in the swap dealer definition for certain swaps entered into for the purpose of hedging risks related to physical positions mean that the Commissions, or the CFTC in particular, have implemented two different definitions of hedging. In fact, neither of these exclusions define the term ''hedging.'' Rather, the differences between the two exclusions reflect differences in the parameters that must be satisfied in order to ensure that hedging swaps are appropriately excluded from the two different definitions.

[228] As noted in the preceding paragraph, it is not necessary to make this distinction for purposes of the major swap participant definition.

[229] *See, e.g.,* 42 FR 42751 (Aug. 8, 1977). Although the latest formulation of the definition of bona fide hedging—CFTC Regulation § 151.5(a)—was recently adopted, *see* CFTC, Position Limits for Futures and Swaps; Final Rule and Interim Final Rule, 76 FR 71626 (Nov. 18, 2011), the bona fide hedging test has been in use for decades.

[230] To be clear, the swaps a person enters into for hedging physical positions as defined in CFTC Regulation § 1.3(ggg)(6)(iii) are not indicative of dealing activity under any of the prongs of the swap dealer definition.

[231] In this regard, CFTC Regulation § 1.3(ggg)(6)(iii) is different from certain of the CFTC's rules regarding bona fide hedging, where a person's purpose in entering into a swap may not be relevant.

[232] We believe that, in practice, the difficulty of distinguishing, in applying the swap dealer definition, swaps entered into for the purpose of hedging from other types of swaps will be resolvable when the facts and circumstances of a person's swap activities are taken into consideration in light of our interpretive guidance.

[233] *See, e.g.,* letters cited in note 141, *supra.*

§ 1.3(kkk) but would not qualify for the exclusion under CFTC Regulation § 1.3(ggg)(6)(iii)? If so, specifically identify the types of market participants and swaps. If the CFTC were to apply in the swap dealer definition the exclusion in CFTC Regulation § 1.3(kkk) in lieu of the exclusion in CFTC Regulation § 1.3(ggg)(6)(iii), would there be negative market impacts? If so, what are they? Would there be positive market impacts? If so, what are they? In particular, what type(s) of swaps that ''hedge or mitigate commercial risk,'' but that are not excluded under the interim rule, may constitute dealing activity in light of the rules and interpretive guidance regarding the swap dealer definition set forth in this Adopting Release?

Comments regarding the costs and benefits related to the interim final rule and any alternative approaches, including in particular the quantification of such costs and benefits, are also invited.

Commenters are encouraged, to the extent feasible, to be comprehensive and detailed in providing their approach and rationale. The comment period for the interim final rule will close July 23, 2012.

f. Swaps Entered Into by Persons Registered as Floor Traders

Commenters discussed whether the swap dealer definition encompasses the activity of entering into swaps on or subject to the rules of a DCM or SEF, and submitted for clearing to a derivatives clearing organization (''DCO''), particularly when firms engage in that activity using only proprietary funds.[234] Because Title VII of the Dodd-Frank Act amended the definition of floor trader specifically to encompass activities involving swaps,[235] the CFTC believes that it would lead to potentially duplicative regulation if floor traders engaging in swaps in their capacity as floor traders were also required to register as swap dealers. Accordingly, the CFTC believes that it is appropriate not to consider such swaps when determining whether a person acting as a floor trader, as defined under CEA section 1a(23),[236] and registered with the CFTC under CFTC Regulation § 3.11, is a swap dealer if the floor trader meets certain conditions. Specifically, the final rule provides that, in determining whether a person is a swap dealer, each swap that the person enters into in its capacity as a floor trader as defined by CEA section 1a(23) or on a SEF shall not be considered for the purpose of determining whether the person is a swap dealer, provided that the person:

(i) Is registered with the CFTC as a floor trader pursuant to CFTC Regulation § 3.11;

(ii) enters into swaps solely with proprietary funds for that trader's own account on or subject to the rules of a DCM or SEF, and submits each such swap for clearing to a DCO;

(iii) is not an affiliated person of a registered swap dealer;

(iv) does not directly, or through an affiliated person, negotiate the terms of swap agreements, other than price and quantity or to participate in a request for quote process subject to the rules of a DCM or SEF;

(v) does not directly or through an affiliated person offer or provide swap clearing services to third parties;

(vi) does not directly or through an affiliated person enter into swaps that would qualify as hedging physical positions pursuant to CFTC Regulation § 1.3(ggg)(6)(iii) or hedging or mitigating commercial risk pursuant to CFTC Regulation § 1.3(kkk), with the exception of swaps that are executed opposite a counterparty for which the transaction would qualify as a bona fide hedging transaction;

(vii) does not participate in any market making program offered by a DCM or SEF; and

(viii) complies with the record keeping and risk management requirements of CFTC Regulation §§ 23.201, 23.202, 23.203, and 23.600 with respect to each such swap as if it were a swap dealer.[237]

This rule permits floor traders who might otherwise be required to register as a swap dealer to be registered solely as floor traders with the CFTC. Given the limitations on the scope of the rule, the requirements for floor traders using the relief to comply with recordkeeping and risk management rules applicable to swap dealers as a condition of the relief, and the fact that swaps subject to the rule are traded on a DCM or SEF and cleared through a DCO, the CFTC believes it is not necessary to have floor traders subject to this rule register as both floor traders and swap dealers as a result of swaps activities covered by the rule.[238]

g. Additional Interpretive Issues Relating to the ''Swap Dealer'' Definition

As noted above, the Commissions, in consideration of comments received, are making certain modifications to the interpretive guidance concerning the definition of the term ''swap dealer'' set out in the Proposing Release. However, the Commissions are retaining certain elements of their proposed interpretation of the term ''swap dealer,'' as discussed below.

First, with respect to the comments asserting that the proposed interpretive approach is overly broad,[239] we note that the statute provides that the term ''swap dealer'' means ''any person'' who engages in the activities described in any of the four prongs of the definition, subject to the exceptions and qualifications set out in the statute. In view of this statutory text, these comments effectively assert that the statute should be interpreted to include preconditions to swap dealer status that are not set forth in the statute. For example, the assertion that the swap dealer definition must be limited to persons who enter into swaps on both sides of the market would impose a requirement that does not exist in the statute. Similarly, the comments to the effect that swap dealers are only those persons who seek to profit by intermediating between swap market participants adds a requirement not set forth in the statute.

We believe, though, that the activities that cause a person to be covered by the

[234] *See* letter from Trading Coalition. One commenter specifically discussed floor traders and floor brokers and the regulatory regime that should apply to them following implementation of the Dodd Frank Act. *See* letter from Christopher K. Hehmeyer.

We note that other commenters suggested that all swaps cleared on an exchange should be excluded from the dealer definitions. *See* letters cited in note 138, *supra.* However, the discussion here is limited to persons who are registered as floor traders and meet other conditions. Also, the final rule provision discussed here does not exclude floor traders from the definition of the term ''swap dealer;'' rather, it provides that if the stated conditions are met, certain swaps entered into by floor traders are excluded from the swap dealer analysis.

[235] *See* section 721(a)(11) of the Dodd-Frank Act (amending the definition of the term ''floor trader'' in CEA section 1a(23)). The Exchange Act does not have an equivalent regulatory category to floor trader under the CEA, and thus Congress did not make a similar amendment to the Exchange Act.

[236] The definition of the term ''floor trader'' includes a person entering into swaps on a ''contract market.'' *See* CEA section 1a(23). This exclusion also encompasses swaps that a registered floor trader enters into on or subject to the rules of a SEF, in addition to on or subject to the rules of a DCM, so long as the swap meets the conditions stated in the exclusion.

[237] *See* CFTC Regulation § 1.3(ggg)(6)(iv).

[238] The Commissions note the rule applies only to CFTC-registered floor traders engaging in swaps on DCMs or SEFs and cleared through DCOs. As noted above, the SEC does not have a regulatory category under the Exchange Act equivalent to floor trader under the CEA and none of these provisions apply in the context of security-based swap dealers or any entity regulated under the Exchange Act. Any person engaging in security-based swap transactions, whether or not these activities are similar to those engaged in by floor traders, will need to independently consider whether they need to register as security-based swap dealers as a result of their activities.

[239] *See* letters cited at notes 83 to 84, *supra.*

swap dealer definition should be addressed in the context of the four prongs of the statutory definition. That is, the relevant question is whether a person engages in any of the types of activities enumerated in the statute, and not whether the person meets any additional, supposedly implicit preconditions to swap dealer status.

Second, the Commissions continue to believe, as stated in the Proposing Release, that accommodating demand and facilitating interest are appropriately used as factors in identifying swap dealers. As noted by commenters, however, the mere fact that a person entering into a particular swap has the effect of ''accommodating demand'' or ''facilitating interest'' in swaps does not conclusively establish that the person is a swap dealer. Instead, the person's overall activities in the swap market (or particular sector of the swap market if the person is active in a variety of sectors) should be compared against these factors. If, in the context of its overall swap activities, a person fulfills a function of accommodating demand or facilitating interest in swaps for other parties, then these factors would be significant in the analysis and the person is likely to be a swap dealer.[240]

Third, as discussed above, we have adopted some of the objective criteria suggested by commenters with respect to the indicia of holding oneself out as a dealer or being commonly known as a dealer, market making, and the ''regular business'' prongs of the swap dealer definition.[241] For instance, allocating staff and technological resources to swap activity, deriving revenue and profit from swap activity, or responding to customer-initiated orders for swaps can all be indicative of having ''a regular business'' of entering into swaps and, therefore, indicative of being a swap dealer. In addition, activities such as providing advice about swaps or offering oneself as a point of connection to other parties needing access to the swap market are indicative of a person holding itself out as a swap dealer, if the person also enters into swaps in conjunction with such activities.

The guidance we have provided about these indicia is responsive to concerns expressed by commenters about the application of the swap dealer definition to energy markets. As described above, some commenters stated that in energy markets, unlike in some other markets, end-users often enter into swaps directly with each other, on both sides of the market, without the involvement of a separate category of businesses serving as intermediaries.[242] As a result, according to these commenters, energy swap market participants often engage in some of the activities that are indicative of swap dealer status. Some of these commenters contended that our activity-based interpretation of the swap dealer definition could therefore result in the inappropriate inclusion of energy market participants in the coverage of the definition of the term ''swap dealer.''[243]

We believe that the language of the statutory ''swap dealer'' definition supports our activity-based interpretation and does not support categorical exclusions of particular types of persons from the ''swap dealer'' definition based on the general nature of their businesses. Further evidence that such a categorical exclusion is unwarranted is provided by the fact that a number of energy market participants—BP Plc., Cargill, Incorporated, Centrica Energy Limited, ConocoPhillips, EDF Trading Limited, GASELYS, Hess Energy Trading Company, LLC, Hydro-Quebec, Koch Supply & Trading, LP, RWE Supply & Trading GmbH, Shell Energy North America (US), L.P., STASCO, Totsa Total Oil Trading S.A., and Vattenfall Energy Trading Netherlands N.V.—have voluntarily joined ISDA as primary dealers.[244] As previously noted, any business organization that ''deals in derivatives shall be eligible for election to membership in the Association as a primary member, provided that no person or entity shall be eligible for membership as a Primary Member if such person or entity participates in derivatives transactions solely for the purpose of risk hedging or asset or liability management.''[245] Hence, a categorical exclusion from the ''swap dealer'' definition based on any particular type of business or general market activity also would be inconsistent with current industry structure and practice.

At the same time, however, the fact that a person engages in some swap activities that are indicative of swap dealer status does not, by itself, mean that the person is covered by the definition of the term ''swap dealer.'' The ''not as part of a regular business'' exception and our guidance about its meaning address the issue of swap market participants that engage to some extent in the activities characteristic of swap dealers. The guidance we have provided here therefore provides the appropriate approach to addressing these issues in energy markets as elsewhere.

Although several commenters attempted to articulate bright-line tests that would differentiate swap dealers from other swap market participants, the suggested bright-line tests generally could not be applied across the board to all types of swap market activity. For example, some commenters suggested that swap dealers can be identified as those who profit from entering into swaps on both sides of the market (and under the interpretive approach set forth in this Adopting Release, such activity may be an indicator of swap dealing).[246] But other commenters said that, in certain circumstances, entering into swaps on both sides of the market is not necessarily indicative of swap dealing.[247]

The ways in which participants throughout the market use swaps are simply too diverse for swap dealer status to be resolved with a single, one-factor test. This is reflected in the statutory definition of the term ''swap dealer'' itself. Focused as it is on types of activities, with four prongs set forth in the alternative to cover different types of swap dealing activity, the statutory swap dealer definition is not susceptible to the bright-line test that

[240] The language of the four statutory tests for swap dealer status (which refer to a person who holds itself out as a dealer, is commonly known as a dealer, makes a market in swaps or regularly enters into swaps with counterparties) contemplate that a dealer is a person who, through its swap activities, functions to create legal relationships that transfer risk between independent persons. *See* CEA section 1a(49)(A), 7 U.S.C. 1a(49)(A).

See also Proposing Release, 75 FR at 80177 (describing swap dealers as those persons whose function is to serve as the points of connection in the swap markets); letter from COPE I at 4 (''Simply stated, dealers are in the regular business of being a point of connection to the market for others that need access to the market to hedge risk.''): Roundtable Transcript at 21 (remarks of Richard Ostrander, Morgan Stanley; ''a dealer is someone who is out there willing to enter into trades'').

[241] *See* part II.B.2.d.iii, *supra.*

[242] *See* parts II.A.2.f.ii and iii, *supra.*

[243] *See* letters cited in note 117, *supra.* Comments expressing concern that the definition of the term ''swap dealer'' could include physical commodities businesses also were presented to Congress during consideration of legislation leading to passage of the Dodd-Frank Act. *See* Proposed Legislation by the U.S. Department of the Treasury Regarding the Regulation of Over-The-Counter Derivatives Markets: Hearing Before the H. Comm. On Agriculture, 111th Cong. 103 (2009) (submitted report on behalf of the Working Group of Commercial Energy Firms). However, as noted above, there is no exclusion in the statutory definition for such businesses.

[244] The list of ISDA Primary Members is available at *http://www.isda.org/membership/isdamemberslist.pdf.*

[245] *See* note 188, *supra.*

[246] *See* letters cited in note 84, *supra.*

[247] *See* letters cited in note 86, *supra.* As noted above in the discussion of market making, a swap dealer may in some circumstances enter into swaps on only one side of the market.

some commenters seek. For these reasons, we continue to believe that it is appropriate to apply the multi-factor interpretive approach set forth in this Adopting Release.

In closing, we emphasize that the purpose of in this part IV.A.4 is to provide guidance as to how the rules further defining the term ''swap dealer'' will be applied in particular, complex situations where a person's status as a swap dealer may be uncertain. Even though bright-line tests and categorical exclusions are inappropriate, we recognize that the large majority of market participants use swaps for normal course hedging, financial, investment or trading purposes and are not swap dealers.

5. Final Rules and Interpretation—Definition of ''Security-Based Swap Dealer''

a. General Reliance on the Dealer-Trader Distinction

As discussed above, we are adopting a rule under the Exchange Act that defines ''security-based swap dealer'' in terms of the four statutory tests and the exclusion for security-based swap activities that are not as part of a ''regular business.'' [248] Also, we believe that the dealer-trader distinction [249]—which already forms a basis for identifying which persons fall within the longstanding Exchange Act definition of ''dealer''—in general provides an appropriate framework for interpreting the meaning of ''security-based swap dealer.'' [250] While there are differences in the structure of those two statutory definitions,[251] we believe that their parallels—particularly both definitions' exclusions for activities that are ''not part of a regular business''—warrant analogous interpretive approaches for distinguishing dealers from non-dealers.

As discussed above,[252] the Commissions note that interpretations of the applicability of the dealer-trader distinction to the ''swap dealer'' definition under the CEA do not affect existing, or future, interpretations of the dealer-trader distinction under the Exchange Act—both with regard to the ''security-based swap dealer'' definition, and with regard to the ''dealer'' definition.

In interpreting the security-based swap dealer definition in terms of the dealer-trader distinction, the Commissions have been mindful that some commenters expressed the view that we instead should rely on other interpretive factors that were identified in the Proposing Release (*e.g.,* accommodating demand). We believe, nonetheless, that the dealer-trader distinction forms the basis for a framework that appropriately distinguishes between persons who should be regulated as security-based swap dealers and those who should not. We also believe that the distinction affords an appropriate degree of flexibility to the analysis, and that it would not be appropriate to seek to codify the distinction.

At the same time, the Commissions recognize that the dealer-trader distinction needs to be adapted to apply to security-based swap activities in light of the special characteristics of security-based swaps and the differences between the ''dealer'' and ''security-based swap dealer'' definitions. Relevant differences include:

- *Level of activity*—Security-based swap markets are marked by less activity than markets involving certain other types of securities (while recognizing that some debt and equity securities are not actively traded). This suggests that in the security-based swap context concepts of ''regularity'' should account for the level of activity in the market.
- *No separate issuer*—Each counterparty to a security-based swap in essence is the ''issuer'' of that instrument; in contrast, dealers in cash market securities generally transact in securities issued by another party. This distinction suggests that the concept of turnover of ''inventory'' of securities, which has been identified as a factor in connection with the dealer-trader distinction, is inapposite in the context of security-based swaps. Moreover, this distinction—along with the fact that the ''security-based swap dealer'' definition lacks the conjunctive ''buying *and* selling'' language of the ''dealer'' definition [253]—suggests that concepts of two-sided markets at times would be less relevant for identifying ''security-based swap dealers'' than they would be for identifying ''dealers.'' [254]
- *Predominance of over-the-counter and non-standardized instruments*—Security-based swaps thus far are not significantly traded on exchanges or other trading systems, in contrast to some cash market securities (while recognizing that many cash market securities also are not significantly traded on those systems).[255] These attributes—along with the lack of ''buying *and* selling'' language in the security-based swap dealer definition, as noted above—suggest that concepts of what it means to make a market need to be construed flexibly in the context of the security-based swap market.[256]
- *Mutuality of obligations and significance to ''customer'' relationship*—In contrast to a secondary market transaction involving equity or debt securities, in which the completion of a purchase or sale transaction can be expected to terminate the mutual obligations of the parties to the

[248] *See* Exchange Act rule 3a71–1(a), (b).

[249] *See* note 31, *supra.*

[250] The principles embedded within the ''dealer-trader distinction'' are not solely useful for distinguishing persons who constitute dealers from active ''traders,'' but also are applicable to distinguishing dealers from non-dealers such as hedgers or investors. The ''dealer-trader'' nomenclature has been used for decades. *See* Loss, *Securities Regulation* 722 (1st ed. 1951) (''One aspect of the 'business' concept is the matter of drawing the line between a 'dealer' and a trader—an ordinary investor who buys and sells for his own account with some frequency.'').

[251] For example, while the ''dealer'' definition encompasses certain persons in the business of ''buying and selling'' securities, the ''security-based swap dealer'' definition does not address either ''buying'' or ''selling.'' As we noted in the Proposing Release, we do not believe that the lack of those terms in the ''security-based swap dealer'' definition leads to material interpretive distinctions, as the Dodd-Frank Act amended the Exchange Act definitions of ''buy'' and ''purchase,'' and the Exchange Act definitions of ''sale'' and ''sell,'' to encompass the execution, termination (prior to its scheduled maturity date), assignment, exchange or similar transfer or conveyance of, or extinguishing of rights or obligations under, a security-based swap. *See* Proposing Release, 75 FR at 80178 n.26 (*citing* Dodd-Frank Act sections 761(a)(3), (4), which amend Exchange Act sections 3(a)(13), (14)).

At the same time, we note that the ''dealer'' definition requires the conjunctive ''buying *and* selling''—which connotes a degree of offsetting two-sided activity. In contrast, the ''security-based swap dealer'' definition (particularly the ''regularly enters into security-based swaps'' language of the definition's third test) lacks that conjunctive terminology.

[252] *See* note 171, *supra.*

[253] *See* note 251, *supra.*

[254] The analysis also should account for the fact that a party to a security-based swap can use other derivatives or cash market instruments to hedge the risks associated with the security-based swap position, meaning that two-way trading is not necessary to maintain a flat risk book.

[255] Even though we expect trading of security-based swaps on security-based swap execution facilities or exchanges following the implementation of Title VII, we expect there to remain a significant amount of over-the-counter activity involving security-based swaps.

[256] For example, the definition of ''market maker'' in Exchange Act section 3(a)(38)—which is applicable for purposes of the Exchange Act ''unless the context otherwise requires'' (*see* Exchange Act section 3(a))—defines the term ''market maker'' to mean ''any specialist permitted to act as a dealer, any dealer acting in the capacity of block positioner, and any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis.'' That definition is useful in the context of systems in which standardized securities are regularly or continuously bought and sold, but would not be apposite in the context of non-standardized securities or securities that are not regularly or continuously transacted.

transaction, the parties to a security-based swap often will have an ongoing obligation to exchange cash flows over the life of the agreement. In light of this attribute, some market participants have expressed the view that they have ''counterparties'' rather than ''customers'' in the context of their swap activities.

It also is necessary to use the dealer-trader distinction to interpret the security-based swap dealer definition so that the statutory provisions that will govern security-based swap dealers are applied in an effective and logical way. Those statutory provisions added by the Dodd-Frank Act advance financial responsibility (*e.g.,* the ability to satisfy obligations, and the maintenance of counterparties' funds and assets) associated with security-based swap dealers' activities,[257] other counterparty protections,[258] and the promotion of market efficiency and transparency.[259] As a whole, the relevant statutory provisions suggest that we should apply the dealer-trader distinction to interpret the security-based swap dealer definition in a way that identifies those persons for which regulation is warranted either: (i) Due to the nature of their interactions with counterparties;[260] or (ii) to promote market stability and transparency, in light of the role those persons occupy within the security-based swap markets.[261]

b. Principles for Applying the Dealer-Trader Distinction to Security-Based Swap Activity

In light of the statutory security-based swap dealer definition, statutory provisions applicable to security-based swap dealers and market characteristics addressed above, the Commissions believe that the factors set forth below are relevant for identifying security-based swap dealers and for distinguishing those dealers from other market participants. This guidance seeks to address commenter requests that we further clarify the scope of the security-based swap dealer definition, and the Commissions believe that these factors provide appropriate guidance without being inflexible or allowing the opportunity for evasion that may accompany a bright-line test. At the same time, the determination of whether a person is acting as a security-based swap dealer ultimately depends on the relevant facts and circumstances. In light of the overall context in which a person's activity occurs, the absence of one or more of these factors does not necessitate the conclusion that a person is not a security-based swap dealer.[262]

• *Providing liquidity to market professionals or other persons in connection with security-based swaps.* A market participant might manifest this indication of dealer activity by accommodating demand or facilitating interest expressed by other market participants,[263] holding itself out as willing to enter into security-based swaps, being known in the industry as being available to accommodate demand for security-based swaps, or maintaining a sales force in connection with security-based swap activities.[264]

• *Seeking to profit by providing liquidity in connection with security-based swaps.* A market participant may manifest this indication of security-based swap dealer activity—which is consistent with the definition's ''regular business'' requirement—by seeking compensation in connection with providing liquidity involving security-based swaps (*e.g.,* by seeking a spread, fees or other compensation not attributable to changes in the value of the security-based swap).[265] The Commissions do not believe that this necessarily requires that a person be available to take either side of the market at any time, or that a person continuously engage in this type of activity, to be a security-based swap dealer. Although one commenter expressed the view that the security-based swap dealer definition requires that a person be consistently available to take either side of the market,[266] in our view such an approach would be underinclusive.[267]

[257] *E.g.,* capital and margin requirements (Exchange Act section 15F(e)), and requirements for segregation of collateral (Exchange Act section 3E).

[258] *E.g.,* requirements with respect to business conduct when transacting with special entities (Exchange Act sections 15F(h)(2), (h)(4), (h)(5)); disclosure requirements (Exchange Act section 15F(h)(3)(B)); requirements for fair and balanced communications (Exchange Act section 15F(h)(3)(C)); other requirements related to the public interest and investor protection (Exchange Act section 15F(h)(3)(D)); and conflict of interest provisions (Exchange Act section 15F(j)(5)).

[259] *E.g.,* reporting and recordkeeping requirements (Exchange Act section 15F(f)); daily trading records requirements (Exchange Act section 15F(g)); regulatory standards related to the confirmation, processing, netting, documentation and valuation of security-based swaps (Exchange Act section 15F(i)); position limit monitoring requirements (Exchange Act section 15F(j)(1)); risk management procedure requirements (Exchange Act section 15F(j)(2)); and requirements related to the disclosure of information to regulators (Exchange Act section 15F(j)(3)).

[260] The conclusion that a person's relationship with its counterparties can lead to associated obligations is consistent with the ''shingle theory,'' which implies a duty of fair dealing when a person hangs out its shingle to do business. *See* Securities and Exchange Commission, *Report of the Special Study of Securities Market* Part I at 238 (1963) (''An obligation of fair dealing, based upon the general antifraud provisions of the Federal securities laws, rests upon the theory that even a dealer at arm's length impliedly represents when he hangs out his shingle that he will deal fairly with the public.''; footnote omitted); Weiss, *Registration and Regulation of Brokers and Dealers* 171 (1965) (''the solicitation and acceptance by a broker-dealer of orders from customers and the confirmation of transactions do constitute a representation by the broker-dealer that he will deal fairly with his customers and that such transactions will be handled promptly in the usual manner, in accordance with trade custom'').

[261] The importance of regulating dealers due to the centrality of their market role was illustrated by the Government Securities Act of 1986. When Congress provided for the regulation of government securities dealers, Congress specifically cited the lack of regulation as contributing to the failures of several unregulated government securities dealers. *See* S. Rep. No. 99–426 (1986), as reprinted in 1986 U.S.C.C.A.N. 5395, 5400–04. The resulting statute provided for a definition of ''government securities dealer'' that in relevant part is parallel to the definitions of ''dealer'' and ''security-based swap dealer,'' particularly with regard to sharing an exclusion for activities that are not part of a ''regular business.'' *See* Exchange Act section 3(a)(44).

[262] Similarly, depending on the relevant facts and circumstances, the presence of certain of the illustrative activities described here does not necessitate the conclusion that the entity is a dealer.

[263] This is to be distinguished from an entity entering into security-based swaps for other business purposes, such as to gain economic exposure to a particular market.

[264] A sales force, however, is not a prerequisite to a person being a security-based swap dealer. For example, a person that enters into security-based swaps in a dealing capacity can fall within the dealer definition even if it uses an affiliated entity to market and/or negotiate those security-based swaps (*e.g.,* the person is a booking entity). Depending on the applicable facts and circumstances, the affiliate that performs the marketing and/or negotiation functions may fall within the Exchange Act's definition of ''broker'' (which was not revised by Title VII). *See* Exchange Act section 3(a)(4)(A).

[265] Indicia of this objective may include, but would not be limited to, maintaining separate profit/loss statements in connection with this type of activity, and/or devoting staff and resources to this type of activity.

In this regard, we believe that the issue of whether a person tends to take the prices offered in the market, rather than helping to set those prices (such as by providing quotes, placing limit orders, or otherwise accommodating demand), can be relevant as a factor for distinguishing security-based swap dealers from non-dealers. At the same time, we are mindful that a dealer may also accept the market price as part of its dealer activity (such as when a person enters into a security-based swap to offset the risk it assumes in connection with its security-based swap dealing activity); as a result, the fact that a person regularly takes the market price as part of its security-based swap transactions does not foreclose the possibility that the person may be a security-based swap dealer.

[266] *See* letter from ISDA I.

[267] It is possible for a dealer to be compensated for providing liquidity by entering into sequential offsetting positions, or by hedging the security-based swap position by using a different type of security-based swap, a swap or some other financial instrument. Accordingly, a rule of decision that permitted a person to avoid dealer regulation by providing liquidity in connection with security-based swaps, and laying off the associated risk using a different type of security-based swap, a swap or a different instrument entirely, would be susceptible to abuse. Moreover, as noted above, the

Continued

• *Providing advice in connection with security-based swaps or structuring security-based swaps.* Advising a counterparty as to how to use security-based swaps to meet the counterparty's hedging goals, or structuring security-based swaps on behalf of a counterparty, also would indicate security-based swap dealing activity. It particularly is important that persons engaged in those activities are appropriately regulated so that their counterparties will receive the protections afforded by certain of the statutory business conduct rules (*e.g.,* special entity requirements and communication requirements) [268] applicable to security-based swap dealers.[269] The Commissions recognize commenter concerns that end-users may also develop new types of security-based swaps,[270] but also recognize that the activities of end-users related to the structuring of security-based swaps for purposes of hedging commercial risk are appreciably different than being in the business of structuring security-based swaps on behalf of a counterparty.

• *Presence of regular clientele and actively soliciting clients.* These dealer-trader factors would reasonably appear to be applicable in the security-based swap context, just as they are applicable in the context of other types of securities, as indicia of a business model that seeks to profit by providing liquidity. The Commissions are mindful that some industry participants have highlighted a distinction between ''counterparties'' and ''customers'' in connection with swaps, and have suggested that they have no ''customers'' in the swap context. We do not believe such points of nomenclature are significant for purposes of identifying security-based swap dealers, however.[271]

• *Use of inter-dealer brokers.* As with activities involving other types of securities, the Commissions would expect that a person's use of an inter-dealer broker in connection with security-based swap activities to be an indication of the person's status as a dealer.

• *Acting as a market maker on an organized security-based swap exchange or trading system.* Acting in a market maker capacity on an organized exchange or trading system for security-based swaps would indicate that the person is acting as a dealer.[272] While the Commissions recognize that some commenters have expressed the view that persons who solely enter into security-based swaps on an organized security-based swap exchange or trading system should not be regulated as security-based swap dealers,[273] in our view such an approach would be contrary to the express language of the definition. This is not to say, of course, that the presence of an organized exchange or trading system is a prerequisite to being a market maker for purposes of the security-based swap dealer definition.[274] Moreover, acting as a market maker is not a prerequisite to being a security-based swap dealer.[275] On the other hand, being a member of an organized exchange or trading system for purposes of trading security-based swaps does not necessarily by itself make a person a security-based swap dealer.[276]

As with the current application of the dealer-trader distinction to the Exchange Act ''dealer'' definition, the question of whether a person is acting as a security-based swap dealer ultimately will turn upon the relevant facts and circumstances, as informed by these criteria.

c. Additional Interpretive Issues

Activity by hedgers. As noted above, a number of commenters raised concerns that an overbroad ''security-based swap dealer'' definition would inappropriately encompass persons

definition of ''security-based swap dealer'' does not contain the ''buying *and* selling'' language found in the general Exchange Act definition of ''dealer.'' Thus, while being regularly willing to enter into either side of the security-based swap market would suggest that a person is engaged in dealing activity, the absence of such activity should not necessarily lead to an inference that a person is not acting as a dealer.

We also note that some commenters have stated that two-way quoting by itself should not necessarily be enough to make a person a dealer, and some of those commenters specifically stated that a person may use two-sided quotes as part of the price discovery process or to elicit trading interest. *See, e.g.,* letter from MFA I. Here too, it is important to consider whether the activity also has a dealing business purpose, such as seeking to profit by providing liquidity. Moreover, all participants in the security-based swap market, whether or not security-based swap dealers, should be mindful of the potential application of the antifraud and anti-manipulation provisions of the federal securities laws to such activities. Section 10(b) of the Exchange Act and Exchange Act rule 10b-5 particularly prescribe the use of any manipulative or fraudulent device in connection with the purchase or sale of any security, which includes manipulative trading. *See* Terrance Yoshikawa, Securities Exchange Act Release No. 53731 (Apr. 26, 2006), 87 SEC Docket 2924, 2930–31 & n.19 (citing *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 199 (1976)). The SEC has characterized manipulation as ''the creation of deceptive value or market activity for a security, accomplished by an intentional interference with the free forces of supply and demand.'' *See Swartwood, Hesse, Inc.,* 50 S.E.C. 1301, 1307 (1992) (citing *Hochfelder,* 425 U.S. at 199; *Schreiber* v. *Burlington Northern, Inc.,* 472 U.S. 1 (1985); *Feldbaum* v. *Avon Products, Inc.,* 741 F.2d 234 (8th Cir. 1984)).

[268] The SEC has proposed rules to implement Title VII provisions relating to external business conduct standards for security-based swap dealers (as well as major security-based swap participants). *See* Exchange Act Release No. 64766 (June 29, 2011), 76 FR 42396 (July 18, 2011).

[269] This factor would also reasonably take into account whether a preexisting relationship involving other types of securities or other financial instruments is present. For example, to the extent a person has an existing broker or dealer relationship with a counterparty in connection with other types of securities, and also enters into a security-based swap with that counterparty, a reasonable inference would be that the person entered into the security-based swap in a dealer capacity. Any other approach would invite abuse, as persons could seek to leverage existing relationships of trust while avoiding regulation as a security-based swap dealer.

[270] *See* letter from FSR I.

[271] For purposes of the dealer-trader analysis, as it applies in the context of security-based swaps or any other security, we would not expect contractual provisions stating that the counterparty is not relying on the person's advice to have any significance.

[272] Under the proposal of the SEC, the Board, the OCC and the FDIC to implement the provisions of section 619 of the Dodd-Frank Act (also known as the ''Volcker Rule''), a person who claims the benefit of the market maker exception to that section's prohibitions and restrictions on proprietary trading in connection with security-based swap activities would be required to register with the SEC as a security-based swap dealer, unless the person is exempt from registration or is engaged in a dealing business outside the U.S., and is subject to substantive regulation in the jurisdiction where the business is located. *See* Securities Exchange Act Release No. 65545, 76 FR 68846, 68947 (Nov. 7, 2011) (proposed implementing rule § ___.4(b)(2)(iv)(C)).

[273] *See, e.g.,* letter from Traders Coalition.

[274] Given the current nature of the security-based swap market, including the present level of activity and the present lack of significant trading of security-based swaps on exchanges or organized trading systems, we believe that it would negate the legislative intent to interpret the definition's use of market making concepts to require the same use of quotation media that are incorporated into the interpretation of market making concepts in the context of securities that are actively traded on an organized exchange or trading system. At the same time, we recognize that routine activity in the security-based swap market is not necessarily indicative of making a market in security-based swaps. For example, persons may routinely be active in the market for purposes of hedging, to advance their investment objectives, or to engage in proprietary trading.

[275] The definition of ''security-based swap dealer'' contains four alternative tests, only two of which use market making terminology. Moreover, the third test of the security-based swap dealer definition—which addresses persons who regularly enter into security-based swaps as an ordinary course of business for their own account—appears particularly inapt as a proxy for market making activity. Transacting with customers is not an element of this alternative test. A person thus may be a security-based swap dealer even if it transacts exclusively with other market professionals. *Cf.* OCC, ''Risk Management of Financial Derivatives'' 3–4 (1997) (stating that OCC has classified banks as ''Tier I'' dealers if they act as market makers by ''providing quotes to other dealers and brokers, and other market professionals''). *Compare* letter from ISDA I (taking the view that the dealer definition should be interpreted in the context of market-making concepts).

[276] The analysis of the status of members of such exchanges and trading systems in part may be influenced by the final Exchange Act rules that govern such systems, as well as the internal rules of such systems.

using security-based swaps for hedging purposes.[277] As we stated in the Proposing Release, however, under the dealer-trader distinction the Commissions would expect persons that use security-based swaps to hedge their business risks, absent other activity, likely would not be dealers.[278] We maintain that view. In other words, to the extent that a person engages in security-based swap activity to hedge commercial risk, or otherwise to hedge risks unrelated to activities that constitute dealing under the dealer-trader distinction (particularly activities that have the business purpose of seeking to profit by providing liquidity in connection with security-based swaps), the Commissions would not expect those hedging transactions to lead a person to be a security-based swap dealer.[279] Of course, to the extent a person engages in dealing activities involving security-based swaps, the presence of offsetting positions that hedge those dealing activities would not excuse the requirement that the person register as a security-based swap dealer.[280]

No predominance test. As discussed in the Proposing Release, the Commissions do not believe that the security-based swap dealer analysis should appropriately turn upon whether a person's dealing activity constitutes that person's sole or predominant business. The separate *de minimis* exemption, however, may have the effect of excusing from dealer regulation those persons whose security-based swap dealing activities are relatively modest.

Presence or absence of a customer relationship. Although commenters have expressed the view that a person that engages in security-based swap activities on an organized market should not be deemed to be a dealer unless it engages in those activities with customers,[281] we do not agree. It is true that having a customer relationship can illustrate a business model of seeking to profit by providing liquidity, and thus provide one basis for concluding that a person is acting as a security-based swap dealer. Nonetheless, the presence of market making terminology within the definition is inconsistent with the view that a security-based swap dealer must have ''customers.'' Also, Title VII requirements applicable to security-based swap dealers address interests apart from customer protection.[282] Accordingly, to the extent that a person regularly enters into security-based swaps with a view toward profiting by providing liquidity—rather than by taking directional positions—that person may be a security-based swap dealer regardless of whether it views itself as maintaining a ''customer'' relationship with its counterparties.[283]

Criteria associated with ''holding self out'' as a dealer or being ''commonly known in the trade'' as a security-based swap dealer. The Proposing Release articulated a number of activities that could satisfy the definition's tests for a person ''holding itself out'' as a dealer or being ''commonly known in the trade'' as a dealer.[284] Several commenters criticized those proposed criteria, largely on the grounds that those criteria would inappropriately encompass end-users who seek to use security-based swaps for hedging purposes, or otherwise would be overbroad or irrelevant.[285] The Commissions recognize the significance of the concerns those commenters raised, and agree that these activities need to be considered within the context of whether a person engages in those activities with the purpose of facilitating dealing activity. While we do not believe that any of those activities by themselves would necessarily indicate that a person is acting as a security-based swap dealer, under certain circumstances they may serve as an indicia of a business purpose of seeking to profit by providing liquidity in connection with security-based swaps.[286]

6. Requests for Exclusions From the Dealer Definitions

Certain commenters have sought to exclude entire categories of persons from the dealer definitions, notwithstanding that some persons in those categories may engage in the activities set forth in the statutory definition (as further defined by the Commissions).[287] The final rules nonetheless do not incorporate categorical exclusions of persons from the dealer definitions because the statutory definitions provide that ''any person'' who engages in the activities enumerated in the definitions is covered by the dealer definitions, unless the person's activities fall within one of the statutory exceptions.[288] In this regard, it is significant that the exceptions in the dealer definitions depend on whether a person engages in certain types of swap or security-based swap activity, not on other characteristics of the person. That is, the exceptions apply for swaps between an insured depository institution and its customers in connection with originating loans,[289] swaps or security-based swaps entered into not as a part of a regular business,[290] and swap or security-based swap dealing that is below a *de minimis*

[277] *See, e.g.,* letter from Church Alliance.

[278] *See* Proposing Release, 75 FR at 80178 n.27. The Proposing Release also noted that if a person's other activities satisfy the definition of security-based swap dealer, the person must comply with the applicable requirements with regard to all of its security-based swap activities, absent an order to the contrary. We further noted in the Proposing Release that we would expect end-users to use security-based swaps for hedging purposes less commonly than they use swaps for hedging purposes.

[279] In addition, consistent with the exclusion from the dealer analysis of activities involving majority-owned affiliates, *see* part II.C, *infra,* to the extent that a person engages in activities to hedge positions subject to the inter-affiliate exclusion, absent other activity, the Commission would not expect those hedging transactions to lead a person to be a security-based swap dealer. Conversely, security-based swap activities connected with the indicia of dealing discussed above (*e.g.,* seeking to profit by providing liquidity in connection with security-based swaps) themselves would suggest security-based swap dealing activity.

[280] For example, if a person were to use other instruments to hedge the risks associated with its security-based swap dealing activity, that hedging would not undermine the obligation of the person to register as a security-based swap dealer, notwithstanding the fact that it could be asserted that the dealing positions happen to hedge those other positions.

[281] *See* letters from ISDA I and Traders Coalition.

[282] Particularly in light of the view expressed by some market participants that they only have ''counterparties'' in the swap markets, and not ''customers,'' any interpretation of the ''security-based swap dealer'' definition that is predicated on the existence of a customer relationship may lead to an overly narrow construction of the definition.

[283] For example, a person's activity involving entering into security-based swaps on a SEF may cause it to be a security-based swap dealer even in the absence of a customer relationship with any of its counterparties.

[284] As noted above, these were: contacting potential counterparties to solicit interest; developing new types of swaps or security-based swaps and informing potential counterparties of their availability and of the person's willingness to enter into the swap or security-based swap; membership in a swap association in a category reserved for dealers; providing marketing materials describing the type of swaps or security-based swaps the party is willing to enter into; and generally expressing a willingness to offer or provide a range of products or services that include swaps or security-based swaps. *See* Proposing Release, 75 FR at 80178.

[285] *See* part II.A.2.a, *supra.*

[286] While the Proposing Release identified ''membership in a swap association in a category reserved for dealers'' as a factor in connection with the ''holding out'' and ''commonly known'' tests, we recognize that, depending on the applicable facts and circumstances, such membership may not be sufficient to cause a person to be a security-based swap dealer if the person does nothing else to cause it to be considered a dealer.

[287] *See* part II.A.2.f, *supra.*

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

[289] *See* CEA section 1a(49)(A), 7 U.S.C. 1a(49)(A).

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

level.[291] The Dodd-Frank Act does not exclude any category of persons from the coverage of the dealer definitions; rather, it excludes certain activities from the dealer analysis.

Given that the statutory dealer definitions focus on a person's activity, the Commissions believe that it is appropriate to determine whether a person meets any of the tests set forth in those statutory definitions, and thus is acting as a swap dealer or security-based swap dealer, on a case-by-case basis reflecting the applicable facts and circumstances.[292] If a person's swap or security-based swap activities are of a nature to be covered by the statutory definitions, and those activities are not otherwise excluded, then the person is covered by the definitions. The contrary is equally true—a person who is not engaged in activities covered by the statutory definitions, or whose activities are excluded from the definition, is not covered by the definitions.[293] The *per se* exclusions requested by the commenters have no foundation in the statutory text, and have the potential to lead to arbitrary line drawing that may result in disparate regulatory treatment and inappropriate competitive advantages.[294]

The final rules particularly do not include any exclusions for aggregators of swaps or other persons that use swaps in connection with the physical commodity markets, including swaps in connection with the generation, transmission and distribution of electricity. It is likely, though, that a significant portion of the financial instruments used for risk management by such persons are forward contracts in nonfinancial commodities that are excluded from the definition of the term ''swap.'' [295] Such forward contracts are not relevant in determining whether a person is a swap dealer.

B. ''Swap Dealer'' Exclusion for Swaps in Connection With Originating a Loan

1. Proposed Approach

The statutory definition of the term ''swap dealer'' excludes an insured depository institution (''IDI'') ''to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer.'' [296] This exclusion does not appear in the definition of the term ''security-based swap dealer.''

Proposed CFTC Regulation § 1.3(ggg)(5) would implement this statutory exclusion by providing that an IDI's swaps with a customer in connection with originating a loan to that customer are disregarded in determining if the IDI is a swap dealer. In order to prevent evasion, the proposed rule further provided that the statutory exclusion does not apply where the purpose of the swap is not linked to the financial terms of the loan; the IDI enters into a ''sham'' loan; or the purported ''loan'' is actually a synthetic loan such as a loan credit default swap or loan total return swap.

1. Commenters' Views

Nearly all the commenters on this issue were IDIs seeking a broad interpretation of the exclusion. The commenters addressed four primary issues: (i) The type of swaps that should be covered by the exclusion; (ii) the time period during which parties would be required to enter into the swap in order for the swap to be considered to be ''in connection with originating a loan;'' (iii) which transactions should be deemed to be ''loans'' for purposes of the exclusion; and (iv) which entities should be included within the definition of IDI.

First, regarding the type of swap that should be covered by the exclusion, as proposed, § 1.3(ggg)(5) would require that the rate, asset, liability or other notional item underlying the swap be, or be directly related to, a financial term of the loan (such as the loan's principal amount, duration, rate of interest or currency). Some commenters agreed with the principle of limiting the exclusion to swaps that are connected to the financial terms of the loan, stating that the exclusion should cover any swap between a borrower and the lending IDI, so long as the swap's notional amount is no greater than the loan amount, the swap's duration is no longer than the loan's duration, and the swap's index and payment dates match the index and payment dates of the loan.[297] Another commenter, agreeing with the proposed approach, said that there is no basis to extend the loan origination exclusion to swaps related to the borrower's business risks, as opposed to the financial terms of the loan.[298]

Other commenters, though, said that this limitation to swaps connected to the financial terms of the loan was inappropriate or inconsistent with the Dodd-Frank Act, and that any swap required by the loan agreement or required by the IDI as a matter of prudent lending should be covered by the exclusion.[299] Some of the commenters arguing for the broader exclusion emphasized that the exclusion should be available for any swap with the lending IDI which reduces the borrower's risks, such as a commodity swap the borrower uses for hedging, because reduction of commodity price risks faced by the borrower also reduces the risk that the loan will not be repaid to the IDI.[300] Commenters said that if the exclusion does not apply to swaps hedging the borrower's commodity price risks, then only IDIs that are able to create a separately capitalized affiliate will be able to offer commodity swaps (because section 716 of the Dodd-Frank Act limits the ability of IDIs to offer commodity swaps), thereby reducing the availability of commodity swaps to

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

[292] The Commissions believe that a facts and circumstances approach is particularly appropriate here, where the broad terms of the statutory dealer definitions indicate that the Commissions should apply their expertise and discretion to interpret the statutory text.

[293] For example, a manufacturer, producer, processor, or merchant that enters into swaps to hedge its currency or interest rate risk, absent any facts and circumstances establishing dealing activity, is not a swap dealer.

[294] In response to the commenters concerns, the Commissions have adopted certain tailored exclusions of certain types of swaps and security-based swaps in the final rule.

[295] A coalition of not-for-profit power utilities and electric cooperatives has advised that it plans to submit a request for an exemption for transactions between entities described in section 201(f) of the Federal Power Act, as contemplated by section 722(f) of the Dodd-Frank Act. *See* letter from NFPEEU. Separately, some regional transmission organizations and independent systems operators have expressed interest in submitting an exemption application to the CFTC as well. *See generally* section 722(e) of the Dodd-Frank Act. Such exemptions, if granted after notice and comment pursuant to CEA section 4(c), 7 U.S.C. 6(c), could further address commenters' concerns in this regard.

[296] *See* CEA section 1a(49)(A), 7 U.S.C. 1a(49)(A).

[297] *See* letters from Branch Banking & Trust Company (''BB&T'') dated February 3, 2011 (''BB&T I''), B&F Capital Markets, Inc. (''B&F Capital'') dated February 18, 2011 (''B&F Capital I''), Capital One Financial Corporation (''Capital One'') and Capstar Bank (''Capstar''); *see also* joint letter from Atlantic Capital Bank, Cobiz Bank, Cole Taylor Bank, Commerce Bank, N.A., East West Bank, First Business Bank, First National Bank of Pennsylvania, Heartland Financial USA, Inc., Old National Bancorp, Peoples Bancorp of North Carolina, Inc., Susquehanna Bank, The PrivateBank and Trust Co, The Savannah Bank, N.A., The Washington Trust Company, Trustmark National Bank, UMB Financial Corporation, Valley National Bank, Webster Bank NA, WesBanco Bank (''Regional Banks'') (general support for limitation to swaps connected to financial terms of the loan).

[298] *See* letter from Better Markets I.

[299] *See* letters from BOK dated February 18, 2011 (''BOK II''), FSR I, ISDA I, Midsize Banks, OCC Staff at 6 (noting that ''[l]oan underwriting criteria for community and mid-size banks * * * may require, as a condition of the loan, that the borrower be hedged against the commodity price risks incidental to its business'') and White & Case LLP (''White & Case'') and joint letter from Senator Stabenow and Representative Lucas.

[300] *See* letters from BOK II, FSR I, OCC Staff and White & Case.

borrowers that are smaller companies.[301]

Second, regarding timing, the proposed rule requested comment on whether this exclusion should apply only to swaps that are entered into contemporaneously with the IDI's origination of the loan (and if so, how ''contemporaneously'' should be defined for this purpose), or whether this exclusion also should apply to swaps entered into during part or all of the duration of the loan. In response, commenters said that the exclusion should apply to swaps entered into in anticipation of a loan or at any time during the loan term.[302] Commenters said that application of the exclusion throughout the duration of the loan would give IDIs and borrowers flexibility as to when to fix interest rates in fixed/floating swaps relating to loans and would allow borrowers to make other hedging decisions over a longer time period.[303] Commenters also said that loans such as construction loans, equipment loans and committed loan facilities may allow for draws of loan principal over an extended period of time, and that swaps entered into by the borrower and lending IDI through the course of such a loan should be covered by the exclusion.[304]

Third, as to which transactions should be deemed ''loans'' for purposes of the exclusion, the proposal said that the exclusion should be available in connection with all transactions by which an IDI is a source of funds to a borrower, including, for example, loan syndications, participations and refinancings. Commenters agreed that the exclusion should be available for IDIs that are in a loan syndicate, purchasers of a loan, assignees of a loan or participants in a loan.[305] On loan syndications and participations in particular, one commenter said that the exclusion should be available even if the notional amount of the swap is more than the amount of the loan tranche assigned to the IDI, so long as the swap notional amount is not more than the entire amount of the loan.[306] Another commenter said that the exclusion should not be available if the IDI's participation in the loan drops below a minimum level (such as 20 percent) because such use of the exclusion by minimally-participating IDIs would invite abuse.[307]

Some commenters said that other types of transactions also should be treated as ''loans'' for purposes of the exclusion. The transactions cited by commenters in this regard include leases, letters of credit, financings documented as sales of financial assets, bank qualified tax exempt loans and bonds that are credit enhanced by an IDI.[308] Other commenters said the exclusion should apply where entities related to an IDI provide financing, such as loans or financial asset purchases by bank-sponsored commercial paper conduits where the IDI provides committed liquidity,[309] and transactions where a special purpose entity formed by an IDI is the source of financing and enters into the swap.[310] Some commenters said the exclusion should encompass all transactions where an IDI facilitates a financing,[311] or all extensions of credit by an IDI,[312] or all transactions where an IDI provides risk mitigation to a borrower.[313]

Fourth, with respect to the types of financial institutions that are eligible for the loan origination exclusion, three commenters said that IDIs, for purposes of this exclusion, encompass more than banks or savings associations with federally-insured deposits. The Farm Credit Council said the exclusion should be extended to Farm Credit System institutions because one of these institutions enters into interest rate swaps with borrowing customers identical in function to those offered by commercial banks and savings associations in connection with loans, and the institutions are subject to similar regulatory requirements and covered by a similar insurance regime.[314] Another commenter said that the exclusion should be extended to other regulated financial institutions, such as insurers, so as not to create an unlevel playing field.[315] And the Federal Home Loan Banks said that the exclusion should be available to them because they are subject to similar regulatory oversight and capital standards and engage in a similar function of extending credit as do commercial banks and savings associations.[316] In addition, some commenters said the exclusion should be broadly construed as a general matter, to encourage competition in the swap market between smaller and larger banks and to increase borrowers' choice among potential swap providers.[317]

Two commenters asked for clarification of the following technical points in the proposed rule: (i) Whether a swap would be covered by the exclusion even if it does not hedge all the risks under the loan, (ii) whether a swap that is within the exclusion could continue to be treated as covered by the exclusion by an IDI if the IDI transfers the loan, and (iii) whether an IDI should count swaps covered by the exclusion in determining if its dealing activity is above the *de minimis* thresholds.[318] Another commenter asked whether an IDI with swaps that are covered by the exclusion could be a swap dealer based on other dealing activity.[319] And others asked whether the exclusion would cover swaps used by an IDI to hedge its risks arising from a loan (*i.e.,* a swap which the IDI enters into with a party other than the loan borrower).[320]

3. Final Rule

The CFTC believes that the extent of this exclusion should be determined by

[301] *See* letters from ABA I and BOK I. Other commenters addressed the relationship between the swap dealer definition and section 619 of the Dodd-Frank Act (the ''Volcker Rule''). *See* joint letter from Capital One, Fifth Third Bancorp and Regions Financial Corporation.

[302] *See* letters from BB&T I, B&F Capital I, BOK II, Capital One, Capstar, FSR I, Midsize Banks, Manufacturers and Traders Trust Company (''M&T'') dated June 3, 2011 (''M&T I'') and September 28, 2011 (''M&T II''), Peoples Bank Co. (''Peoples Bank''), Regional Banks and White & Case.

[303] *See* letters from B&F Capital I, BOK II, Capital One, Capstar and M&T I and M&T II.

[304] *See* letters from FSR dated October 17, 2011 (''FSR VI''), M&T II and Wells Fargo Bank, N.A. (''Wells Fargo'') dated August 16, 2011 (''Wells Fargo II'').

[305] *See* letters from BB&T I, Midsize Banks, Regional Banks and White & Case; *see also* letter from Loan Market Association (providing background information on loan participations).

[306] *See* letter from Regional Banks.

[307] *See* letter from Better Markets I.

[308] *See* letters from BB&T I, Capital One, FSR I, M&T I, Midsize Banks and Regional Banks.

[309] *See* letter from FSR I.

[310] *See* letter from Midsize Banks.

[311] *See* letters from Pacific Coast Bankers' Bancshares (''PCBB'') and Regional Banks.

[312] *See* letters from FSR I and Midsize Banks.

[313] *See* letter from PCBB.

[314] Consequently, the Farm Credit Council argued, disallowing these institutions from using the exclusion would give commercial banks and savings associations a competitive advantage in agricultural lending. *See* letters from Farm Credit Council I and dated February 17, 2012 (''Farm Credit Council II''). Another commenter argued that, to the contrary, making Farm Credit System institutions eligible for the exclusion would confer an inappropriate competitive advantage on those institutions. *See* letter from ABA dated February 14, 2012 (''ABA II''). This commenter said that Farm Credit System institutions have certain advantages over other IDIs, and the commenter asserted that Farm Credit System institutions were left out of the statutory language of the exclusion in order that they would not receive additional competitive advantages. *See id.*

[315] *See* letter from NAIC.

[316] *See* letter from FHLB I. The Credit Union National Association said that the Federal Home Loan Banks should not be covered by the swap dealer definition because they do not enter into swaps for their own account as part of a regular business. *See* letter from CUNA.

[317] *See* letters from BB&T I, B&F Capital dated June 1, 2011 (''B&F Capital II''), Capital One, Capstar, M&T I and Peoples Bank.

[318] *See* letters from FSR VI and Midsize Banks.

[319] *See* letter from Better Markets I.

[320] *See* letters from B&F Capital I, FSR I, ISDA I, M&T I and Midsize Banks.

the language of the statutory definition, which relates to an IDI that ''offers to enter into a swap with a customer in connection with originating a loan with that customer.'' The expansive interpretation of the exclusion advanced by some commenters, however, would read the statute to exclude almost any swap that an IDI enters into with a loan customer. That is not the exclusion that was enacted. Instead, we interpret the statutory phrase ''enter into a swap with a customer in connection with originating a loan with that customer'' to mean that the swap is directly connected to the IDI's process of originating the loan to the customer.

Because of the statute's direct reference to ''originating'' the loan, it would be inappropriate to construe the exclusion as applying to all swaps entered into between an IDI and a borrower at any time during the duration of the loan. If this were the intended scope of the statutory exclusion, there would be no reason for the text to focus on swaps in connection with ''originating'' a loan. The CFTC recognizes the concern expressed by commenters that: (i) there be flexibility regarding when the IDI and borrower enter into a swap relating to a loan, and (ii) the expectation when an IDI originates a loan with a customer is often that the customer will enter into a swap with the IDI when there is a subsequent advance, or a draw, of principal on the loan. We do not believe, however, that the statutory term ''origination'' can reasonably be stretched to cover the entire term of every loan that an IDI makes to its customers. At some point, the temporal distance renders the link to loan origination too attenuated, and the risk of evasion too great, to support the exclusion. In order to balance these competing and conflicting considerations, the final rule applies the exclusion to any swap that otherwise meets the terms of the exclusion and is entered into no more than 90 days before or 180 days after the date of execution of the loan agreement, or no more than 90 days before or 180 days after the date of any transfer of principal to the borrower from the IDI (*e.g.,* a draw of principal) pursuant to the loan, so long as the aggregate notional amount of the swaps in connection with the financial terms of the loan at any time is no more than the aggregate amount of the borrowings under the loan at that time.[321]

Since a loan involves the repayment of funds to the IDI on particular terms, a swap that relates to those terms of repayment should be covered by the exclusion. In addition, we recognize that, as stated by commenters, requirements in an IDI's loan underwriting criteria relating to the borrower's financial stability are an important part of ensuring that loans are repaid.[322] Therefore, the final rule modifies the proposed rule to provide that the exclusion applies to swaps between an IDI and a loan borrower that are connected to the financial terms of the loan, such as, for example, the loan's duration, interest rate, currency or principal amount, or that are required under the IDI's loan underwriting criteria to be in place as a condition of the loan in order to hedge commodity price risks incidental to the borrower's business.[323] The first category of swaps generally serve to transform the financial terms of a loan for purposes of adjusting the borrower's exposure to certain risks directly related to the loan itself, such as risks arising from changes in interest rates or currency exchange rates. The second category of swaps mitigate risks faced by both the borrower and the lender, by reducing risks that the loan will not be repaid. Thus, both types of swaps are directly related to repayment of the loan. Although some commenters said that this exclusion should also apply to other types of swaps, we believe it would be inappropriate to construe this exclusion as encompassing all swaps that are connected to a borrower's other business activities, even if the loan agreement requires that the borrower enter into such swaps or otherwise refers to them.[324] In contrast to a swap that transforms the financial terms of a loan or is required by the IDI's loan underwriting criteria to reduce the borrower's commodity price risks, other types of swaps serve a more general risk management purposes by reducing other risks related to the borrower or the loan. If the purpose of the exclusion were to cover the broad range of swaps cited by some commenters (such as all swaps reducing a borrower's business risks), then the terms of the statute limiting the exclusion to swaps that are ''in connection with originating a loan with that customer'' would be superfluous.[325] To give effect to the statutory text, the exclusion is limited to a swap that is connected to the financial terms of the loan or is required by the IDI's loan underwriting criteria to to be in place as a condition of the loan in order to hedge commodity price risks incidental to the borrower's business.

Regarding the types of transactions that will be treated as a ''loan'' for purposes of the exclusion, courts have defined the term ''loan'' in other statutory contexts based on the settled meaning of the term under common law. This definition encompasses any contract by which one party transfers a defined quantity of money and the other party agrees to repay the sum transferred at a later date.[326] Rather than examine at this time the many particularized examples of financing transactions cited by some commenters, the term ''loan'' for purposes of this exclusion should be interpreted in accordance with this settled legal meaning.[327]

As stated in the proposed rule, this exclusion is available to all IDIs that are a source of a transfer of money to a borrower pursuant to a loan. The final rule adopts provisions from the proposed rule that the exclusion is available to an IDI that is a source of money by being part of a loan syndicate, being an assignee of a loan, obtaining a participation in a loan, or purchasing a loan.[328] However, the proposed rule did

[321] We note that because the exclusion is available within the specified time period around the execution of the loan agreement and any draw of principal under the loan, any amendment, restructuring, extension or other modification of the loan will, in itself, neither preclude application of the exclusion nor expand application of the exclusion.

[322] *See* letter from OCC Staff.

[323] The final rule provides that the second category of swaps must hedge a price risk related to a commodity other than an excluded commodity because if the price risk relates to an excluded commodity (such as an interest rate) the swap must be connected to the financial terms of the loan in order to be covered by the exclusion.

[324] On the other hand, there is no requirement that the loan agreement reference a swap in order for the swap to be excluded, if the swap otherwise qualifies for the exclusion.

[325] Also, we believe that the broader range of swaps serving general risk management purposes are more likely to involve concerns regarding market transparency and appropriate business conduct practices addressed by swap dealer regulation than are the narrower range of swaps that are encompassed by the exclusion.

[326] *See, e.g., In Re Renshaw,* 222 F.3d 82, 88 (2d Cir. 2000) (''Because Congress did not define the term ''loan'' for [11 U.S.C.] § 523(a)(8), we must interpret it according to its settled meaning under common law. The classic definition of a loan [is] * * * as follows: To constitute a loan there must be (i) a contract, whereby (ii) one party transfers a defined quantity of money, goods, or services, to another, and (iii) the other party agrees to pay for the sum or items transferred at a later date.'') (*citing In re Grand Union Co.,* 219 F. 353, 356 (2d Cir. 1914)).

[327] The final rule adopts provisions from the proposed rule that, in order to prevent evasion, the statutory exclusion does not apply where the IDI originates a ''sham'' loan; or the purported ''loan'' is actually a synthetic loan such as a loan credit default swap or loan total return swap. *See* CFTC Regulation § 1.3(ggg)(5)(iii).

[328] *See* CFTC Regulation § 1.3(ggg)(5)(ii). As is also stated in the Proposing Release, if an IDI were to transfer its participation in a loan to a non-IDI, then the non-IDI would not be able to claim this

not state explicitly how the notional amount of a swap subject to the exclusion must relate to the amount of money provided by an IDI that is in a loan syndicate or is an assignee of, participant in or purchaser of a loan. In this regard, some commenters said that a borrower and the IDIs in a lending syndicate need flexibility to allocate responsibility for the swap(s) related to the loan as they may agree.[329] We believe that, to allow for this flexibility, the exclusion may apply to a swap (which is otherwise covered by the exclusion) even if the notional amount of the swap is different from the amount of the loan tranche assigned to the IDI. However, we also agree with a commenter that the IDI should have a substantial participation in the loan.[330] The requirement of substantial participation would prevent an IDI from applying the exclusion where the IDI makes minimal lending commitments in multiple loan syndicates where it offers swaps, causing its swap activity to be far out of proportion to its loan activity.[331]

Therefore, the final rule includes a provision that the exclusion may apply regardless of whether the notional amount of the swap is the same as the amount of the loan, but only if the IDI is the sole source of funds under the loan or is committed to be, under the applicable loan agreements, the source of at least 10 percent of the maximum principal amount under the loan.[332] If the IDI does not meet this 10 percent threshold, the final rule provides that the exclusion may apply only if the aggregate notional amount of all the IDI's swaps with the customer related to the financial terms of the loan is no more than the amount lent by the IDI to the customer.[333] We also note that, in all cases, application of the exclusion requires that the aggregate notional amount of all swaps entered into by the borrower with any person in connection with the financial terms of the loan at any time is not more than the aggregate principal amount outstanding under the loan at that time.[334]

We also reiterate the interpretation in the Proposing Release that the word ''offer'' in this exclusion includes scenarios where the IDI requires the customer to enter into a swap, or where the customer asks the IDI to enter into a swap, specifically in connection with a loan made by that IDI.

We also continue to emphasize, as stated in the Proposing Release, that the statutory language of the exclusion limits its availability to only IDIs as defined in the statute. Regarding some commenters' statements about the competitive effect of this interpretation of the term ''insured depository institution,'' we believe that the scope of application of the swap dealer definition to various entities should be treated in the *de minimis* exception, which is available to all persons.

In order to provide clarification in response to certain technical questions raised by commenters, we note that whether a swap hedges all of the risk, or only some of the risk, of a loan is not relevant to application of the exclusion. Nor is it relevant to the exclusion if the IDI later transfers or terminates the loan in connection with which the swap was entered into, so long as the swap otherwise qualifies for the exclusion and the loan was originated in good faith and was not a sham.[335] Further, swaps that are covered by the exclusion should not be considered in determining if an IDI exceeds the *de minimis* level of swap dealing activity, because the statute provides that swaps covered by the exclusion should not be considered in determining if an IDI is a swap dealer, and the *de minimis* exception provides that it considers the ''quantity of [a person's] swap dealing.''[336] The application of the exclusion to swaps entered into by an IDI in connection with the origination of loans, however, does not mean that the IDI could not be a swap dealer because of other of the IDI's activities that constitute swap dealing. Regarding swaps used by an IDI to hedge or lay off its risks arising from a loan, we do not believe it is appropriate to treat such swaps as covered by the exclusion, because the statute explicitly limits the exclusion to swaps ''with a customer,'' which such hedging swaps are not. However, a swap that an IDI enters into for the purpose of hedging or laying off the risk of a swap that is covered by the IDI exclusion will not be considered in the *de minimis* determination, or otherwise in evaluating whether the IDI is covered by the swap dealer definition.[337]

Last, we believe it is appropriate to require that an IDI claiming the exclusion report its swaps that are covered by the exclusion to a swap data repository (''SDR''). This requirement is consistent with the prevailing practice that IDIs handle the documentation of loans made to borrowers, and will provide for consistent reporting of swaps that are covered by the exclusion, thereby allowing the CFTC and other regulators to monitor the use of the exclusion.

In sum, the final rule balances the need for flexibility in response to existing lending practices, consistent with the constraints imposed by the statutory text as enacted, against the risk of establishing a gap in the regulatory framework enacted in Title VII.[338] It provides that the exclusion may be claimed by a person that meets the following conditions: (i) The person is an IDI; (ii) the IDI enters into a swap with the borrower that does not extend beyond the termination of the loan; (iii) the swap is connected to the financial terms of the loan or is required by the IDI's loan underwriting criteria to to be in place as a condition of the loan in order to hedge commodity price risks incidental to the borrower's business; (iv) the loan is within the common law meaning of ''loan'' and it is not a sham or a synthetic loan; (v) the IDI is the source of money to the borrower in connection with the loan either directly, or (so long as the IDI is the source of at least 10 percent of the entire amount of the loan) through syndication, participation, assignment, purchase, refinancing or otherwise; (vi) the IDI

exclusion, regardless of the terms of the loan or the manner of the transfer. Similarly, a non-IDI that is part of a loan syndicate with IDIs would not be able to claim the exclusion.

[329] *See, e.g.,* letter from Regional Banks.

[330] *See* letter from Better Markets I. This commenter suggested a minimal threshold of at least 20 percent of the loan. However, we believe that a 10 percent commitment constitutes a substantial participation in the loan which supports offering of a swap up to the loan's full amount.

[331] For example, an IDI could act as a 0.1 percent participant in one hundred different loans in order to serve as the sole swap counterparty to the borrowers for hedging the borrowers' interest rate risk on the loans. Thus, by lending or committing to lend $100 million, the IDI could apply the exclusion to swaps with an aggregate notional amount of $100 billion.

[332] *See* CFTC Regulation § 1.3(ggg)(5)(i)(D)(*1*) and (*2*).

[333] *See* CFTC Regulation § 1.3(ggg)(5)(i)(D)(3).

[334] *See* CFTC Regulation § 1.3(ggg)(5)(i)(E). Paragraphs (D)(3) and (E) of this regulation refer to all swaps ''in connection with the financial terms of the loan'' in order to clarify that only such swaps are relevant in this regard. For example, if the IDI were to enter into a swap with the customer that is not in connection with the loan's financial terms, the swap would not be relevant because the exclusion would not apply to the swap.

[335] On the other hand, if the IDI were to transfer the swap (but not the loan) to another IDI, and the IDI that is the transferee of the swap is not a source of money to the borrower under the loan, then the transferee IDI would not be able to apply the exclusion to the swap.

[336] *See* CEA sections 1a(49)(A) and 1a(49)(D), 7 U.S.C. 1a(49)(A) and 1a(49)(D).

[337] An IDI that is seeking out swap counterparties to enter into swaps in order to hedge or lay off the risk of a swap that is subject to the IDI exclusion would generally not be accommodating demand for swaps or facilitating interest in swaps.

[338] The final rule text in CFTC Regulation § 1.3(ggg)(5)(i) has been revised to conform the text of the rule to the statutory provision which refers to ''an insured depository institution [that] * * * enter[s] into a swap with a customer in connection with originating a loan with that customer.'' *See* CEA § 1a(49)(A), 7 U.S.C. 1a(49)(A)

enters into the swap with the borrower within 90 days before or 180 days after the date the execution of the loan agreement, or within 90 days before or 180 days after any transfer of principal to the borrower from the IDI pursuant to the loan; (vii) the aggregate notional amount of all swaps entered into by the borrower with all persons in connection with the financial terms of the loan at any time is not more than the aggregate amount of the borrowings under the loan at that time; and (viii) the IDI agrees to report the swap to an SDR.

An IDI that enters into swaps that do not meet these conditions, and thus do not qualify for the statutory exclusion, is not necessarily required to register as a swap dealer. Rather, the IDI would apply the statutory definition and the provisions of the rule (taking into account the applicable interpretive guidance set forth in this Adopting Release), solely with respect to its swaps that are not subject to the IDI exclusion, in order to determine whether it is engaged in swap dealing activity that exceeds the *de minimis* threshold.

C. Application of Dealer Definitions to Legal Persons and to Inter-Affiliate Swaps and Security-Based Swaps

1. Proposed Approach and Commenters' Views

In the Proposing Release, the Commissions preliminarily concluded that designation as a dealer would apply on an entity-level basis (rather than to a trading desk or other business unit that is not organized as a separate legal person), and that an affiliated group of legal persons could include more than one dealer.[339] The Proposing Release also stated that the dealer analysis should consider the economic reality of swaps and security-based swaps between affiliates, and preliminarily noted that swaps or security-based swaps ''between persons under common control may not involve the interaction with unaffiliated persons that we believe is a hallmark of the elements of the definitions that refer to holding oneself out as a dealer or being commonly known as a dealer.'' [340]

Commenters supported the view that swaps and security-based swaps among affiliates should be excluded from the dealer analysis.[341] A number of commenters took the view that the dealer definitions should not apply when there is common control between counterparties, or when common control is combined with the consolidation of financial statements.[342] Some commenters suggested that this interpretation regarding the scope of the dealer definitions should incorporate concepts of affiliation that are found in other statutory and regulatory provisions.[343] Several commenters also opposed the suggestion (raised as part of the Proposing Release's request for comments) that this interpretation be limited to transactions among wholly owned subsidiaries.[344]

2. Final Interpretation and Rule

a. Application to Legal Persons

Consistent with the Proposing Release, the Commissions interpret ''person'' as used in the swap dealer and security-based swap dealer definitions to refer to a particular legal person. Accordingly, the dealer definitions will apply to the particular legal person performing the dealing activity, even if that person's dealing activity is limited to a trading desk or discrete business unit,[345] unless the person is able to take advantage of a limited designation as a dealer.[346]

b. Application to Inter-Affiliate Swaps and Security-Based Swaps

The final rules codify exclusions from the dealer definitions for a person's swap or security-based swap activities with certain affiliates.[347] These rules are consistent with the Proposing Release's recognition of the need to consider the economic reality of any swaps or security-based swaps that a person enters into with affiliates. Market participants may enter into such inter-affiliate swaps or security-based swaps for a variety of purposes, such as to allocate risk within a corporate group or to transfer risks within a corporate group to a central hedging or treasury entity.

Under the final rules, the dealer analysis will not apply to swaps and security-based swaps between majority-owned affiliates.[348] When the economic interests of those affiliates are aligned adequately—as would be found in the case of majority-ownership—such swaps and security-based swaps serve to allocate or transfer risks within an affiliated group, rather than to move those risks out of the group to an unaffiliated third party. For this reason, and as contemplated by the Proposing Release,[349] we do not believe that such

[339] *See* Proposing Release, 75 FR at 80183.

[340] *Id.* The Proposing Release further noted that sections 721(c) and 761(b)(3) give the Commissions anti-evasion authority, to the extent that an entity were to seek to use transactions between persons under common control to avoid one of the dealer definitions. *See id.* (erroneously referring to section 721(c) as section 721(b)(3).

[341] *See, e.g.,* letters from API I, COPE I, ISDA I, Midsize Banks, ONEOK, Inc. (''ONEOK'') and Peabody.

Several commenters explained the widespread use of central hedging desks to allocate risk within affiliate groups or to gather risk from within a group and lay that risk off on the market. *See, e.g.,* letters from EEI/EPSA, Kraft Foods Inc. (''Kraft''), MetLife and Prudential Financial, Inc. (''Prudential'') dated February 17, 2011 (''Prudential I'').

Some commenters particularly stated that the use of a single entity to face the market on behalf of an affiliate group had several risk-reducing and efficiency-enhancing benefits, and that those benefits would be lost if the dealer definitions were to lead corporate groups to avoid using central trading desks and instead require each affiliate to face the market as an independent end-user. *See* letters from FSR I, Philip Morris International Inc. (''Philip Morris''), Shell Trading dated June 3, 2011 (''Shell Trading II'') and Utility Group, and joint letter from ABA Securities Association, American Council of Life Insurers (''ACLI''), FSR, Futures Industry Association (''FIA''), Institute of International Bankers, ISDA and SIFMA (''Financial Associations'').

Some commenters also stated that legislative history suggested that Congress did not intend that the dealer definition capture transactions involving the use of an affiliate to hedge commercial risk. *See* letters from CDEU and Prudential I.

[342] *See* letters from CDEU (common control), Financial Associations (common control and consolidation), MetLife (consolidation), ONEOK (common control, evaluated based on whether the trading interests of the entities are aligned) and Prudential I (citing CFTC letter interpretation regarding common control).

[343] *See, e.g.,* letters from EDF Trading (proposing definition from regulations promulgated by the Federal Energy Regulatory Commission) and Peabody (proposing definition of ''affiliate'' used in federal securities laws) and joint letter from the Bank of Tokyo-Mitsubishi UFJ, Ltd., Mizuho Corporate Bank, Ltd. and Sumitomo Mitsui Banking Corp. (suggesting use of control definition in Bank Holding Company Act).

[344] *See, e.g.,* letters from Kraft and ONEOK.

[345] Within an affiliated group of companies, however, only those legal persons that engage in dealing activities will be designated as dealers; that designation will not be imputed to other non-dealer affiliates or to the group as a whole. A single affiliate group may, however, have multiple swap or security-based swap dealers.

[346] Limited designation as a dealer is addressed in more detail below in part II.E.

[347] *See* CFTC Regulation § 1.3(ggg)(6)(i); Exchange Act rule 3a71–1(d). A person's market-facing swap or security-based swap activity may still cause that person to be a dealer, even if that market-facing activity is linked to the inter-affiliate activity, to the extent that the market-facing activity satisfies the dealer definition. However, a person's market-facing swap activity for hedging purposes as defined in CFTC Regulation § 1.3(ggg)(6)(iii) would not cause that person to be a dealer.

[348] *See* CFTC Regulation § 1.3(ggg)(6)(i); Exchange Act rule 3a71–1(d)(1). For the purposes of these rules, the counterparties are majority-owned affiliates if one party directly or indirectly holds a majority ownership interest in the other, or if a third party directly or indirectly holds a majority interest in both, based on holding a majority of the equity securities of an entity, or the right to receive upon dissolution or the contribution of a majority of the capital of a partnership. *See* CFTC Regulation § 1.3(ggg)(6)(i); Exchange Act rule 3a71–1(d)(2).

[349] *See* Proposing Release, 75 FR at 80183 (noting that swaps or security-based swaps between affiliates ''may not involve the interaction with unaffiliated persons that we believe is a hallmark of the elements of the definitions that refer to

swaps and security-based swaps involve the interaction with unaffiliated persons to which dealer regulation is intended to apply.

The standard in the final rules differs from the standard suggested by the Proposing Release, which alluded to affiliates as legal persons under ''common control.'' This change is based on our further consideration of the issue, including consideration of comments that an inter-affiliate exclusion should be available when common control is combined with the consolidation of financial statements. Although we are not including a requirement that financial statements be consolidated—as we do not believe that the scope of this exclusion should be exposed to the risk of future changes in accounting standards—in our view a majority ownership standard is generally consistent with consolidation under GAAP.[350] Absent majority ownership, we cannot be confident that there would be an alignment of economic interests that is sufficient to eliminate the concerns that underpin dealer regulation.

In taking this approach, we have also considered alternatives suggested by commenters. For example, while one commenter suggested that we adopt a definition of ''affiliate'' as used in the securities laws,[351] we believe that such an approach would be too broad for the purpose of this exclusion from dealing activity, given that common control by itself does not ensure that two entities' economic interests are sufficiently aligned.[352]

c. Application to Cooperatives

Similar considerations apply, in certain situations, to cooperative entities that enter into swaps with their members in order to allocate risk between the members and the cooperative. Commenters identified two general types of such cooperatives—''cooperative associations of producers'' as defined in section 1a(14) of the CEA [353] and cooperative financial entities such as Farm Credit System institutions and Federal Home Loan Banks.[354] As is the case for affiliated groups of corporate entities, we believe that when one of these cooperatives enters into a swap with one of its members,[355] the swap serves to allocate or transfer risks within an affiliated group, rather than to move those risks from the group to an unaffiliated third party, so long as the cooperative adheres to certain risk management practices.

Accordingly, the final rules specifically provide that the dealer analysis excludes swaps between a cooperative and its members, so long as the swaps in question are reported to the relevant SDR by the cooperative and are subject to policies and procedures of the cooperative which ensure that it monitors and manages the risk of such swaps.[356] The final rules define the term ''cooperative'' to include cooperative associations of producers and any entity chartered under Federal law as a cooperative and predominantly engaged in activities that are financial in nature.[357] The cooperatives covered by this relief are subject to provisions of Federal law providing for their cooperative purpose. Cooperative associations of producers have been recognized since the passage of the Capper-Volstead Act as being permitted to engage in certain cooperative activities without violating antitrust laws.[358] Cooperative financial institutions such as the Farm Credit System institutions and Federal Home Loan Banks are chartered under Federal laws that limit their membership and require that they serve certain public purposes.[359]

We are aware that other persons commented that their swap activities should be excluded from the dealer analysis because they use swaps in connection with a cooperative or non-profit purpose, or because they aggregate demand for swaps arising from numerous small entities.[360] However, the key distinction drawn in granting this relief is that cooperatives covered by the exclusion enter into swaps with their members in order to allocate risk between the members and

holding oneself out as a dealer or being commonly known as a dealer'').

[350] *See* FASB ASC Section 810–10–25, Consolidation—Overall—Recognition (stating that consolidation is appropriate if a reporting entity has a controlling financial interest in another entity and a specific scope exception does not apply).

[351] *See* letter from Peabody. The commenter did not specify which definition of ''affiliate'' in the securities laws it was proposing. For example, Rule 405 of the Securities Act of 1933 defines affiliate in terms of common control, *see* 17 CFR 230.405, and Section 20(a) of the Exchange Act takes a similar approach. The Investment Company Act of 1940 (''ICA'') defines affiliate to include entities with a common ownership interest as low as 5 percent, ICA section 2(a)(3). Two other commenters proposed using a common control standard, perhaps also in reference to the Rule 405 definition of ''affiliate.''

[352] The definitions of ''affiliate'' and ''control'' found in Rule 405 and other securities law provisions are appropriate in the context of the prophylactic and remedial provisions in which they are found. Rule 405, for example, uses the terms ''affiliate'' and ''control'' to identify those persons that have the power to effect registration of an issuer's securities, and the broad definitions ensure that the persons with that power actually fulfill their obligation to do so. By comparison, the exclusion of inter-affiliate swaps and security-based swaps from the dealer analysis should be more tightly focused to address situations in which counterparties have similar economic interests.

Another commenter noted the definition of ''affiliate'' found in certain Federal Energy Regulation Commission regulations—which define ''affiliate'' in terms of a ten percent or five percent common ownership interest. *See* letter from EDF Trading. Those relatively low ownership thresholds, however, are intended to address different concerns regarding collusion and cross-subsidization, and do not appear appropriate for an interpretation that has the potential to reduce the counterparty and market protections provided by Title VII. *See* 18 CFR sections 35.36(a)(9), 35.39, 366.2(b), 366.3.

[353] 7 U.S.C. 1a(14). A cooperative association of producers is at least 75 percent owned or controlled, directly or indirectly, by producers of agricultural products and must comply with the Capper-Volstead Act (referred to in the CEA as the Act of February 18, 1922, 7 U.S.C. 291 and 292). *See* letters from Land O'Lakes II, NCFC I and NMPF.

[354] *See* letters from Farm Credit Council I and FHLB I. The NRU CFC qualifies as a cooperative financial entity, but we understand that it does not enter into a significant amount of swaps with its members; rather, it enters into swaps with unaffiliated third parties. *See* letter from NRU CFC I and meeting with NRU CFC on January 13, 2011.

[355] The term ''cooperative association of producers'' also includes any organization acting for a group of such associations and owned or controlled by such associations. *See* CEA section 1a(14), 7 U.S.C. 1a(14). For a cooperative association of producers that is acting for and owned or controlled by such associations, we believe that this conclusion applies to any swap between such cooperative association of producers and any cooperative association of producers that is a member of it, and any producer that is a member of any such cooperative association of producers that is itself a member of the first cooperative association of producers. *See* CFTC Regulation § 1.3(ggg)(6)(ii)(C).

However, we do not believe that this conclusion applies to any security-based swap that a cooperative association of producers may enter into, nor does it apply to any swap related to a non-physical commodity (such as a rate swap). For this reason, the exclusion for cooperative associations of producers is limited to swaps that are primarily based on a commodity that is not an excluded commodity. *See* CFTC Regulation § 1.3(ggg)(6)(ii)(A)(*3*). The term ''excluded commodity'' is defined in CEA section 1a(19), 7 U.S.C. 1a(19).

[356] *See* CFTC Regulation § 1.3(ggg)(6)(ii). To be clear, these cooperatives are not excluded from the dealer definitions. *See* part II.A.6, *supra*. Rather, swaps between a cooperative and its members (and swaps that a cooperative enters into to hedge or lay off the risk of such swaps) are excluded from the dealer analysis. If a cooperative were to engage in other swap activities that are covered by, and not otherwise excluded from, the statutory definition of the term ''swap dealer,'' then it would be required to register as a swap dealer.

[357] *See* CFTC Regulation § 1.3(ggg)(6)(ii)(B).

[358] *See* Capper-Volstead Act section 1, 7 U.S.C. 291.

[359] *See* Farm Credit Act of 1971, 12 U.S.C. 2001 et seq. and Federal Home Loan Bank Act, 12 U.S.C. 1421 et seq.

[360] *See* letter from NFPEEU (not-for-profit power utilities, electric cooperatives and related persons); letters from Farmers' Associations, NGFA I and NMPF (referring to private companies that serve as aggregators for swaps in agricultural commodities or otherwise offer swaps for agricultural risk management); and letter from Northland Energy (small energy firm that aggregates demand for swaps from small energy retailers and consumers).

the cooperative. By contrast, the other entities noted above enter into swaps with unaffiliated parties in order to transfer risks between unaffiliated parties.[361] As noted above, the Commissions believe that the contemplated scope of the statutory definitions does not include instances where a person's swap activities transfer risk within an affiliated group, but does extend to activities that create legal relationships that transfer risk between unaffiliated parties. Thus, it is appropriate that the dealer analysis exclude swaps between a cooperative and its members, but such analysis should include swaps between a cooperative or other aggregator and unaffiliated persons.

D. De Minimis Exception

1. Proposed Approach

The Dodd-Frank Act's definitions of ''swap dealer'' and ''security-based swap dealer'' require that the Commissions exempt from dealer designation any entity ''that engages in a *de minimis* quantity'' of dealing ''in connection with transactions with or on behalf of customers.'' The statutory definitions further require the Commissions to ''promulgate regulations to establish factors with respect to the making of any determination to exempt.'' [362]

In the Proposing Release, we preliminarily concluded that the *de minimis* exception ''should be interpreted to address amounts of dealing activity that are sufficiently small that they do not warrant registration to address concerns implicated by the regulations governing swap dealers and security-based swap dealers. In other words, the exception should apply only when an entity's dealing activity is so minimal that applying dealer regulations to the entity would not be warranted.'' [363] In taking this view, we rejected the suggestion that the *de minimis* exception should compare a person's swap or security-based swap dealing activities to the person's non-dealing activities.[364]

At the same time, we recognized that this proposed approach did not appear to ''readily translate into objective criteria.'' We further recognized that a range of alternative approaches may be reasonable, and we solicited comment as to what factors should be used to implement the exception.[365]

The proposed *de minimis* exception was comprised of three factors, all of which a person would have had to satisfy to avail itself of the exception.[366] The first proposed factor would have limited the aggregate effective amount, measured on a gross basis, of the swaps or security-based swaps that a person entered into over the prior 12 months in connection with its dealing activities to $100 million [367] (or $25 million with regard to counterparties that are ''special entities'').[368]

The second proposed factor would have limited a person's swap or security-based swap dealing activity to no more than 15 counterparties over the prior 12 months (while counting counterparties that are members of an affiliated group as one counterparty for these purposes). The final proposed factor would have limited a person's dealing activity to no more than 20 swaps or security-based swaps over the prior 12 months (without counting certain amendments as new swaps or security-based swaps).

2. Commenters' Views

a. Basis for the Exception

Some commenters sought to link the *de minimis* exception to systemic risk criteria by taking the position that a person should have to register as a dealer only if its dealing activities pose systemic significance.[369] One commenter specifically objected to the position in the Proposing Release that the *de minimis* exception should take into account customer protection principles.[370] On the other hand, one commenter supported the rejection of a risk-based *de minimis* test.[371]

Some commenters argued that the *de minimis* test should account for proportionality criteria that would excuse entities whose dealing activity is relatively minor compared to their other activities.[372]

b. Significance of ''Customer'' Language

One commenter took the position that the language within the *de minimis* exception that specifically referred to ''transactions with or on behalf of customers'' meant that the exception should be available only for persons who limit their swaps or security-based swaps to those that are entered into with or on behalf of customers.[373] Other commenters posited the opposite view that the ''customer'' language should be read to mean that a person's dealing activities with counterparties other than customers may be disregarded for purposes of the exception (*i.e.,* non-customer transactions would not count against the *de minimis* thresholds).[374] Some commenters argued that

[361] *See, e.g.,* letter from NFPEEU (not-for-profit power utilities and electric cooperatives generally enter into swaps between themselves, with large industrial consumers, and a wide range of other counterparties). Indeed, the Dodd-Frank Act permits the CFTC to exempt agreements, contracts or transactions between entities described in section 201(f) of the Federal Power Act, such as certain not-for-profit power utilities and electric cooperatives. *See* section 722(f) of the Dodd-Frank Act. As noted above, a coalition of not-for-profit power utilities and electric cooperatives has advised that it plans to submit a request for the exemption contemplated by section 722(f) of the Dodd-Frank Act. *See* note 295 *supra.*

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

[363] Proposing Release, 75 FR at 80179 (footnote omitted).

[364] *See id.* at 80179–80.

[365] *See id.* at 80180.

[366] Under the proposal, the factors would consider a person's swap or security-based swap dealing activity as a whole, rather than separately considering different types of swaps or security-based swaps. *See* Proposing Release, 75 FR at 80181.

[367] *See* proposed Exchange Act rule 3a71–2(a). The proposed standard reflected our understanding that in general the notional size of a small swap or security-based swap is $5 million or less, and that the proposed threshold would reflect 20 instruments of that size. The standard also sought to reflect the customer protection issues implicated by swaps and security-based swaps. *See* Proposing Release, 75 FR at 80180.

The proposed notional threshold would not consider the market risk offsets associated with combining long and short positions. In addition, the proposed notional threshold would not account for the amount of collateral held or posted by the entity, or other risk mitigating factors. *See id.*

[368] *See* proposed Exchange Act rule 3a71–2(a). As set forth by the statutory business conduct rules applicable to security-based swap dealers (as set forth in Exchange Act section 15F(h)(2)(C)), ''special entity'' refers to: Federal agencies; States, State agencies and political subdivisions (including cities, counties and municipalities); ''employee benefit plans'' as defined under the Employee Retirement Income Security Act of 1974 (''ERISA''); ''governmental plans'' as defined under ERISA; and endowments. Title VII imposes additional business conduct requirements on security-based swap dealers in connection with special entities. *See* CEA sections 4s(h)(2), 4s(h)(4), 4s(h)(5); Exchange Act section 15F(h)(2), (4), (5).

[369] *See, e.g.,* letters from CDEU, MFX II, NCGA/NGSA II and SIFMA—Regional Dealers Derivatives Committee (''SIFMA—Regional Dealers'').

[370] *See* letter from WGCEF I (arguing that basing the exception on customer protection principles would be contrary to the statutory framework, given that only ECPs are eligible to participate in off-exchange swap transactions).

[371] *See* letter from Better Markets I.

[372] *See, e.g.,* letters from FHLB I, IECA–Credit I, NCGA/NGSA I, NRG Energy, Peabody and WGCEF I. One commenter said the proportionality criteria should also consider an entity's activities with respect to the physical commodity underlying its swaps. *See* letter from NCGA/NGSA I. *But see* letter from Better Markets I (supporting rejection of a proportionality test). Some commenters suggested more than one alternative approach.

[373] *See* letter from Better Markets I. Another commenter said that the ''customer'' language serves to emphasize that the *de minimis* exception is available to entities that provide swaps to customers. *See* letter from NGFA I.

[374] *See* letters from ISDA I, Vitol and WGCEF I. Another commenter said that the use of the term ''customer'' indicates that all transactions with physical commodity customers should be disregarded in determining if a person is a dealer. *See* letter from EDF Trading.

transactions entered into in a fiduciary capacity should be disregarded for purposes of the exception.[375] One commenter questioned the proposal's use of the term ''counterparty'' in lieu of the statutory term ''customer.''[376]

c. Proposed Tests and Thresholds

Commenters criticized the proposed *de minimis* thresholds in a variety of ways. These included arguments that the proposed thresholds were inappropriately low,[377] would harm end-users by reducing the number of entities willing to enter into low-value swaps and security-based swaps,[378] would be unjustified on a cost-benefit basis,[379] and were disproportionately low compared to the activities of recognized dealers.[380] Other commenters said the *de minimis* thresholds should be set at a level to allow entities to engage in a meaningful amount of customer-facing swaps or security-based swaps without being required to register as dealers.[381]

A number of commenters particularly criticized the proposed notional threshold, with some commenters suggesting that the threshold should be based on a percentage of the total swap market[382] or some other fixed value,[383] or arguing in favor of an exposure-based threshold in lieu of a notional threshold.[384] Other commenters said that the aggregate notional amount of swaps is not a meaningful measure of an entity's dealing activity.[385] A few commenters supported the proposed notional threshold.[386]

Some commenters argued against basing the *de minimis* exception on the number of a person's swaps or security-based swaps or the number of a person's counterparties,[387] or supported increasing those thresholds above the proposed standard.[388] Commenters also suggested a variety of other alternatives to the proposed tests.[389]

d. Additional Issues

Some commenters emphasized the need to provide protections in connection with ''special entities.''[390] Certain commenters sought to identify problems related to the application of the proposed thresholds in connection with particular types of businesses or markets,[391] or to aggregators or

[375] *See, e.g.,* letter from FSR I.

[376] *See* letter from Vitol (suggesting that the proposed language meant that dealing activity involved ''customers'' but not ''counterparties'').

[377] *See, e.g.,* letters from API I, CDEU, DFA, EDF Trading, Farm Credit Council I, Growmark, Land O'Lakes dated January 13, 2011 (''Land O'Lakes I''), Midsize Banks, NCFC I, NCGA/NGSA II, New York City Bar Association—Committee on Futures and Derivatives Regulation (''NYCBA Committee''), Northland Energy, NRG Energy, Regional Banks and SIFMA—Regional Dealers. Some commenters also said that the thresholds, particularly those for swaps, should vary according to the riskiness of the swap or type of commodity underlying the swap. *See* letters from BG LNG I, Farm Credit Council I, Gavilon II, ISDA I, NFPEEU, Vitol and WGCEF I.

[378] *See, e.g.,* letters from API I, BG LNG IFarm Credit Council I, Midsize Banks, NCFC I, NGFA I, Regional Banks and SIFMA—Regional Dealers and meetings with Electric Companies on April 13, 2011, the Asset Management Group of SIFMA (''SIFMA—AMG'') on February 4, 2011 and WGCEF on April 28, 2011.

[379] *See, e.g.,* letters from CDEU and Vitol. Another commenter noted that application of a cost-benefit analysis of the *de minimis* threshold could be challenging. *See* Roundtable Transcript at 193–94 (remarks of Camille Rudge, The PrivateBank and Trust Company).

[380] *See* letter from CDEU (citing statistics indicating that the average respondent to an ISDA survey had an annual ''event volume'' of over 297,000 OTC derivatives trade processing actions); *see also* letter from Regional Banks.

[381] *See* meetings with Electric Companies on April 13, 2011, Gavilon on May 11, 2011 and WGCEF on April 28, 2011.

[382] *See* letter from COPE I (suggesting 0.001% of the total U.S. swap market, amounting to approximately $3 billion); *see also* letters from API dated June 3, 2011 (''API II''), EDF Trading, Edison Int'l, EEI/EPSA, IECA–Credit I, NCGA/NGSA II, NextEra, NFPEEU, Utility Group and WGCEF I (suggesting 0.001% of the total U.S. swap market).

[383] *See, e.g.,* meeting with Land O'Lakes on January 6, 2011 (suggesting the threshold be increased by 2 to 5 times—*i.e.,* to $200 million to $500 million); letters from Growmark, FHLB I and MFX II (each supporting $1 billion notional standard); Regional Banks (supporting $2 billion notional standard); letter from NCFC dated October 31, 2011 (''NCFC III'') (supporting alternative notional standards of $1 billion or $3 billion depending on certain assumptions); letter from FSR VI and joint letter from Capital One, Fifth Third Bancorp and Regions Financial Corporation (suggesting notional standard of at least $2 billion); letter from WGCEF dated June 3, 2011 regarding the swap dealer definition (''WGCEF V'') (suggesting notional standard of $3.5 billion); and letter from IPR–GDF Suez Energy North America (suggesting notional standard of $10 billion). Some commenters suggested more than one possible threshold.

[384] *See, e.g.,* letters from Farm Credit Council I, FSR VI and Midsize Banks. Other commenters said the threshold should account for the effect of netting. *See* letters from API II, Chesapeake Energy, Land O'Lakes I and MFX II. On the other hand, one commenter specifically supported the use of the gross notional amount. *See* letter from Greenberger.

[385] *See* letters from Farm Credit Council I, ISDA I, Land O'Lakes I, Midsize Banks, NCFC I, SIFMA—Regional Dealers and Vitol.

[386] *See* letters from AFR, Better Markets I, Greenberger and NMPF. One of these commenters said that data on credit default swaps analyzed by the SEC's Division of Risk, Strategy, and Financial Innovation indicates that the $100 million proposed notional thresholds are too high. *See* letters from Better Markets to CFTC and SEC dated April 6, 2012 (''Better Markets III'').

[387] *See, e.g.,* letters from API II, Atmos Energy, Chesapeake Energy, COPE I, EEI/EPSA, Gavilon II, IECA–Credit I, Land O'Lakes I, NCGA/NGSA II, NEM, NextEra I, NMPF, NRG Energy, Peabody and Utility Group.

[388] *See, e.g.,* letters from ISDA I (suggesting 25 transactions over 12 months); FHLB I (suggesting 25 counterparties and 50 transactions over 12 months) FSR I and Midsize Banks (each suggesting 75 counterparties and 200 transactions over 12 months); Regional Banks (suggesting 100 counterparties and 300 transactions over 12 months); Growmark and MFX II (suggesting thresholds should be increased by a factor of 10) and meeting with Land O'Lakes on January 6, 2011 (suggesting thresholds should be increased by a factor of between 2 and 5).

One commenter said the number of transaction and number of counterparty standards should be disjunctive—*i.e.,* a dealer's activity would be *de minimis* if it were below either standard. *See* letter from Northland Energy. Other commenters raised questions about how counterparties or transactions should be counted for purposes of the standard. *See* letters from CDEU (novations should not be counted as new transactions) and J.P. Morgan (members of an affiliated group should be counted as one counterparty), joint letter from BB&T, East West Bank, Fifth Third Bank, The PrivateBank and Trust Company, Regions Bank, Sun Trust Bank, U.S. Bank National Association and Wells Fargo Bank, N.A. (''Midmarket Banks'') (questioning how to count multiple borrower counterparties to a loan and swap) and meeting with Land O'Lakes on January 6, 2011 (members of a cooperative should be counted as one counterparty).

Last, some commenters said that the number of transaction or number of counterparty standards should be deleted because they are not useful as tests of *de minimis* status. *See* letters from Gavilon II (eliminate both standards) and SIFMA—Regional Dealers (eliminate number of counterparties standard).

[389] *See* letters from IECA–Credit I (suggesting that exception exclude persons whose positions either are below a notional threshold or are below a combined proportionality and revenue threshold), SIFMA—Regional Dealers (supporting annual threshold of 500 customer-facing or riskless principal swaps, consistent with the *de minimis* exception from the Exchange Act ''broker'' definition in connection with bank brokerage activity, as well as SEC rules in connection with the Exchange Act definition of ''dealer''), FHLB I (supporting non-quantitative test accounting for relatively small swap-related exposure compared to primary customer activity, collateral that also provides credit support for other business done with the customer, an existing relationship with customer and inability of customer to obtain swaps from entities that primarily are dealers), Gavilon II (alluding to use of non-quantitative tests), MFX II (suggesting establishment of a separate qualitative process by which a dealer may establish why registration is not warranted) and DC Energy (thresholds should be set at a level appropriate to support the capital levels to be required for swap dealers).

[390] *See* letters from Better Markets I (arguing that the *de minimis* exception should not be available in connection with transactions with special entities), AFR (similar), Greenberger (supporting reduction of the notional threshold for transactions with special entities to $5 million) and AFSCME. Some commenters said the standard for swaps and security-based swaps with special entities should be a notional value equal to 0.0001% of the total U.S. swap market. *See* letters from COPE I, EDF Trading, EEI/EPSA, IECA–Credit I, NFPEEU and Utility Group. One commenter said the threshold for special entities should be eliminated because it is not useful in determining *de minimis* status. *See* letter from Gavilon II.

[391] *See* letters from BG LNG I (small energy companies), COPE I and Northland Energy (each discussing commodity markets, suggesting that notional thresholds be based on the unit of a

Continued

cooperatives.[392] Other commenters suggested that the exception should focus dealer regulation toward ''financial'' entities.[393] One commenter emphasized the need for the exception to be available when the end-user is a credit union, bank or thrift.[394]

Commenters sought clarification that the *de minimis* criteria would not apply to transactions for hedging or proprietary trading purposes,[395] or to inter-affiliate transactions.[396]

Commenters also raised issues related to the exception's treatment of the proposed use of a rolling annual period for calculations,[397] the proposed use of ''effective notional amounts,'' [398] the possibility of adjusting the thresholds over time,[399] how the *de minimis* tests would apply in the context of affiliated positions,[400] and how the exception would account for swaps or security-based swaps entered into before the definition's effective date.[401]

Some commenters suggested that the *de minimis* thresholds be set higher initially to provide for efficient use of regulatory resources.[402] One commenter requested clarification that the exception would apply prospectively without regard to dealing activities taken prior to the effectiveness of Title VII.[403] One commenter requested that a person that falls above the *de minimis* tests be able to take advantage of application and re-evaluation periods akin to those associated with the major participant definitions.[404]

Two commenters expressed support for the proposed self-executing approach of the exception.[405] Some commenters requested clarification that the *de minimis* exception is independent of the loan origination exclusion in the CEA ''swap dealer'' definition.[406]

A number of commenters also addressed the application of dealer regulation to non-U.S. entities. While those comments did not specifically address the *de minimis* exception, the exception may be relevant to addressing these cross-border issues.[407]

One commenter separately addressed the credit default swap data analysis made available by CFTC and SEC staffs.[408] The commenter expressed the view that this data supported the adoption of a *de minimis* threshold of $100 million or less, particularly focusing on the number of entities that may be excluded under particular thresholds.[409]

3. Final Rules—General Principles for Implementing the *De Minimis* Exception

a. Balancing Regulatory Goals and Burdens

The Commissions recognize that implementing the *de minimis* exception requires a careful balancing that considers the regulatory interests that could be undermined by an unduly broad exception as well as those regulatory interests that may be promoted by an appropriately limited exception.

On the one hand, a *de minimis* exception, by its nature, will eliminate key counterparty protections provided by Title VII for particular users of swaps and security-based swaps.[410] The broader the exception, the greater the loss of protection.[411] Moreover, in determining the scope of the exception, it is important to consider not only the current state of the swap and security-based swap markets, but also to account for how those markets may evolve in the future. This is particularly important because the full implementation of Title VII—including enhancements to pricing transparency and the increased access to central clearing—reasonably may be expected to facilitate new entrants into the swap and security-based swap markets. To the extent that such entrants engage in dealing activity below the *de minimis* threshold—either for the long term or until their activity surpasses the threshold—the relative amount of unregistered activity within the market may be expected to increase. Accordingly, a higher *de minimis* threshold may not only result in a certain percentage of unregistered activity being transacted initially, consistent with the current market, but also may result in an even greater proportion of unregistered activity being transacted in the future.

On the other hand, the Commissions also recognize that Congress included a statutorily mandated *de minimis* exception for certain swap and security-based swap dealing activity, and that an appropriately calibrated *de minimis* exception has the potential to advance other interests. For example, the *de minimis* exception may further the interest of regulatory efficiency when

commodity), NCFC I (commodity prices), NGFA I (grain elevators) and WGCEF I (energy prices).

[392] *See, e.g.,* letters from Growmark and Land O'Lakes I.

[393] *See* letters from NEM, NextEra I, and NGFA I.

[394] *See* letter from CUNA.

[395] *See, e.g.,* letters from API I, EDF Trading, Gavilon II and SIFMA—Regional Dealers.

[396] *See, e.g.,* letter from Atmos Energy Holdings, Inc (''Atmos Holdings'').

[397] *See* letters from NCGA/NGSA I (supporting measurement of rolling period average over 12 months), NextEra I (supporting evaluation as of the last day of each calendar quarter rather than over the immediate preceding 12 months) and Northland Energy (requesting clarification that if a monetary notional amount is used, the evaluation periods should be fixed rather than rolling).

[398] *See* letters from ISDA I (stating that the use of ''effective notional amount'' in the test introduces ambiguity and uncertainty) and WGCEF I (notional amounts should be measured on a ''delta-equivalent'' basis).

[399] *See* letters from Farm Credit Council I (supporting automatic periodic increases to reflect changes in market size, the size of typical contracts and inflation), Greenberger (supporting reevaluation of the *de minimis* criteria on an ongoing basis), and BG LNG I, EEI/EPSA, NCFC I and WGCEF I (each supporting inflation or market size adjustments).

[400] *See* meeting with Edison Int'l (requesting clarification that an entity that is prohibited from coordinating its financial derivatives activities should determine whether it qualifies for the *de minimis* exception without considering financial derivatives entered into by its affiliated entities).

[401] *See* letter from Covington & Burling (urging clarification that lookback period will not commence until all the relevant regulations become effective).

[402] *See* letters from BGLNG I and WGCEF V. *See also* Roundtable Transcript at 50–51 (remarks of Ron Oppenheimer, WGCEF), 57 (remarks of Richard Ostrander, Morgan Stanley) and 208–09 (remarks of Bella Sanevich, NISA Investment Advisors).

[403] *See* letter from FSR I.

[404] *See* letter from WGCEF I; *see also* Northland Energy (supporting grace period for registration if the *de minimis* threshold is exceeded).

[405] *See* letters from ISDA I and Northland Energy.

[406] *See* letters from FSR VI and Midsize Banks.

[407] Some commenters particularly took the view that the application of the dealer definitions to non-U.S. persons should solely address those persons' U.S. dealing activities. *See* letters from FSR I, ISDA I and Société Générale. Some commenters also specifically identified concerns of international comity in this context. *See* letters cited in note 148, *supra.*

The Commissions intend to address the application of dealer regulation to non-U.S. persons as part of separate releases that generally will address the application of Title VII to non-U.S. persons.

[408] *See* letter from Better Markets III.

[409] *See id.*

[410] A number of commenters expressed particular concerns as to the threats that an overbroad exception would pose to special entities. *See* letters from AFR (noting that Congress incorporated special protections for special entities in reaction to news reports about special entities losing millions of dollars ''after signing up for derivatives deals they did not understand,'' and urging the elimination of any *de minimis* exception for transactions with special entities); Better Markets I (stating that history has shown that special entities are vulnerable to abuse, and that they need capital, collateral and business conduct protections as much as or more than any other category of market participants); and AFSCME (expressing skepticism as to the view that dealer status would preclude firms from entering into transactions with special entities). Some of those commenters also generally supported the proposed $100 million *de minimis* threshold. *See* letters from AFR and Better Markets I; *see also* letter from Greenberger (stating that the dynamic nature of the derivatives sector of the financial markets should counsel caution, and that the *de minimis* threshold should be reevaluated on an ongoing basis).

[411] Notwithstanding the reduction in protection, however, in the case of swaps and security-based swaps the general antifraud provisions of the CEA and the securities laws, respectively, including rules to be adopted by the SEC pertaining specifically to security-based swaps, will continue to apply to all transactions in security-based swaps. *See, e.g.,* CEA section 4b(2), 7 U.S.C. 6b(2).

the amount of a person's dealing activity is, in the context of the relevant market, limited to an amount that does not warrant registration to address the concerns implicated by government regulation of swap dealers and security-based swap dealers. To advance this interest, it is necessary to consider the benefits to the marketplace associated with the regulation of dealers against the total burdens and potential impacts on competition, capital formation and efficiency associated with that regulation.[412]

In addition, the exception can provide an objective test for persons who engage in some swap or security-based swap activities that, in their view, potentially raise the risk that they would be deemed to be dealers.[413] The exception also may permit persons that are not registered as dealers to accommodate existing clients that have a need for swaps or security-based swaps in conjunction with other financial services or commercial activities, thus avoiding the need for such clients to establish separate relationships with registered dealers, which may have attendant costs. The exception further may promote competition in dealing activity within the swap or security-based swap markets, by helping to allow non-registered persons to commence providing dealing services while avoiding the costs associated with full-fledged dealers. More competition within the market for swaps and security-based swaps may not only decrease the costs for participants in the market, but also may help to decrease systemic risk by lessening the current apparent concentration of dealing activity among a few major market participants.[414]

The statutory requirements that apply to swap dealers and security-based swap dealers include requirements aimed at the protection of customers and counterparties,[415] as discussed above, as well as requirements aimed at helping to promote effective operation and transparency of the swap and security-based swap markets.[416] The overall economic benefits provided by these requirements in large part will depend on the proportion of swaps and security-based swaps that are transacted subject to these requirements. In other words, the greater the dealing activity of a registered dealer, the more significant the resulting increase in market efficiency,[417] and the greater the reduction in risks faced by the entity's customers and counterparties.[418] These benefits can be expected to accrue over the long term and be distributed over the market and its participants as a whole. This is not to say, however, that it would be insignificant for any particular counterparty if its swaps or security-based swaps were to fall outside of the ambit of dealer regulation. For example, a customer or counterparty that is not protected by the business conduct rules applicable to dealers might be more likely to suffer losses associated with entering into an inappropriate or misunderstood swap or security-based swap than if the instrument was transacted pursuant to the business conduct rules applicable to registered dealers.

In contrast to the benefits associated with dealer regulation, many of the burdens of dealer regulation will accrue in the short term and will fall directly on registered dealers.[419] Some of those burdens may be expected to be independent of the amount of an entity's dealing activity (*i.e.,* entities that engage in minimal dealing activity would still be expected to face certain burdens associated with the registration process and the development of compliance and other systems if they are required to register as dealers), while other burdens (*e.g.,* the impact of margin and capital rules applicable to dealers) may be more directly linked to the amount of that entity's dealing activity.

As discussed below, the Commissions have sought to balance the various interests associated with a *de minimis* exception, as well as the benefits and burdens associated with such an exception, in developing the factors to implement the *de minimis* exceptions to the ''swap dealer'' and ''security-based swap dealer'' definitions.

However, in moving forward with implementing this balancing approach, we recognize that the information that currently is available regarding certain portions of the swap market is limited. Following the full implementation of Title VII, more information will be available to permit us to assess the effectiveness of this balancing for particular markets and to revise the exception as appropriate.

In that context—and in light of the tools currently available to us—we have been influenced, in particular, by comments taking the view that the *de minimis* factors should take into account the size and unique attributes of the market for swaps and security-based swaps.[420] We believe that factors that exclude entities whose dealing activity is sufficiently modest in light of the total size, concentration and other attributes of the applicable markets can be useful in avoiding the imposition of

[412] While we are mindful that the Commissions have yet to adopt all the final substantive rules applicable to swap dealers and security-based swap dealers, we nonetheless believe that we have sufficient understanding of those potential requirements to reasonably balance the relevant factors to identify the initial level of dealing activity that should be considered to be *de minimis.* Moreover, finalizing the dealer definitions will help provide for the orderly and informed finalization of those other substantive rules governing swap dealers and security-based swap dealers.

[413] ''Congress incorporated a *de minimis* exception to the Swap Dealer definition to ensure that smaller institutions that are responsibly managing their commercial risk are not inadvertently pulled into additional regulation.'' *See* 156 Cong. Rec. S6192 (daily ed. July 22, 2010) (letter from Senators Dodd and Lincoln to Representatives Frank and Peterson).

[414] *See* 478 through 487 and accompanying text, *infra.*

[415] As discussed above, in part, these customer and counterparty protections derive from the financial responsibility requirements applicable to dealers, particularly: capital and margin requirements (CEA section 4s(e); Exchange Act section 15F(e)), and requirements for segregation of collateral (CEA sections 4d(f), 4s(l); Exchange Act section 3E).

These customer and counterparty protections also derive from certain other requirements applicable to dealers, particularly: requirements with respect to business conduct when transacting with special entities (CEA sections 4s(h)(2), 4s(h)(4), 4s(h)(5); Exchange Act sections 15F(h)(2), (h)(4), (h)(5)); disclosure requirements (CEA section 4s(h)(3)(B); Exchange Act section 15F(h)(3)(B)); requirements for fair and balanced communications (CEA section 4s(h)(3)(D); Exchange Act section 15F(h)(3)(C)); other requirements related to the public interest and investor protection (CEA section 4s(h)(3)(D); Exchange Act section 15F(h)(3)(D)); and conflict of interest provisions (CEA section 4s(j)(5); Exchange Act section 15F(j)(5)).

[416] Relevant provisions are: reporting and recordkeeping requirements (CEA section 4s(f); Exchange Act section 15F(f)); daily trading records requirements (CEA section 4s(g); Exchange Act section 15F(g)); regulatory standards related to the confirmation, processing, netting, documentation and valuation of security-based swaps (CEA section 4s(i); Exchange Act section 15F(i)); position limit monitoring requirements (CEA section 4s(j)(1); Exchange Act section 15F(j)(1)); risk management procedure requirements (CEA section 4s(j)(2); Exchange Act section 15F(j)(2)); and requirements related to the disclosure of information to regulators (CEA section 4s(j)(3); Exchange Act section 15F(j)(3)).

[417] For example, the more swaps or security-based swaps a dealer enters into, the more significant will be the efficiency benefits associated with confirmation, processing, netting documentation and valuation requirements applicable to dealers.

[418] For example, the more swaps or security-based swaps a dealer enters into, the more significant the number of counterparties that will be protected by the disclosure and other business conduct obligations imposed on dealers.

[419] Certain commenters also have expressed concerns that the prospect of regulation may deter certain entities from engaging in limited swap or security-based swap dealing activities, *see, e.g.,* letters from SIFMA—Regional Dealers and Midsize Banks, which could reduce the availability of those instruments.

[420] *See, e.g.,* letters from CDEU (comparing proposed thresholds with statistics regarding the activities of recognized dealers) and EEI/EPSA (recommending that thresholds be set at an amount equal to 0.001 percent of the aggregate size of the U.S. swaps market, and 0.0001 percent for swaps in which the counterparty is a special entity).

regulatory burdens on those entities for which dealer regulation would not be expected to contribute significantly to advancing the customer protection, market efficiency and transparency objectives of dealer regulation. The Commissions note, however, that they are not of the general view that the costs of extending regulation to any particular entity must be outweighed by the quantifiable or other benefits to be achieved with respect to that particular entity. The Commissions, rather, analyze the overall benefits and costs of regulation, keeping in mind, as noted above, that the benefits may be distributed, accrue over the long-term, and be difficult to quantify or to measure as easily as certain costs.[421]

b. Specific Factors Implementing the *De Minimis* Exception

i. Notional Test

Consistent with the proposal, the final rules implementing the *de minimis* exception take into account the notional amount of an entity's swap or security-based swap positions over the prior 12 months arising from its dealing activity.[422] While the Commissions recognize that notional amounts do not directly measure the exposure or risk associated with a swap or security-based swap position, such measures do reflect the relative amount of an entity's dealing activity.[423] Moreover, although some commenters have posited measures of risk or exposure as alternatives to notional measures, such risk or exposure measures could, to the extent they allow for netting or collateral offsets, potentially allow an unregistered entity to engage in large amounts of swap or security-based swap dealing activity while remaining within the *de minimis* exception so long as that entity nets or collateralizes its swap or security-based swap positions. Such an outcome could undermine the customer protection and market operation benefits associated with dealer regulation. As with the proposed rules, the notional factor in the final rules is based on the notional positions of an entity over a 12 month period, rather than capping the current notional amount of a position at any time, to better reflect the amount of an entity's current activity.

The final rules, like the proposed rules, include lower notional thresholds for dealing activities in which the counterparty is a ''special entity.''[424] This is consistent with the fact that Title VII's requirements applicable to swap dealers and security-based swap dealers provide heightened protection to those types of entities.[425] It is important that the *de minimis* exception not undermine those statutory protections.[426] Also, consistent with the Proposing Release, these notional standards will be based on ''effective notional'' amounts when the stated notional amount is leveraged or enhanced by the structure of the swap or security-based swap.[427]

ii. Other Tests From the Proposing Release

The proposed rules limited the number of swaps or security-based swaps that an entity could enter into in a dealing capacity, and the number of an entity's counterparties in a dealing capacity. The final rules do not include those measures. In part, this reflects commenter concerns that a standard based on the number of swaps or security-based swaps or counterparties can produce arbitrary results by giving disproportionate weight to a series of smaller transactions or counterparties.[428]

c. Significance of Statutory ''Customer'' Language

Consistent with the Proposing Release, the final rules implementing the *de minimis* exception do not require the presence of any type of defined ''customer'' relationship.

In adopting these rules the Commissions have considered alternative approaches suggested by commenters, including one commenter's suggestion that the *de minimis* exception should be available only in connection with swaps or security-based swaps entered into as part of a ''customer'' relationship.[429] In considering that alternative view, however, we believe that it is significant that the statutory exception lacks terminology such as ''existing'' or ''preexisting'' that limits the availability of the exception or otherwise to distinguishes a ''customer'' relationship from other types of counterparty relationship. Also, while that alternative view could still permit an unregistered person to provide limited dealer services as an accommodation to an existing customer or counterparty, an interpretation that predicates the exception on the presence of a particular type of ''customer'' relationship would not advance other potential benefits associated with a *de minimis* exception, including the

[421] For example, it does not appear possible to demonstrate empirically—let alone quantify—the increase or decrease in the possibility that a financial crisis would occur at a particular future time and with a particular intensity in the absence of financial regulation or as a result of varying levels or types of financial regulation. It also is difficult to demonstrate empirically that the customer protections associated with dealer regulation would increase or decrease the likelihood that any particular market participant would suffer injury (or the degree to which the participant would suffer injury) associated with entering into an inappropriate swap or security-based swap. At the same time, certain costs may also not be readily susceptible to quantification or measurement, for example, the costs that might be associated with diminished presence, if any, of new entrants. The inability to quantify these benefits and costs does not mean that the benefits and costs of dealer regulation are any less substantial.

[422] *See* CFTC Regulation § 1.3(ggg)(4); Exchange Act rule 3a71–2(a)(1). Over the first year following the effective date of the final rules implementing the statutory definition of ''swap'' and ''security-based swap'' as set forth in CEA section 1a(47) and Exchange Act section 3(a)(68), respectively, this notional test will be based on the person's dealing activity following that effective date. *See id.* Accordingly, the analysis of whether a person may take advantage of the *de minimis* exception will not encompass the person's dealing activity prior to that effective date, given the need for the person to know whether an instrument is a swap or security-based swap for purposes of the analysis.

[423] ''Changes in notional volumes are generally reasonable reflections of business activity, and therefore can provide insight into potential revenue and operational issues. However, the notional amount of derivatives contracts does not provide a useful measure of either market or credit risks.'' OCC Quarterly Report at 8.

[424] For these purposes, ''special entity'' means: (i) A Federal agency; (ii) a state, state agency, city, county, municipality, or other political subdivision of a state; (iii) any employee benefit plan, as defined in section 3 of the Employee Retirement Income Security Act of 1974 (''ERISA''); (iv) any governmental plan, as defined in section 3 of ERISA; or (v) any endowment, including an endowment that is an organization described in section 501(c)(3) of the Internal Revenue Code of 1986. *See* CEA section 4s(h)(2)(C) and CFTC Regulation § 23.401(c); Exchange Act section 15F(h)(2)(C).

[425] *See* CEA sections 4s(h)(2), (4), (5); *see also* CFTC, Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties; Final Rule, 77 FR 9733 (Feb. 17, 2012); Exchange Act sections 15F(h)(2), (4), (5) (providing additional requirements for dealers that advise special entities or that enter into swaps or security-based swaps with special entities).

[426] The importance of the statutory protections for special entities has been highlighted by the SEC's recent action in connection with the inappropriate sale of notes linked to the performance of synthetic collateralized debt obligations to a number of school districts. According to a complaint filed in federal district court, these securities were unsuitable for the investment needs of the school districts, were sold to school districts that lacked the requisite sophistication and experience to independently evaluate the risks of the investment, and exposed the school districts to a heightened risk of catastrophic loss ultimately led to a complete loss of their investments. ''SEC Charges Stifel, Nicolaus and Former Executive with Fraud in Sale of Investments to Wisconsin School Districts,'' SEC Litigation Release No. 22064 (Aug. 10, 2011) (*http://www.sec.gov/litigation/litreleases/2011/lr22064.htm*).

[427] For example, if an exchange of payments associated with a $1 million notional equity swap was based on three times the return associated with the underlying equity, the effective notional amount of the equity swap would be $3 million.

[428] *See, e.g.,* letter from COPE I.

[429] *See* letter from Better Markets I.

benefit of providing certainty in connection with the swap or security-based swap activities of end-users.[430] Accordingly, we do not believe that the ''customer'' reference standing alone provides a sufficient basis to conclude that the exception should only be available if there is an existing relationship of some type, and the final rules neither require that a dealer accommodate the demand of an existing customer nor require the presence of a preexisting relationship for the exception to apply.

We also are not persuaded by the different commenter suggestion that the statutory *de minimis* exception's ''customer'' language means that an unregistered dealer should be permitted to engage in unlimited dealing activity so long as its counterparties are not customers.[431] Such an unlimited exception would appear to be contrary to the express language of the statutory exception. In addition, such an approach would lead to the perverse result of discouraging entities from entering into swaps or security-based swaps to facilitate risk management activities of customers (while encouraging other dealing activities), which appears contrary to Title VII's general approach of seeking to limit undue impacts on the swap and security-based swap activities of commercial end-users.

d. Focus on ''Dealing'' Activity

Some commenters suggested that we clarify that the limitations associated with the *de minimis* exception apply only in connection with a person's dealing activities, and not to the person's hedging or proprietary trading activities.[432] The Commissions agree that the *de minimis* exception is intended to permit an unregistered person to engage in a limited amount of dealing activity without regard to the person's non-dealing activity. Thus, to the extent that a particular swap or security-based swap position is not connected to dealing activity under the applicable interpretation of the statutory dealer definition, it will not count against the *de minimis* thresholds. Conversely, if a swap or security-based swap position is connected to the person's dealing activity, the position will count against those thresholds.[433]

Commenters also requested clarification that the *de minimis* thresholds do not apply to a person's inter-affiliate swaps and security-based swaps, nor apply to swaps covered by the exclusion for swaps entered into by insured depository institutions in connection with the origination of loans to customers.[434] Consistent with the discussion above,[435] such swaps or security-based swaps do not constitute dealing activity and should not be counted against the *de minimis* thresholds. Similarly, swaps between a cooperative and its members, as provided in CFTC Regulation § 1.3(ggg)(6)(ii), and swaps entered into for the hedging purpose defined in CFTC Regulation § 1.3(ggg)(6)(iii) should not be counted against the *de minimis* threshold.[436]

In light of the increased notional thresholds of the final rules, and the resulting opportunity for a person to evasively engage in large amounts of dealing activity if it can multiply those thresholds, the final rules provide that the notional thresholds to the *de minimis* exception encompass swap and security-based swap dealing positions entered into by an affiliate controlling, controlled by or under common control with the person at issue.[437] This is necessary to prevent persons from avoiding dealer regulation by dividing up dealing activity in excess of the notional thresholds among multiple affiliates.[438]

e. Alternative Approaches We Are Not Following

Certain commenters have suggested alternative approaches to implementing the *de minimis* exception. While the Commissions have considered those suggested alternatives, we do not believe that they provide the optimal framework for implementing the exception.

For example, some commenters took the position that the *de minimis* exception should focus dealer regulation on those entities whose dealing activities pose systemic risk, and excuse other dealers from having to register.[439] Such an approach, however, would fail to account for regulatory interests apart from the control of systemic risk that are addressed by dealer regulation, including statutory provisions that protect customers and counterparties in other ways, and that promote effective market operations and transparency.[440]

Some commenters also have suggested that the *de minimis* exception should subsume a proportionality

[430] As discussed above, *see* note 413, *supra,* there is legislative history that suggests that an intended purpose of the exception would be to ensure that the dealer definition does not encompass ''smaller institutions that are responsibly managing their commercial risk.''

[431] *See, e.g.,* letter from ISDA I.

[432] *See, e.g.,* letters from SIFMA—Regional Dealers and EDF Trading.

[433] For purposes of the *de minimis* exception to the security-based swap dealer definition, we note that one indicator of dealing activity under the dealer-trader distinction is that a person profit by providing liquidity in connection with security-based swaps. Accordingly, for purposes of the *de minimis* exception to the security-based swap dealer definition, a security-based swap position that hedges or otherwise offsets a position that was entered into as part of dealing activity would itself comprise part of the person's dealing activity, and hence count against the *de minimis* thresholds.

For purposes of the *de minimis* exception to the swap dealer definition, we take the view that the relevant question in determining whether swaps count as dealing activity against the *de minimis* thresholds is whether the swaps fall within the swap dealer definition under the statute and the final rules, as further interpreted by this Adopting Release. If hedging or proprietary trading activities did not fall within the definition, including because of the application of CFTC Regulation § 1.3(ggg)(6), they would not count against the *de minimis* thresholds.

[434] *See, e.g.,* letters from Atmos Holdings and FSR I.

[435] *See* parts II.B and II.C, *supra.*

[436] Swaps and security-based swaps that hedge, mitigate, or offset the types of swaps and security-based swaps discussed in the foregoing paragraph, which do not constitute dealing activity, similarly should not be counted against the *de minimis* thresholds.

[437] *See* CFTC Regulation § 1.3(ggg)(4)(i); Exchange Act rule 3a71–2(a)(1). For these purposes, we interpret control to mean the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract or otherwise. This is consistent with the definition of ''control'' and ''affiliate'' in connection with Exchange Act rules regarding registration statements. *See* Exchange Act rule 12b–2.

The final rules use a control standard in connection with the *de minimis* notional thresholds as a means reasonably designed to prevent evasion of the limitations of that exception. This contrasts with the majority-ownership standard used by the inter-affiliate exclusions from the dealer and major participant definitions. *See* parts II.C.2 and IV.G.2, *infra.* That majority-ownership standard, which in application will not be expected to be satisfied in all circumstances in which a control standard is satisfied, is reasonably designed to reflect the economic alignment that appropriately underpins those exclusions.

[438] In other words, for example, if a parent entity controls two subsidiaries which both engage in activities that would cause the subsidiaries to be covered by the dealer definitions, then each subsidiary must aggregate the swaps or security-based swaps that result from both subsidiaries' dealing activities in determining if either subsidiary qualifies for the *de minimis* exception.

The SEC expects to address the application of this principle to the security-based swap activities of non-U.S. persons in a separate release.

[439] *See, e.g.,* letters from CDEU and SIFMA—Regional Dealers.

[440] We also disagree with the suggestion that it would be inconsistent with the Title VII framework to consider customer protection issues in setting the *de minimis* factors. *See* letter from WGCEF I. While the restrictions on the availability of swaps and security-based swaps to non-ECPs help to mitigate certain customer protection concerns, Title VII includes specific safeguards designed to protect dealers' customers and counterparties regardless of whether those are ECPs. It would not be consistent with Title VII to ignore those interests.

standard, whereby an entity may be excluded from dealer regulation if its dealing activity comprises only a relatively small portion of its overall activities (or its overall swap or security-based swap activities), or if its dealing activity is ''tangential'' to its principal business.[441] We are not incorporating that type of approach into the *de minimis* factors, however, because that approach would not appear to provide a logical way to balance the benefits and burdens of dealer regulation. A proportionality approach could permit a large entity to engage in a significant amount of dealing activity without being subject to dealer regulation, thus undermining the benefits of dealer regulation. Moreover, a proportionality approach could lead to arbitrary results by excusing a large entity from dealer regulation while requiring the registration of a smaller entity that engages in less total dealing activity (if that smaller amount of dealing activity comprises a greater portion of the smaller entity's total activity).[442]

Some commenters also supported the use of non-quantitative standards in connection with the *de minimis* exception.[443] Although we recognize that such an approach may help us weigh the facts and circumstances associated with a particular person's dealing activity, we believe that it is more appropriate to base the exception on an objective quantitative standard, to allow the exception to be self-executing, and to promote predictability among market participants and the efficient use of regulatory resources. Unlike the overall definitions of ''swap dealer'' and ''security-based swap dealers,'' which consider the entirety of a person's activities with respect to swaps, the *de minimis* exception is only relevant to persons who have determined that they are engaged in swap or security-based swap dealing, and are looking to determine whether the quantity of their dealing activity is *de minimis.* For this more particular and focused determination, an objective quantitative standard is more appropriate.

Commenters also made various suggestions as to the types of factors and accompanying thresholds that should be used in connection with the *de minimis* exception. Those suggestions are addressed more specifically below in the specific context of the swap dealer and security-based swap dealer *de minimis* exceptions.

4. Final Rules—*De Minimis* Exception to Swap Dealer Definition

a. Overview of the Final Rule

After considering commenters' views, the final rule implementing the *de minimis* exception caps an entity's dealing activity involving swaps at $3 billion over the prior 12 months.[444] This amount is based on input from commenters and is supported by several rationales, including the estimated size of the domestic swap market, among others.

As noted above, commenters who suggested a fixed notional standard proposed that the standard be set at a level between $200 million and $3.5 billion in notional amount of swaps entered into over a period of twelve months.[445] In considering these comments, we are mindful of the variety of uses of swaps in various markets and therefore it is understandable that various commenters would reach different conclusions regarding the appropriate standard. At the same time, we see value in setting a single standard for all swaps so that there is a ''level playing field'' for all market participants and so that the standard can be implemented easily without the need to categorize swaps. Considering the written input of the commenters as well as the discussions of the *de minimis* standard at the Commissions' joint roundtable and numerous meetings with market participants, and the benefits of the regulation of swap dealers (*i.e.*, protection of customers and counterparties, and promotion of the effective operation and transparency of the swap markets), we believe a notional standard at a level of $3 billion appropriately balances the relevant regulatory goals.

As noted above, several commenters suggested that the standard be set at an amount equal to 0.001 percent of the overall domestic market for swaps. The Commissions note, however, that comprehensive information regarding the total size of the domestic swap market is incomplete, with more information available with respect to certain asset classes than others. The CFTC evaluated data regarding one particular type of swap—credit default swaps (''CDS'') based on indices of debt securities known as ''index CDS''—that was provided by the SEC.[446] As noted in the CFTC analysis of this data, however, the information is not filtered to reflect activity that would constitute swap dealing under the Dodd-Frank Act, so it is not possible to use the data to draw conclusions regarding any specific entity's status as a swap dealer.[447] The data reflects only activity relating to index CDS, which constitute a very narrow part of the overall swap market, and, as noted in the CFTC analysis, similar data regarding other types of swaps is not available.[448] Subject to these limitations, the data may help evaluate the impact of alternative approaches to implementing the *de minimis* exception.

One often-cited measure of the market, the Quarterly Report on Bank Trading and Derivatives Activities issued by the OCC (''OCC Quarterly Report'') is both limited, in that it includes only data related to the activities of U.S. bank holding companies, commercial banks and trust companies, and over-inclusive, in that it includes activities related to instruments that are not or may not be included in the final definition of ''swap'' (including futures, forwards, certain foreign exchange instruments, and certain options) and it includes both swaps and security-based swaps. Nonetheless, the Commissions believe that the available (imperfect) data suggests that a $3 billion notional standard is generally consistent with the commenters' suggestion of basing the standard on a percentage of the overall domestic market for swaps.

The total notional value of $333.1 trillion in ''derivatives'' stated in the most recent OCC Quarterly Report includes approximately $221.1 trillion

[441] *See* letter from FHLB I.

[442] As discussed below, if an entity is a dealer, the regulations applicable to dealers in general will govern all of the entity's swap or security-based swap activities and positions. Depending on the applicable facts and circumstances, however, the entity may be able to avail itself of a limited purpose designation as a dealer. *See* part II.E, *infra.*

[443] *See* letters from FHLB I, Gavilon II, and MFX II.

[444] CFTC Regulation § 1.3(ggg)(4). As noted above, for the first year following the effective date of the rules implementing the definition of ''swap'' the analysis would only address activity following that effective date. For clarity, the final rule also has been revised from the proposal to provide that persons taking advantage of the exception ''shall be deemed not to be'' swap dealers (the proposed rule used the phrasing ''shall not be deemed to be'' swap dealers) The final rule also reflects certain structural changes consistent with the substantive changes from the proposed rule. In addition, as discussed above, *see* part II.D.3.d, *supra,* the final rule has been revised to provide that the notional thresholds to the *de minimis* exception encompass swap dealing positions entered into by an affiliate controlling, controlled by or under common control with the person at issue.

[445] One commenter suggested a threshold of $3 billion. *See* letter from COPE I (suggesting 0.001% of the total U.S. swap market, amounting to approximately $3 billion). Other commenters also supported a threshold of 0.001% of the total U.S. swap market. *See* letters cited in note 382, *supra.*

[446] The CFTC analysis was made available to the public. *See* memorandum to the public comment file from the CFTC Office of the Chief Economist.

[447] *See id.*

[448] *See id.*

in ''swaps'' and ''credit derivatives.''[449] Since some instruments that are security-based swaps are included in this total,[450] the total notional value of swap positions at U.S. bank holding companies, commercial banks and trust companies at the end of the second quarter of 2011 of may be estimated to be somewhat less than $221.1 trillion.

This total notional value is by nature under-inclusive, because it reflects only swap positions at U.S. bank holding companies, commercial banks and trust companies and not the swap positions of other market participants. However, there are also reasons that the information from the OCC Quarterly Report may overstate the notional value of swaps that would be relevant to estimating the size of the domestic swap market for purposes of the *de minimis* standard. While we believe the data is not sufficiently precise at this time to serve as the sole basis for the notional standard, a standard of $3 billion seems that it is likely generally consistent with 0.001 percent of the domestic swap market that would be relevant to a potential dealer's *de minimis* swap activity figure. First, the large majority of derivatives in the OCC Quarterly Report (approximately $229 trillion in notional value for commercial banks and trust companies) are derivatives between ''dealers'' (as defined for the purposes of the report.)[451] Thus, it is likely that a large part of the derivatives in the OCC Quarterly Report reflect transactions between financial institutions that will be swap dealers. It is also notable that approximately $204.6 trillion in notional value of the derivatives (*i.e.,* not only swaps) reported by U.S. commercial banks were interest rate contracts, many of which are swaps entered into by IDIs with customers in connection with the origination of loans which will be excluded from the determination of whether the IDIs are swap dealers.[452] Finally, the OCC Quarterly Report measures swap positions held at a certain point in time, rather than the level of swap activity over a certain time period, again indicating that the figures are broader than those that would be subject to the *de minimis* figure. Accordingly, it appears that notional amount of the overall domestic market for swaps that actually would be relevant to determining the notional standard, and thus the appropriate basis for the 0.001 percent calculation, may be significantly lower than $331 trillion.

Because there is merit in the 0.001 percent ratio suggested by several commenters, we believe an appropriate balance of the goal of promoting the benefits of regulation (while recognizing the unquantifiable nature of those benefits) against the competing goal of avoiding the imposition of burdens on those entities for which regulation as a dealer would not be associated with achieving those benefits in a significant way, would be reached by setting the notional standard for swaps at a level that is near (taking into account the uncertainties noted above) 0.001 percent of a reasonable estimate of the overall domestic market for all swaps between all counterparties. We believe a $3 billion notional value standard is appropriate taking all these considerations into account.

b. Dealing Activity Involving Special Entities

For swaps in which the counterparty is a special entity, the final rules set a notional standard consistent with the proposal of $25 million over the prior 12 months.[453] The Commissions believe that this notional standard is appropriate in light of the special protections that Title VII affords to special entities. In adopting this threshold, we recognize the serious concerns raised by commenters stating that the *de minimis* exception should not permit any dealing activities (by persons who are not registered as swap dealers) involving special entities, in light of losses that special entities have incurred in the financial markets.[454] However, the final rule does not fully exclude such dealing activity from the exception, in light of the potential benefits that may arise from a *de minimis* exception. In this way, the threshold would not completely foreclose the availability of swaps to special entities from unregistered dealers, but the threshold would limit the financial and other risks associated with those positions for a special entity, which would in turn limit the possibility of inappropriately undermining the special protections that Title VII provides to special entities.

c. Phase-in Procedure

The Commissions believe that a phase-in period for the *de minimis* threshold would facilitate the orderly implementation of Title VII by permitting market participants and the Commissions to familiarize themselves with the application of the swap dealer definition and swap dealer requirements and to consider the information that will be available about the swap market, including real-time public reporting of swap data and information reported to swap data repositories. In addition, a phase-in period would afford the Commissions additional time to study the swap markets as they evolve in the new regulatory framework and allow potential swap dealers that engage in smaller amounts of activity (relative to the current size of the market) additional time to adjust their business practices, while at the same time preserving a focus on the regulation of the largest and most significant swap dealers. The Commissions also recognize that the data informing their current view of the *de minimis* threshold is based on the markets as they exist today, and that the markets will evolve over the coming years in light of the new regulatory framework and other developments.

We have also considered that there may be some uncertainty regarding the exact level of swap dealing activity, measured in terms of a gross notional amount of swaps, that should be regarded as *de minimis.* While some quantitative data regarding the usage of swaps is available, there are many aspects of the swap markets for which definitive data is not available. We have also considered comments suggesting that the *de minimis* thresholds should be set higher initially to provide for efficient use of regulatory resources,[455] or that implementation of the dealer requirements should be phased.[456] For

[449] *See* Office of the Comptroller of the Currency, ''Quarterly Report on Bank Trading and Derivatives Activities, Second Quarter 2011'' at tables 1 and 2 (*http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq211.pdf*). These totals reflect the sum of the amounts reported for the top 25 bank holding companies reported in table 1 and for all but the top 25 commercial banks and trust companies reported in table 2.

However, this adjustment is only approximate, because the definitions of ''swap'' and ''credit derivative'' used in the OCC Quarterly Report are likely to be significantly different from the final definition of ''swap'' and ''security-based swap'' for purposes of the Dodd-Frank Act. For the same reason, it is uncertain how many of the notional value of $54.5 trillion in options reported in the OCC Quarterly Report are swaps or security-based swaps.

Also, data from the CDS trade information warehouse maintained by the Depository Trust & Clearing Corporation (''DTCC'') indicates that total global notional CDS positions on indices amount to approximately $10.47 trillion. *See http://dtcc.com/products/derivserv/data_table_i.php?tbid=3* (data for the week ending October 7, 2011, obtained on October 17, 2011).

[450] *See* part II.D.5, *infra,* for a discussion of the size of the security-based swap market.

[451] *See* OCC Quarterly Report at Graph 1.

[452] *See* OCC Quarterly Report at Graph 3.

[453] CFTC Regulation § 1.3(ggg)(4)(i).

[454] *See* letters from AFR and Better Markets I.

[455] *See* letters cited in footnote 402, *supra.*

[456] *See, e.g.,* Roundtable Transcript at 35 (remarks of Ron Filler, New York Law School) and letters from FSR dated May 12, 2011 (''FSR III'') and WGCEF V.

all these reasons, the Commissions believe it is appropriate that the final rules provide for a phase-in period following the effective date during which higher *de minimis* thresholds would apply.

In particular, during this phase-in period, a person's swap dealing activity over the prior 12 months is capped at a gross notional value of $8 billion.[457] With respect to swaps with special entities, the Commissions believe it is appropriate that the $25 million gross notional value threshold apply during the phase-in period.[458] In light of the available data—and the limitations of that data in predicting how the full implementation of Title VII will affect dealing activity in the swap markets—the Commissions believe that the appropriate threshold for the phase-in period is an annual gross notional level of swap dealing activity of $8 billion or less. In particular, the $8 billion level should still lead to the regulation of persons responsible for the vast majority of dealing activity within the swap markets.

Accordingly, the Commissions believe that while a $3 billion notional threshold reflects an appropriate long-term standard based on the available data,[459] it also is appropriate to allow a degree of latitude in applying the threshold over time in the event that subsequent developments in the markets or the evaluation of new data from swap data reporting facilities suggest that the thresholds should be adjusted. In particular, the implementation of swap data reporting under the Dodd-Frank Act may result in new data that would be useful in confirming the Commissions' determination to establish the $3 billion threshold which applies after the phase-in period.

For these reasons, review of the *de minimis* exception will comprise an important part of the reports that the CFTC is directing its staff to conduct with regard to the swap dealer definition during the phase-in period. Among other topics, the report should consider market data addressing swap dealing activity over a period of approximately two years, and any resulting changes in swap dealing activity, by dealers above and below the $8 billion phase-in threshold, and above and below the $3 billion level applicable after the phase-in period. The report is required to be completed by the CFTC staff no later than 30 months following the date that a swap data repository first receives swap data under the CFTC's regulations, and the report will be published for public comment.[460] The CFTC will take this report, in conjunction with any public comment on it, into account in weighing further action on the *de minimis* exception at the end of the phase-in period.

The final rules provide that nine months after publication of its staff report, the CFTC may, in its discretion, either promulgate an order that the phase-in period will end as of the date set forth by the CFTC in that order, or issue for public comment a notice of proposed rulemaking to modify the *de minimis* threshold, in which case the CFTC would also issue an order establishing the date that the phase-in period will end.[461] The period of nine months provided in the rule is intended to provide the CFTC an opportunity to consider its staff report, public comments on the staff report and any other relevant information.

The CFTC recognizes that the determination of the appropriate *de minimis* threshold is a significant issue requiring thorough consideration of a variety of regulatory and market factors. At the same time, the CFTC recognizes the need for predictability in how the *de minimis* exception will apply. Therefore, the final rules include a finality provision, stating that the phase-in period will end no later than five years after the date that a swap data repository first receives swap data under the CFTC's regulations.[462]

Persons who are able to avail themselves of the higher *de minimis* threshold that applies during the phase-in period will not be required to do so. In particular, a person that is engaged in dealing activity involving swaps in excess of the $3 billion threshold may choose to commence the process for registering as a swap dealer during the phase-in period.[463]

d. CFTC Staff Report

As noted above, the CFTC is directing its staff to report to the CFTC as to whether changes are warranted to the rules implementing the swap dealer definition, including the rule implementing the *de minimis* exception. We are mindful that following the full implementation of Title VII—which itself is contingent on the implementation of the dealer definition—more data will be available to the CFTC via swap data repositories. We expect that this additional data will assist the CFTC in testing the assumptions and addressing the effects of the final rule we are adopting to implement the *de minimis* exception. For example, this data should help the CFTC assess, among other things, the nature and amount of unregulated dealing activity that occurs under the $3 billion threshold. The CFTC will make this report available for public comment so that it may benefit from additional input and analysis regarding the swap dealer definition.

By making use of post-implementation data, the staff report (together with public comment on the report) will help the CFTC better evaluate the exception in light of potential market changes resulting from the full implementation of Title VII—including market changes resulting from the *de minimis* exception itself—as part of determining whether revised *de minimis* thresholds would be appropriate. The report and public comment thereon will also be taken into consideration by the CFTC in determining what action, if any, to take with respect to the phase-in period associated with the *de minimis* exception.

The final rules provide, moreover, that the CFTC may change the requirements of the *de minimis* exception by rule or regulation.[464] Through this mechanism, the CFTC may revisit the rule implementing the exception and potentially change that rule, for example, if data regarding the post-implementation swap market suggests that different *de minimis* thresholds would be appropriate.[465] In determining whether to revisit the thresholds, the CFTC intends to pay particular attention to whether the *de minimis* exception results in a swap dealer definition that encompasses too many entities whose activities are not

[457] *See* CFTC Regulation § 1.3(ggg)(4)(i).

[458] This limitation regarding swaps with special entities during the phase-in period is consistent with the Dodd-Frank Act's goal of helping special entities be in a position to benefit from the counterparty protections associated with the regulation of registered swap dealers under Title VII.

[459] *See, e.g.,* part II.D.4.a, *supra.*

[460] *See* CFTC Regulation § 1.3(ggg)(4)(ii)(C).

[461] *See* CFTC Regulation § 1.3(ggg)(4)(ii)(C).

[462] *See* CFTC Regulation § 1.3(ggg)(4)(ii)(D).

[463] *See* CFTC Regulation § 1.3(ggg)(4)(vi).

[464] CFTC Regulation § 1.3(ggg)(4)(v). CEA section 1a(49)(D) (like Exchange Act section 3(a)(71)(D)) particularly states that the ''Commission''—meaning the CFTC—may exempt *de minimis* dealers and promulgate related regulations. We do not interpret the joint rulemaking provisions of section 712(d) of the Dodd-Frank Act to require joint rulemaking here, because such an interpretation would read the term ''Commission'' out of CEA section 1a(49)(D) (and Exchange Act section 3(a)(71)(D)), which themselves were added by the Dodd-Frank Act.

[465] *See* letter from Greenberger (stating that the dynamic nature of the derivatives sector of the financial markets should counsel caution, and that the *de minimis* threshold should be reevaluated on an ongoing basis).

significant enough to warrant full regulation under Title VII, or, alternatively, whether the *de minimis* exception leads an undue amount of dealing activity to fall outside of the ambit of the Title VII regulatory framework, or leads to inappropriate reductions in counterparty protections (including protections for special entities). The CFTC also intends to pay particular attention to whether alternative approaches would more effectively promote the regulatory goals that may be associated with a *de minimis* exception.

5. Final Rules—*De Minimis* Exception to ''Security-Based Swap Dealer'' Definition

a. Overview of the Final Rule

The final rule implementing the *de minimis* exception to the ''security-based swap dealer'' definition has been revised from the proposal in a number of ways. As discussed above, the final rule does not incorporate proposed limits on the number of security-based swaps that a person may enter into in a dealing capacity, or on the number of security-based swap counterparties a person may have when acting in a dealing capacity.[466] Moreover, the provisions of the exception that cap an unregistered person's annual notional dealing activity with counterparties other than ''special entities'' have been increased from the proposed $100 million threshold.[467] Instead, the final rule caps such dealing activity involving security-based swaps that are credit default swaps—which largely would consist of single-name credit default swaps—at $3 billion in notional amount over the prior 12 months.[468] For other types of security-based swaps (*e.g.,* single-name or narrow-based equity swaps or total return swaps), the exception caps an unregistered person's dealing activity at $150 million in notional amount over the prior 12 months.[469] Also, as addressed below, the final rule provides for phase-in levels in excess of those $3 billion and $150 million thresholds for a certain period of time.

In addition, consistent with the proposal, the final rule caps an unregistered person's security-based swap dealing activity involving counterparties that are ''special entities'' at $25 million in notional amount over the prior 12 months.[470] The final rule further provides that the SEC may establish alternative methods of determining the scope of the *de minimis* exception by rule or regulation.[471]

b. Interests Associated With a *De Minimis* Exception

In developing this final rule, we have sought to balance the interests advanced by the *de minimis* exception against the protections that would be weakened were the exception applied in an overbroad manner. In making this evaluation, we have taken into account data regarding the security-based swap market and especially data regarding the activity—including activity that may be suggestive of dealing behavior—of participants in the single-name credit default swap market.[472]

As discussed above, a *de minimis* exception eliminates key Title VII protections for some market participants by regulating less dealer activity. Conversely, an appropriately applied *de minimis* exception may provide an objective test when there is doubt as to whether particular activities may cause a person to be deemed to be a dealer;[473] allow non-dealers to accommodate the incidental security-based swap needs of existing clients; and help to facilitate competition by allowing the entry of new dealers into the market. In addition, as discussed above, a *de minimis* exception may promote regulatory efficiency by providing a framework to help focus dealer regulation upon those entities for which such regulation is warranted, rather than upon entities that engage in relatively limited amounts of dealing activity.[474]

i. Providing for Regulatory Coverage of the Vast Majority of Dealing Activity

In seeking to develop a *de minimis* exception that preserves key counterparty and market protections while promoting regulatory efficiency, we have considered the comparative amount of security-based swap dealing activity that could fall outside the ambit of dealer regulation as a result of the exception. In doing so we have considered not only the security-based swap market as it currently exists, but also how the market reasonably may be expected to change after the full implementation of Title VII.

In performing this comparative exercise we are, in part, drawing inferences from the CDS Data Analysis, a dataset released by the SEC staff that characterizes nearly all transactions in single-name credit default swaps during the 2011 calendar year.[475] Though the final rules apply to all security-based swaps, not just single-name credit

[466] *See* part II.D.3.b, *supra.*

[467] For clarity, the final rule also has been revised from the proposal to provide that persons taking advantage of the exception ''shall be deemed not to be'' dealers (the proposed rule used the phrasing ''shall not be deemed to be'' dealers), and to provide that such persons ''shall not be subject to Section 15F of the Exchange Act and the rules, regulations and interpretations issued thereunder.'' *See* Exchange Act rule 3a71–2(a). The final rule also reflects certain structural changes consistent with the substantive changes from the proposed rule.

In addition, as discussed above, *see* part II.D.3.d, *supra,* the final rule has been revised to provide that the notional thresholds to the *de minimis* exception encompass swap and security-based swap dealing positions entered into by an affiliate controlling, controlled by or under common control with the person at issue.

[468] Exchange Act rule 3a71–2(a)(1)(i). The final rule, like the proposal, requires the analysis of *de minimis* levels to be based on effective notional amounts to the extent that the stated notional amount is leveraged or enhanced by the structure of the security-based swap (such as, for example, if the exchange of payments associated with an equity swap was based on a multiple of the return associated with the underlying equity). *See* Exchange Act rule 3a71–2(a)(3).

It is important to recognize that while these types of *de minimis* principles are relevant to the ''security-based swap dealer'' definition, they are not applicable to the general definitions of ''broker'' and ''dealer'' under the Exchange Act, or the broker-dealer registration requirements of Exchange Act section 15(a). Unlike the ''security-based swap dealer'' definition, those other definitions, with the exception of the bank-broker definition in section 3(a)(4)(B)(xi) of the Exchange Act, lack *de minimis* exceptions.

[469] Exchange Act rule 3a71–2(a)(1)(ii).

[470] Exchange Act rule 3a71–2(a)(1)(iii).

[471] Exchange Act rule 3a71–2(d); *see* part II.D.5.f, *infra.*

[472] Certain data has been addressed by an analysis regarding the market for single-name credit default swaps performed by the SEC's Division of Risk, Strategy, and Financial Innovation. *See* ''Information regarding activities and positions of participants in the single-name credit default swap market'' (Mar. 15, 2012) (available at *http://www.sec.gov/comments/s7-39-10/s73910-154.pdf*) (''CDS Data Analysis''). We believe that the data underlying this analysis provides reasonably comprehensive information regarding the credit default swap activities and positions of U.S. market participants, but note that the data does not encompass those credit default swaps that both: (i) do not involve U.S. counterparties; and (ii) are based on non-U.S. reference entities. Our reliance on this data, which we believe to be the best available, should not be interpreted to indicate our views as to the nature or extent of the application of Title VII to non-U.S. persons; instead, the SEC anticipates that issues regarding the extraterritorial application of Title VII will be addressed in a separate release.

As discussed below, *see* notes 476 and 485, *infra,* we also have considered more limited publicly available data regarding equity swaps.

The CDS Data Analysis also included an appendix of data regarding index credit default swaps. We do not consider that data for purposes of the analysis described in this section because the statutory definition of ''security-based swap'' in relevant part encompasses swaps based on single securities or on narrow-based security indices. *See* Exchange Act sec. 3(a)(68)(A); *see also* Exchange Act Release No. 64372, 76 FR 29818 (May 23, 2011) (proposed rules further defining ''security-based swap'' and certain other terms).

[473] We believe that the application of the dealer-trader distinction and the guidance we have provided that distinguishes hedging activities from dealing activities in the security-based swap market will also help dealers meet their obligations.

[474] *See* part II.D.3.a, *supra.*

[475] *See* note 472, *supra.*

default swaps, the SEC believes that these data are sufficiently representative of the market to help inform the analysis because an estimated 95 percent of all security-based swap transactions appear likely to be single-name credit default swaps.[476] The SEC also recognizes that although the *de minimis* exception is applicable to persons only with respect to their dealing activity, the CDS Data Analysis contains transactions reflecting both dealing activity and non-dealing activity, including transactions by persons who may engage in no dealing activity whatsoever.[477]

As described more fully in the CDS Data Analysis, to ascertain which entities might be transacting as dealers, and which may not be, various criteria were employed as indicia of possible dealing activity. In each case, the results suggest the great extent to which there is currently a high degree of concentration of potential dealing activity in the single-name credit default swap market. For example, using the criterion that dealers are likely to transact with many counterparties who themselves are not dealers, analysis of 2011 transaction data show that only 28 out of 1,084 market participants have three or more counterparties that themselves are not recognized as dealers by ISDA.[478] As the data show, 15 of these 28 potential dealers exceeded a threshold of $100 billion notional transacted in single-name credit swaps during 2011, which accounts for over 98 percent of the 28 entities' total activity.[479] At a lower threshold of $10 billion notional, 21 of the 28 potential dealers are included (representing 99.7 percent of the activity of potential dealers), and at an even lower threshold of $3 billion notional, 25 potential dealers are included (representing 99.9 percent).[480]

Other criteria for identifying possible dealing activity based on the number of an entity's non-dealer counterparties similarly suggest a high degree of concentration of dealing activity within the current security-based swap market.[481] Criteria that consider the number of an entity's total single-name security-based swap counterparties,[482] criteria that consider alternative factors for identifying dealing activity,[483] and certain combined criteria[484] further

[476] While recognizing that the Commissions have yet to adopt final rules defining a ''security-based swap,'' we believe that single-name credit default swaps will constitute roughly 95 percent of the market, as measured on a notional basis, for instruments that will fall within that definition, with certain equity swaps (in other words, total return swaps based on single equities or narrow-based indices of equities) constituting the primary example of security-based swaps that are not credit default swaps.

In particular, according to data published by BIS, the global notional amount outstanding in equity forwards and swaps as of June 2011 was $2.03 trillion, and the notional amount outstanding in credit default swaps was approximately $32.4 trillion. *See* Statistical Annex, BIS Quarterly Review (December 2011), at A10 (available at *http://www.bis.org/publ/qtrpdf/r_qs1112.pdf*). Although the BIS data reflects the global OTC derivatives market, and not just U.S. market, we have no reason to believe that these ratios differ significantly in the U.S. market. In fact, OCC data regarding U.S. entities generally confirms these ratios, in that as of June 30, 2011, U.S. commercial banks and trust companies held $15.23 trillion in notional outstanding credit derivative positions and $677 billion in equity derivative positions, meaning that credit derivatives accounted for approximately 95 percent of the total credit and equity derivative positions held by these entities. *See* OCC Quarterly Report at tables 1 and 10. *Cf.* letter from Greenberger (referencing OCC data as relevant to determining size of swap market).

[477] A person that is engaged in security-based swap dealing activity, for example, may also engage in proprietary trading involving security-based swaps that would be reflected in the transaction data. Even accounting for such possibilities, however, the SEC believes that the data nonetheless support the broad conclusion described below that dealing activity within the security-based swap market is highly concentrated.

[478] *See* CDS Data Analysis at table 3c. The SEC recognizes that the analysis of this transaction data is imperfect as a tool for identifying dealing activity, given that the presence or absence of dealing activity ultimately turns upon the relevant facts and circumstances of an entity's security-based swap transactions, as informed by the dealer-trader distinction. Criteria based on the number of an entity's counterparties that are not recognized as dealers nonetheless appear to be useful for identifying apparent dealing activity in the absence of full analysis of the relevant facts and circumstances, given that engaging in security-based swap transactions with non-dealers would be consistent with the conduct of seeking to profit by providing liquidity to others, as anticipated by the dealer-trader distinction. In emphasizing this criterion for identifying dealing activity, we are not seeking to predict with precision how many entities ultimately may register as security-based swap dealers. The ultimate number of dealers that may register can also be expected to reflect growth in the market, new dealing entrants, and in some cases the registration of multiple dealing entities within an affiliated group.

[479] *See* CDS Data Analysis at table 3c. In particular, those 15 entities engaged in a total of $11.01 trillion in notional single-name credit default swap transactions over 2011, which reflects 98.5 percent of the total $11.18 trillion in notional transactions over 2011 for the 28 total identified possible dealers.

[480] *See id.* The 21 possible dealers with a 2011 notional in excess of $10 billion account for a total of $11.15 trillion in notional single-name credit default swap transactions in 2011, or over 99.7 percent of the total. The 25 possible dealers in excess of $3 billion account for almost $11.18 in notional transactions in 2011, or over 99.9 percent of the total.

[481] For example, two other criteria consider the number of an entity's non-dealer counterparties (in those cases identifying as dealers those persons that have seven or more, or five or more, counterparties not recognized as dealers by ISDA) also indicate that potential dealers with notional amounts in excess of $100 billion in 2011 account for over 98 percent of the notional transactions of all entities meeting the applicable criteria in 2011. Potential dealers with notional transactions above $10 billion in 2011 (let alone those with notional transactions above $3 billion) reflect all or virtually the entire notional amount of all dealers identified by those criteria. *See id.* at tables 3a and 3b.

[482] The CDS Data Analysis also sought to identify dealing activity based on the total number of an entity's counterparties. *See id.* at tables 2a through 2c. Those criteria similarly suggest a high degree of concentration of dealing activity within the single-name credit default swap market:

i. A criterion that identifies potential dealing activity based on an entity having twenty or more counterparties in single-name security-based swaps identified 16 possible dealers. Fourteen of those entities had notional transactions in excess of $100 billion in 2011, reflecting over 99 percent of the total associated with all 16. The remaining two identified entities had notional transactions in excess of $10 billion in 2011. *See id.* at table 2a.

ii. A criterion that identifies potential dealing activity based on an entity having 15 or more counterparties in single-name security-based swaps identified 33 possible dealers. Fifteen of those entities had notional transactions in excess of $100 billion in 2011, reflecting over 97 percent of the total associated with all 33. A total of 27 of those entities had notional transactions in excess of $10 billion in 2011, and a total of 32 of those entities had notional transactions in excess of $3 billion in 2011, both reflecting over 99 percent of the total. *See id.* at table 2b.

iii. A criterion that identifies potential dealing activity based on an entity having 10 or more counterparties in single-name security-based swaps identified 154 possible dealers. Fifteen of those exceeded $100 billion in notional transactions in 2011, reflecting over 90 percent of the total; 49 of those exceeded $10 billion in notional transactions in 2011, reflecting over 97 percent of the total; and 93 exceeded $3 billion in notional transactions in 2011, reflecting over 99 percent of the total. *See id.* at table 2c.

In considering the data we are weighing these criteria less heavily than we are weighing the criteria based on the number of counterparties who are not identified by ISDA as dealers. This is because it is reasonable to foresee a non-dealer making use of multiple dealers to get the best possible price or to make use of special expertise possessed by certain dealers, meaning that the criteria discussed in this footnote are more likely to identify entities not engaged in dealing activity.

[483] Other criteria in the CDS Data Analysis sought to identify dealing activity based on whether an entity maintains a relatively flat book. Those criteria also indicated that entities with notional transactions in excess of $100 billion in 2011 represented over 97 percent of the total for all entities identified by those criteria, while entities with notional transactions in excess of $10 billion in 2011 represented over 99 of the total for all entities identified by those criteria. *See id.* at tables 4 and 5. We are weighing those criteria less heavily than we are weighing the counterparty-based criteria discussed above because an entity that engages in directional trades could also appear to have a flat book if its portfolio contained transactions representing various directional bets, but of similar aggregate notional sizes on both sides of the market. *See id.* at 3.

The analysis also included one criterion that considers potential dealing activity based on a low propensity to post margin. *See id.* at table 6. While we do not believe that this analysis deserves the same degree of weight as the others, given concerns about the completeness of the data (*see id.* at 4), we note that this criterion nonetheless also indicates a high concentration of dealing activity in the market. *See id.* at table 6 (indicating that of the 473 entities identified by this criterion, the 14 entities with notional transactions in excess of $100 billion in 2011 account for roughly 94 percent of the total notional transaction activity associated with all 473 entities over 2011).

[484] Finally, the CDS Data Analysis also included criteria that identified potential dealing activity

suggest a high concentration of dealing activity within the security-based swap market.

While less data are available in connection with other types of instruments constituting security-based swaps, such as equity swaps, the available data similarly suggest a high concentration of positions in those instruments among potential dealers.[485]

Though inspection of the data does not seem to suggest a single precise *de minimis* threshold, the above analysis of potential dealing activity is useful in that it reveals a range of possible thresholds from $100 billion to $3 billion that would cover anywhere from 98 percent through 99.9 percent of the total activity of all potential dealers in 2011. However, these thresholds—and their implied market coverage ratios—only reflect levels of activity that exist in today's highly concentrated market. In order to further narrow the range of possible thresholds, and to select an appropriate level for the *de minimis* exception, the analysis must consider the potential state of the market as it might reasonably exist after the implementation of Title VII.

ii. Avoiding Gaps Resulting From the Regulatory Changes in Conjunction With the Exception

Although the overall portion of security-based swap activity that would appear to be subject to dealer regulation based on current measures of dealing concentration in the market constitutes an important factor to consider in balancing the regulatory burdens and benefits associated with a *de minimis* exception, analysis of the current market should not serve as the sole mechanism for setting the exception.

In particular, sole reliance on an approach that focuses on current measures of market concentration would not adequately account for likely changes to the market associated with the implementation of regulation. In part, these changes may be a direct result of the full implementation of Title VII—including enhancements to transparency and increases in central clearing—as those changes reasonably may be expected to reduce the concentration of dealing activity within the market over time.[486] Also, to the extent implementation of Title VII permits new dealers to enter the market, the availability of a *de minimis* exception would mean those new dealing entrants would fall outside the ambit of dealer regulation, either for the long term or until their dealing activity surpasses the applicable notional threshold.[487] Accordingly, *de minimis* thresholds that are based solely on the current state of the market, including the current concentration of dealing activity within the market, may reasonably be expected to fail to account for the amount of dealing activity that in the future could fall outside of the ambit of dealer regulation due to the exception.[488]

For example, as discussed above, when possible dealers in single-name credit default swaps are identified by an entity having three or more counterparties that are not recognized by ISDA as being dealers, entities with notional transactions in excess of $100 billion over a 12 month period represent over 98 percent of the total activity of all such possible dealers over that period, leaving two percent of possible dealing activity below that level.[489] However, a *de minimis* threshold of $100 billion would allow new entrants to commence engaging in unregulated dealing in competition with persons who are regulated as dealers pursuant to Title VII, which, depending on the number and size of such entrants, could significantly decrease the portion of dealing activity in the market done by registered dealers (at least until the point that new entrants cross the *de minimis* threshold, if they do at all). For example, if 15 new entrants[490] were to engage in security-based swap dealing activity up to a $100 billion threshold, the result could be that nearly 15 percent of dealing activity within the single-name credit default swap market would be left outside of the ambit of dealer regulation.[491]

based on an entity meeting two or three of the other criteria considered. *See id.* at tables 7 and 8. These criteria again indicate a high degree of concentration of dealing activity in the market. The analysis that addressed whether an entity met two of the other criteria identified 92 possible dealers, with the 15 entities having notional transactions in excess of $100 billion in 2011 representing over 96 percent of the total activity of those 92 entities in 2011. *See id.* at table 7. The analysis that addressed whether an entity met three of the other criteria identified 41 possible dealers, with the 15 entities having notional transactions in excess of $100 billion in 2011, representing over 98 percent of the total activity of those 41 entities in 2011. *See id.* at table 8.

[485] For example, OCC data shows that, of the five largest bank or trust companies, four have notional equity derivative positions of above $1 billion, and that those four entities account for $630 billion in notional positions out of $677 billion for all U.S. commercial banks or trust companies, which constitutes approximately 93 percent of the total. *See* OCC Quarterly Report at table 10. Similarly, a review of the equity swaps positions of the 50 largest U.S. bank holding companies shows that nine bank holding companies have notional equity swap positions exceeding $1 billion, and account for 99.5 percent of the total positions held by such companies, and 29 have no positions in equity swaps. (Data was compiled from each bank holding company's FR 9–YC, available at *http://www.ffiec.gov/nicpubweb/nicweb/Top50Form.aspx*). *Cf.* letter from WGCEF V (referencing swap position data from bank holding companies' Forms FR Y–9C as relevant to determining size of the swap market).

[486] *Cf.* Bessembinder and Maxwell, ''Transparency and the Corporate Bond Market,'' Journal of Economic Perspectives, Spring 2008, at 217, 226 (noting that after reporting of U.S. OTC bond transactions through the Trade Reporting and Compliance Engine (''TRACE'') became mandatory, the portion of trades completed by the 12 largest dealers fell from 56 percent to 44 percent).

[487] We understand that large dealers have competitive advantages under the current market, in light of the desire of counterparties to engage in security-based swap transactions with large, well capitalized and highly rated dealers. *See, e.g.,* Craig Pirrong, *Rocket Science, Default Risk and The Organization of Derivatives Markets,* Working Paper, University of Houston (2006) (available at *http://www.cba.uh.edu/spirrong/Derivorg1.pdf*). The lower business costs associated with being unregulated may prove to partially offset that advantage. At the same time, we reasonably may expect that informed counterparties will take into account the lower protections—and higher risks—associated with transactions with unregulated dealers in determining whether to use regulated or unregulated dealers as counterparties.

[488] We note that there also are benefits to increased competition and a decrease in concentration of dealer activity, as contemplated by Title VII, including potentially lower costs for market participants and a decrease in systemic risk.

[489] *See* CDS Data Analysis at table 3c; *see also* note 479, *supra.* As noted above, these amounts may not only reflect dealing activity by an entity. Thus, even putting aside the possibility of new unregulated entrants into the market, the portion of dealing activity in the market that is represented by entities whose trailing notional dealing activity exceeds $100 billion may in fact be less than 98 percent.

[490] The illustrative use of new entrants for purposes of this discussion is intended to reflect the potential that new entrants to the market could take advantage of a *de minimis* threshold in a way that leads to a higher level of unregulated dealing activity within the market. In using this illustration we are not seeking to explicitly predict how many new entrants may come into the market in response to any particular *de minimis* threshold, nor are we seeking to predict how many new entrants may seek to stay under the *de minimis* thresholds and how many instead would seek to use the exception as a step on the way to eventually registering as a security-based swap dealer. Rather, we simply are illustrating why it is important to account for market changes in connection with setting the *de minimis* threshold.

The OTC Derivatives Supervisors Group—a group chaired by the Federal Reserve Bank of New York and consisting of the CFTC and SEC as well as other international supervisors and major over-the-counter derivatives market participants—currently recognizes 15 major OTC derivatives dealers. Accordingly, as an illustrative example, we have assumed that this number of significant security-based swap dealers would approximately double—*i.e.,* include 15 new dealers—in the wake of the various regulatory changes contemplated by the Dodd-Frank Act, many of which may result in increased access and competition in the security-based swap market (*e.g.,* enhanced priced transparency and increased access to central clearing). However, we emphasize that this number has been selected as an illustrative example, and have accordingly provided similar examples assuming ten and five new entrants.

[491] Fifteen new entities that each engage in $100 billion in dealing activity would reflect $1.5 trillion in additional dealing activity outside the ambit of

Continued

Similarly, a *de minimis* threshold of $25 billion may also lead to a material reduction in the portion of the market covered by registered dealers. For example, using the same assumptions as above, 15 new entrants up to a $25 billion threshold could leave over four percent of dealing activity in the market outside of the ambit of dealing regulation.[492] When other metrics are used to identify possible dealing activity, the possibility of a significant regulatory gap remains.[493]

Overall, it is reasonable to conclude that the higher the *de minimis* threshold, the greater the likelihood that the exception, combined with other changes resulting from the implementation of Title VII that may encourage new entrants, will lead to a proportionately larger amount of unregulated (except with respect to antifraud and anti-manipulation prohibitions) dealing activity.[494] We believe that it is reasonable to interpret the statutory language of the *de minimis* exception in a way that prevents a proportionately large amount of dealing activity within the security-based swap market from falling outside the ambit of dealer regulation. Accordingly, choosing to set a lower *de minimis* threshold from among the range of potential thresholds would limit the amount of potential future dealing activity that could be transacted without being subject to dealer rules and regulations.[495]

iii. Promoting Statutory Counterparty Protections

Sole reliance on an approach based on overall market coverage in balancing regulatory burdens and benefits would also threaten to unduly discount important counterparty protection interests, as discussed above and highlighted in the proposal.[496] For example, in light of data indicating that $5 million constitutes a common notional size for a single-name credit default swap position,[497] a *de minimis* notional threshold of $25 billion annually would permit an unregistered dealer to engage in as many as 5000 trades of that size. The counterparties to these unregistered dealers would not receive the benefit of the protections that Title VII affords to the counterparties of registered dealers. These include, among others, the segregation protections afforded to persons who post margin to dealers in connection with over-the-counter security-based swap transactions.[498] Accordingly, this consideration also suggests that choosing a *de minimis* threshold closer to the lower end of the range of potential thresholds would better preserve the counterparty protections contemplated by Title VII.

c. Balancing Reflected in the Final Rules—Credit Default Swaps That Constitute Security-Based Swaps

The final thresholds that implement the *de minimis* exception (and corresponding phase-in levels) address security-based swaps that are credit default swaps separately from other types of security-based swaps, in light of differences in the respective markets.

i. General Threshold for Credit Default Swaps That Constitute Security-Based Swaps

We conclude that $3 billion over the prior 12 months constitutes an appropriate notional threshold for applying the *de minimis* exception in connection with dealing activity involving credit default swaps that constitute security-based swaps.

dealer regulation, which could lead to roughly 14.9 percent of total dealing activity being outside the ambit of dealing regulation (with that $1.5 trillion being added to the existing $168 billion reflected by entities that fall below the $100 billion threshold, and that sum divided by $11.18 trillion, under the assumption that the new entrants displace business from the fifteen entities above the *de minimis* threshold). To further illustrate, under the same assumptions and analysis, the implied unregulated market share would be roughly 10.4 percent for ten new entities and 6.0 percent for five new entities.

In certain regards these illustrations, on the one hand, may overestimate the effect of new entrants because of the assumption that such entrants engage in dealing activities up to, but not surpassing, the *de minimis* threshold. While it is not impossible that some entities may seek to use the *de minimis* exception to conduct business as an unregulated niche dealer, it also is plausible that entities generally may seek to use the exception to commence engaging in dealing activity, with the goal of ultimately becoming registered dealers that are not constrained by the *de minimis* threshold.

On the other hand, these illustrations in certain respects may underestimate the amount of dealing activity that can fall outside of the regulatory ambit. For example, the amounts of security-based swap activity of persons identified in the analysis as dealers may not exclusively constitute dealing activity, meaning that persons whose notional transactions over a 12-month period exceed a particular threshold in fact may not be engaged in that amount of dealing activity, and hence may still be able to take advantage of the *de minimis* exception. Also, these illustrations do not seek to reflect increased activity by existing dealers that already fall below the assumed threshold.

[492] Fifteen new entities each engaged in $25 billion in dealing activity would reflect $375 billion in additional dealing activity outside the ambit of dealer regulation, which could lead to 4.1 percent of total dealing activity being outside the ambit of dealing regulation (with that $375 billion being added to the existing $80.2 billion reflected by entities that fall below the $25 billion threshold, and that sum divided by $11.18 trillion, under the assumption that the new entrants displace business from the seventeen entities above the *de minimis* threshold). To further illustrate, under the same assumptions and analysis, the implied unregulated market share would be 3.0 percent for 10 new entities and 1.8 percent for 5 new entities. Obviously, these illustrations are subject to the same limitations as are discussed above in the context of the $100 million threshold illustration.

[493] For example, similar results are obtained when possible dealing activity is identified based on whether an entity passes at least three of the other metrics discussed above. *See* CDS Data Analysis at table 8. Using the same types of assumptions as are discussed above, with fifteen new entities, a *de minimis* threshold of $100 billion could lead to 15.0 percent of dealing activity falling outside the ambit of dealer regulation, while a *de minimis* threshold of $25 billion could lead to 4.2 percent of dealing activity falling outside of regulation.

[494] As noted above, encouraging new entrants also has benefits flowing from increased competition and a decrease in concentration of dealer activity. *See* note 488, *supra.*

[495] For example, 15 new dealer entrants engaged in up to $3 billion in dealing activity would account for up to $45 billion in dealing activity. This result would mean approximately 0.4 percent of total potential future dealing activity could be transacted by unregistered dealers, as opposed to the potential for approximately 15 percent of potential future dealing activity to be transacted by unregistered dealers if the *de minimis* were set to $100 billion. *See* CDS Data Analysis at table 3c. As with the illustrative examples above, these calculations assume that the new entrants displace business from the entities above the *de minimis* threshold.

[496] *See* part II.D.3.a, *supra; see also* Proposing Release at 80180 (highlighting ''customer protection issues raised by swaps and security-based swaps—including risks that counterparties may not fully appreciate when entering into swaps and security-based swaps'').

[497] *See* Federal Reserve Bank of New York staff report, ''An Analysis of CDS Transactions: Implications for Public Reporting'' (2011) at 8 (stating that for dollar-denominated single name CDS on corporate or sovereign reference entities, $5 million represented the most common notional size) (available at *http://www.newyorkfed.org/research/staff_reports/sr517.pdf*); *see also* Proposing Release at 80180 (noting ''that in general the notional seize of a small swap or security-based swap is $5 million or less'').

We note, by comparison, that Congress has determined that a *de minimis* amount of securities broker activity by banks entails 500 trades annually. *See* Exchange Act section 3(a)(4)(B)(xi) (excluding from the ''broker'' definition a bank that annually effects no more than 500 securities transactions, other than transactions subject to certain other exceptions, so long as the transaction is not effected by a bank employee that also is a broker-dealer employee).

We further note that, while the number of counterparties or transactions potentially implicated by unregistered dealing activity is an important consideration in establishing an initial *de minimis* level, it does not alter our view, described above, that a single *de minimis* standard based on notional value—rather than the proposal's framework of three distinct standards based on notional value, number of counterparties, and number of transactions—is an appropriate choice in light of concerns expressed by commenters that a standard based on the number of transactions or counterparties can produce arbitrary results. *See* part II.D.3.b.ii, *supra.*

[498] Exchange Act section 3E, which was added by section 763(d) of the Dodd-Frank Act, provides a series of requirements in connection with the segregation of assets held as collateral in security-based swap transactions. These include requirements that security-based swap dealers and major security-based swap participants provide their counterparties with notice that they have the right to require segregation, and that such segregation must be at an independent third-party custodian.

In reaching this conclusion, we recognize the significance of comments that supported the proposed $100 million threshold,[499] and that urged caution in raising that proposed threshold,[500] as well as commenters who supported increases to the threshold.[501] We further recognize the importance of applying the *de minimis* exception in a way that promotes regulatory efficiency. We also recognize the range of potential thresholds suggested by the data currently available. Based on the competing factors described above, we believe that $3 billion reflects a reasonable notional threshold—though not necessarily the only such threshold.

In our view, the currently available data regarding the single-name credit default swap market indicates that a notional threshold of $3 billion would be expected to result in the regulation, as dealers, of persons responsible for the vast majority of dealing activity within that market, both as of today and, as described above, in the future as the benefits of the other Title VII rules are implemented and new dealer entrants come to market.[502]

In providing for a $3 billion notional threshold, we also recognize the threshold would permit an unregistered dealer annually to engage in up to 600 security-based swaps (as opposed to 20 transactions under the proposed threshold, assuming a $5 million average notional size). In this regard, we note that Congress, in another statutory *de minimis* exception within the Exchange Act, determined that 500 securities transactions annually constituted a *de minimis* amount of transactions for banks under the ''broker'' definition.[503] We further believe that a $3 billion threshold appropriately addresses commenter concerns regarding the *de minimis* exception being unduly narrow.[504]

In adopting this $3 billion threshold, we have carefully considered one commenter's view that the CDS Data Analysis suggests that the proposed $100 million threshold in fact is too high, and that any increase in that proposed $100 million threshold would be arbitrary and capricious.[505] In reaching these conclusions, the commenter focused on the number of entities that potentially are engaged in dealing activity but that could be excluded based on particular *de minimis* thresholds. For example, the commenter indicated that pursuant to one of the CDS Data Analysis's combined metrics for identifying dealing activity, a *de minimis* threshold of $3 billion could lead to the exclusion of up to 58 percent of all persons engaged in possible dealing activity. The commenter further suggested that some entities engaged in dealing activity may reduce their activities to take advantage of the *de minimis* exception and hence reduce liquidity, and argued that there would be no basis for the exception to be based on a market participant's percentage of total security-based swap activity.[506]

It is important to recognize that while the commenter focused on the number of entities that might be excluded pursuant to the exception, and suggested that higher notional dollar amount thresholds could lead to the exclusion of a larger number of entities, the statutory provision for the *de minimis* exception does not require the exemption of a ''*de minimis* number'' of dealers. The statute instead requires the exemption of persons engaged in a ''*de minimis* quantity'' of dealing activity.[507] The statutory language therefore indicates that the focus of the rule implementing the exception should be the amount of an entity's dealing activity, not how many entities ultimately may be able to take advantage of the exception.

Also, although the commenter implied that there would be no basis for the rule implementing the exception to take into account a market participant's security-based swap dealing activity compared to total dealing activity in the market, for the reasons discussed in this section we believe that such an approach can appropriately provide for the regulatory coverage of the vast majority of dealing activity in a way that promotes regulatory efficiency, without leading to unwarranted regulatory gaps. In contrast, in our view the commenter did not persuasively articulate a strong rationale for adopting the alternative approach proposed in the letter, which would appear to lead to the registration of a number of dealers that proportionately engage in a very small amount of dealing activity.[508]

In support of its approach, the commenter emphasized data regarding persons who meet certain combined criteria outlined in the CDS Data

[499] *See* letters from Better Markets I and AFR.

[500] *See* letter from Greenberger.

[501] *See, e.g.*, letter from COPE I.

[502] Of the 28 market participants that have three or more security-based swap counterparties that themselves are not recognized by dealers by ISDA, 25 had notional single-name credit default swap positions in excess of $3 billion in 2011. The remaining three entities in total accounted for only $3.59 billion in notional transactions in 2011, reflecting less than 0.1 percent of the $11.18 trillion total for those 28 market participants. *See* CDS Data Analysis at table 3c.

The other criteria set forth in the analysis for identifying possible dealing activity in general similarly indicate that entities with notional transactions in excess of $3 billion in 2011 account for more than 99 percent of the total notional transactions of all identified entities in 2011. *See id.* at tables 2a–c, 3a–b, 4, 5, 7 and 8. While the criterion based on the posting of initial margin only indicates 98 percent coverage for all of the 473 identified entities, *see id.* at table 6, as discussed above we believe it is appropriate to provide less weight to that criterion, which is based on voluntary reporting.

As noted above, *see* note 478, *supra,* we recognize that the underlying market data encompasses all of the security-based swap activity of persons identified as dealers, not only their dealing activity. Because the thresholds that implement the *de minimis* exception address only a person's dealing activity, this raises the possibility that the analysis overstates the extent to which a $3 billion threshold would encompass persons responsible for dealing activity within the single-name security-based swap market. Even with that possibility, however, we believe that the data indicates such a high concentration of dealing activity within the market that it is reasonable to conclude that a $3 billion threshold likely would encompass persons responsible for the vast majority of dealing activity within the market.

[503] *See* Exchange Act section 3(a)(4)(B)(xi); *see also* letter from SIFMA—Regional Dealers (supporting a threshold of 500 trades consistent with the statutory *de minimis* exception in connection with bank brokerage activity).

[504] For example, $3 billion is equal to the threshold suggested by many commenters in the context of the swap market, which is much larger than the security-based swap market. *See* letter from COPE (supporting a 0.001 percent notional threshold based on the overall swaps market, which would amount to $3 billion). Indeed, this $3 billion threshold appears to reflect roughly 0.024 percent of the overall market for single-name credit default swaps, a percentage that is much greater than the 0.001 percent multiplier that a number of commenters (*see, e.g.*, letters cited in note 382, *supra*) suggested in the swap market context. *See* CDS Data Analysis at table 1 (indicating that participants in the single-name credit default swap market engage in a total of $12.6 trillion in single-name credit default swap transactions in 2011).

[505] *See* letter from Better Markets III.

[506] The letter also raised issues regarding the ''customer'' language of the exception and argued that the *de minimis* exception should not represent a risk-based test. We address those issues elsewhere. *See* parts II.D.3.c (regarding ''customer'' language) and II.D.3.e (regarding rejection of risk-based and proportionality tests), *infra.*

In addition, the letter expressed the view that a percentage-based formula would be difficult to implement, by requiring market participants to repeatedly calculate the ratio of their activity to total market activity. We concur. The $3 billion threshold we are adopting reflects a fixed dollar amount, and does not share the complications that would arise from an approach based on a particular percentage of the market.

[507] *See* Exchange Act section 3(a)(71)(D).

[508] The commenter correctly pointed out that the regulatory requirements applicable to registered dealers encompass counterparty protection requirements, and that the *de minimis* exception should not defeat those requirements. We recognize that the implementation of the exception should take those counterparty protections into account, and we have sought to do so. We do not believe, however, that those important counterparty protection goals require a *de minimis* approach that focuses on the number of entities that would be excluded, in lieu of the statutory focus on whether a particular entity engages in a *de minimis* quantity of dealing activity.

Analysis. As discussed above, we believe that criteria based on the number of an entity's counterparties that are not recognized as dealers deserve special weight due to the potential consistency of those criteria with the dealer-trader distinction.[509] Identifying dealer activity using those criteria does not support the view that a $3 billion threshold would lead to the exclusion of a large *number* of entities engaged in dealing activity.[510]

Finally, we also are not persuaded by the commenter's suggestion that a number of entities engaged in dealing activity would reduce those activities to take advantage of a $3 billion *de minimis* threshold, and hence reduce liquidity in the market by five percent. To reach that figure, the commenter needed to exclude the vast majority of dealing activity in the market.[511] While we recognize that it is possible that current market participants may adjust their dealing activity in light of the *de minimis* threshold, and that this potentially could reduce the liquidity provided by certain entities, we also recognize that the *de minimis* exception has the potential to promote liquidity by facilitating new entrants into the market.

ii. Phase-in Period in Connection With Dealing Activity Involving Credit Default Swaps That Constitute Security-Based Swaps

The final rules further provide that persons with notional dealing activity of $8 billion or less over the prior 12 months involving credit default swaps that constitute security-based swaps would be able to avail themselves of a phase-in period.[512] Those persons would not be subject to the generally applicable compliance date that occurs no later than 60 days following publication of these final rules in the **Federal Register**.[513]

The use of a phase-in period—in connection with a person's status as a security-based swap dealer and in connection with the other regulatory requirements that are appurtenant to dealer status—is intended to facilitate the orderly implementation of Title VII. In addition, the phase-in period will afford the SEC additional time to study the security-based swap market as it evolves in the new regulatory framework and will allow potential dealers that engage in smaller amounts of activity (relative to the current size of the market) additional time to adjust their business practices, while at the same time preserving the focus of the regulation on the largest and most significant dealers. The SEC also recognizes that the data informing its current view of the *de minimis* threshold is based on the market as it exists today, and that the market will evolve over the coming years in light of the new regulatory framework and other developments.

Accordingly, while the SEC believes that a $3 billion notional threshold reflects an appropriate long-term standard based on the currently available data,[514] it also is appropriate to provide for a phase-in period for those entities with $8 billion or less in dealing activity, because subsequent developments in the market or the evaluation of new data from the security-based swap reporting facilities contemplated by the Dodd-Frank Act may suggest that the threshold should be increased or decreased. In particular, the implementation of security-based swap data reporting under the Dodd-Frank Act will result in significant new data and afford an opportunity to review the Commission's determination to establish a $3 billion threshold.

For these reasons, an important part of the report that the SEC is directing its staff conduct with regard to the definitions of ''security-based swap dealer'' and ''major security-based swap participant'' (described in detail below) will be a consideration of the operation of the *de minimis* exception following the full implementation of Section 15F under Title VII.[515] The SEC will take into account this report, along with public comment on the report, in determining whether to propose any changes to the rule implementing the *de minimis* exception, including any increases or decreases to the $3 billion threshold. The report will be linked to the availability of data regarding the activity of regulated security-based swap market participants in that it must be completed no later than three years[516] following a ''data collection initiation date'' that is the later of: the last compliance date for the registration and regulatory requirements for security-based swap dealers and major security-based swap participants under Section 15F of the Exchange Act; or the first date on which compliance with the trade-by-trade reporting rules for credit-related and equity-related security-based swaps to a registered security-based swap data repository is required.[517]

In light of the available data—and the limitations of that data in predicting how the full implementation of Title VII will affect dealing activity in the security-based swap market—the SEC believes that $8 billion constitutes an appropriate level for the availability of the phase-in period. The available data indicate that such a level generally comports with the balance of interests that informed the determination of the appropriate long-term threshold of $3 billion described above. In particular, the $8 billion level should still lead to the regulation of persons responsible for the vast majority of dealing activity

[509] *See* notes 478, 482, and 483, *supra.*

[510] For example, the CDS Data Analysis identifies:

- Three possible dealers with notional transactions below $3 billion in 2011—out of a total of 28 possible dealers—when possible dealing activity is based on having three or more counterparties that themselves are not identified as dealers;
- One possible dealer with notional transactions below $3 billion in 2011– out of a total of 20 possible dealers—when possible dealing activity is based on having five or more counterparties that themselves are not identified as dealers; and
- Zero possible dealers with notional transactions below $3 billion in 2011—out of a total of 16 possible dealers—when possible dealing activity is based on having seven or more counterparties that themselves are not identified as dealers.

See CDS Data analysis at tables 3c, 3b and 3a.

In addition, as described above, an approach focused on the quantity of activity is supported by relatively consistent results depending on which criterion from the CDS Data Analysis is applied—*i.e.*, each criterion shows a high amount of concentration and a commensurately low quantity of activity below the $3 billion threshold. By contrast, applying different criteria results in very different numbers of entities excluded under any specified threshold, suggesting that an approach focused on the number of entities may be highly dependent on how the possible dealing activity of those entities is defined.

[511] In particular, in arguing that this incentive would reduce liquidity by five percent, the commenter excluded all business done by entities within the top two brackets (*i.e.*, above $100 billion notional), on the grounds that those entities ''are assumed to transact mostly with larger entities.'' Based on the criteria on which the commenter relied, those 15 entities are responsible for over 96 percent of the activity of all possible dealers. *See* CDS Data Analysis at tables 7 and 8. Absent that exclusion, the estimated reduction of liquidity would amount to a small fraction of a percent.

[512] Exchange Act rule 3a71–2(a)(2).

[513] Even with the general 60 day compliance period, however, market participants will not necessarily be security-based swap dealers at the end of 60 days. In particular, for the first year following the effective date of the final rules implementing the definition of ''security-based swap'' pursuant to the Exchange Act section 3(a)(68), the *de minimis* analysis would only address security-based swap dealing activity following that effective date. *See* Exchange Act rule 3a71–2(a)(1). Among other things, this means that until the rules defining ''security-based swap'' are effective, no market participants would be deemed to be security-based swap dealers.

[514] *See* note 502, *supra.*

[515] *See* Exchange Act rule 3a71–2A(a)(1); *see also* part V, *infra.*

[516] *See* Exchange Act rule 3a71–2A(b).

[517] The SEC will announce the data collection initiation date on its Web site and publish it in the **Federal Register**. *See* Exchange Act rule 3a71–1(a)(2)(iii).

within the market.[518] In addition, we do not believe that providing a phase-in period for persons with notional dealing activity over the prior 12 months of less than $8 billion would lead to a risk of an undue portion of the market falling outside of the ambit of dealer regulation, even after considering the potential entry of unregulated new dealers into the market.[519]

The final rule provides that the phase-in period will continue until the ''phase-in termination date'' that the SEC will publish on its Web site and in the **Federal Register**.[520] In particular, the rule provides that nine months following publication of that report, and after giving due consideration of the report and associated public comment, the SEC may either: (1) Terminate the phase-in period and by order establish and publish the phase-in termination date; or (2) determine that it is necessary or appropriate in the public interest to propose an alternative *de minimis* threshold, in which case the SEC, by order published in the **Federal Register**, will provide notice of that determination and establish the phase-in termination date.[521] If the SEC does not establish the phase-in termination date in either of those ways, the phase-in termination date shall automatically occur in any event on what would be a date certain, which will be five years following the data collection initiation date.[522]

These provisions should allow sufficient time for the staff to complete its report, for the SEC to receive and review public comment on the report, and for the SEC to draw conclusions regarding establishing the phase-in termination date or proposing potential changes to the rule implementing the *de minimis* exception, in a way that also promotes the orderly and predictable termination of the phase-in period.[523]

This phase-in period will not be available in connection with the $25 million threshold for dealing activity involving special entities, discussed below. In addition, the final rule provides that this phase-in period will not be available in connection with security-based swap dealing activities involving natural persons, other than natural persons who qualify as ECPs by virtue of CEA section 1a(18)(A)(xi)(II), which addresses natural persons who have $5 million or more invested on a discretionary basis and who enter into a security-based swap to manage the risk associated with their assets and liabilities.[524] These limitations to the availability of the phase-in period are consistent with the Dodd-Frank Act's goal of helping special entities be in a position to benefit from the counterparty protections associated with the regulation of registered security-based swap dealers under Title VII, as well as the SEC's mandate to protect participants in the securities markets.

Persons who are able to avail themselves of the phase-in period, of course, will not be required to do so. Any person that chooses to register with the SEC as a security-based swap dealer shall be deemed to be a security-based swap dealer subject to all applicable regulatory requirements for such registrants, regardless of whether the person engages in security-based swap dealing activity in an amount that is below the applicable *de minimis* threshold or phase-in level.[525]

d. Balancing Reflected in the Final Rules—Other Types of Security-Based Swaps

The final rule provides that the *de minimis* exception for dealing activity involving security-based swaps other than credit default swaps will be based on a threshold of $150 million notional over the prior 12 months.[526] In addition, a phase-in period will be available in connection with persons whose dealing activity involving those instruments is $400 million or less in notional amount over the prior 12 months.

These amounts reflect roughly one-twentieth of the corresponding amounts associated with the exception for credit default swaps that constitute security-based swaps. As discussed above, while less data is available regarding other types of security-based swaps than is available regarding single-name credit default swaps, the available data is consistent in indicating that those other types of security-based swaps on a notional basis currently comprise roughly one-twentieth of the total amount of instruments that will be expected to constitute security-based swaps.[527] In light of this significantly smaller market, we believe that a $3 billion notional threshold would threaten to cause an overly large portion of dealing activity within the market to fall outside the ambit of dealer regulation.

In this regard, we note that it is likely that there are fewer barriers to entry in connection with acting as a dealer in security-based swaps such as equity swaps and total return swaps on debt than there are in connection with acting as a dealer in single-name credit default

[518] Of the 28 market participants that have three or more security-based swap counterparties that themselves are not recognized by dealers by ISDA, 23 had notional single-name credit default swap transactions in excess of $8 billion in 2011. The remaining five entities in total accounted for only $12.3 billion in notional transactions in 2011, reflecting roughly 0.1 percent of the $11.18 total for the 28 market participants. *See* CDS Data Analysis at table 3c. Only two of the 28 entities identified as possible dealers by that criterion had annual notional transactions between $3 billion and $8 billion in 2011.

Most of the other criteria set forth in the analysis for identifying possible dealing activity in general similarly indicate that entities with notional transactions in excess of $8 billion in 2011 account for more than 99 percent of the total notional transactions of all identified entities that year. *See id.* at tables 2a–b, 3a–b, 4 and 5. While the criterion based on an entity having 10 or more counterparties only indicates 98 percent coverage for all of the 154 identified entities at an $8 billion transaction level, *see id.* at table 2c, as noted above this criterion may identify persons who in reality are not engaged in dealing activity. *See* note 482, *supra.* Also, while the criterion based on the posting of initial margin only indicates 97 percent coverage for all of the 473 identified entities at an $8 billion transaction level, *see id.* at table 6, as discussed above that criterion is based on voluntary reporting.

[519] For example, 15 new dealer entrants up to $8 billion in annual notional dealing activity would account for $120 billion in dealing activity. This would amount to roughly 1.2 percent of the total notional single-name security-based swap activity over 12 months of entities identified as possible dealers by virtue of having three or more counterparties that are not recognized by dealers by ISDA. *See* CDS Data Analysis at table 2c.

[520] Exchange Act rule 3a71–2(a)(2)(i).

[521] Exchange Act rule 3a71–2(a)(2)(iii)(A).

[522] Exchange Act rule 3a71–2(a)(2)(iii)(B).

[523] This approach balances the fact that the SEC believes that its $3 billion and $150 million *de minimis* thresholds are appropriate in light of the currently available data and the market's need for a degree of certainty as to the length of this phase-in period, on the one hand, against the possibility that the staff report and the accompanying public comment may demonstrate that revision to these thresholds is necessary, on the other hand.

[524] *See* Exchange Act rule 3a71–2(a)(2)(i). In other words, the phase-in period will still be available in connection with dealing activities with natural persons who are ECPs because they have entered into a security-based swap for hedging purposes. While we recognize the importance of Title VII protections to natural persons who engage in security-based swap activity, we also recognize the benefit of facilitating such persons' use of security-based swaps as hedges. Accordingly, persons who engage in dealing activity with natural persons who are ECPs under other provisions of the ECP definition will be subject to the applicable *de minimis* threshold for all of their dealing activity, without the availability of the phase-in period.

Persons who engage in dealing activity with natural persons who are not ECPs will fall within the Exchange Act definition of ''dealer,'' which has no *de minimis* exception. *See* Exchange Act section 3(a)(5)(A) (generally excluding dealers in security-based swaps from the Exchange Act definition of ''dealer,'' unless the counterparty is not an ECP).

[525] *See* Exchange Act rule 3a71–2(e).

[526] Exchange Act rule 3a71–2(a)(1)(ii). The proposal requested comment on whether different segments of the security-based swap market should be treated differently. *See* Proposing Release at 80101 (''Commenters further are requested to address * * * whether the [*de minimis*] exemption's factors should vary depending on the type of swap or security-based swap at issue.'').

[527] *See* note 476, *supra.*

swaps.[528] We also note that because equity swaps and total return swaps on debt can serve as close economic proxies for equity and debt securities, an overly broad *de minimis* threshold in connection with such instruments could threaten to undermine the Exchange Act framework for regulating persons who act as dealers in equity and debt.

At the same time—notwithstanding the smaller scope of this market and the lesser availability of data regarding dealing activity within the market—we do not believe that it is necessary to make the *de minimis* exception unavailable in connection with dealing activity involving security-based swaps that are not credit default swaps. In this regard we particularly note that the limited available data regarding equity swaps suggests a high degree of concentration in dealing activity involving those instruments,[529] which indicates that an appropriately sized *de minimis* threshold can be expected to promote regulatory efficiency.

Balancing those factors, we conclude that a $150 million annual notional threshold is appropriate to implement the *de minimis* exception in connection with security-based swaps that are not credit default swaps, consistent with our understanding of the comparative size of that market as applied to the threshold applicable to credit default swap dealing activity. For reasons similar to those described above, we conclude that there should be a phase-in period available to persons whose annual notional dealing activity in connection with security-based swaps that are not credit default swaps is no more than $400 million in annual 12-month notional amount. This phase-in period is subject to the same limitations regarding transactions involving special entities and natural persons as apply to the phase-in period for credit default swaps. It also will be subject to the same provisions regarding the termination of the phase-in period as apply in connection with credit default swaps.[530] The comparative lack of data involving these markets—in contrast to the market for single-name credit default swaps—particularly highlights how the use of a phase-in period that is linked to the availability of post-implementation data is appropriate.[531]

As above, a person who is eligible to take advantage of the phase-in period in connection with these types of security-based swaps may nonetheless register as a security-based swap dealer.

e. Dealing Activity Involving Special Entities

Consistent with the proposal, the final rules in general will cap an entity's dealing activity involving security-based swaps at no more than $25 million notional amount over the prior 12 months when the counterparty to the security-based swap is a special entity.[532] There will be no phase-in period in connection with transactions involving special entities. In adopting this threshold, we recognize the serious concerns raised by commenters that stated that the *de minimis* exception should not permit any dealing activities involving special entities in light of losses that special entities have incurred in the financial markets,[533] as well as the special protection that Title VII affords special entities.[534]

At this time, the final rule does not fully exclude such dealing activity from the exception, in light of the potential benefits that may arise from a *de minimis* exception. In this way, the threshold would not completely foreclose the availability of security-based swaps to special entities from unregistered dealers—as $25 million would annually accommodate up to five single-name credit default swaps of a $5 million notional size—but the threshold would limit the financial and other risks associated with those positions for a special entity, which would in turn limit the possibility of inappropriately undermining the special protections that Title VII provides to special entities.

In reaching this conclusion we recognize that special entities do participate in the single-name credit default swap market, given that an analysis of market data indicates that in 2011 special entities were parties to over $40 billion in single-name credit default swap transactions.[535] At the same time, the impact of this $25 million threshold—particularly concerns that the threshold may foreclose the ability of special entities to access dealers in the market—appears to be mitigated by the fact that the counterparties to those special entities tend to engage in notional transactions in single-name credit default swap well in excess of the general *de minimis* standards.[536] In light of the underlying counterparty protection issues, we see no basis to distinguish between types of security-based swaps in setting this special entity threshold.

For similar reasons, in the future as we consider whether to amend the *de minimis* exception we expect to pay particular attention to whether the threshold for transactions involving special entities should further be lowered.

f. Future Revisions to the Rule

As noted above and described in detail below in part V, the SEC is directing its staff to report on whether changes are warranted to the rules and interpretations implementing the security-based swap dealer definition, including the rule implementing the *de minimis* exception.[537] The SEC will take the report and associated public comment into account in determining whether to propose any changes to the rule implementing the exception.[538] Consistent with that possibility, the final rule provides that the SEC may change the requirements of the *de minimis* exception by rule or regulation.[539] Through this mechanism,

[528] For example, persons registered with the SEC as broker-dealers in connection with other types of securities would appear to be well positioned to act as dealers in connection with equity swaps, as such broker-dealers already would be expected to have systems in place to enter into equity positions to hedge their equity swap dealing positions.

[529] As noted above, four commercial banks and trust companies accounted for 93 percent of all equity positions held by such companies as of June 30, 2011, and nine bank holding companies accounted for over 99 percent of all equity positions held by the fifty largest such companies as of December 2011. *See* note 485, *supra.*

[530] *See* Exchange Act rule 3a71–2(a)(2); *see also* notes 520 through 522, *supra,* and accompanying text.

[531] The SEC expects that the staff report should be especially helpful for providing data regarding dealing activity in connection with those other types of security-based swaps to consider the impact of the termination of the phase-in period, as well as potential changes to the *de minimis* exception in connection with these instruments.

[532] Exchange Act rule 3a71–2(a)(1)(iii).

[533] *See* letters from AFR and Better Markets I.

[534] In this regard we note that Title VII authorizes the SEC to impose special business conduct requirements when a security-based swap dealer is counterparty to a special entity. *See* Exchange Act section 15F(h)(5). In proposing rules to implement these requirements, the SEC requested comment regarding the scope of the ''special entity'' definition, including, for example, regarding whether the SEC should interpret ''special entity'' to exclude a collective investment vehicle in which one or more special entities have invested. *See* Exchange Act Release No. 64766 (June 29, 2011), 76 FR 42396, 42422 (July 18, 2011). For purposes of interpreting this special entity threshold to the *de minimis* exception—particularly with regard to when a special entity would be a counterparty to a person that is engaged in dealing activity—the SEC believes that it will be appropriate to be guided by final interpretations regarding when a dealer will be a counterparty to a special entity for purposes of those business conduct requirements.

[535] *See* CDS Data Analysis at table 9.

[536] *See id.* at n.8 (noting that the average notional activity of those 16 counterparties was $680 billion, with the lowest being approximately $9 billion).

[537] *See* Exchange Act rule 3a71–2A(a)(1).

[538] *See* notes 520 through 522, *supra,* and accompanying text.

[539] Exchange Act rule 3a71–2(d). Exchange Act section 3(a)(71)(D) particularly states that the ''Commission''—meaning the SEC—may exempt *de minimis* dealers and promulgate related regulations. We do not interpret the joint rulemaking provisions of section 712(d) of the Dodd-Frank Act to require

the SEC may revisit the rule implementing the exception and potentially change that rule, for example, if data regarding the security-based swap market following the implementation of Section 15F under Title VII suggests that different *de minimis* thresholds would be appropriate.[540] In determining whether to revisit the thresholds, the SEC intends to pay particular attention to whether the *de minimis* exception results in a dealer definition that encompasses too many entities whose activities are not significant enough to warrant full regulation under Title VII, or, alternatively, whether the *de minimis* exception leads an undue amount of dealing activity to fall outside of the ambit of the Title VII regulatory framework, or leads to inappropriate reductions in counterparty protections (including protections for special entities). The SEC also intends to pay particular attention to whether alternative approaches would more effectively promote the regulatory goals that may be associated with a *de minimis* exception.

6. Registration Period for Entities That Exceed the *De Minimis* Factors

The *de minimis* exception raises implementation issues akin to those associated with the major participant definition, in that both provisions use tests that have retrospective elements to determine whether an entity must register and be subject to future regulation. As a result, some commenters have suggested that entities that surpass the *de minimis* thresholds should be able to take advantage of a grace period to undertake the process of registering as swap dealers or security-based swap dealers.[541] Otherwise, absent such a ''roll-in'' period, entities whose dealing activities surpass the relevant *de minimis* factors would immediately be in violation of dealer registration requirements. In light of these concerns, and the interest of avoiding undue market disruptions, the Commissions believe that it is appropriate to provide entities that exceed applicable the *de minimis* factors a period of time to register as dealers.

Accordingly, the final rules have been revised from the proposal to provide for a timing standard that is similar to what we are using in connection with the major participant definition.[542] That is, if an entity that has relied on the *de minimis* exception no longer is able to rely on the exception because its dealing activity exceeds a relevant threshold, the entity would have two months, following the end of the month in which it no longer is able to take advantage of the exception, to submit a completed application to register as a swap dealer or security-based swap dealer.[543]

Also, akin to the major participant definitions,[544] a person registered as a swap dealer or security-based swap dealer may apply to withdraw that registration, while continuing to engage in a limited amount of dealing activity in reliance on the *de minimis* exception, if that person has been registered as a dealer for at least 12 months.[545] This should help ensure that persons do not rapidly move in and out of dealer status based on short-term fluctuations in their swap or security-based swap activities.

The final rules implementing the *de minimis* exception do not provide any reevaluation period for entities that engage in a level of dealing activity above the *de minimis* thresholds, in contrast to the major participant definitions.[546] We do not believe that there is an appropriate basis for such a provision, particularly given that dealer regulation addresses customer protection and market operation and transparency concerns apart from risk concerns.

E. Limited Purpose Designation as a Dealer

1. Proposed Approach

The definitions of the terms ''swap dealer'' and ''security-based swap dealer'' provide that the Commissions may designate a person as a dealer for one type, class or category of swap or security-based swap, or specified swap or security-based swap activities, without the person being considered a dealer for other types, classes, categories or activities.[547]

In the Proposing Release, we noted that these provisions represent permissive grants of authority that do not require the Commissions to provide limited designations.[548] We further stated that a person that is covered by the definitions of the terms ''swap dealer'' or ''security-based swap dealer'' would be considered a dealer for all types, classes or categories of the person's swaps or security-based swaps, or activities involving swaps or security-based swaps, in light of the difficulty of seeking to separate a person's dealing activities from their non-dealing activities involving swaps or security-based swaps, unless such person sought and received designation as a dealer for only specified categories of swaps or security-based swaps, or specified activities.[549] We explained that this would provide persons the opportunity to seek a limited designation based on applicable facts and circumstances, and that we anticipated that a dealer could seek a limited designation at the time of its initial registration or later.[550]

In the Proposing Release, the CFTC further noted that non-financial entities such as physical commodity firms potentially may conduct dealing activity through a division rather than through a separately incorporated subsidiary, and that such an entity's swap dealing activity would not be a core component of its overall business. The CFTC added that if this type of entity registered as a dealer, certain swap dealer requirements would apply to the dealing activities of the division, but not necessarily to the swap activities of other parts of the entity.[551]

joint rulemaking here, because such an interpretation would read the term ''Commission'' out of Exchange Act section 3(a)(71)(D), which itself was added by the Dodd-Frank Act.

[540] *See* letter from Greenberger (stating that the dynamic nature of the derivatives sector of the financial markets should counsel caution, and that the *de minimis* threshold should be reevaluated on an ongoing basis).

[541] *See* letters from Northland Energy and WGCEF I.

[542] *Compare* CFTC Regulation § 1.3(hhh)(3); Exchange Act rule 3a67–8(a) (providing that persons who meet the criteria to be major participants will have two months to submit a completed registration application).

[543] *See* CFTC Regulation § 1.3(ggg)(4)(ii); Exchange Act rule 3a71–2(b). As discussed below with regard to the implementation period for the major participant definitions, persons will have additional time to comply with the applicable requirements following the submission of a completed application. *See* part IV.L.3, *infra.*

[544] *Compare* CFTC Regulation § 1.3(hhh)(5); Exchange Act rule 3a67–8(c) (providing that a major participant may be deemed to no longer be a major participant if its swap or security-based swap positions are below the relevant thresholds for four quarters).

[545] *See* CFTC Regulation § 1.3(ggg)(4)(ii); Exchange Act rule 3a71–2(c). Consistent with this approach, moreover, the final rule has been revised from the proposal to clarify that the *de minimis* exception in general is not available to a registered swap dealer or security-based swap dealer. *See* CFTC Regulation § 1.3(hhh)(1)(i); Exchange Act rule 3a71–2(a)(1) (revised language clarifying availability of exception to a person that is not a swap dealer or security-based swap dealer).

[546] *Compare* CFTC Regulation § 1.3(hhh)(4); Exchange Act rule 3a67–8(b) (providing for a reevaluation period in connection with the major participant definitions when a person does not exceed any applicable threshold by more than 20 percent in a calendar quarter).

[547] CEA section 1a(49)(B); Exchange Act section 3(a)(71)(B).

[548] *See* Proposing Release, 75 FR at 80182.

[549] *See id.; see also* proposed CFTC Regulation § 1.3(ggg)(3); proposed Exchange Act rule 3a71–1(c).

[550] *See* Proposing Release, 75 FR at 80182.

[551] *See id.*

2. Commenters' Views

A number of commenters addressed the limited designation of dealers in conjunction with the limited designation of major participants. Many of the issues those commenters raised thus are relevant to both sets of definitions.

a. Presumption of Full Designation

A number of commenters objected to the proposed presumption that an entity would be designated as a dealer (or major participant) for all categories of swaps or security-based swaps and all of the person's activities connected to swaps or security-based swaps. Several commenters argued that this approach would be contrary to Congressional intent,[552] conflict with the statutory language,[553] or conflict with underlying policy concerns.[554] One commenter suggested that the Commissions lack the statutory authority to apply swap dealer requirements to an entity's non-swap dealing activities.[555]

b. Potential Types of Limited Designations

A number of commenters addressed potential types of limited designations. One expressed support for limited swap dealer designations for particularized business units and for particular swap categories,[556] while another requested that limited swap dealer designations be available based on any reasonable commercial groupings.[557] Some commenters urged that limited dealer designations should be available for the branches or business units of foreign swap dealers and security-based swap dealers with U.S.-based customers or U.S. business lines.[558]

c. Applications for Limited Designations

A number of commenters addressed issues relating to the application process for limited designations. Some commenters supported the ability of a person to apply for limited designations at the time of initial registration,[559] while one commenter sought clarification on how and when a person could apply for limited swap dealer status.[560] Some commenters suggested that entities should be considered to have a provisional limited designation upon the filing of a completed application for limited dealer designation.[561]

Some commenters requested further clarification as to what factors or criteria would be considered relevant to limited designation determinations.[562] One commenter stated that non-financial companies should have a presumption of limited swap dealer designation under certain circumstances.[563] Another commenter took the view that commercial firms should be able to determine whether to register a legal entity or a division as a dealer.[564] One commenter suggested the analysis consider the complexity of an entity's dealing and non-dealing activities, and further suggested that limited designations should automatically be available if an entity's dealing activities do not exceed 50 percent of its total swap activities.[565] Commenters also raised issues related to how a person's status as a financial or a non-financial entity affects a person's eligibility for limited designations.[566]

d. Application of Regulatory Requirements to Limited Dealers

Commenters also addressed issues related to the application of regulatory requirements to limited dealers. One commenter recommended that dealer regulatory requirements generally should apply only to a division undertaking limited dealing activities; that commenter further stated that capital requirements should be calculated based only on the activities of that division, while recognizing that capital must be held by the entity as a whole.[567] Other commenters argued that capital and margin requirements should only be applied to an entity on a limited basis.[568]

e. Miscellaneous Issues

One commenter recommended that non-financial entities that are deemed to be limited dealers (or major participants) be permitted to be treated as end-users for the aspects of their businesses that are not subject to the limited designation.[569] The commenter further suggested that the swaps ''push-out'' rule requirements of section 716 of the Dodd-Frank Act be interpreted so that an insured depository institution that is a limited purpose dealer would only have to push out the dealing portion of its swap business, and be allowed to retain the other aspects of its swaps business.[570] One commenter requested clarification as to whether a person that is a limited purpose dealer in connection with one category of swap could be a major participant in connection with another category (in light of the statutory language excluding dealers from the major participant definitions).[571]

3. Final Rules and General Principles

Consistent with the proposal, the final rules retain the presumption that a

[552] *See* letters from Cargill Incorporated (''Cargill''), CDEU and Investment Company Institute (''ICI'') dated February 22, 2011 (''ICI I'').

[553] *See* letters from MetLife and WGCEF I.

[554] *See* letter from Cargill (stating that limited designation promotes the policy of encouraging non-financial firms that primarily are engaged in non-dealing businesses to continue to conduct limited dealing activities, adding that such firms ''do not present the potential systemic risks of financial firms,'' and that their full designation as dealers would discourage them from providing risk management products).

[555] *See* letter from EDF Trading.

[556] *See* letter from Capital One.

[557] *See* letters from NCGA/NGSA II (particularly referring to groupings based on individual physical commodities) and WGCEF dated June 9, 2011 (''WGCEF VII'') (limited designation should permit firms to structure organization of limited purpose registrans as appropriate in particular circumstances).

[558] *See* letters cited in note 148, *supra.*

[559] *See* letters from MFA I (specifically requesting that the rules provide that an entity can receive a limited purpose designation at the time of their initial registration) and FSR I.

[560] *See* letter from National Futures Association (''NFA'').

[561] *See* letters from Capital One, Farm Credit Council I and FHLB I.

[562] *See* letters from BG LNG I and ISDA I.

[563] *See* letter from Cargill (arguing that a firm should be presumptively entitled to limited swap dealer status if: it is a non-financial company; its non-dealing activities include (but need not be limited to) production, merchandising or processing of physical commodities; the firm's dealing activities take place in a separately identifiable division or business unit with separate management; and dealing revenues are less than 30 percent of the firm's total revenues in the firm's most recent fiscal year).

[564] *See* letter from WGCEF VII (stating that so long as a registered swap dealer bears the onus of demonstrating compliance with regulatory requirements, regulators ''should not dictate'' whether the firm registers a legal entity or a division as a dealer; also requesting guidance as to how applicable regulatory requirements may apply to a subdivision of a legal entity that registers as a dealer, and requesting a safe harbor from enforcement action when a decision to register only a particular desk or division as a dealer is made in good faith).

[565] *See* letter from Capital One.

[566] *Compare* letter from Capital One (stating that all market participants, including financial institutions, should be allowed to apply for limited swap dealer designations) *with* letter from Cargill (suggesting that an entity's status as a financial company should be relevant to limited dealer determinations).

[567] *See* letter from Cargill.

[568] *See* letter from FSR I (recommending that to the extent that capital requirements are tied to swap activity or exposures, that only activities or exposures in the designated category be reflected in the calculation).

[569] *See id.* (recommending that the corporate treasurer of an entity with a limited designation as a swap dealer for ''other commodity swaps'' as a result of its energy derivatives activity be able to hedge the entity's interest rate and currency risk without being subject to the business conduct, reporting, recordkeeping or other rules applicable to dealers and major participants).

[570] *See id.*

[571] *See* letter from NFA. As discussed below, *see* 752, *infra,* a person who is designated as a dealer in connection with particular types of swaps or security-based swaps may be major participants with regard to other types.

person who meets one of the dealer definitions will be deemed to be a dealer with regard to all of its swaps or security-based swaps activities, unless the CFTC or SEC exercises its authority to limit the person's designation as a dealer to specified categories of swaps or security-based swaps, or specified activities.[572] As discussed in the Proposing Release, moreover, a person may apply for a limited designation when it submits a registration application, or at a later time.[573] The final rules also contain a technical change from the proposed rules to clarify that limited designations may be based on a particular type, class or category of swap or security-based-swap.[574]

a. Default Presumption of Full Designation

Consistent with the proposal, the final rules retain the standard that a person that satisfies the ''swap dealer'' or ''security-based swap dealer'' definition in general would be considered a dealer for all types, classes or categories of the person's swaps or security-based swaps, or all activities involving swaps or security-based swaps.

The Commissions are not persuaded by the suggestion that this presumption is inconsistent with the statute, legislative intent or underlying policy. Not only is the relevant statutory language written as a grant of authority rather than a specific mandate to designate certain entities as limited purpose dealers, but the presumption also reasonably reflects the difficulty of separating a dealer's dealing activities from its non-dealing activities, and the challenges of applying dealer regulatory requirements to only a portion of a dealer's swap or security-based swap activities.[575]

We similarly are not persuaded by the view that the Commissions lack the authority to apply dealer regulation to non-dealing activities of a registered swap dealer or security-based swap dealer.[576] Certain of the statutory requirements applicable to swap dealers and security-based swap dealers—such as capital requirements—simply do not distinguish between a person's dealing activities and their non-dealing activities.[577] In other words, absent a limited designation, the statutory requirements applicable to dealers address the regulation of all of a dealer's swap or security-based swap activities.[578]

b. Demonstration of Compliance With Dealer Requirements

The Commissions will consider limited purpose applications on an individual basis through analysis of the unique circumstances of each applicant, given that the types of entities that engage in swap or security-based swap dealing are diverse and their organization and activities are varied.[579]

Regardless of the type of limited designation being requested, the Commissions will not designate a person as a limited purpose dealer unless it can demonstrate that it can fully comply with the requirements applicable to dealers.

Certain of the statutory requirements applicable to dealers particularly focus on the entity's swap or security-based swap activities and positions. These include, among other aspects, requirements related to trading records, documentation and confirmations.[580] An applicant for a limited purpose designation would have to demonstrate how it would satisfy those transaction-specific requirements in the context of a limited designation.

Other statutory requirements applicable to dealers particularly focus on the entity itself. These include requirements related to registration, capital, risk management, supervision, and chief compliance officers.[581] Here too, an applicant for a limited purpose designation would have to demonstrate how it would satisfy those requirements in the context of limited designations.

A limited purpose designation might be appropriate, for example, where a commercial agricultural company is a dealer in swaps related to a thinly-traded commodity, such as a particular fertilizer, but is not a dealer in, and does not wish to be subject to the swap dealer requirements with respect to its swaps that relate to broadly-traded commodities like corn or wheat (or where, say, a commercial energy company is a dealer in swaps involving a commodity to be delivered at a particular location and does not wish to be subject to the swap dealer requirements for its swaps involving that commodity to be delivered at other locations, for which it is not a swap dealer). A limited designation might also be appropriate so that the swap dealer requirements do not apply to interest rate or currency swaps that the agricultural or energy company enters into in managing its financial risk.

[572] CFTC Regulation§ 1.3(ggg)(3); Exchange Act rule 3a71–1(c).

[573] The SEC expects to address the process for submitting an application for limited designation as a security-based swap dealer, along with principles to be used by the SEC in analyzing such applications, as part of separate rulemakings.

[574] The rules particularly have been revised from the proposal to add ''type'' and ''class'' language to supplement the use of the term ''category.'' This change is consistent with the statutory language. In addition, the final rules related to limited designations for ''security-based swap dealers'' corrects an erroneous reference to major participant designation.

[575] This approach also is consistent with the treatment of dealers of other types of securities under the Exchange Act. When a person's securities activities cause them to be a ''dealer'' for purposes of the Exchange Act, the statutory requirements and regulations applicable to dealers will apply to all of that person's securities activities, regardless of whether particular activities would not have caused the entity to fall within the ''dealer'' definition. For example, Exchange Act section 15(c)(3)(A) prohibits brokers and dealers from engaging in certain securities-related activity in contravention of SEC-prescribed rules with respect to financial responsibility or related practices. This provision does not distinguish between those activities that cause a person to fall within the ''broker'' or ''dealer'' definitions, and other activities that themselves do not cause that person to be a broker or dealer. The SEC's authority extends to all securities activities by those brokers or dealers.

[576] *See* letter from EDF Trading.

[577] *See, e.g.,* CEA section 4s(e); Exchange Act section 15F(e).

[578] The substantive regulations applicable to dealers, of course, can account for the nature of a dealer's particular swap or security-based swap activities.

The SEC also intends to address limited designation issues in the context of a separate release addressing the application of Title VII to non-U.S. entities.

[579] Consistent with this approach, applications to limit a person's dealer designation to ''specified categories'' of swaps or security-based swaps (*see* CFTC Regulation § 1.3(ggg)(3); Exchange Act rule 3a71–1(c)), would not be required to interpret the term ''category'' consistently with the use of that term in connection with the major participant definitions. CFTC Regulation § 1.3(iii) and Exchange Act rule 3a67–2, defining the terms ''major swap category'' and ''major security-based swap category,'' respectively, do not apply for this purpose.

[580] *See, e.g.,* CEA section 4s(h)(3), Exchange Act section 15F(h)(3) (business conduct standards, including disclosure requirements, for dealers); CEA section 4s(g), Exchange Act section 15F(g) (daily trading record requirements for dealers); CEA section 4s(i); Exchange Act section 15F(i) (documentation requirements for dealers).

[581] *See, e.g.,* CEA section 4s(a)(1), Exchange Act section 15F(a)(1) (registration requirements for dealers); CEA section 4s(e), Exchange Act section 15F(e) (capital and margin requirements for dealers). The Dodd-Frank Act provides that in setting the capital requirements for swap dealers and security-based swap dealers (as well as major participants) that are subject to a limited designation, the Commissions and the prudential regulators must take into account the risks associated with other types, classes, or categories of swaps or security-based swaps engaged in, and the other swap or security-based swap activities conducted by, that person ''that are not otherwise subject to regulation applicable to that person by virtue of the status of the person'' as a dealer or major participant. *See* CEA section 4s(e)(2)(C); Exchange Act section 15F(e)(2)(C). In the case of a commercial agricultural or energy company that obtains a limited purpose designation for a particular business unit, the CFTC does not expect that this provision will generally require the limited purpose designee to calculate its required capital on the basis of swaps engaged in, or activities conducted by, other business units within the company, to the extent those swaps or activities do not generate risk beyond the agricultural or energy company's ordinary commercial line of business.

A limited purpose designee could be a particular business unit within a company. Additionally, a limited designation might be considered to ''split the desk'' by applying the swap dealer requirements solely to the designee's limited activities involving swaps not entered into for the purpose of hedging a physical position as defined in CFTC Regulation § 1.3(ggg)(6)(iii). Any particular limited purpose application will be analyzed in light of the unique circumstances presented by the applicant.

A key challenge that any applicant to a limited dealer designation will face is the need to demonstrate full compliance with the requirements that apply to the type, class or category of swap or security-based swap, or the activities involving swaps or security-based swaps, that fall within the swap dealer designation.

III. Amendments to the Definition of Eligible Contract Participant

A. Background

The Dodd-Frank Act makes it unlawful for a person that is not an eligible contract participant (''ECP'') to enter into a swap other than on, or subject to the rules of, a DCM.[582] In addition, section 763(e) of the Dodd-Frank Act makes it unlawful for a person to effect a transaction in a security-based swap with or for a person that is not an ECP unless the transaction is effected on a national securities exchange registered with the SEC.[583] Moreover, section 768(b) of the Dodd-Frank Act makes it unlawful for a person to offer to sell, offer to buy or purchase, or sell a security-based swap to a person that is not an ECP unless a registration statement under the Securities Act of 1933 (''Securities Act'')[584] is in effect with respect to that security-based swap.[585] These provisions mean that persons can engage in neither swaps nor security-based swaps transactions with persons that are not ECPs on SEFs, on security-based SEFs, or on a bilateral, off-exchange basis.

The Dodd-Frank Act also amended the ECP definition by:[586] (i) Providing that, for purposes of CEA sections 2(c)(2)(B)(vi) and 2(c)(2)(C)(vii), the term ECP does not include a commodity pool in which any participant is not itself an ECP; (ii) raising the monetary threshold that governmental entities may use to qualify as ECPs, in certain situations, from $25 million in investments owned and invested on a discretionary basis to $50 million in investments owned and invested on a discretionary basis;[587] and (iii) replacing the ''total asset'' standard for individuals to qualify as ECPs with an ''amounts invested on a discretionary basis'' standard.[588]

Commodity pools may, among other things, enter into transactions involving foreign currency. ECP status is important for commodity pools that enter into the following types of foreign currency transactions (such commodity pools, ''Forex Pools''): (i) Off-exchange foreign currency futures; (ii) off-exchange options on foreign currency futures; (iii) off-exchange options on foreign currency; (iv) leveraged or margined foreign currency transactions; and (v) foreign currency transactions that are financed by the offeror, the counterparty or a person acting in concert with the offeror or counterparty on a similar basis.[589] In some cases, discussed below in detail, if a Forex Pool does not satisfy the ECP definition applicable to commodity pools engaging in the types of foreign currency transactions noted above[590] and it engages in these types of foreign currency transactions (such transactions, ''retail forex transactions'' and such commodity pools, ''Retail Forex Pools''), the transactions will be subject to a regulatory regime that imposes certain requirements and restrictions on the counterparties to the Retail Forex Pool, and, if the Retail Forex Pool engages in retail forex transactions other than with certain counterparties, on the commodity pool operator (''CPO'') who operates the Retail Forex Pool. These requirements and restrictions do not apply if the Forex Pool satisfies the ECP definition applicable to commodity pools engaging in the types of foreign currency transactions noted above.

The Commissions are adopting further definitions of the term ''eligible contract participant'' in the following six respects: (i) Generally prohibiting a Forex Pool from qualifying as an ECP if such Forex Pool directly enters into retail forex transactions[591] and has one or more direct participants that are not ECPs;[592] (ii) clarifying that, in determining whether a direct participant in a Forex Pool is an ECP, the indirect participants in the Forex Pool will not be considered unless such Forex Pool, a commodity pool holding a direct or indirect (through one or more intermediate tiers of pools) interest in

[582] In particular, section 723(a)(2) of the Dodd-Frank Act adds new subsection (e) to CEA section 2 (7 U.S.C. 2(e)), providing that ''[i]t shall be unlawful for any person, other than an eligible contract participant, to enter into a swap unless the swap is entered into on, or subject to the rules of, a board of trade designated as a contract market under section 5.''

[583] In particular, section 763(e) of the Dodd-Frank Act adds paragraph (l) to Exchange Act section 6 (15 U.S.C. 78f(l)), providing that ''[i]t shall be unlawful for any person to effect a transaction in a security-based swap with or for a person that is not an eligible contract participant, unless such transaction is effected on a national securities exchange registered pursuant to subsection (b).''

[584] 15 U.S.C. 77a *et seq.*

[585] In particular, section 768(b) of the Dodd-Frank Act adds paragraph (d) to Securities Act section 5 (15 U.S.C. 77e(d)), providing that ''[n]otwithstanding the provisions of section 3 or 4, unless a registration statement meeting the requirements of section 10(a) is in effect as to a security-based swap, it shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell, offer to buy or purchase or sell a security-based swap to any person who is not an eligible contract participant as defined in section 1a(18) of the Commodity Exchange Act (7 U.S.C. 1a(18)).'' The Commissions note that market participants must make the determination of ECP status with respect to the parties to transactions in security-based swaps and mixed swaps prior to the offer to sell or the offer to buy or purchase the security-based swap or mixed swap.

[586] *See* Sections 741(b)(10) and 721(a)(9) of the Dodd-Frank Act; *see also* Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation, available at *http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf*, at 48–49 (June 17, 2009).

[587] *See* CEA section 1a(18)(A)(vii), 7 U.S.C. 1a(18)(A)(vii).

[588] *See* CEA section 1a(18)(A)(xi), 7 U.S.C. 1a(18)(A)(xi). The Dodd-Frank Act did not amend the monetary thresholds for individuals to qualify as ECPs. As such, an individual can qualify as an ECP if such individual has amounts invested on a discretionary basis, the aggregate of which is in excess of (i) $10,000,000, or (ii) $5,000,000 if such individual also enters into the agreement, contract, or transaction in order to manage the risk associated with an asset owned or liability incurred, or reasonably likely to be owned or incurred, by such individual.

[589] *See* CEA sections 2(c)(2)(B)(vi) and 2(c)(2)(C)(vii), 7 U.S.C. 2(c)(2)(B)(vi) and 7 U.S.C. 2(c)(2)(C)(vii). In this context, the term ''off-exchange'' means other than on or subject to the rules of an organized exchange, as defined in CEA section 1a(37), 7 U.S.C. 1a(37).

[590] *See* CEA section 1a(18)(A)(iv), 7 U.S.C. 1a(18)(A)(iv); *see also* CFTC Regulation § 1.3(m)(5) (exporting the look-through language of CEA section 1a(18)(A)(iv) to CEA section 1a(18)(A)(v)). The Dodd-Frank Act amended the ECP definition to include a provision that specifically applies to Forex Pools engaging in these types of foreign currency transactions. *See* Section 741(b)(10) of the Dodd-Frank Act (adding a provision to CEA section 1a(18)(A)(iv), 7 U.S.C. 1a(18)(A)(iv), stating ''provided, however, that for purposes of section 2(c)(2)(B)(vi) and section 2(c)(2)(C)(vii), the term 'eligible contract participant' shall not include a commodity pool in which any participant is not otherwise an eligible contract participant.''). *See* part III.B below for a discussion of this provision. This provision applies only with respect to retail forex transactions. This means that a Retail Forex Pool, as defined above, that is not an ECP for retail forex transaction purposes could be an ECP for other transactions it enters into that are not retail forex transactions.

[591] In many commodity pool structures, this is the master fund alone.

[592] *But see* note 652, *infra,* with respect to single level Forex Pools using retail forex transactions solely to hedge.

such Forex Pool, or any commodity pool in which such Forex Pool holds a direct or indirect interest has been structured to evade Subtitle A of Title VII of the Dodd-Frank Act;[593] (iii) prohibiting a commodity pool from qualifying as an ECP unless it has total assets exceeding $5 million and is operated by a person described in CEA section 1a(18)(A)(iv)(II);[594] (iv) explicitly including swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants in the definition of ECP; (v) permitting a non-ECP to qualify as an ECP, with respect to certain swaps, based on the collective net worth of its owners, subject to several conditions, including that the owners are ECPs; and (vi) permitting a Forex Pool to qualify as an ECP notwithstanding that it has one or more direct participants that are not ECPs if the Forex Pool (a) is not formed for the purpose of evading regulation under CEA sections 2(c)(2)(B) or (C) or related rules, regulations or orders, (b) has total assets exceeding $10 million and (c) is formed and operated by a registered CPO or by a CPO who is exempt from registration as such pursuant to § 4.13(a)(3). In addition, the Commissions are issuing interpretive guidance regarding the definition of ECP to correct an inaccurate statutory cross-reference with respect to the ability of government entities to qualify as ECPs under CEA section 1a(18)(A)(vii).[595] The Commissions also are issuing interpretive guidance with respect to the ECP status of Forex Pools whose participants are limited solely to non-U.S. persons and which are operated by CPOs located outside the United States, its territories or possessions.

The Commissions note that commenters raised interpretive and other issues related to the ECP definition that the Commissions may consider in the future.[596]

B. Commodity Pool Look-Through for Retail Forex Transactions

1. Statutory Provisions

Prior to the Dodd-Frank Act, clause (A)(iv) of the ECP definition provided that a commodity pool was an ECP if it had $5 million in total assets and was operated by a person regulated under the CEA, regardless of whether each participant in the commodity pool was itself an ECP.[597] Section 741(b)(10) of the Dodd-Frank Act added a proviso to clause (A)(iv)[598] stating that a Forex Pool will not qualify as an ECP, solely for purposes of CEA sections 2(c)(2)(B)(vi) or 2(c)(2)(C)(vii) (*i.e.,* retail forex transactions) if any participant in the Forex Pool is itself not an ECP.[599]

Thus, for purposes of retail forex transactions, the Dodd-Frank Act imposed a requirement to ''look through'' a Forex Pool—meaning that ECP status would be limited to Forex Pools in which each participant is itself an ECP. This is important for two reasons. First, a Forex Pool that does not qualify as an ECP can enter into a retail forex transaction described in CEA section 2(c)(2)(B)(i)(I) only with one of the federally-regulated counterparties enumerated in CEA sections 2(c)(2)(B)(i)(II)(aa) (U.S. financial institutions),[600] (bb) (certain brokers, dealers and their associated persons),[601] (cc) (certain futures commission merchants (''FCMs'') and their affiliated persons),[602] (dd) (certain financial holding companies)[603] or (ff) (certain retail foreign exchange dealers (''RFEDs''))[604] (each an ''Enumerated Counterparty'' and collectively ''Enumerated Counterparties''); the counterparty restriction does not apply to retail forex transactions described in CEA section 2(c)(2)(C)(i)(I)(bb)[605] entered into by a Forex Pool that does not qualify as an ECP, though such transactions are subject to antifraud protections and related enforcement provisions if entered into with a

[593] Section 721(c) of the Dodd-Frank Act requires the CFTC to adopt a rule to further define the terms ''swap,'' ''swap dealer,'' ''major swap participant,'' and ''eligible contract participant,'' in order ''[t]o include transactions and entities that have been structured to evade'' subtitle A of Title VII (or an amendment to the CEA made by subtitle A).

[594] 7 U.S.C. 1a(18)(A)(iv)(II).

[595] 7 U.S.C. 1a(18)(A)(vii).

[596] These issues include: (i) The ECP status of jointly and severally liable borrowers and counterparties, non-ECPs guaranteed by ECPs, and non-ECP swap collateral providers; (ii) whether bond proceeds count toward the ''owns and invests on a discretionary basis $50,000,000 or more in investments'' element of the governmental ECP prong (CEA section 1a(18)(A)(vii), 7 U.S.C. 1a(18)(A)(vii)); (iii) the relationship between the ECP and eligible commercial entity definitions for purposes of CEA section 1a(18)(A)(vii), 7 U.S.C. 1a(18)(A)(vii); (iv) the scope of the ''proprietorship'' element of the entity prong of the ECP definition in CEA section 1a(18)(A)(v), 7 U.S.C. 1a(18)(A)(v) (which the Commissions are addressing to a limited extent in the discussion of the new line of business ECP category in part III.F, *infra,* and in Regulation § 1.3(m)(7)(ii)(C) under the CEA); (v) the meaning of the new ''amounts invested on a discretionary basis'' element of the individual prong of the ECP definition (CEA section 1a(18)(A)(xi), 7 U.S.C. 1a(18)(A)(xi)); (vi) whether persons can be ECPs in anticipation of receiving, but before they have, the necessary assets; and (vii) that swap dealers are not among the entities listed in CEA section 2(c)(2)(B)(i)(II), 7 U.S.C. 2(c)(2)(B)(i)(II), as acceptable counterparties to non-ECPs engaging in retail forex transactions.

[597] Clause (A)(iv) of the pre-Dodd-Frank Act ECP definition also included a commodity pool operated by a foreign person performing a similar role or function as a person regulated under the CEA and subject as such to foreign regulation (regardless of whether the foreign person was itself an ECP).

[598] The proviso states ''provided, however, that for purposes of section 2(c)(2)(B)(vi) and section 2(c)(2)(C)(vii), the term 'eligible contract participant' shall not include a commodity pool in which any participant is not otherwise an eligible contract participant.'' CEA section 1a(18)(A)(iv); 7 U.S.C. 1a(18)(A)(iv).

[599] *See* CEA section 1a(18)(A)(iv), 7 U.S.C. 1a(18)(A)(iv). In other words, the proviso in section 1a(18)(A)(iv) does not reference or implicate ECP status for purposes of (i) CEA section 2(e), 7 U.S.C. 2(e) (which, as discussed above, permits non-ECPs to trade swaps only on or subject to the rules of a DCM); (ii) Securities Act section 5(d) (which, as discussed above, makes it unlawful for a person to offer to sell, offer to buy or purchase, or sell a security-based swap to a person that is not an ECP unless a registration statement under the Securities Act is in effect with respect to that security-based swap); or (iii) Exchange Act section 6(l) (which as discussed above, makes it unlawful for a person to effect a transaction in a security-based swap with or for a person that is not an ECP unless the transaction is effected on a national securities exchange registered with the SEC). The look-through proviso does not expressly state that indirect participants, as well as direct participants, in the Forex Pool must be ECPs for the Forex Pool to be an ECP. *But see* notes 636 and 638, *infra* (discussing the authority for such an approach).

[600] 7 U.S.C. 2(c)(2)(B)(i)(II)(aa). The term ''financial institution'' is defined in CEA Section 1a(21), 7 U.S.C. 1a(21).

[601] 7 U.S.C. 2(c)(2)(B)(i)(II)(bb). This category is comprised of each:

(AA) [] broker or dealer registered under section 15(b) (except paragraph (11) thereof) or 15C of the Securities Exchange Act of 1934 (15 U.S.C. 78o(b), 78o–5); [and] (BB) [ ] associated person of a broker or dealer registered under section 15(b) (except paragraph (11) thereof) or 15C of the Securities Exchange Act of 1934 (15 U.S.C. 78o(b), 78o–5) concerning the financial or securities activities of which the broker or dealer makes and keeps records under section 15C(b) or 17(h) of the Securities Exchange Act of 1934 (15 U.S.C. 78o–5(b), 78q(h)).

[602] 7 U.S.C. 2(c)(2)(B)(i)(II)(cc). This category is comprised of each:

(cc)(AA) []futures commission merchant that is primarily or substantially engaged in the business activities described in section 1a of this Act, is registered under this Act, is not a person described in item (bb) of this subclause, and maintains adjusted net capital equal to or in excess of the dollar amount that applies for purposes of clause (ii) of this subparagraph; [and] (BB) [ ] affiliated person of a futures commission merchant that is primarily or substantially engaged in the business activities described in section 1a of this Act, is registered under this Act, and is not a person described in item (bb) of this subclause, if the affiliated person maintains adjusted net capital equal to or in excess of the dollar amount that applies for purposes of clause (ii) of this subparagraph and is not a person described in such item (bb), and the futures commission merchant makes and keeps records under section 4f(c)(2)(B) of this Act concerning the futures and other financial activities of the affiliated person.

[603] 7 U.S.C. 2(c)(2)(B)(i)(II)(dd). The enumerated counterparty in this category is ''a financial holding company (as defined in section 2 of the Bank Holding Company Act of 1956).''

[604] 7 U.S.C. 2(c)(2)(B)(i)(II)(ff). This category is comprised of each:

retail foreign exchange dealer that maintains adjusted net capital equal to or in excess of the dollar amount that applies for purposes of clause (ii) of this subparagraph and is registered in such capacity with the [CFTC], subject to such terms and conditions as the [CFTC] shall prescribe, and is a member of a futures association registered under section 17 [of the CEA].

[605] 7 U.S.C. 2(c)(2)(C)(i)(I)(bb).

counterparty other than an Enumerated Counterparty described in CEA section 2(c)(2)(B)(i)(II)(aa), (bb) or (dd).[606] Second, the operator of a Retail Forex Pool engaging in retail forex transactions with an Enumerated Counterparty that is an FCM, specified affiliated person of an FCM or RFED must register with the CFTC as a CPO,[607] unless the CPO also is an Enumerated Counterparty under 2(c)(2)(B)(i)(II)(aa), (bb) or (dd)[608] or an exemption from CPO registration applies.[609] Moreover, CEA section 2(c)(2)(E)(ii)(I),[610] which was added by section 742(c)(2) of the Dodd-Frank Act, prohibits an Enumerated Counterparty from entering into retail forex transactions described in CEA section 2(c)(2)(B)(i)(I) with a person that is not an ECP ''except pursuant to a rule or regulation of [the appropriate Federal regulator of such Enumerated Counterparty allowing such transactions] under such terms and conditions as [such regulator] shall prescribe.'' CEA section 2(c)(2)(E)(iii)(II)[611] requires that such rules or regulations treat similarly all agreements, contracts, and transactions in foreign currency that are functionally or economically similar to CEA section 2(c)(2)(B)(i)(I) agreements, contracts, and transactions.

Separately, subclause (A)(v)(III) of the ECP definition, both before and after enactment of the Dodd-Frank Act, provides that a corporation, partnership, proprietorship,[612] organization, trust or other business entity may qualify as an ECP if it has a net worth exceeding $1 million and ''enters into an agreement, contract, or transaction in connection with the conduct of the entity's business or to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by the entity in the conduct of the entity's business.''[613]

2. Proposed Approach

The Commissions stated in the Proposing Release that ''in some cases commodity pools unable to satisfy the conditions of clause (A)(iv) of the ECP definition may rely on clause (A)(v) to qualify as ECPs instead for purposes of retail forex'' and that permitting such reliance would frustrate the intent of Congress in imposing the look-through requirement on Forex Pools in clause (A)(iv) of the ECP definition.[614]

The Commissions proposed to further define the term ''eligible contract participant'' to preclude a Forex Pool from qualifying as an ECP for purposes of retail forex transactions in reliance on clause (A)(v) of the ECP definition if

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[606] The counterparty limitation with respect to CEA section 2(c)(2)(B)(i)(I) retail forex transactions is a function of the fact that the CEA's exchange-trading requirement generally applies with respect to foreign currency futures, foreign currency options on futures, and foreign currency options. *See* CEA section 4(a), 7 U.S.C. 6(a) (generally requiring futures contracts to be traded on or subject to the rules of a DCM); CEA section 4c(b), 7 U.S.C. 6c(b) (prohibiting trading options subject to the CEA contrary to CFTC rules, regulations or orders permitting such trading); Part 32 of the CFTC's rules, 17 CFR part 32 (generally prohibiting entering into options subject to the CEA) and CFTC Regulation § 33.3(a), 17 CFR 33.3(a) (prohibiting entering into options on futures other than on or subject to the rules of a DCM). Because CEA section 4(a) would render an off-exchange futures contract illegal but for CEA section 2(c)(2)(B) permitting such transactions with an Enumerated Counterparty, it would be illegal for a non-Enumerated Counterparty to enter into a futures contract described in 2(c)(2)(B)(i)(I) with a non-ECP. Similarly, because options can be conducted only pursuant to CFTC authority and the CFTC has proposed to treat commodity options within its jurisdiction as swaps, CEA section 2(e) would prohibit such options, if on foreign exchange and entered into with a non-ECP, but for the fact that 2(c)(2)(B) permits them if traded with an Enumerated Counterparty.

The lack of a counterparty limitation with respect to CEA section 2(c)(2)(C)(i)(I)(bb) retail forex transactions is a function of the different structures of CEA sections 2(c)(2)(B) and (C). Whereas CEA section 2(c)(2)(B)(i) covers transactions that would be illegal but for compliance with CEA section 2(c)(2)(B) (due to such section's incorporation of the entire CEA, including, for example, the exchange-trading requirement discussed above), falling within CEA section 2(c)(2)(C)(i)(I), by that section's own terms, merely brings a covered transaction within the scope of CEA section 2(c)(2)(C), which does not include the exchange-trading requirement of CEA section 4(a). Because CEA section 2(c)(2)(C)(i)(I) covers transactions that may or may not also be transactions described in section 2(c)(2)(B)(i)(I) and the far fewer requirements imposed by CEA section 2(c)(2)(C) invite characterization of such difficult-to-categorize transactions as falling solely within CEA section 2(c)(2)(C), the CFTC will interpret such dually characterizable transactions as governed by CEA section 2(c)(2)(B). If such transactions fall only within CEA section 2(c)(2)(C), however, because they would be subject to neither the exchange-trading requirement of CEA section 4(a) nor the CFTC's plenary options authority under CEA section 4c(b) (while CEA section 2(c)(2)(C)(ii)(I), 7 U.S.C. 2(c)(2)(C)(ii)(I), reserves the CFTC's section 4c(b) authority, in this scenario, the contract in question is not an option), a person other than an Enumerated Counterparty may act as counterparty to a non-ECP. Such contracts would, however, be subject to two of the CEA's antifraud provisions, sections 4(b) and 4b, 7 U.S.C 6(b) and 7 U.S.C 6b, respectively, as if they were futures contracts. *See* CEA section 2(c)(2)(C)(iv), 7 U.S.C. 2(c)(2)(C)(iv). Such contracts also would be subject to related enforcement provisions. *See* CEA section 2(c)(2)(C)(ii)(I), 7 U.S.C. 2(c)(2)(C)(ii)(I).

[607] *See* CEA sections 2(c)(2)(B)(iv)(I) and (C)(iii)(I) (requiring registration for CPOs of Retail Forex Pools entering into retail forex transactions with FCMs, specified affiliated persons thereof or RFEDs). By contrast, those sections exclude from the CPO registration requirement CPOs of Retail Forex Pools engaging in retail forex transactions with Enumerated Counterparties described in CEA section 2(c)(2)(B)(i)(II)(aa), (bb), (ee) and (ff). While the cited CEA sections refer to counterparties not described in ''any of item (aa), (bb), (ee), or (ff)'' of subparagraph (B)(i)(II), the CFTC Reauthorization Act of 2008 (''CRA''), included as Title XIII of the Food, Conservation and Energy Act of 2008, Pub.L. 110–246, 122 Stat. 1651 changed item (ee) to item (dd) (a financial holding company as defined in section 2 of the Bank Holding Company Act of 1956) and removed item (ff) (formerly an investment bank holding company (as defined in section 17(i) of the Exchange Act (15 U.S.C. 78q(i))). Therefore, the Commissions interpret the reference in CEA sections 2(c)(2)(B)(iv)(I)(cc) and 2(c)(2)(C)(iii)(I)(cc) to items (aa), (bb), (ee), or (ff) to be references to items (aa), (bb) and (dd). *Cf.* Retail Foreign Exchange Transactions; Conforming Changes to Existing Regulations in Response to the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR 56103 (Sept. 12, 2011) (providing background on related incorrect internal references in CEA sections 2(c)(2)(B) and (C)). *See also* CFTC Regulation § 5.3(a)(2)(i), 17 CFR 5.3(a)(2)(i), which requires a CPO, as defined in CFTC Regulation § 5.1(d)(1), 17 CFR 5.1(d)(1), to register as such. CFTC Regulation § 5.1(d)(1), in turn, defines a CPO, for purposes of Part 5 of the CFTC's Regulations, 17 CFR part 5, as ''any person who operates or solicits funds, securities or property for a pooled investment vehicle that is not an [ECP] as defined in section 1a(18) of the Act, and that engages in retail forex transactions.'' The CFTC interprets the references in Regulation § 5.1(d)(1) to ECPs as defined in CEA section 1a(18) to include the ECP definition as further defined or interpreted by the Commissions under authority conferred by the Dodd-Frank Act or otherwise amended or interpreted by the Commissions or a court. While the statutory CPO definition in CEA section 1a(11)(A), 7 U.S.C. 1a(11)(A), does not include transactions described in CEA section 2(c)(2)(B)(i), the Commissions believe this was an oversight. In any case, CEA section 1a(11)(B), 7 U.S.C. 1a(11)(B), grants the CFTC the authority to further define the term CPO, which the CFTC has done in CFTC Regulation § 5.1(d)(1). Therefore, a person operating a commodity pool engaging in transactions described in CEA section 2(c)(2)(B)(i) is a CPO.

[608] *See* CEA sections 2(c)(2)(B)(iv)(II) and 2(c)(2)(C)(iii)(II). While CEA sections 2(c)(2)(B)(iv)(II) and 2(c)(2)(C)(iii)(II) refer to counterparties described in item (aa), (bb), (ee), or (ff) of subparagraph (B)(i)(II), the CFTC Reauthorization Act of 2008 changed item (ee) to item (dd) and removed item (ff). Therefore, the Commissions interpret the reference in CEA sections 2(c)(2)(B)(iv)(II) and 2(c)(2)(C)(iii)(II) to items (aa), (bb), (ee), or (ff) to be references to items (aa), (bb) and (dd). *Cf.* Retail Foreign Exchange Transactions; Conforming Changes to Existing Regulations in Response to the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR 56103 (Sept. 12, 2011) (providing background on related incorrect internal references in 2(c)(2)(B) and (C)).

[609] *See, e.g.,* CFTC Regulation § 4.13(a)(3) (exempting from CPO registration operators of commodity pools engaged in a *de minimis* amount of trading in CFTC-jurisdictional contracts).

[610] 7 U.S.C. 2(c)(2)(E)(ii)(I).

[611] 7 U.S.C. 2(c)(2)(E)(iii)(II).

[612] Individuals also are covered by a different prong of the ECP definition. An individual can qualify as an ECP under clause (A)(xi) of the ECP definition. *See* CEA section 1a(18)(A)(xi), 7 U.S.C. 1a(18)(A)(xi).

[613] There are two other ways a person can qualify as an ECP under clause (A)(v): (i) being an entity with total assets exceeding $10 million; or (ii) being an entity the obligations of which under an agreement, contract, or transaction are guaranteed or otherwise supported by a letter of credit or keepwell, support, or other agreement by an entity with total assets exceeding $10 million or an entity described in clause (A)(i), (ii), (iii), (iv) or (vii), or paragraph (C), of the ECP definition. *See* CEA section 1a(18)(A)(v)(I) and (II), 7 U.S.C. 1a(18)(A)(v)(I) and (II), respectively.

[614] Proposing Release, 75 FR at 80185.

such Forex Pool has any participant that is not an ECP and, therefore, is not an ECP due to the look-through provision added to clause (A)(iv). Further, because commodity pools can be structured in various ways and can have one or more feeder funds and/or pools, the Commissions proposed to preclude a Forex Pool from being an ECP for purposes of retail forex transactions if there was any non-ECP participant at any level of the pool structure (*e.g.,* the pool itself, a direct participant that invests in the pool, or any indirect participant that invests in that pool through other pools or vehicles).

3. Commenters' Views

One commenter supported the Commissions' efforts to close the potential loophole of Forex Pools that are unable to qualify as ECPs due to the new look-through provision in clause (A)(iv) of the ECP definition instead qualifying as ECPs under clause (A)(v) of the ECP definition.[615] This commenter indicated that it shares the Commissions' concern that Forex Pools that do not satisfy the amended ECP definition due to the look-through provision for commodity pools in clause (A)(iv) may alternatively rely upon clause (A)(v) of the ECP definition to qualify as an ECP for purposes of retail forex transactions.[616] This commenter further stated that Congressional intent in requiring a look-through for Forex Pools would be frustrated if fraudulent pool operators could avail themselves of this alternative.[617]

However, several commenters recognized the importance of the concern about a potential loophole[618] but stated that the Commissions should revise the proposal to mitigate the potential adverse consequences to market participants. One commenter, for example, commented on the expected effects of the proposed rule on funds of funds (''FOFs'').[619] According to this commenter, FOFs (i) normally face as counterparties foreign subsidiaries of U.S. banks and foreign banks, and (ii) would incur substantial counterparty, documentation and operational costs in moving their retail forex transactions onto DCMs or toward the Enumerated Counterparties.

In a similar vein, two commenters advised that a substantial number of hedge funds, as well as publicly offered commodity pools, would, under the Commissions' proposal, fail to qualify as ECPs for purposes of retail forex transactions, as most such funds have at least one direct or indirect non-ECP participant.[620] These commenters indicated that this would disrupt the trading strategies employed by many commodity trading advisors (''CTAs'') on behalf of commodity pools.[621] One of these commenters suggested an anti-evasion approach combining a lower level of pool assets with a requirement that the commodity pool not be formed for the purpose of evading the regulatory requirements applicable to retail forex transactions.[622]

Another commenter argued that Congress did not include the look-through provision in clause (A)(v) of the ECP definition because of its effect on bona fide hedgers.[623] This commenter also advised that the primary entities affected are hedge fund and private equity fund managers investing in securities who use retail forex transactions solely to hedge investment portfolio currency risks, and/or because they accept subscriptions in currencies other than U.S. dollars.[624]

Several commenters disagreed with the Commissions' statement in the proposal that extending the look-through provision in clause (A)(iv) of the ECP definition to clause (A)(v) would effectuate Congressional intent. Two commenters noted that there is no specific Dodd-Frank Act provision requiring such a change.[625] Two other commenters argued that clause (v) of the ECP definition provides an independent basis for qualification as an ECP, which should not be affected by the changes in clause (A)(iv) of the ECP definition.[626]

One commenter indicated that the extraterritorial application of the proposed rules regarding the ECP definition is unclear.[627] Among other things, this commenter indicated it is unnecessary to extend the scope of the look-through to protect possible retail investors outside of the U.S., especially where a CPO has not marketed a pool in the U.S. and does not otherwise have any U.S. investors.[628]

Commenters proposed several alternative approaches that they believed would address the Commissions' concerns. One commenter suggested that the Commissions create a new category of ECPs for Forex Pools comprised entirely of qualified eligible persons (''QEPs'')[629] and operated by persons subject to regulation under the CEA.[630] This commenter also suggested that the Commissions create a new category of ECPs for Forex Pools that satisfy a monetary threshold for total assets or for the minimum initial investment of a Forex Pool to be sufficiently large that, in general, only legitimate pools would exceed such thresholds.[631] Finally, this commenter suggested that the Commissions create a category of ECPs

[615] *See* letter from the NFA. The NFA indicated that it recently took separate emergency actions against two firms that did not qualify under the NFA's requirements for retail forex transactions. In one case, the commodity pool fell short of the $5 million total asset requirement in clause (A)(iv) of the ECP definition; in the other case, the firm never properly formed a commodity pool. The NFA cautioned in its letter, ''these cases illustrate that firms will attempt to obtain ECP status to shield themselves from the jurisdiction of regulators to the detriment of pool participants.''

[616] *Id.*

[617] *Id.*

[618] *See, e.g.,* letters from SIFMA—AMG dated September 15, 2011 (''SIFMA AMG IV'') (acknowledging some form of ECP look-through is appropriate to prevent evasion where circumvention otherwise could occur and stating that it is sympathetic to the Commissions' implicit objective of ensuring that a person that would not qualify as an ECP not be permitted to accomplish indirectly what it is not permitted to do directly), Sidley Austin LLP (''Sidley'') (stating that the commenter fully appreciates that Congress added the look-through language to the ECP definition to prevent unscrupulous forex market participants from avoiding the retail forex provisions of the CEA and the CFTC's rules by ''engineering'' an ECP by pooling the capital of a large group of retail customers, thus depriving those investors of the protections otherwise afforded to them), AIMA I (stating that ''we understand Congress has made a decision to try to protect retail investors by amending the definition of ECP under Section 1a(1[8]) of the [CEA] to include that, for a commodity pool to qualify as an ECP under sub-section (A)(iv), the pool's underlying participants must also qualify as ECPs under section 1a(1[8])).''

[619] *See* letter from Sidley. Sidley noted that FOF managers' retail forex transactions are largely undertaken for hedging purposes and that most FOF managers offer investments to non-U.S. persons, a significant number of which pay for their investments in FOF interests using their own currency. Sidley further noted that, because most FOFs accept investments only in U.S. dollars, FOF managers must convert to U.S. dollars the foreign currency received from such investors and invest those dollars in underlying funds, and that they enter into a hedging transaction to reduce the risk of exchange rate changes between an investor's currency and the U.S. dollar.

[620] *See* letters from Willkie Farr & Gallagher LLP (''Willkie Farr'') and the NYCBA Committee.

[621] *Id.*

[622] *See* letter from Willkie Farr.

[623] *See* letter from Akin Gump Strauss Hauer & Feld LLP (''Akin Gump'').

[624] *Id.*

[625] *See* letters from AIMA I and Ropes & Gray LLP (''Ropes & Gray'').

[626] *See* letters from Akin Gump, Sidley and Skadden, Arps, Slate, Meagher & Flom LLP (''Skadden''). Sidley also indicated that there seems to be no compelling reason to treat commodity pools worse than other sophisticated market participants with respect to retail forex transactions with non-Enumerated Counterparties, and no reason to treat them worse than a corporation or other entity with only $10 million in total assets that therefore qualifies as an ECP under clause (A)(v) of the ECP definition to trade retail forex transactions although it may have no particular expertise in such markets.

[627] *See* letter from AIMA I.

[628] *Id.*

[629] The term ''qualified eligible person'' is defined in CFTC Regulation §§ 4.7(a)(2) and (3).

[630] *See* letter from Sidley.

[631] *Id.*

for non-U.S. persons.[632] A second commenter suggested that the Commissions create a category of ECPs for commodity pools that are operated by a CPO or advised by a CTA subject to regulation by a foreign regulator comparable to the CFTC.[633]

One commenter suggested (i) allowing commodity pools and their counterparties to rely, for the duration of an investment and each time commodity pool participants make an investment decision, on participant ECP representations provided in connection with an initial investment, provided that each participant covenants to update such representations if they become inaccurate, and (ii) providing specific relief for FOFs because they generally invest all or substantially all of their assets in underlying portfolio funds and use retail forex transactions to reduce foreign exchange exposure.[634]

4. Final Rule

After considering commenters' concerns, the Commissions are adopting final rules that have been revised from the proposal. In particular, consistent with the statutory text of the Dodd-Frank Act, CFTC Regulation § 1.3(m)(5)(i) further defines the term ''eligible contract participant'' to prohibit a Forex Pool that directly enters into a retail forex transaction (*i.e.,* a transaction-level commodity pool)[635] from qualifying as an ECP under clause (A)(iv) or clause (A)(v) of the ECP definition, solely for purposes of entering into retail forex transactions, if the pool has one or more direct participants that are not ECPs. In response to commenters' concerns described above, CFTC Regulation § 1.3(m)(5)(ii) is revised to provide that, in determining whether a commodity pool that is a direct participant in a transaction-level Forex Pool is an ECP, the indirect participants in the transaction-level Forex Pool[636] will not be considered unless such Forex Pool, a commodity pool holding a direct or indirect (through one or more intermediate tiers of pools) interest in such Forex Pool, or any commodity pool in which such Forex Pool holds a direct or indirect interest has been structured to evade Subtitle A of Title VII of the Dodd-Frank Act by permitting persons that are not ECPs to participate in agreements, contracts, or transactions described in section 2(c)(2)(B)(i) or section 2(c)(2)(C)(i) of the Commodity Exchange Act. That is, absent evasion, the Commissions are changing the proposed ''indefinite look-through'' to an ''evasion-based look-through'' in the final rule.[637]

In adding the look-through provision to the commodity pool prong of the ECP definition, Congress made a decision to protect retail foreign exchange investors by requiring that the participants in a Forex Pool qualify as ECPs for the Forex Pool itself to qualify as an ECP. The Commissions believe that the intent of the look-through provision—protecting Forex Pool participants from fraudulent and abusive conduct—must be given effect to comply with this Congressional mandate. Nevertheless, the Commissions acknowledge commenters' concerns about potential unintended consequences of applying an indefinite look-through to every direct and indirect participant of a Forex Pool, as proposed. Accordingly, to avoid unintended consequences and related costs for Forex Pools whose operators and managers have not historically presented the risks that the look-through provision was intended to address,[638] the Commissions are replacing the proposed indefinite look-through of every participant in a Forex Pool with a limited, evasion-based look-through pursuant to which a transaction-level Forex Pool will qualify as an ECP, for purposes of retail forex transactions, if all of such Forex Pool's direct participants are ECPs, and will look through a commodity pool participant in such Forex Pool only if it, at any level, has been structured to evade the look-through provision in clause (A)(iv) of the ECP definition.

The Commissions believe the final rule strikes the right balance between implementing strong protections for non-ECP commodity pool participants and not imposing undue burdens or costs on CPOs, CTAs and commodity pool participants related to retail forex transactions. In addition, the Commissions believe that replacing the indefinite look-through with the limited, evasion-based look-through alleviates many of the commenters' concerns. Accordingly, the Commissions believe it is appropriate to limit the look-through provision to the level of a commodity pool structure that enters into retail forex transactions and to look through commodity pools to their ultimate participants only in those

[632] *Id.* Sidley cited to the approach in Regulation S under the Securities Act (17 CFR 230.901 *et seq.*), Sections 3(c)(1) and (7) of the Investment Company Act of 1940 (15 U.S.C. 80a–3(c)(1) and (7)), and CFTC Regulation § 4.7(a)(2)(xi).

[633] *See* letter from Willkie Farr.

[634] *See* letter from Sidley.

[635] Commodity pool structures can take various forms. One common commodity pool structure is a ''master-feeder'' fund structure. In such a structure, investors purchase interests in ''feeder funds,'' which in turn purchase interests in a ''master fund.'' Typically, the only fund in a commodity pool structure that enters into retail forex transactions (and other transactions) directly is the master fund; the feeder funds (and their investors) typically would participate indirectly by receiving the profit or loss from such retail forex transactions (and other transactions) as distributions based on the feeder funds' interests in the master fund. Notwithstanding that the master-feeder structure is common, other structures exist. Thus, each fund in a commodity pool structure that directly enters into retail forex transactions is a transaction-level commodity pool.

[636] A fund that does not itself engage in retail forex transactions but that holds an interest in a transaction-level Forex Pool that engages in retail forex transactions is itself a commodity pool. *Cf.* U.S. Regulation of the International Securities and Derivatives Markets—Greene, Beller, Rosen, Silverman, Braverman and Sperber, § 12.13[1], n.351 and related text.

[637] The Commissions caution, however, that they will closely monitor developments in this part of the market and will not hesitate to revisit their decision to limit the look-through provision pursuant to 1.3(m)(5)(ii) should they observe a pattern of evasion or misconduct.

[638] The proposed rule was based on the CFTC's longstanding, broad view of what constitutes a ''pool,'' a view recently codified in the ''commodity pool'' definition by section 721(a)(5) of the Dodd-Frank Act in CEA section 1a(10), 7 U.S.C. 1a(10), and recognized by courts, and thus applied the look-through provision at each level of a Forex Pool's investment structure. *See* CFTC, Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations, 77 FR 11252 (Feb. 24, 2012) (''CPO/CTA Compliance Release'') (advising that ''it is the position of the [CFTC] that a fund investing in an unaffiliated commodity pool it itself a commodity pool'' and ''[t]his interpretation is consistent with the statutory definition of commodity pool, which draws no distinction between direct and indirect investments in commodity interests''); *CFTC* v. *Equity Financial Group,* 572 F.3d 150, 157–158 (July 13, 2009) (concluding, in the context of a commodity pool that invested all of its assets with a commodity pool operated by a different CPO, that the CFTC's commodity pool regulations ''cover pools that invest in other pools'' and that ''the remedial purposes of the statute would be thwarted if the operator of a fund could avoid the regulatory scheme simply by investing in another pool rather than trading''). The same logic applies to a master-feeder structure operated by the same CPO: the remedial purpose of the look-through proviso in clause (A)(iv) of the statutory ECP definition would be thwarted if the look-through could be defeated simply by funneling pool participants into a master fund through a feeder fund.

The proposed rule also was borne of the CFTC's long history of combating fraudulent practices by typically unregistered individuals or entities that prey upon often unsophisticated retail customers through complex and highly leveraged off-exchange transactions in foreign currency. However, the operators and managers of commodity pool FOFs, master-feeder structures and hedge funds for sophisticated investors have not generally been the subject of CFTC enforcement actions with respect to retail forex transactions. For an in depth discussion of the history of the CFTC's authority over retail forex transactions, the abuses giving rise to that authority, and related enforcement actions, *see* CFTC, Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries, 75 FR 3282 (Jan. 20, 2010). Congress acted three times in a decade to clarify the CFTC's authority to prosecute the rampant fraud seen in this area—first in the Commodity Futures Modernization Act of 2000, Public Law 106–554, 114 Stat. 2763 (Dec. 21, 2000) in 2000, then again in the CRA, and finally in the Dodd-Frank Act in 2010.

cases in which it is required to prevent evasion of the protections for those persons whom Congress intended to be subject to retail forex transactions restrictions.

At the same time, the Commissions do not believe that Forex Pools failing to qualify as ECPs due to the look-through provision in clause (A)(iv) of the ECP definition should, nonetheless, be permitted unfettered access to ECP status under clause (A)(v).[639] The look-through provision for Forex Pools provides heightened investor protection from forex fraud for Forex Pool participants that are not themselves ECPs. Thus, the Commissions believe that permitting Forex Pools with one or more non-ECP participants to achieve ECP status by relying on clause (A)(v) of the ECP definition, which applies to business entities generally, would serve to undermine the look-through provision that Congress specifically imposed on Forex Pools under clause (A)(iv).[640]

Moreover, developments subsequent to the issuance of the Proposing Release should ameliorate commenters' concerns that CEA section 2(c)(2)(E)(ii)(I) significantly limits the universe of possible retail forex transaction counterparties.[641] At the time the Commissions issued the Proposing Release and throughout the comment period, the CFTC was the only Federal regulatory agency that had issued final rules governing retail forex transactions by its regulated persons and entities.[642] Since then, though, both the OCC and the FDIC finalized (effective July 15, 2011) rules governing retail forex transactions by Enumerated Counterparties regulated by those agencies.[643] In addition, the SEC has issued interim temporary final rules (also effective July 15, 2011) governing retail forex transactions by registered broker-dealers.[644] Also, the Federal Reserve Board proposed rules to govern retail forex transactions by its regulated banks on August 3, 2011.[645] As a result of these regulatory actions, Forex Pools that are not ECPs due to the look-through provision and who are subject to a counterparty limitation[646] may enter into retail forex transactions with any Enumerated Counterparty but for those regulated by the Federal Reserve Board.[647]

The Commissions believe that the final rules reasonably address commenters' concerns. In this regard, the Commissions note that in applying the look-through provision, the Commissions will consider the indirect participants in a transaction-level Forex Pool if such Forex Pool, a commodity pool holding a direct or indirect (through one or more intermediate tiers of pools) interest in such Forex Pool, or any commodity pool in which such Forex Pool holds a direct or indirect interest has been structured to evade Subtitle A of Title VII of the Dodd-Frank Act by permitting persons that are not ECPs to participate in agreements, contracts, or transactions described in section 2(c)(2)(B)(i) or section 2(c)(2)(C)(i) of the Commodity Exchange Act. One example of a scheme to evade would be if a commodity pool tier has been included in the structure of the Forex Pool primarily to provide non-ECP participants exposure to retail forex transactions rather than to achieve any other legitimate business purpose.[648] One example of a ''legitimate business purpose'' that would not trigger the look-through provision is a FOF operated primarily for the purpose of investing in underlying funds and using retail forex transactions solely to hedge the currency risk posed by an unfavorable change in the exchange rate between the currency in which underlying funds accept investments and the currency in which FOF investors pay for their investments in the FOF.[649] Similarly, the Commissions would not consider a commodity pool using retail forex transactions solely for bona fide hedging purposes[650] with

[639] In section 712(d)(2)(A) of the Dodd-Frank Act, Congress granted the Commissions the authority to adopt such rules regarding the ECP definition as the Commissions determine are necessary and appropriate, in the public interest, and for the protection of investors.

[640] The Commissions note that several commenters requested clarification regarding the relationship between the look-through provision set forth in CFTC Regulation § 1.3(m)(5) and the prohibition on a commodity pool qualifying as an ECP under clause (A)(v) of the ECP definition if it does not qualify as an ECP under clause (A)(iv) of the ECP definition set forth in CFTC Regulation § 1.3(m)(6). *See, e.g.,* meeting with SIFMA—AMG on August 2, 2011. The look-through provision is limited to determining ECP status under clause (A)(iv) or clause (A)(v) of the ECP definition for purposes of retail forex transactions entered into by Forex Pools. The look-through provision does not reference or implicate ECP status for purposes of CEA section 2(e) (which prohibits non-ECPs from entering into swaps other than on or subject to the rules of a DCM), Securities Act section 5(d) (which prohibits a person from offering to sell, offering to buy or purchase, or selling a security-based swap to a person that is a non-ECP unless a registration statement under the Securities Act is in effect with respect to that security-based swap), or Exchange Act section 6(l) (which prohibits a person from effecting a transaction in a security-based swap with or for a person that is a non-ECP unless the transaction is effected on a national securities exchange registered with the SEC). The prohibition in CFTC Regulation § 1.3(m)(6) on a commodity pool qualifying as an ECP under clause (A)(v) of the ECP definition if it does not qualify as an ECP under clause (A)(iv) of the ECP definition does not involve any look-through. Rather, in contrast with CFTC Regulation § 1.3(m)(5), CFTC Regulation § 1.3(m)(6) applies for purposes of all agreements, contracts and transactions for which ECP status is relevant. *See* part III.C, *infra,* for a discussion of the prohibition on a commodity pool qualifying as an ECP under clause (A)(v) of the ECP definition if it does not qualify as an ECP under clause (A)(iv) of the ECP definition.

[641] *See also* part III.G, *infra,* discussing CFTC Regulation § 1.3(m)(8), one effect of which is to eliminate the retail forex transaction counterparty restriction for Forex Pools qualifying as ECPs.

[642] *See generally* Part 5 of the CFTC's regulations, 17 CFR 5, and CFTC, Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries, 75 FR 55410 (Sept. 10, 2010). *See also* CFTC, Retail Foreign Exchange Transactions; Conforming Changes to Existing Regulations in Response to the Dodd-Frank Wall Street Reform and Consumer Protection Act 76 FR 56103 (Sept. 12, 2011).

[643] *See* FDIC, Retail Foreign Exchange Transactions, 76 FR 40779 (July 12, 2011) (final FDIC retail forex rules); OCC, Retail Foreign Exchange Transactions, 76 FR 41375 (July 14, 2011) (final OCC retail forex rules); *see also* OCC, Retail Foreign Exchange Transactions, 76 FR 56094 (Sept. 12, 2011) (interim final OCC retail forex rules for federal savings associations and their operating subsidiaries).

[644] *See* SEC, Retail Foreign Exchange Transactions, 76 FR 41676 (July 15, 2011). In the release accompanying the rules, the SEC requested comment on broker-dealers' involvement in retail forex transactions to inform the SEC in developing permanent rules to regulate these activities. *See id.* at 46181–83.

[645] *See* Board, Retail Foreign Exchange Transactions (Regulation NN), 76 FR 46652 (Aug. 3, 2011) (proposed Board rules for retail forex transactions).

[646] *See* part III.B.1, *supra,* discussing the applicability of the counterparty limitation.

[647] Of course, upon the Board's finalization of its retail forex rules, U.S. financial institutions regulated by the Board also will be acceptable counterparties.

[648] Feeder funds are usually added to commodity pool structures for purposes such as tax efficiency. A master-feeder structure ''[permits] U.S. taxable investors to take advantage of investing in a U.S. limited partnership feeder fund, which[,] through certain elections made at the time the structure is established, is tax effective for such U.S. taxable investors'' and ''[permits] [n]on-U.S. and U.S. tax-exempt investors [to] subscribe via a separate offshore feeder company so as to avoid coming directly within the U.S. tax regulatory net applicable to U.S. taxable investors.'' Effie Vasilopoulos & Katherine Abrat, *The Benefits of Master-Feeder Fund Structures for Asian-based Hedge Fund Managers,* Hedge Fund Monthly (April 2004), available at *http://www.eurekahedge.com/news/04apr_archive_Sidley_master_feeder.asp.* Other benefits can include efficiencies gained by the use of only a single trading entity, avoiding the need to split trade tickets, eliminating the need to duplicate agreements with counterparties and greater economies of scale in administering the fund. *Id.*

[649] Sidley notes that the typical FOF operates in this manner. *See generally* letter from Sidley for a more detailed discussion of these transactions.

[650] In this context, bona fide hedging purposes means bona fide hedging purposes within the meaning and intent of CFTC Regulation § 1.3(z)(1), except that the requirement therein that the transaction or position be on a DCM or SEF that is a trading facility will not be a factor in the bona fide hedging purpose analysis. *Compare* CFTC Regulation § 4.5(c)(2)(iii)(A) (relying in part on the bona fide hedging concepts in CFTC Regulations §§ 1.3(z)(1) and 151.5 to provide relief from the CPO definition). *See also* CPO/CTA Compliance Release

Continued

respect to currency risk as being structured to avoid the look-through provision.[651] The ''participate in agreements, contracts, or transactions described in section 2(c)(2)(B)(i) or section 2(c)(2)(C)(i) of the Act'' language of CFTC Regulation § 1.3(m)(5)(ii) is aimed at exposure to retail forex transactions as an asset class, investment strategy, or an end in itself, not at exposure to retail forex transactions solely designed for bona fide hedging purposes with respect to foreign exchange exposure arising in the course of a commodity pool's business.[652]

In applying the limited look-through provision in the final rule, the Commissions would consider a Forex Pool's direct participants to include not only persons that initially hold interests in the level of the commodity pool structure that enters into retail forex transactions, but also persons that can acquire those interests or that subsequently hold those interests. As applied to exchange-traded products (''ETPs'') that are Forex Pools, any person that acquires an interest in the ETP Forex Pool in secondary market transactions would be a direct participant. ETPs typically issue shares only in the large aggregations or blocks (such as 50,000 ETP shares) called ''Creation Units.'' An authorized purchaser, usually an investment bank, broker dealer or large institutional investor, may purchase a Creation Unit. After purchasing a Creation Unit, the authorized purchaser may hold the Creation Unit, or sell some or all of the ETP shares in the Creation Unit to investors in secondary market transactions by splitting up the Creation Unit and selling the individual ETP shares on a national securities exchange or in off-exchange transactions. The ability to break up the Creation Unit into ETP shares permits other investors, such as non-ECPs, to purchase the individual ETP shares in secondary market transactions.

All participants in an ETP Forex Pool must be ECPs when they purchase or otherwise acquire an interest in the ETP Forex Pool. In addition, an ETP Forex Pool will not be able to verify whether the persons that acquire interests in the ETP Forex Pool in exchange transactions are ECPs. The ability of non-ECPs to acquire interests in an ETP Forex Pool and the inability of the ETP Forex Pool to verify ECP status with respect to exchange transactions create a presumption that ETP Forex Pools are not ECPs and, therefore, are Retail Forex Pools. This presumption would not apply in the case of a Forex Pool that is structured in a manner that does not involve exchange trading and in which the Forex Pool would be able to verify the ECP status of its participants.

One commenter suggested that the Commissions allow commodity pools and their counterparties to rely on participant ECP representations provided in connection with an initial investment.[653] The Commissions note that the obligation to determine that the parties to retail forex transactions are ECPs is imposed on the CPOs of Forex Pools and the counterparties looking to enter into retail forex transactions with Forex Pools. In making that determination, the Commissions expect CPOs and retail forex transaction counterparties to Forex Pools to be guided by the principles for verifying the ECP status of a swap dealer's or major swap participant's counterparty discussed in the CFTC's recently adopted external business conduct standards, including the safe harbor.[654] Thus, solely for purposes of CEA section 1a(18)(A)(iv) and CFTC Regulation § 1.3(m)(5), the Commissions will permit CPOs and retail forex transaction counterparties to rely on written representations from, as applicable, pool participants or potential pool participants that the person making the representation is an ECP (or is a non-U.S. person; as discussed below in this section III.B.4., solely for purposes of CEA section 1a(18)(A)(iv) and CFTC Regulation § 1.3(m)(5), the Commissions will consider Forex Pools whose participants are limited solely to non-U.S. persons (and which are operated by CPOs located outside of the U.S., its territories or possessions) to be ECPs), or from Forex Pools that the Forex Pool is an ECP, provided that the CPO or retail forex transaction counterparty has a reasonable basis to so rely, just as swap dealers and major swap participants are permitted to do pursuant to the safe harbor in new CFTC Regulation § 23.430(d), 17 CFR 23.430(d). Solely for purposes of CEA section 1a(18)(A)(iv) and CFTC Regulation § 1.3(m)(5), a CPO or retail forex transaction counterparty will have a reasonable basis to rely on such written representations if the person making the representation specifies therein the provision(s) of, as applicable, section 1a(18) of the CEA or CFTC Regulation § 4.7(a)(1)(iv) pursuant to which the person qualifies as an ECP or a non-U.S. person, respectively, unless it has information that would cause a reasonable person to question the accuracy of the representation.[655] Solely for purposes of CEA section 1a(18)(A)(iv) and CFTC Regulation § 1.3(m)(5), persons representing that they qualify as non-U.S. persons based on CFTC Regulation § 4.7(a)(1)(iv)(D) must represent that they are relying on such provision as modified as discussed below (*i.e.*, without the 10% carve-out for U.S. persons).

Furthermore, the CFTC recognizes that, despite a counterparty's reasonable good faith efforts to ensure that Forex Pools do not in fact have any U.S. participants, a situation may arise where a Forex Pool does turn out to have U.S. participants. If a counterparty has reasonable policies and procedures in place to verify the ECP status of Forex Pool counterparties and, notwithstanding such reasonable good faith efforts and following such policies and procedures, enters into retail forex transactions with such a Forex Pool in good faith and it was subsequently determined that U.S. participants represented no more than a *de minimis* number of participants or amount of ownership of the Forex Pool, absent other material factors, the CFTC would not expect to bring an enforcement action against the counterparty for entering into a retail forex transaction in contravention of the requirements of the retail forex regime. For purposes of this analysis only, and without this being viewed as a *de minimis* threshold for purposes of this rule or otherwise, the CFTC would consider as *de minimis,* ownership of units of participation of a Forex Pool held by U.S. participants of less than 10% of the beneficial interest in the Forex Pool. The fact that, absent other material factors, the CFTC would not expect to bring an enforcement action against a forex transaction counterparty in such case does not

at 11256–11257 (discussing and declining to adopt commenters' request to expand the definition of bona fide hedging to include risk management). Where a Forex Pool's counterparty, but not the Forex Pool, is hedging its risks, it is not the case that the Forex Pool is entering the retail forex transaction solely to hedge its own risk.

[651] The examples mentioned in text should not be construed to mean that any other fact pattern does or does not constitute evasion, which must be determined on a case-by-case basis.

[652] Based on the same reasoning, the Commissions do not believe it was the intent of the look-through proviso in CEA section 1a(18)(A)(iv) to subject to a retail forex regime a single level commodity pool engaging in retail forex transactions solely for bona fide hedging purposes with respect to foreign exchange exposure arising in the course of a commodity pool's operations. Consequently, the Commissions will interpret such a commodity pool as an ECP if it otherwise satisfies the terms of CEA section 1a(18)(A)(iv) even if such a pool has one or more non-ECP participants.

[653] *See* letter from Sidley.

[654] *See* CFTC, Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties; Final Rule, 77 FR 9733 (Feb. 17, 2012).

[655] *Cf.* CFTC Regulation §§ 23.430(d), 23.402(d).

relieve any obligation on the part of the CPO of the Forex Pool either to register as a CPO, claim the 4.13(a)(3) exemption therefrom or redeem the U.S. participants as described above.

One commenter suggested that the Commissions allow commodity pools and their counterparties to rely on participant ECP representations provided in connection with an initial investment.[656] The Commissions believe that if participants make ECP representations in connection with an initial investment in a Forex Pool, absent an additional investment (which would require a new ECP verification, other than in the case of automatically reinvested distributions), the subsequent loss of a participant's ECP status would not cause the Forex Pool to lose its own ECP status for purposes of retail forex transactions so long as the operating agreement of the Forex Pool or the subscription or other agreement pursuant to which the participant invested in the Forex Pool requires the participant to advise the CPO of the Forex Pool promptly of a loss of the participant's ECP status. In the event of the loss of ECP status of a participant, the CPO would be required to redeem the non-ECP from the Forex Pool at the first opportunity following notification to avoid the Forex Pool losing its ECP status for subsequent retail forex transactions.

The Commissions are mindful that several commenters indicated that CPOs do not customarily include a question or representation as to ECP status in subscription agreements for pool participants, and stated that requiring CPOs to qualify or redeem existing participants due to the new look-through provision would be expensive, burdensome and disruptive.[657] In this regard, the Commissions note that the look-through requirement for commodity pools was imposed by statute. As a result of the Commissions adopting the limited look-through in the final rule (as compared to the proposed indefinite look-through), however, the number of commodity pools subject to the look-through provision should be dramatically reduced, reducing the number of pools subject to regulation of their retail forex transactions, and the associated costs, accordingly.[658]

Also, in response to commenter concerns that the look-through provision would be applied to entities other than commodity pools (*e.g.*, operating companies),[659] the Commissions revised the text of CFTC Regulation § 1.3(m)(5)(i) to reflect their intent to apply the look-through provision solely to commodity pools qualifying as ECPs, if at all, under clause (A)(iv) and clause (A)(v) of the ECP definition.[660] This is consistent with the statutory text, which is limited to looking through commodity pools under clause (A)(iv) of the ECP definition, and the intent behind the look-through provision, as it relates to clause (A)(v) thereof.

Commenters also stated that Retail Forex Pools will no longer be able to enter into retail forex transactions with foreign financial institutions.[661] As discussed in section III.B.1. above, however, this is not the case with respect to retail forex transactions described in CEA section 2(c)(2)(C)(i)(I)(bb). With respect to retail forex transactions described in CEA section 2(c)(2)(B)i)(I), this is a consequence of the express statutory text of the Dodd-Frank Act, which removed non-U.S. financial institutions from the list of Enumerated Counterparties eligible to enter into retail forex transactions with non-ECPs.[662]

Commenters further suggested generally that the Commissions create additional categories of ECPs to address the Commissions' concerns regarding the potential loophole of Retail Forex Pools that are unable to qualify as ECPs due to the new look-through provision in clause (A)(iv) of the ECP definition qualifying as an ECP under clause (A)(v) of the ECP definition. While one commenter proposed adopting a new rule clarifying that Forex Pools comprised entirely of QEPs and operated by persons subject to regulation under the CEA are ECPs,[663] Congress chose to look to ECP status of Forex Pool participants, not QEP status, as the basis for determining whether such Forex Pools are ECPs. Therefore, it is more appropriate to rely on Retail Forex Pool participants' ECP status than to rely on QEP status to establish ECP status.

One commenter stated a concern regarding what it characterized as the lack of clarity surrounding the extraterritoriality impact of the proposed ECP rules.[664] The Commissions recognize the potential consequences of the broad look-through language in CEA section 1a(18)(A)(iv)[665] and are providing guidance as to the application of the look-through to Forex Pools whose participants are limited solely to non-U.S. persons and which are operated by CPOs located outside the United States, its territories or possessions.

As discussed below, while foreign entities are not necessarily immune from U.S. jurisdiction for commercial activities undertaken with U.S. counterparties or in U.S. markets, canons of statutory construction ''assume that legislators take account of the legitimate sovereign interests of other nations when they write American laws,''[666] particularly when limited U.S. interests are at stake.[667]

[656] *See* letter from Sidley. The Commissions note that the obligation to determine that the parties to retail forex transactions are ECPs is imposed on the CPOs of Forex Pools and the persons looking to engage in retail forex transactions with Forex Pools.

[657] *See, e.g.*, letter from SIFMA AMG IV.

[658] The adoption of CFTC Regulation § 1.3(m)(8), discussed in part III.G, *infra,* also should reduce the number of pools subject to regulation of their retail forex transactions, and the associated costs, accordingly.

[659] *See, e.g.*, letter from Sandalwood Securities, Inc. (expressing concern that ''the Proposed Rule extends Dodd-Frank's limited look-through provision to all sub-sections of section la(12)'').

[660] Thus, for example, investment companies qualifying under clause (A)(iii) of the ECP definition and employee benefit plans qualifying under clause (A)(vi) of the ECP definition (and, as stated in each clause, ''a foreign person performing a similar role or function subject as such to foreign regulation'') would not be covered by the look-through provision. To the extent that other entities would otherwise be captured by the look-through as proposed (such as collective investment trusts whose investors are ERISA plans not excluded from the commodity pool definition by CFTC Regulation § 4.5(a)(4) and which qualify as ECPs under clause (A)(v) of the ECP definition), the Commissions believe that focusing on the level of the Forex Pool entering into the retail forex transactions, and such Forex Pool's direct participants (absent evasion), should alleviate such concerns.

[661] *Cf.* letters from Sidley and Millburn Ridgefield Corporation (''Millburn'').

[662] *See* section 742(c) of the Dodd-Frank Act, amending CEA section 2(c)(2)(B)(i)(II)(aa), 7 U.S.C. 2(c)(2)(B)(i)(II)(aa).

[663] *See* letter from Sidley. This commenter also suggested deeming non-U.S. persons to be ECPs by definition. The Commissions have addressed this comment below in this section in response to the comment regarding the extraterritorial impact of the proposed ECP rules.

[664] *See* letter from AIMA I.

[665] 7 U.S.C. 1a(18)(A)(iv).

[666] *See F. Hoffman-LaRoche, Ltd.* v. *Empagran S.A.,* 542 U.S. 155, 164 (2004), *citing Murray* v. *Schooner Charming Betsy,* 2 Cranch 64, 118, 2 L.Ed. 208 (1804) (''[A]n act of congress ought never to be construed to violate the law of nations if any other possible construction remains''); *Hartford Fire Insurance Co.* v. *California,* 509 U.S. 764 (1993) (Scalia, J., dissenting). *See also* Restatement (Third) Foreign Relations Law § 403 (scope of a statutory grant of authority must be construed in the context of international law and comity including, as appropriate, the extent to which regulation is consistent with the traditions of the international system).

[667] *See also* CFTC, Exemption From Registration for Certain Foreign Persons, 72 FR 63976 (Nov. 14, 2007) (where the CFTC stated that:

Given this agency's limited resources, it is appropriate at this time to focus [the Commission's] customer protection activities upon domestic firms and upon firms soliciting or accepting orders from domestic users of the futures markets and that the protection of foreign customers of firms confining their activities to areas outside this country, its territories, and possessions may best be for local authorities in such areas)

Continued

The Commissions do not believe that Congress intended for Forex Pools with no U.S. participants and operated by CPOs located outside the United States, its territories or possessions to be subject to a U.S. retail forex regime and, therefore, will consider Forex Pools whose participants are limited solely to non-U.S. persons and which are operated by CPOs located outside the United States, its territories or possessions to be ECPs for purposes of CFTC Regulation § 1.3(m)(5). For this purpose, a Forex Pool participant is a non-U.S. person if it satisfies the definition of ''Non-United States person'' in CFTC Regulation 4.7(a)(1)(iv); *provided, however,* that, if a participant is an entity organized principally for passive investment, such as a pool, investment company or other similar entity, such entity will be considered to be a Non-United States person under paragraph (D) of CFTC Regulation 4.7(a)(1)(iv) for purposes of CFTC Regulation § 1.3(m)(5) solely if all units of participation in such passive investment vehicle participant are held by Non-United States persons.[668] A broader interpretation or relief is not appropriate at this time.[669]

C. ECP Status for Commodity Pools Under Clause (A)(v) vs. Under Clause (A)(iv) of the ECP Definition

1. Proposed Approach

The Commissions stated in the Proposing Release that they believe ''some commodity pools unable to satisfy the total asset or regulated status components of clause (A)(iv) of the ECP definition may rely on clause (A)(v) to qualify as ECPs instead.''[670] The Commissions further stated in the Proposing Release that ''a commodity pool that cannot satisfy the monetary and regulatory status conditions prescribed in clause (A)(iv) should not qualify as an ECP in reliance on clause (A)(v) of the ECP definition.''[671] Based on those views, the Commissions proposed to further define the term ''eligible contract participant'' to prevent such a commodity pool from qualifying as an ECP pursuant to clause (A)(v) of the ECP definition. This proposal applied to all commodity pools, not just Forex Pools engaged in retail forex transactions.

2. Commenters' Views

Two commenters argued that, had Congress wished to prevent commodity pools from relying on the general ECP provision for business entities in clause (A)(v), it could have expressly excluded commodity pools from clause (A)(v).[672] Another commenter attempted to illustrate that clause (A)(v) of the ECP definition is an independent basis for qualifying as an ECP by distinguishing clause (A)(v) from clause (A)(iv).[673]

One commenter expressed the view that it is unclear whether ''subject to regulation under this Act'' in CEA section 1a(18)(A)(iv)(II)[674] means a registered CPO or something else (*e.g.,* a person excluded from the definition of a CPO, a CPO exempt from registration conditioned in part upon making a filing to claim such relief).[675]

3. Final Rule

The Commissions are adopting CFTC Regulation § 1.3(m)(6) as proposed, which states that ''[a] commodity pool that does not have total assets exceeding $5,000,000 or that is not operated by a person described in subclause (A)(iv)(II) of section 1a(18) of the Act is not an eligible contract participant pursuant to clause (A)(v) of such Section.''[676] As noted, the Commissions are concerned that clause (A)(v) of the ECP definition may undermine the protections that specifically apply to commodity pool participants pursuant to the limitations on ECP status for commodity pools set forth in clause (A)(iv) of the ECP definition. Allowing a commodity pool that cannot satisfy the monetary and regulatory status conditions prescribed for commodity pools in clause (A)(iv) to qualify as an ECP under clause (A)(v) would undermine these protections.

The Commissions acknowledge the comments stating that clause (A)(v) of the ECP definition is an independent basis for qualifying as an ECP and that Congress did not explicitly provide that a commodity pool that fails to qualify as an ECP under clause (A)(iv) cannot do so under clause (A)(v). However, when specifically legislating for commodity pools, Congress determined that total assets of $5 million and operation by a person subject to regulation under the CEA (or a foreign equivalent) are necessary to assure appropriate protection for non-ECP participants in a commodity pool. Furthermore, the commenters' view that Congress's use of the disjunctive term ''or'' between clauses (A)(x) and (A)(xi) of the ECP definition means that an entity can rely on clause (A)(v) of the ECP definition, notwithstanding that such entity cannot satisfy a prong more specific to it, would largely render superfluous each clause under subparagraph (A) of the ECP definition other than clause (v) and clause (xi) (for individuals).[677] As such, the Commissions believe that the final rule adopted in this release is consistent with Congressional intent.

The Commissions also are mindful that one commenter expressed a concern that the Commissions' reliance on clause (A)(iv) of the ECP definition

(citing CFTC, Introducing Brokers and Associated Persons of Introducing Brokers, Commodity Trading Advisors and Commodity Pool Operators; registration and Other Regulatory Requirements, 48 FR 35248, 35261 (Aug. 3, 1983)).

[668] CFTC Regulation § 4.7(a)(i)(iv)(D) lists the following as one category of non-United States person:

An entity organized principally for passive investment such as a pool, investment company or other similar entity; Provided, That units of participation in the entity held by persons who do not qualify as Non-United States persons or otherwise as qualified eligible persons represent in the aggregate less than 10% of the beneficial interest in the entity, and that such entity was not formed principally for the purpose of facilitating investment by persons who do not qualify as Non-United States persons in a pool with respect to which the operator is exempt from certain requirements of part 4 of the Commission's regulations by virtue of its participants being Non-United States persons.

It would be inappropriate to disregard the presence of U.S. persons constituting as much as 10% of such entities' participants in the context of this interpretive guidance. As discussed elsewhere herein, however, entities described in CEA section 1a(18)(A)(iii) or (vi), 7 U.S.C. 1a(18)(A)(iii) or (vi), are not subject to the look-through and are ECPs irrespective of the ECP status of their participants.

[669] *Cf.* CPO/CTA Compliance Release at 11264 (stating that ''it is prudent to withhold consideration of a foreign advisor exemption until the [CFTC] has received data regarding such firms on Forms CPO–PQR and/or CTA–PR * * * to enable the [CFTC] to better assess [which] firms * * * may be appropriate to include within the exemption, should the [CFTC] decide to adopt one'').

[670] Proposing Release, 75 FR at 80185.

[671] *Id.*

[672] *See* letters from Sidley and Skadden.

[673] *See* letter from Akin Gump. Akin Gump noted that ''[a]s opposed to [clause] (A)(iv), [clause] (A)(v) includes as one means of satisfying its criteria that the entity be entering into a contract for hedging purposes.'' While correct, clause (A)(v) also includes as another means of satisfying its criteria that an entity enter into agreements, contracts or transactions in connection with the conduct of the entity's business, which would be a much lower standard.

[674] 7 U.S.C. 1a(18)(A)(iv)(II).

[675] *See* letter from SIFMA AMG IV. CEA Section 1a(18)(A)(iv)(II) refers to a commodity pool that ''is formed and operated by a person subject to regulation under this Act or a foreign person performing a similar role or function subject as such to foreign regulation (regardless of whether each investor in the commodity pool or the foreign person is itself an eligible contract participant) provided, however, that for purposes of section 2(c)(2)(B)(vi) and section 2(c)(2)(C)(vii), the term 'eligible contract participant' shall not include a commodity pool in which any participant is not otherwise an eligible contract participant.''

[676] The Commissions have made certain technical corrections to proposed CFTC Regulation § 1.3(m)(6)(i) as concerns its citations to the CEA.

[677] Interpreting statutory language as surplusage is disfavored. Effect should be given to every clause and word of a statute. *See Negonsott* v. *Samuels,* 507 U.S. 99 (1993).

might cause commodity pools to lose their ability to claim ECP status under clauses of the ECP definition, other than clause (v), and asked the Commissions to clarify the meaning of the phrase ''formed and operated by a person subject to regulation under the [CEA]'' in clause (A)(iv).[678] In response, the Commissions note that a commodity pool that does not qualify for ECP status under clause (A)(iv) of the ECP definition may still qualify as an ECP under either of the two clauses of the ECP definition other than clause (A)(v) applicable to subcategories of commodity pools. Thus, registered investment companies and foreign equivalents may qualify as ECPs under clause (A)(iii) of the ECP definition, and ERISA plans and the other entities described in clause (A)(vi) of the ECP definition may qualify as ECPs thereunder. The Commissions' actions in this release do not change that result.

Also, with regard to that commenter's request for clarification, for purposes of CFTC Regulation § 1.3(m)(6), the Commissions interpret the language ''subject to regulation under the [CEA]'' in clause (A)(iv) of the ECP definition as requiring lawful operation of the commodity pool by a person excluded from the CPO definition, a registered CPO, or a person properly exempt from CPO registration.[679] Congress did not limit ECP status under clause (A)(iv) to commodity pools operated by persons registered as CPOs; it used the more encompassing phrase ''subject to regulation'' under the CEA.[680] On the other hand, to construe that phrase to include any person operating a commodity pool would render the phrase superfluous.[681] The commenters' view would enable a CPO that fails to register as required to claim that the commodity pool it operates is an ECP under clause (A)(v) and thus is not subject to regulation of its retail forex transactions. The Commissions believe that construing the phrase ''formed and operated by a person subject to regulation under the [CEA]'' to refer to a person excluded from the CPO definition, registered as a CPO or properly exempt from CPO registration appropriately reflects Congressional intent.

D. Dealers and Major Participants as ECPs

1. Proposed Approach

The Commissions proposed to add swap dealers, security-based swap dealers, major swap participants and major security-based swap participants to the ECP definition on the basis that such persons ''are likely to be among the most active and largest users of swaps and security-based swaps.''[682]

2. Commenters' Views

Several commenters supported the proposed addition of swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants to the ECP definition.[683] No commenter opposed this aspect of the proposal.

3. Final Rule

The Commissions are adopting the new ECP categories as proposed. The rules as adopted clarify that the terms ''swap dealer,'' ''security-based swap dealer,'' ''major swap participant,'' and ''major security-based swap participant'' have their respective meanings as defined in the CEA and the Exchange Act and as otherwise further defined by the Commissions.[684]

E. Government Entities: Incorrect Cross-Reference

1. Description of the Issue

Clause (A)(vii) of the ECP definition conditions the ECP status of governmental entities, and their political subdivisions, agencies, instrumentalities and departments (collectively, ''government entities''), in part, on the identity of their counterparties. Specifically, a government entity may qualify as an ECP under the provision in clause (A)(vii) that requires the entity's counterparty to be ''listed in any of subclauses (I) through (VI) of section 2(c)(2)(B)(ii)'' of the CEA.[685] However, subclauses (I) through (III) of CEA section 2(c)(2)(B)(ii)[686] are unrelated to counterparty types (rather, they describe the dollar amounts that apply for purposes of retail forex transactions under CEA section 2(c)(2)(B)), and subclauses (IV) through (VI) of CEA section 2(c)(2)(B)(ii) no longer exist in the statute. Read literally, then, this provision of the ECP definition is inherently a nullity and, thus, cannot enable government entities to qualify as ECPs.[687]

2. Commenters' Views

One commenter traced the history of the relevant provisions and concluded that the reference to subclauses (I) through (VII) of CEA section 2(c)(2)(B)(ii) in clause (A)(vii) of the ECP definition is erroneous.[688] This commenter pointed instead to CEA section 2(c)(2)(B)(i)(II)[689] as the reference that should be included in clause (A)(vii) of the ECP definition because it lists the entities that are eligible to serve as counterparties in retail forex transactions.

This commenter noted that the cross-reference in clause (A)(vii) of the ECP definition was correct when it was added to the CEA as part of the CFMA, but that it became incorrect in 2008 when an unrelated amendment to the CEA was enacted[690] that changed the numbering of the CEA's provisions governing retail forex transactions but that failed to make a conforming amendment to clause (A)(vii) of the ECP definition. As a result of this 2008 amendment to the CEA, the list of entities that formerly appeared in subclauses (I) through (VI) of CEA sections 2(c)(2)(B)(ii) now appear in items (aa) through (ff) of CEA section

[678] *See* letter from SIFMA AMG IV.

[679] For these purposes, the Commissions would take the same approach to insignificant deviations from exemptive filings as the CFTC does in CFTC Regulation § 4.7(e).

[680] If the Commissions interpreted the ''subject to regulation under this Act'' language in CEA section 1a(18)(A)(iv)(II) to mean that the commodity pool operator must be registered as a CPO and limited CPOs to claiming ECP status solely under clause (iv) of the ECP definition, then the operators of all commodity pools trading swaps would have to register as CPOs to be ECPs. While more CPOs will be registering with the CFTC because the CFTC has withdrawn CFTC Regulation § 4.13(a)(4), *see* CPO/CTA Compliance Release, and the Dodd-Frank Act has expanded the scope of the transactions within the CFTC's jurisdiction, thus reducing the number of CPOs who can rely on the 5 percent threshold in CFTC Regulation § 4.13(a)(3) and thus claim the CPO registration exemption, the CFTC did not withdraw 4.13(a)(3), so some CPOs will be able to continue to rely on it. Also, not all persons operating commodity pools will be CPOs. *See* CFTC Regulation § 4.5 (exclusion from the definition of the term ''commodity pool operator''). The Commissions do not believe Congress intended commodity pool ECP status to require CPO registration by the commodity pools' operators in all cases.

[681] If the mere act of forming or operating a commodity pool means that a person is ''subject to regulation'' under the CEA, then the ''subject to regulation'' language would not be needed.

[682] Proposing Release, 75 FR at 80184.

[683] One representative commenter stated that ''the proposed definition in CFTC Proposed CFTC Regulation § 1.3(m)(1)–(4) fills important gaps left by Congress by ensuring that major swap participants, major security-based swap participants, swap dealers and security-based swap dealers are treated as ECPs.'' *See* letter from Sidley.

[684] These new ECP categories are set forth in new CFTC Regulation § 1.3(m)(1)–(4).

[685] CEA section 1a(18)(A)(vii)(cc), 7 U.S.C. 1a(18)(A)(vii)(cc).

[686] 7 U.S.C. 2(c)(2)(B)(ii)(I)–(III).

[687] A government entity, though, can still qualify as an ECP under the other provisions of clause (A)(vii) if it is a certain type of ''eligible commercial entity'' as defined in CEA section 1a(17), 7 U.S.C. 1a(17), or owns and invests on a discretionary basis $50 million or more in investments.

[688] *See* letter from Wells Fargo dated June 3, 2011 (''Wells Fargo I'').

[689] 7 U.S.C. 2(c)(2)(B)(i)(II).

[690] *See* section 13101 of the CRA.

2(c)(2)(B)(i)(II) instead.[691] This commenter requested that ''the Commissions correct this clearly erroneous reference in the definition of ECP through interpretive guidance, rulemaking or Commission order.'' [692]

3. Interpretive Guidance

Clause (A)(vii) of the ECP definition contains an erroneous cross-reference to subclauses (I) through (VI) of CEA section 2(c)(2)(B)(ii). Accordingly, the Commissions are issuing interpretive guidance by identifying the counterparties with which a governmental entity can enter into swaps to attain ECP status under the provision in clause (A)(vii) that requires the entity's counterparty to be ''listed in any of subclauses (I) through (VI) of section 2(c)(2)(B)(ii)'' of the CEA. The Commissions consider a government entity covered by the counterparty limitation in clause (A)(vii) to be an ECP with respect to an agreement, contract, or transaction that is offered by, and entered into with, a person that is listed in items (aa) through (ff) of section 2(c)(2)(B)(i)(II) of the CEA. The limitation of ECP status ''with respect to'' a particular transaction is consistent with Congress' determination that, for purposes of this provision of clause (A)(vii), governmental entities may derive their ECP status from the status of their counterparty.

F. Qualification as an ECP With Respect to Swaps Used To Hedge or Mitigate Commercial Risk in Connection With the Conduct of an Entity's Business

1. Proposing Release

In the Proposing Release, the Commissions requested comment on whether any additional categories should be added to the definition of ECP, ''such as the following categories suggested by commenters [on the ANPRM]: Commercial real estate developers; energy or agricultural cooperatives or their members; or firms using swaps as hedges pursuant to the terms of the CFTC's Swap Policy Statement.'' [693] As noted above, the ECP definition is important because the Dodd-Frank Act amended the CEA to prohibit a person that is not an ECP from entering into swaps other than on or subject to the rules of a DCM.[694]

2. Commenters' Views

Several commenters supported the addition of categories to the definition of ECP because, these commenters said, not all current swap market participants are ECPs. Many of these commenters said that non-ECPs have entered into swaps in reliance on the Swap Policy Statement.[695] Commenters highlighted, among other things, the importance of the Swap Policy Statement to pass-through entities used by farmers,[696] operating companies [697] and commercial property developers,[698] noting that such entities may not meet the ECP criteria. According to these commenters, these pass-through entities often are small and medium-sized businesses that enter into interest rate swaps with lending financial institutions in reliance on the Swap Policy Statement.[699] The commenters explained that the loans usually are guaranteed by the principals of the entity entering into the swap, and that the borrower would qualify as an ECP if structured as a single-level corporate entity or sole proprietorship.[700] Commenters said that if these non-ECP entities were limited to swaps that are available on or subject to the rules of a DCM, many regional bank borrowers would lose the ability to use swaps, real estate companies would have less flexibility in risk management, and smaller lenders would be at a competitive disadvantage.[701] Another commenter said that Dodd-Frank Act provisions such as the end-user clearing exception indicate that Congress intended to preserve the availability of swaps used for business reasons rather than for investment or speculation.[702]

To mitigate the impact of restricting non-ECPs to swaps that are available on or subject to the rules of DCMs, some commenters said that an entity should be able to qualify as an ECP based on the financial qualifications of related entities, so long as various conditions proposed by the commenters are satisfied. Some commenters said that an entity should be eligible to be an ECP if its swap obligations are guaranteed by an ECP,[703] or if its controlling entity qualifies as an ECP under clause (A)(v) of the statutory definition.[704] Another commenter suggested revisions to the

[691] 7 U.S.C. 2(c)(2)(B)(i)(II)(aa)–(ff).

[692] *See* letter from Wells Fargo I.

[693] *See* Proposing Release, 75 FR at 80185. The reference to the ''Swap Policy Statement'' is to the CFTC's Policy Statement Concerning Swap Transactions, 54 FR 30694 (July 21, 1989). The Swap Policy Statement ''identifie[d] those swap transactions which [were] not * * * regulated as futures or commodity option transactions under the [CEA] or the related regulations.'' 54 FR at 30694. One element of the Swap Policy Statement required that the swap be entered into in connection with each swap counterparty's line of business. *Id.* at 30697. The Swap Policy Statement was applicable to cash-settled swaps only, with foreign exchange considered to be cash for this purpose. *Id.* at 30696. The Swap Policy Statement required that the terms of the relevant swap be individually tailored, meaning that the material terms of the swap had to be negotiated, the parties had to make individualized credit determinations, and the swap documentation could not be fully standardized. *Id.* at 30696–97. The Swap Policy Statement did not apply to swaps subject to exchange-style offset, swaps that were cleared or subject to a margin system, or swaps marketed to the public. *Id.* As noted in the Product Definitions Proposal, the Dodd-Frank Act supersedes the Swap Policy Statement. 76 FR at 29829, n. 74.

[694] The discussion in this section relates only to swaps and has no effect on the laws or regulations applicable to security-based swaps, security-based swap agreements or mixed swaps.

As noted above, the Dodd-Frank Act also amended the Exchange Act and the Securities Act to make it unlawful for a person to effect a transaction in a security-based swap with or for a person that is not an ECP unless the transaction is effected on a national securities exchange registered with the SEC, and to make it unlawful for a person to offer to sell, offer to buy or purchase, or sell a security-based swap to a person that is not an ECP unless a registration statement under the Securities Act is in effect with respect to that security-based swap.

[695] *See* letter from CDEU. One commenter estimated that swap transactions completed by regional and community banks in reliance on the Swap Policy Statement constituted 30–40% of all of such banks' swaps, representing approximately 7,000 to 10,000 swaps per year and $15 to $20 billion in related loan principal. *See* letter from B&F I. Another commenter advised that it has entered 11 swaps, with a total notional of $26 million, since its formation in 2007, almost all of the counterparties to which ''qualified for the swap under the [Swap Policy Statement] business purpose exemption.'' *See* letter from Capstar. The CFTC stated when issuing the Swap Policy Statement that it ''reflects the [CFTC]'s view that at this time most swap transactions, although possessing elements of futures or options contracts, are not appropriately regulated as such under the [CEA] and [CFTC] regulations.'' Swap Policy Statement at 30694.

[696] *See, e.g.,* letter from Rabobank, N.A., Rabo AgriFinance, Inc. and Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A. (''Rabobank, New York Branch'') (relating that ''[f]or a variety of estate planning and regulatory purposes, farmers commonly hold their ownership interests in land, buildings and farm equipment indirectly, through a network of legal entities'').

[697] *See, e.g.,* letter from Fifth Third Bank and Union Bank, N.A. (advising that ''[i]t is common for an operating business to organize a separate limited liability company (for tax and legal reasons) to acquire * * * assets * * * and to lease these assets to the operating company[, which] becomes the borrow[er] * * * for the loan used to acquire those assets'' and that ''[t]he limited liability company often does not maintain sufficient capital to qualify as an ECP'').

[698] *See, e.g.,* letters from Capstar, Frost National Bank, FTN Financial Capital Markets, Midsize Banks and NAREIT.

[699] *See* letters from BB&T I and B&F I. Commenters said that these businesses may intentionally maintain less than $1 million in equity primarily for tax and legal reasons. *See* letters from Capital One and Columbia State Bank (stating that over 65% of its borrowers are structured as limited liability companies or S corporations and intentionally maintain less than $1 million in equity at the entity entering into the swap).

[700] *See* letter from Columbia State Bank. *See also* letter from BB&T I.

[701] *See* letters from BB&T I, Capital One, Capstar, Columbia State Bank, Midsize Banks, NAREIT and Wells Fargo II.

[702] *See* letter from FSR I.

[703] *See* letters from BB&T I, Midsize Banks and Wells Fargo II.

[704] *See* letters from CDEU and Regional Banks.

ECP definition that included looking to the ECP status or sophistication of the majority owner of an entity in determining if the entity itself is an ECP.[705] Other commenters suggested other provisions to allow non-ECPs to enter into swaps other than on or subject to the rules of a DCM, so long as the non-ECP meets various conditions indicating that the swap is used in connection with its line of business.[706]

Other commenters argued for per se ECP qualification based on their status as certain types of persons, such as farmers[707] or for ECP status based solely on a combination of a person's status and the swap being related to a person's line of business with no additional conditions.[708]

3. Final Rules and Interpretation

In response to the commenters' concerns, the CFTC is adopting CFTC Regulation § 1.3(m)(7) to permit an entity, in determining its net worth for purposes of subclause (A)(v)(III) of the ECP definition,[709] to include the net worth of its owners, solely for purposes of determining its ECP status for swaps used to hedge or mitigate commercial risk, provided that all of its owners are themselves ECPs (disregarding shell companies). Under CFTC Regulation § 1.3(m)(7) as adopted, an entity seeking to qualify under subclause (A)(v)(III) of the ECP definition in order to enter into a swap used to hedge or mitigate commercial risk is permitted to count the net worth of its owners in determining its own net worth, so long as all its owners are ECPs. This regulation applies only to entities that are otherwise eligible to rely on subclause (A)(v)(III) to determine ECP status; it does not expand or change the scope of application of that paragraph.[710]

CFTC Regulation § 1.3(m)(7) as adopted applies only when determining ECP status for swaps used to hedge or mitigate commercial risk. This new regulation does not apply when determining ECP status for other swaps or for security-based swaps, security-based swap agreements, mixed swaps, or agreements, contracts or transactions that are not swaps (regardless of the purpose for which they are used).

The Commissions have considered the comments indicating that, as currently structured, many businesses are owned by multiple legal entities and/or individuals, and the net worth of all the owners in the aggregate in some cases would satisfy the $1 million net worth requirement in subclause (A)(v)(III), even though the particular legal entity that enters into a swap does not have a net worth exceeding $1 million.[711] While the Commissions recognize that the requirement, in subclause (A)(v)(III)(aa) of the ECP definition, that the entity relying on that paragraph have a net worth exceeding $1 million evidences Congress' intent that only entities with this level of financial resources should be eligible for ECP status under this paragraph of the definition, the Commissions agree with commenters that application of this requirement in these circumstances would inappropriately limit the ability of business entities to use swaps to hedge or mitigate commercial risk. As a result, the Commissions are persuaded that in this limited situation, the entity should qualify as an ECP and be eligible to enter into swaps other than on or subject to the rules of a DCM, so long as the entity is using the swap to hedge or mitigate commercial risk and all of the owners of the entity are ECPs (other than shell companies).

In response to those commenters requesting per se ECP status or the ability to qualify as an ECP based on a combination of status and engaging in swaps related to a line of business, without further restriction, the Commissions do not believe it is necessary or appropriate to further define the term ECP to such an extent in order to address most commenters' concerns. The Commissions note that such approaches would undermine the prohibition in CEA section 2(e)[712] on non-ECPs executing swaps other than on or subject to the rules of a DCM. The Commissions also note that focusing solely on a link between a swap and a line of business would undermine the application of the ECP definition to swaps in that the various prongs of the ECP generally are linked to dollar thresholds, regulated status, or a combination of the two.

The Commissions also note that it currently is considering a draft petition for relief pursuant to CEA section 4(c)(6)(C)[713] for certain entities described in Federal Power Act section 201(f),[714] which may address the concerns of some commenters. Additionally, the Commissions are developing joint rules to further define the term ''swap,'' including the forward exclusion from the swap definition which, in turn, may result in certain transactions not being considered swaps. Further, the CFTC also is considering today a form of trade option exemption, which may further address commenters' concerns.

With respect to farmers, in response to the CFTC's Commodity Options and Agricultural Swaps rulemaking proposal,[715] commenters generally were of the view that the ECP definition is appropriate in its current form.[716] While

[705] *See* letter from NAREIT.

[706] *See* letters from the American Public Gas Association (''APGA''), Capital One and Gavilon dated December 23, 2010 (''Gavilon I'').

[707] *See* meeting with Ron Eliason on December 16, 2010 (in which Mr. Eliason contended that farmers should be able to enter into swaps, even if they do not meet the income or asset tests in the current ECP definition and, therefore, would not be permitted to enter into swaps other than on or subject to the rules of a DCM).

[708] *See* letter from APGA (requesting that ''the [CFTC] exercise its authority under section la(18)(C) of the Act and determine that public natural gas distribution companies, including member-owned co-operatives, that enter into swaps in connection with their business of supplying customers with natural gas are ECPs within the meaning of section la(18) of the Act'').

[709] CEA section 1a(18)(A)(v)(III) provides that the term ''eligible contract participant'' includes ''a corporation, partnership, proprietorship, organization, trust, or other entity * * * that (aa) has a net worth exceeding $1,000,000; and (bb) enters into an agreement, contract, or transaction in connection with the conduct of the entity's business or to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by the entity in the conduct of the entity's business.'' 7 U.S.C. 1a(18)(A)(v)(III).

[710] For example, if a commodity pool were precluded by CFTC Regulation § 1.3(m)(6) from relying on clause (A)(v) of the statutory definition to qualify as an ECP, such pool would not be able to rely on CFTC Regulation § 1.3(m)(7) to qualify as an ECP.

[711] *See, e.g.,* letters from B&F I (stating that ''[i]f the customer does not * * * [itself] meet the ECP definition, then the transaction would have to be guaranteed by any entity or individual who is an owner * * * [who] meets the $10,000,000 total asset test of section 1(a)(18)(A)(v)(I) of the Act or the $1,000,000 net worth test of section 1(a)(18)(A)(v)(III) of the Act.''), NAREIT (urging that the Commissions impute ECP status to non-ECP entities involved in specified real estate businesses to such entities whose ''majority owner or controlling entity'' is an ECP) and Midsize Banks (recommending that the ECP determination be made with respect to a non-ECP entity's owners based on criteria including qualifying natural persons as ECPs based on a $1,000,000 net worth).

[712] 7 U.S.C. 2(e).

[713] 7 U.S.C. 6(c)(6)(C).

[714] 16 U.S.C. 824(f).

[715] 76 FR 6095 (Feb. 3, 2011).

[716] *See, e.g.,* letters from NCFC dated April 4, 2011 (''NCFC II'') (stating ''[o]n behalf of the more than two million farmers and ranchers who belong to one or more farmer cooperative(s), the [NCFC] * * * [believes] the limitation on participation [in agricultural swaps] to [ECPs] outside of a DCM * * * should limit [agricultural swap] participation to appropriate persons'' and that ''[t]he ECP requirement with a threshold of $1 million in net worth to be allowed to use swaps and options, other than on a DCM, is appropriate for the products cooperatives offer their members''), ; letter from NGFA dated April 4, 2011 (''NGFA II'') (stating that ''[t]he use of agricultural swaps has been constrained relative to other swaps by virtue of being subject to CFTC regulatory requirements, while other swaps have been exempted from CFTC oversight,'' ''the Dodd-Frank Act * * * institutes a number of safeguards, including the limitation that

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the Commissions may consider providing further relief should experience show, after the ECP definition becomes effective, that further relief is warranted, neither the ECP definition nor the various actions cited in the foregoing paragraph are final, so providing further relief is premature. The Commissions' measured approach, which builds on the existing net worth requirement in the general entity ECP category, provides broad relief to many of the commenters (*e.g.,* borrowers generally) while otherwise adhering to the existing ECP categories.

The Commissions note that commenters said that, because of the way some businesses are structured for tax, estate planning or other purposes, they enter into swaps through a legal entity that does not, by itself, qualify as an ECP even though the net worth of the business and its owners, taken in the aggregate, would qualify as an ECP pursuant to subclause (A)(v)(III) of the ECP definition. The Commissions believe that the best way to address this concern is to allow such a business to consider the net worth of all its owners in determining whether the net worth requirement in subclause (A)(v)(III) is satisfied.[717]

CFTC Regulation § 1.3(m)(7) is available only to an entity that seeks to qualify as an ECP under subclause (A)(v)(III) of the statutory definition in order to enter into a swap that will be used to hedge or mitigate commercial risk. The Commissions limited CFTC Regulation § 1.3(m)(7) to subclause (A)(v)(III) because this provision of the ECP definition is available to a business entity that uses swaps in connection with the conduct of its business or to manage risks associated with assets or liabilities related to the conduct of its business.[718]

The purpose of CFTC Regulation § 1.3(m)(7) is to maintain the ability of business entities to enter into swaps other than on or subject to the rules of a DCM for limited purposes. This regulation therefore is available only with respect to a swap that is used to hedge or mitigate commercial risk within the meaning of CFTC Regulation § 1.3(kkk).[719] CFTC Regulation § 1.3(m)(7) applies only if all of an entity's owners qualify as ECPs under the provision of the ECP definition applicable to such owner. Although some commenters suggested that an entity should be able to qualify as an ECP based on the status of its majority or controlling owners,[720] the Commissions believe that CFTC Regulation § 1.3(m)(7) should be available only when all of an entity's owners qualify as ECPs. The Commissions do not believe it would be appropriate to impair the protection of non-ECPs that flows from the requirement that non-ECPs enter into swaps only on or subject to the rules of a DCM.[721] In order to maintain these protections and prevent evasion, CFTC Regulation § 1.3(m)(7) provides that any shell company will be disregarded, and in order to determine if the underlying entity may use CFTC Regulation § 1.3(m)(7), each owner of such shell company must be an ECP.[722]

Correspondingly, in aggregating net worth for purposes of determining the ECP status of an entity pursuant to CFTC Regulation § 1.3(m)(7), if the entity is owned by a shell company, then it is the net worth of the owners of that shell company that is relevant, not the net worth of the shell company.[723]

Last, also in order to prevent evasion, CFTC Regulation § 1.3(m)(7)(ii)(C) specifies that an individual may rely on the proprietorship provision of clause (A)(v) of the statutory definition for purposes of determining its status as an ECP owner of an entity only if the proprietorship[724] status arises independent of the business conducted by such entity[725] and the individual proprietor acquires his/her interest in such entity (i) in connection with the conduct of the individual's proprietorship or (ii) to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by the proprietorship.[726] The Commissions are adopting CFTC Regulation § 1.3(m)(7)(ii)(C) because they believe that the only circumstance in which a proprietorship should be considered an ECP for purposes of CFTC Regulation § 1.3(m)(7)(i) is if it is making an investment related to the proprietorship.[727] The ECP status of an individual acting other than with respect to its proprietorship is determined based on the ECP clause applicable to individuals. The Commissions note that they have authority to take action to prevent evasion of the provisions regarding shell companies and proprietorships by entities relying on CFTC Regulation § 1.3(m)(7) to establish ECP status.

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only [ECPs] may engage in swaps unless entered into on a designated contract market,'' and ''[t]he NGFA believes that these safeguards provide more-than-ample protection in the swaps marketplace for both agricultural and non-agricultural swaps and that there is no compelling reason to place additional burdens on agricultural swaps.'').

[717] The Commissions note that this regulation provides an alternative means for certain business entities to qualify as ECPs. It neither diminishes nor qualifies in any way the requirement in CEA section 2(e) that persons that are not ECPs enter into swaps only on or subject to the rules of a DCM.

[718] CEA section 1a(18)(A)(v)(III)(bb), 7 U.S.C. 1a(18)(A)(v)(III)(bb). The Commissions note that an entity that would qualify as an ECP under subclause (A)(v)(III) without application of CFTC Regulation § 1.3(m)(7) is not required to meet the conditions stated in, this regulation.

[719] *See* part IV.C. The use of the phrase ''hedge or mitigate commercial risk'' in CFTC Regulations §§ 1.3(m)(7) and 1.3(kkk) is similar to the use of the same phrase in the exception to the mandatory clearing requirement in CEA section 2(h)(7), 7 U.S.C. 2(h)(7).

[720] *See, e.g.,* letter from NAREIT.

[721] *See* CEA section 2(e), 7 U.S.C. 2(e).

[722] *See* CFTC Regulation § 1.3(m)(7)(ii).

The term ''shell company'' means any entity that limits its holdings to direct or indirect interests in entities that are ECPs through reliance on CFTC Regulation § 1.3(m)(7). Any entity that holds at least one direct or indirect interest in an entity not relying on CFTC Regulation § 1.3(m)(7) would not be a shell company. The ECP status of owners of entities that are not shell companies is not relevant for purposes of CFTC Regulation § 1.3(m)(7), which should permit wider financing of small businesses using swaps to hedge or mitigate commercial risk.

To be clear, an individual will never be considered to be a shell company for purposes of CFTC Regulation § 1.3(m)(7).

[723] This provision may apply repeatedly in a ''chain.'' For example, if in determining whether an entity may rely on CFTC Regulation § 1.3(m)(7), an owner of that entity that is a shell company is disregarded, then if the owner of that shell company is also a shell company, that second shell company also is disregarded, and so on.

[724] A proprietorship generally is a business that a person operates in a personal capacity and with respect to which that person directly owns all the assets and directly is responsible for all of the liabilities, rather than through a corporation, partnership or other structure conveying limited liability. *See* letters from Midmarket Banks and Wells Fargo II (stating that ''proprietors . . . typically are not separate legal entities''); *see also* State of California Franchise Tax Board Web site (advising that ''[t]he business and the owner are one. There is no separate legal entity and thus no separate legal person''), at *https://www.ftb.ca.gov/businesses/bus_structures/soleprop.shtml.* A proprietorship is not a separate taxable entity but reports the income or loss of the business, which is taxed along with a sole proprietor's other income, on a separate schedule attached to his or her individual federal income tax return. *See* letter from Midmarket Banks. *See also* 2011 Form1040 Schedule C: Profit or Loss from Business (Sole Proprietorship), available at *http://www.irs.gov/pub/irs-pdf/f1040sc.pdf*; 2011 Instructions for Schedule C, available at *http://www.irs.gov/pub/irs-pdf/i1040sc.pdf.*

[725] CFTC Regulation § 1.3(m)(7)(ii)(C)(I) is designed to ensure that the individual qualifies as a proprietorship, if at all, other than due to its interest in either an entity seeking to qualify as an ECP under CFTC Regulation § 1.3(m)(7)(i) or in any other entity.

[726] *See* CFTC Regulation § 1.3(m)(7)(ii)(C)(IV). This language is modeled on the language in 7 U.S.C. 1a(18)(A)(v)(III)(bb).

[727] The Commissions note that this guidance regarding proprietorships applies only when an entity is relying on CFTC Regulation § 1.3(m)(7). The Commissions do not intend that this guidance would expand or limit the circumstances when a proprietorship may otherwise rely on clause (A)(v) of the statutory definition in establishing its ECP status.

G. ECP Status for Forex Pools Operated by Registered CPOs or CPOs Exempt From Registration Under Certain Conditions

1. Description of the Issue and Commenters' Views

Notwithstanding the modifications to the look-through provisions for Forex Pools discussed above in section III.B., the Commissions acknowledge commenters' concerns about the potential for unintended consequences arising from the look-through provisions of the Dodd-Frank Act. Several commenters asserted that many Forex Pools are operated by sophisticated, professional managers that do not need the protections of a retail forex regime designed to protect non-ECPs that are engaging in retail forex transactions.[728] More specifically, some commenters, based on CFTC enforcement actions involving Forex Pools, suggested that commodity pools of a sufficient size, and/or operated by a registered or exempt CPO, do not pose the risks of fraud and abuse of non-ECP customers that the statutory look-through provision is intended to address.[729]

As a result, commenters suggested that the look-through provision should not apply in determining ECP status of commodity pools that meet certain conditions. For example, commenters suggested that the look-through not be applied to a commodity pool with $10 million in total assets paired with another or other factors, such as not being structured to evade,[730] being subject to regulation under the CEA[731] or the CPO being registered as such.[732] Another commenter suggested requiring the total assets or minimum initial investment of a Forex Pool to be sufficiently large that, in general, only legitimate pools would exceed such thresholds.[733] This commenter suggested a total asset threshold of $50 million.[734]

Separately, one commenter also claimed that the statutory look-through, if strictly implemented, might inappropriately preclude Forex Pools and their CPOs, many of whom are registered, from engaging in retail forex transactions with swap dealers because swap dealers are not Enumerated Counterparties (and some swap dealers also may not be Enumerated Counterparties in a different capacity, such as being a U.S. financial institution).[735] This commenter stated that such a result could reduce close out netting opportunities in the event of the insolvency of a counterparty.

2. Final Rule

In response to commenters, the CFTC is adopting CFTC Regulation § 1.3(m)(8), pursuant to which certain Forex Pools may qualify as ECPs notwithstanding the look-through requirement. As adopted, CFTC Regulation § 1.3(m)(8) enables a Forex Pool that enters into a retail forex transaction to qualify as an ECP with respect thereto, irrespective of whether each participant in the Forex Pool is an ECP, if the Forex Pool satisfies the following conditions:

- It is not formed for the purpose of evading CFTC regulation under Section 2(c)(2)(B) or Section 2(c)(2)(C) of the CEA or related CFTC rules, regulations or orders governing Retail Forex Pools and retail forex transactions);
- It has total assets exceeding $10 million; and
- It is formed and operated by a registered CPO or by a CPO who is exempt from registration as such pursuant to CFTC Regulation § 4.13(a)(3).

CFTC Regulation § 1.3(m)(8) as adopted requires that the Forex Pool not be formed for the purpose of evading CFTC regulation of Retail Forex Pools and retail forex transactions under CEA Section 2(c)(2)(B) or (C). A Forex Pool that is formed for that purpose would not be an ECP under new CFTC Regulation § 1.3(m)(8).

CFTC Regulation § 1.3(m)(8) as adopted also requires that the Forex Pool have total assets exceeding $10 million to qualify as an ECP. The $10 million threshold is twice the current total asset threshold for a commodity pool to qualify as an ECP under CEA section 1a(18)(A)(iv). The Commissions believe the $10,000,000 threshold is appropriate in light of the potential regulatory burdens a higher threshold might impose on smaller commodity pools. The Commissions believe that such a threshold, coupled with the other conditions of the rule, is sufficiently high to assure that the protections provided to retail forex transactions are not needed for these types of commodity pools. The Commissions will vigilantly monitor developments with respect to Forex Pools, including enforcement activity, and revisit this total asset threshold if warranted by subsequent events.

Finally, CFTC Regulation § 1.3(m)(8) as adopted requires that Forex Pool be formed[736] and operated by a CPO registered as such with the CFTC or by a CPO who is exempt from registration as such pursuant to CFTC Regulation § 4.13(a)(3). The Commissions believe that the registered CPO aspect of this condition is appropriate for several reasons, including that it will ensure

[728] *See, e.g.,* letters from Millburn (characterizing the proposed rules as ''greatly limit[ing] the ability of entities managed by sophisticated money managers that are subject to registration and examination by regulators to qualify as ECPs'') and Sidley (describing ''[a] commodity pool, like a registered investment company or an employee benefit plan, [a]s a pool of assets from investors of varying (and, in some cases, undetermined) levels of sophistication that are advised by a sophisticated adviser'').

[729] *See* joint letter from the Global Foreign Exchange Division (''GXFD'') and MFA dated January 19, 2011 (''GFXD II'') (describing 35 CFTC Forex Pool enforcement cases from 2010 and 2011 and noting that in 80% of these cases, the amount at issue in the misconduct was less than $10 million, and that only one case involved a registered CPO where the amount at issue in the misconduct was more than $10 million; two additional cases involved misconduct involving CPOs exempt from registration as such under CFTC Regulation § 4.13(a). While the commenter did not characterize these amounts as ''total assets'' (instead, the commenter used terms such as ''fraudulently obtained'' or ''sustained losses of'' to modify the cited dollar amounts) in most cases, it is clear that these amounts are equivalent to, or subsets of, total assets. For instance, for a CPO to have fraudulently obtained $10 million from commodity pool participants, the CPO must have taken in $10 million from them, resulting in the commodity pool at one time having $10 million in total assets. *See also* letter from Sidley (providing 26 examples of CFTC Forex Pool-related enforcement cases, all but one of which involved Forex Pools with less than $50 million in total assets). A number of the cases cited by GXFD and Sidley overlap; in the aggregate, these commenters appear to have presented data on 45 different cases rather than 61.

[730] *See* letter from GFXD II.

[731] *See* letters from GXFD II and Skadden.

[732] *See* meeting with SIFMA on January 20, 2012 (in which representatives of SIFMA proposed a new non-exclusive set of criteria for a Forex Pool to qualify as an ECP, which included, as one of several alternatives in one element of the proposed criteria, that a Forex Pool be operated by a registered CPO). *See also* letter from Willkie Farr (observing that ''[i]t may be time to regulate certain previously unregulated transactions and traders, so that more CPOs are registered'' and that ''many commodity pools are operated and advised by registered professionals'').

[733] *See* letter from Sidley.

[734] *See id.*

[735] *See* joint letter from the GFXD and MFA dated January 10, 2012 (''GFXD I''). These commenters indicated that, while

[s]ome swap dealers may be dually licensed as a bank or a broker-dealer [and therefore] eligible to transact in OTC foreign exchange with retail investors as well as swaps with institutional investors * * * as an operational matter, it is not clear that firms will be able to and find it efficient to structure their business so that the retail foreign exchange platform is conducted from the same entity as the institutional swaps business.

[736] Given that (i) many CPOs will be registering as such for the first time due to the CFTC's recent rescission of the exemption from CPO registration set forth in CFTC Regulation § 4.13(a)(4) or its modification of the criteria for claiming the exclusion from the CPO definition in CFTC Regulation § 4.5 and (ii) such pools were formed prior to their CPOs' registration as such, commodity pools formed prior to December 31, 2012 need not have been ''formed'' by a registered CPO or by a CPO exempt from registration as such pursuant to CFTC Regulation § 4.13(a)(3) in order to be qualified as ECPs under the new prong, so long as they are operated by a registered CPO on or before such date.

that the NFA oversees compliance by those registered CPOs relying on this new regulation.[737] CPO registration also provides a clear means of addressing wrongful conduct.[738] Although some commenters suggested that a CPO need only be ''subject to regulation under the CEA'' in order for a Forex Pool operated by that CPO to qualify as an ECP notwithstanding the look-through requirements, CFTC Regulation § 1.3(m)(8) instead requires that the CPO of a Forex Pool be registered as a CPO or be a CPO who is exempt from registration as such pursuant to CFTC Regulation § 4.13(a)(3), alternative conditions supported by other commenters. The Commissions are requiring operation by a registered CPO, or by a CPO who is exempt from registration as such pursuant to CFTC Regulation § 4.13(a)(3), as a condition for a Forex Pool to qualify for ECP status under CFTC Regulation § 1.3(m)(8) because, based on the data presented by commenters, CFTC enforcement actions involving Forex Pools rarely involve registered CPOs or CPOs exempt from registration as such.[739]

While NFA oversight of CPOs operating Retail Forex Pools is a useful criterion to determine whether an exclusion from the look-through provisions of CEA section 1a(8)(A)(iv) and CFTC Regulation § 1.3(m)(5) is warranted, the Commissions believe that Retail Forex Pools operated by CPOs exempt from registration as such pursuant to CFTC Regulation § 4.13(a)(3) also merit relief from those look-through provisions. On September 10, 2010, the CFTC published in the **Federal Register** a final rule revising the CPO registration exemption in CFTC Regulation § 4.13(a)(3) to incorporate retail forex transactions into the transactions subject to the alternative caps on the use of commodity interests[740] by CPOs claiming the exemption.[741] The CFTC explained in the related **Federal Register** proposing release that the proposed change to CFTC Regulation § 4.13(a)(3) was part of a proposal to adopt a comprehensive regulatory scheme to implement the CRA with respect to retail forex transactions (''CRA-Related Forex Proposal'').[742] The CFTC also explained that ''the NFA-specified minimum security deposit for off-exchange retail forex transactions would be included among the amounts that cannot exceed 5 percent of the liquidation value of the pool's portfolio in order for the operator to claim the exemption from registration under Regulation 4.13(a)(3)''[743] and that ''such amounts are roughly equivalent to initial margin and option premiums).''[744] The CFTC also described the CRA-Related Forex Proposal as ''amend[ing] existing regulations as needed to clarify their application to, and inclusion in, the new regulatory scheme for retail forex.''[745] More recently, notwithstanding the Dodd-Frank Act's addition of the look-through provision in CEA section 1a(8)(A)(iv), the CFTC determined to retain the exemption from CPO registration under Regulation 4.13(a)(3), reasoning that ''overseeing entities with less than five percent exposure to commodity interests is not the best use of the Commission's resources.''[746]

Given that, shortly before the adoption of the Dodd-Frank Act, the CFTC proposed to add retail forex transactions to those that can be entered into by CPOs claiming relief from registration as such under CFTC Regulation § 4.13(a)(3), that it finalized that action shortly after the Dodd-Frank Act was adopted and that it recently left CFTC Regulation § 4.13(a)(3) in place despite having proposed to withdraw that CPO registration exemption, and for the reasons described above, the Commissions believe CPOs exempt from registration as such pursuant to CFTC Regulation 4.13(a)(3) and operating Retail Forex Pools should be able to continue to do so outside the retail forex regime.

Section 712(d)(2)(A) of the Dodd-Frank Act grants the Commissions the authority to adopt such rules related to the ECP definition as the Commissions determine are necessary and appropriate, in the public interest, and for the protection of investors. Based on commenters' views, the Commissions have determined that CFTC Regulation § 1.3(m)(8) as adopted is necessary and appropriate because the statutory look-through provision, if strictly implemented, would subject Forex Pools operated by CPOs that are sophisticated, professional asset managers to an array of additional compliance costs and deprive them of access to swap dealers as counterparties when engaging in retail forex transactions.[747] The Commissions also have determined that it is appropriate to limit the availability of ECP status under CFTC Regulation § 1.3(m)(8) to Forex

[737] *See* CPO/CTA Compliance Release at 11254 (noting that ''registration allows the Commission to ensure that all entities operating collective investment vehicles participating in the derivatives markets meet minimum standards of fitness and competency''). *See http://www.nfa.futures.org/NFA-registration/cpo/index.html* for an overview of registration and related requirements for CPOs, their principals and their associated persons and *http://www.nfa.futures.org/NFA-compliance/NFA-commodity-pool-operators/index.html* for an overview of the compliance regime for registered CPOs overseen by the NFA. The CFTC anticipates that more CPOs will register in the coming months now that it has withdrawn the CFTC Regulation § 4.13(a)(4) exemption from CPO registration, increasing the number of registered CPOs, in turn increasing the number of CPOs who can satisfy the registered CPO alternative under CFTC Regulation § 1.3(m)(8)(iii).

[738] *See* CPO/CTA Compliance Release at 11254 (stating that ''the [CFTC] has clear authority to take punitive and/or remedial action against registered entities for violations of the CEA or of the [CFTC''s regulations * * * [and] to deny or revoke registration, thereby expelling an individual or entity from serving as an intermediary in the industry'' and that the CFTC's reparations program and the NFA's arbitration program also are available avenues ''to seek redress for wrongful conduct by a [CFTC] registrant'').

[739] As discussed above in note 729, only one of the 45 unique cases presented by commenters involved a pool with more than $10 million in total assets and a registered CPO. Only two of those cases involved a pool operated by CPOs exempt from registration: in both of those cases, however, the CPO raised less than $10 million. In addition, one of those CPOs relied on the CFTC Regulation § 4.13(a)(4) CPO registration exemption. As discussed above, the CFTC has withdrawn that exemption.

[740] The term ''commodity interest'' is defined in CFTC Regulation § 1.3(yy), and includes ''[a]ny contract, agreement or transaction subject to [CFTC] jurisdiction under section 2(c)(2) of the [CEA].'' CFTC Regulation § 1.3(yy)(3).

[741] *See* CFTC, Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries; Final Rules, 75 FR 55410 (Sept. 10, 2010).

[742] CFTC, Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries; Proposed Rules, 75 FR 3282 (Jan. 10, 2010).

[743] Section 12 of the NFA's Financial Requirements impose the following minimum security deposit requirements for retail forex transactions: (i) 2% of the notional value of transactions in the British pound, the Swiss franc, the Canadian dollar, the Japanese yen, the Euro, the Australian dollar, the New Zealand dollar, the Swedish krona, the Norwegian krone, and the Danish krone; (ii) 5% of the notional value of other transactions; (iii) for short options, the above amount plus the premium received; and (iv) for long options, the entire premium. *See* NFA Manual, available at *http://www.nfa.futures.org/nfamanual/NFAManual.aspx?RuleID=SECTION%2012&Section=7*.

[744] CFTC, Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries; Proposed Rules, 75 FR 3282, 3287 (Jan. 10, 2010).

[745] *Id.* at 3282.

[746] CPO/CTA Compliance Release at 11261. The CFTC also stated that:

[t]he Commission believes that trading exceeding five percent of the liquidation value of a portfolio, or a net notional value of commodity interest positions exceeding 100 percent of the liquidation value of a portfolio, evidences a significant exposure to the derivatives markets, and that such exposure should subject an entity to the Commission's oversight.

Id. at 11263.

[747] The nature of a swap dealer's business activities and assets may detract from what is considered regulatory capital for an FCM or RFED engaging in retail forex transactions, thereby making it difficult for some swap dealers to dually register both as such and as an FCM or RFED in order to do retail forex business. As an ECP, a Forex Pool's choice of retail forex transaction counterparties will not be limited to Enumerated Counterparties, and thus may include swap dealers.

Pools operated by registered CPOs or by CPOs exempt from registration as such pursuant to CFTC Regulation § 4.13(a)(3).[748] The conditions in CFTC Regulation § 1.3(m)(8) also are appropriate in that they require Forex Pools seeking ECP status thereunder to have total assets exceeding $10 million. Historically, CFTC enforcement actions have involved fewer instances of misconduct by CPOs of Forex Pools with total assets above this threshold.[749]

The Commissions have determined that CFTC Regulation § 1.3(m)(8) is in the public interest in that it will make available a category of counterparty (*i.e.,* swap dealers) that likely would not otherwise be available, and help to assure that sophisticated, professional managers operating qualifying Forex Pools can continue to engage in retail forex transactions. The Commissions have determined that the conditions of CFTC Regulation § 1.3(m)(8) are sufficient for the protection of investors for the reasons discussed above, such as a significant reduction in the incidence of Forex Pool misconduct among CPOs, whether registered as such or exempt therefrom, operating Forex Pools with more than $10 million in total assets. The Commissions intend to monitor developments in the Forex Pool area and will revisit the conditions of this regulation as warranted by subsequent events.

IV. Definitions of ''Major Swap Participant'' and ''Major Security-Based Swap Participant''

The statutory definitions of ''major swap participant''[750] and ''major security-based swap participant''[751] (collectively, ''major participant'') encompass any person that is not a swap dealer or security-based swap dealer[752] and that satisfy any one of three alternative statutory tests that encompass a person: (i) That maintains a ''substantial position'' in swaps or security-based swaps for any of the major swap categories as determined by the Commissions; (ii) whose outstanding swaps or security-based swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets;[753] or (iii) that is a ''financial entity'' that is ''highly leveraged'' relative to the amount of capital it holds (and that is not subject to capital requirements established by an appropriate Federal banking agency) and maintains a ''substantial position'' in outstanding swaps or security-based swaps in any major category as determined by the Commissions.[754] The first—and only the first—of those three statutory tests explicitly excludes: (i) Positions held for ''hedging or mitigating commercial risk,'' and (ii) positions maintained by any employee benefit plan as defined in sections 3(3) and (32) of ERISA for the ''primary purpose of hedging or mitigating any risk directly associated with the operation of the plan.''[755]

The statutory definitions require the Commissions to define the term ''substantial position'' at the threshold determined to be prudent for the effective monitoring, management, and oversight of entities that are systematically important or can significantly impact the financial system of the U.S. In setting these thresholds, the Commissions are required to consider the person's relative position in uncleared as opposed to cleared swaps and may take into consideration the value and quality of collateral held against counterparty exposures.[756]

The statutory definitions further permit the Commissions to limit the scope of the major participant designations so that a person may be designated as a major participant in certain categories of swaps or security-based swaps, but not all categories.[757]

In addition, the ''major swap participant'' definition excludes certain entities whose primary business is providing financing *and* that use derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company.[758] The ''major security-based swap participant'' definition does not contain this type of exclusion.

As detailed in the Proposing Release, the major participant definitions focus on the market impacts and risks associated with a person's swap and security-based swap positions.[759] This is in contrast to the definitions of ''swap dealer'' and ''security-based swap dealer,'' which focus on a person's activities and account for the amount or significance of those activities only in the context of the *de minimis* exception. However, persons that meet the major participant definitions in large part must follow the same statutory requirements that will apply to swap dealers and security-based swap dealers.[760] In this way, the statute applies comprehensive regulation to entities whose swap or security-based swap activities do not cause them to be dealers, but nonetheless could pose a high degree of risk to the U.S. financial system generally.[761]

Although the two major participant definitions are similar, they address instruments that reflect different types of risks and that can be used by end-users and other market participants for

[748] The Commissions note that the statistics presented by commenters indicate that Forex Pool misconduct by registered CPOs and those exempt from CPO registration is significantly rarer than Forex Pool misconduct by otherwise unregistered CPOs. *See* letter from the GFXD II.

[749] *See* letter from Sidley (showing that 6 of the 27 cases presented involved more than $10 million).

[750] CEA section 1a(33).

[751] Exchange Act section 3(a)(67).

[752] As discussed above, a person may be designated as a dealer for particular activities involving swaps or security-based swaps, or particular swap or security-based swap activities, without being deemed to be a dealer with regard to other categories or activities. *See* part II.E, *supra.* To the extent that a person is subject to that type of limited designation as a swap dealer or security-based swap dealer, the person may be subject to being a major swap participant or a major security-based swap participant in connection with positions that fall outside of that limited dealer designation.

[753] *See* CEA section 1a(33)(A)(ii); Exchange Act section 3(a)(67)(A)(ii)(II).

[754] *See* CEA section 1a(33)(A)(iii); Exchange Act section 3(a)(67)(A)(ii)(III).

[755] *See* CEA section 1a(33)(A)(i); Exchange Act section 3(a)(67)(A)(ii)(I).

[756] *See* CEA section 1a(33)(B) and Exchange Act section 3(a)(67)(B).

[757] *See* CEA section 1a(33)(C); Exchange Act section 3(a)(67)(C).

[758] *See* CEA section 1a(33)(D).

[759] *See* Proposing Release, 75 FR at 80185.

[760] In particular, under CEA section 4s and Exchange Act section 15F, dealers and major participants in swaps or security-based swaps generally are subject to the same types of margin, capital, business conduct and certain other requirements, unless an exclusion applies. *See* CEA section 4s(h)(4), (5); Exchange Act section 15F(h)(4), (5). *See also* CFTC, Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties; Final Rule, 77 FR 9733 (Feb. 17, 2012); Notice of Proposed Rulemaking: Capital requirements of swap dealers and major swap participants, 76 FR 27802 (May 12, 2011); and SEC, Notice of Proposed Rulemaking: Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, Securities Exchange Act Release No. 64766, 76 FR 42396 (July 18, 2011).

[761] As discussed below, the tests of the major participant definitions use terms—particularly ''systemically important,'' ''significantly impact the financial system'' or ''create substantial counterparty exposure''—that denote a focus on entities that pose a high degree of risk through their swap and security-based swap activities. In addition, the link between the major participant definitions and risk was highlighted during the Congressional debate on the statute. *See* 156 Cong. Rec. S5907 (daily ed. July 15, 2010) (colloquy between Senators Hagen and Lincoln, discussing how the goal of the major participant definitions was to ''focus on risk factors that contributed to the recent financial crisis, such as excessive leverage, under-collateralization of swap positions, and a lack of information about the aggregate size of positions'').

different purposes. Interpretation of the definitions must account for those differences as appropriate.

The Commissions in the Proposing Release proposed to further define the ''major swap participant'' and ''major security-based swap participant'' definitions, by specifically addressing: (i) The ''major'' categories of swaps or security-based swaps; (ii) the meaning of ''substantial position''; (iii) the meaning of ''hedging or mitigating commercial risk''; (iv) the meaning of ''substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets''; and (v) the meanings of ''financial entity'' and ''highly leveraged.'' The proposal also addressed the period of time that a major participant would have to register (as well as the minimum length of time for being a major participant), the limited purpose designations of major participants, the exclusion for ERISA plan hedging positions, and certain additional interpretive issues.

After considering commenters' views, the Commissions are adopting final rules further defining the meaning of major participant.

As discussed below, the Commissions also are directing their respective staffs to report separately as to whether changes are warranted to any of the rules implementing the major participant definitions. These staff reports will help the Commissions evaluate the ''major swap participant and ''major security-based swap participant'' definitions, including whether new or revised tests or approaches would be appropriate for identifying major participants.[762]

A. ''Major'' Categories of Swaps and Security-Based Swaps

1. Proposed Approach

The first and third tests of the statutory major participant definitions encompass entities that maintain a substantial position in a ''major'' category of swaps or security-based swaps.[763]

In the Proposing Release, the Commissions proposed to designate four ''major'' categories of swaps and two ''major'' categories of security-based swaps. These categories sought to reflect the risk profiles of the various types of swaps and security-based swaps, and the different purposes for which end-users use those instruments. The Proposing Release also noted the importance of not parsing the ''major'' categories so finely as to base the ''substantial position'' thresholds on unduly narrow risks and reduce those thresholds' effectiveness as risk measures.[764]

The proposed four ''major'' categories of swaps were rate swaps, credit swaps, equity swaps and other commodity swaps.[765] Rate swaps would encompass any swap which is primarily based on one or more reference rates, such as swaps of payments determined by fixed and floating interest rates, currency exchange rates, or other monetary rates. Credit swaps would encompass any swap that is primarily based on default, bankruptcy and other credit-related risks related to, or the total returns on, instruments of indebtedness (including loans), including but not limited to any swap primarily based on one or more broad-based indices related to debt instruments, and any swap that is a broad-based index credit default swap or total return swap. Equity swaps would encompass any swap that is primarily based on equity securities, such as any swap primarily based on one or more broad-based indices of equity securities, including any total return swap on one or more broad-based equity indices. Other commodity swaps would encompass any swap not included in any of the first three categories, and would generally include, for example and not by way of limitation, any swap for which the primary underlying item is a physical commodity or the price or any other aspect of a physical commodity. The four categories were intended to cover all swaps, and each swap would be in the category that most closely describes the primary item underlying the swap.[766]

The Commissions proposed to designate two ''major'' categories of security-based swaps.[767] The first category would encompass any security-based swap that is based, in whole or in part, on one or more instruments of indebtedness (including loans), or a credit event relating to one or more issuers or securities, including but not limited to any security-based swap that is a credit default swap, total return swap on one or more debt instruments, debt swaps, or debt index swaps. The second category would encompass any other security-based swaps not included in the first category, including for example, swaps on equity securities or narrow-based security indices comprised of equity securities.[768] These proposed categories were based on the different uses of these types of security-based swaps, and were consistent with market statistics and infrastructures that distinguish between those types of security-based swaps.[769]

2. Commenters' Views

Certain commenters requested clarification regarding how the major categories would be applied. One commenter particularly requested additional clarity as to how the proposed categories will apply to mixed swaps and to swaps that are based on debt that is convertible to equity,[770] while another commenter requested additional clarity as to the status of certain mortgage-related transactions.[771]

One commenter suggested that the final rules should include a catch-all provision to allow the Commissions to review large positions that appear to be structured to evade proper categorization, and that market participants should suggest the protocols for categorization of swaps or security-based swaps.[772]

One commenter suggested that the rate swap category should be divided between interest rates and currencies, and that energy, agriculture and metals swaps should be separate categories.[773] Another commenter expressed the view that creation of a separate category for cross currency swaps could lead to confusion among market participants who may feel obligated to bifurcate cross currency swaps between two categories.[774] Some commenters expressed general support for the major categories as proposed.[775]

3. Final Rules

After considering the issue in light of comments received, the Commissions are adopting final rules designating ''major'' categories of swaps and security-based swaps consistent with the proposal. Accordingly, the final rules provide that the four ''major'' categories of swaps are rate swaps,

[762] *See* part V, *infra*.

[763] *See* CEA section 1a(33)(A)(i), (iii); Exchange Act section 3(a)(67)(a)(2)(i), (iii).

[764] *See* Proposing Release, 75 FR at 80186–87.

[765] *See* proposed CFTC Regulation § 1.3(iii).

[766] The statutory definition of ''swap'' lists 22 different types of swaps.

[767] *See* proposed Exchange Act rule 3a67–2.

[768] The second category also encompasses all security-based swaps on narrow based indices that are comprised of both debt and equity components.

[769] *See* Proposing Release, 75 FR at 80187.

[770] *See* letter from ISDA I.

[771] *See* letter from Freddie Mac.

[772] *See* meeting with Professor Darrell Duffie, Stanford University Graduate School of Business (''Duffie'') on February 2, 2011.

[773] *See* letter from Better Markets I.

[774] *See* letter from ACLI.

[775] *See* letters from Barnard, ISDA I and MetLife; *see also* letter from American Insurance Association (''AIA'') (agreeing that the defined major categories would cover substantially all significant swaps and security-based swaps).

credit swaps, equity swaps and other commodity swaps.[776] The two ''major'' categories of security-based swaps are debt security-based swaps[777] and other security-based swaps.[778]

The Commissions believe that it is not necessary to further divide the proposed categories or add new categories for swaps and security-based swaps for purposes of the major participant definitions. We believe that maintaining a large number of narrow categories of swaps and security-based swaps would increase the possibility of confusion by market participants with regard to categorizing the swaps and security-based swaps in which they transact. The Commissions also continue to believe that it is important not to parse the ''major'' categories so finely as to base the ''substantial position'' thresholds on unduly narrow groupings that would reduce those thresholds' effectiveness as risk measures. Categories that are broad and clearly delineated further should help prevent action to evade designation as a major participant in a particular ''major'' category.

While we believe that these rules in general are sufficiently clear to allow each swap and security-based swap to be placed in the appropriate category, we are mindful of the commenters' request for guidance with regard to certain circumstances. In the case of mixed swaps, we would expect that the instrument would be placed in the ''swap'' and ''security-based swap'' categories that are consistent with the underlying attributes that cause such instrument to be a mixed swap.[779] Also, swaps or security-based swaps that are based on more than one item, instrument or risk, should be placed in the category that most closely describes the primary item, instrument or risk underlying the swap or security-based swap.[780]

B. ''Substantial Position''

1. Proposed Approach

The major participant definitions require that the Commissions define a ''substantial position'' in swaps or security-based swaps at a threshold that we determine to be ''prudent for the effective monitoring, management, and oversight'' of entities that are systemically important or can significantly impact the U.S. financial system. The definitions further require that we consider a person's relative position in uncleared and cleared swaps or security-based swaps, and permit us to consider the value and quality of collateral held against counterparty exposure.[781]

The proposed rules provided that a person would have a ''substantial position'' in swaps or security-based swaps if the daily average current uncollateralized exposure associated with its swap or security-based swap positions in a major category in a calendar quarter amounted to $1 billion or more (or $3 billion in the case of rate swaps).[782] A person also would have a ''substantial position'' if the daily average of the sum of the current uncollateralized exposure plus the potential future exposure associated with its positions in a major category in a calendar quarter amounted to $2 billion or more (or $6 billion for the rate swap category).[783]

The proposed rules did not prescribe any particular methodology for measuring current exposure or valuing collateral posted, and instead provided that the method used should be consistent with counterparty practices and industry practices generally.[784] The proposed rules also provided that an entity could calculate its current uncollateralized exposure by accounting for netting agreements on a counterparty-by-counterparty basis,[785] and the Proposing Release set forth a method for allocating any residual uncollateralized exposure to a counterparty that remains following netting.[786]

The proposed potential future exposure test was based on the risk-adjusted notional amount of the entity's swap and security-based swap positions, consistent with a test used by bank regulators for purposes of setting capital standards.[787] The test also excluded or lowered the potential exposure associated with certain lower-risk positions.[788] In addition, the measures of potential future exposure would be discounted by up to 60 percent to reflect the risk mitigation provided by netting agreements,[789] and would further be decreased by 80 percent for positions subject to central clearing or daily mark-to-market margining.[790]

2. Commenters' Views

a. Basis for Regulating Major Participants and Alternative Approaches for Identifying ''Substantial Positions''

Several commenters expressed the view that the major participant definition is intended to address entities whose swap or security-based swap positions pose systemic risk,[791] while one commenter took the contrary view that the definition also is intended to address the significance of an entity's swap or security-based swap positions (as well as the risk those positions pose).[792]

One commenter stated that the proposal inappropriately sought to account for the risk posed by the potential default of multiple entities, rather than a single entity.[793] Some commenters suggested that the analysis should account for the concentration of the risk posed by an entity's

[776] *See* CFTC Regulation § 1.3(iii). The four major categories of swaps are the same as the asset classes used in the CFTC Regulations relating to SDRs and reporting, except that the asset classes for interest rate swaps and foreign exchange transactions are combined into the single rate swap major category of swaps. *See* CFTC, Swap Data Repositories: Registration Standards, Duties and Core Principles; Final Rule, 76 FR 54538 (Sept. 1, 2011) and Swap Data Recordkeeping and Reporting Requirements; Final Rule, 77 FR 2136 (Jan. 13, 2012).

[777] The name of the first major category of security-based swaps has been changed to ''debt security-based swaps'' in this Adopting Release from ''security-based credit derivatives'' in the Proposing Release. This change more accurately reflects the products encompassed by this category, particularly total return swaps on debt instruments. *See* Exchange Act rule 3a67–2(a).

In addition, the final rules defining the major categories for purposes of the major participant definitions remove a cross-reference to the corresponding dealer definitions under the CEA or the Exchange Act to clarify that the rules apply only in the context of the major participant definitions, and not the dealer definitions. *See* CFTC Regulation § 1.3(iii); Exchange Act rule 3a67–2.

[778] *See* Exchange Act rule 3a67–2(b).

[779] The Commissions have proposed rules regarding the regulation of mixed swaps. *See* Product Definitions Proposal, note 3, *supra.*

[780] In the case of instruments on debt securities that are convertible into equity, in general we would expect the instrument to be categorized based on its status (as debt or equity) at the time of evaluation.

[781] *See* CEA section 1a(33)(B); Exchange Act section 3(a)(67)(B).

[782] *See* proposed CFTC Regulation § 1.3(jjj)(1); proposed Exchange Act rule 3a67–3(a)(1), (d).

[783] *See* proposed CFTC Regulation § 1.3(jjj)(1); proposed Exchange Act rule 3a67–3(a)(2), (d).

[784] *See* proposed CFTC Regulation § 1.3(jjj)(2)(ii); proposed Exchange Act rule 3a67–3(a)(2)(i).

[785] *See* proposed CFTC Regulation § 1.3(jjj)(2)(iii); proposed Exchange Act rule 3a67–3(b)(3).

[786] *See* Proposing Release, 75 FR at 80190.

[787] *See id.* at 80191–92.

[788] *See* proposed CFTC Regulation § 1.3(jjj)(3)(iii); proposed Exchange Act rule 3a67–3(c)(2)(i)(C), (D).

[789] *See* proposed CFTC Regulation § 1.3(jjj)(3)(ii)(B); proposed Exchange Act rule 3a67–3(c)(2)(ii).

[790] *See* proposed CFTC Regulation § 1.3 (jjj)(3)(iii)(A); proposed Exchange Act rule 3a67–3(c)(3)(i). This discount for daily margining would be available even in the presence of a threshold or a minimum transfer amount, so long as the threshold and the minimum transfer amount (if the latter exceeds $1 million) are separately added to the entity's current exposure for purposes of the current exposure plus potential future exposure test. *See* proposed CFTC Regulation § 1.3(jjj)(3)(iii)(B); proposed Exchange Act rule 3a67–3(c)(3)(ii).

[791] *E.g.,* letters from BlackRock I and MFA I.

[792] *See* letter from Better Markets I.

[793] *See* letter from BlackRock I.

positions,[794] and one commenter suggested that the analysis should not account for individual categories of swaps or security-based swaps.[795]

b. Levels of Proposed ''Substantial Position'' Thresholds

A number of commenters expressed the view that the proposed thresholds are inappropriately low.[796] Some commenters stated the thresholds initially should be high, with later revisions based on market data.[797]

Some commenters did not oppose the proposed thresholds or expressed support for the thresholds (though many of those commenters separately raised issues about the underlying tests),[798] while two commenters supported lowering the proposed thresholds.[799] Some commenters took the position that the thresholds should be adjusted over time to reflect factors such as inflation or market characteristics.[800]

c. Current Uncollateralized Exposure Test

Measures of exposure and valuation of collateral—A number of commenters supported the Proposing Release's position that the current exposure analysis not prescribe any methodology for measuring exposure or valuing collateral.[801] On the other hand, some commenters requested explicit approval of particular methodologies,[802] a good faith safe harbor,[803] or regulator-prescribed measurement standards.[804] Some commenters emphasized the need to be able to post non-cash collateral in connection with positions.[805] Two commenters requested codification of the proposal's position that operational delays associated with the daily exchange of collateral would not lead to current uncollateralized exposure for purposes of the analysis.[806]

Netting issues—Some commenters stated that the proposed netting provisions should be expanded to encompass additional products that may be netted for bankruptcy purposes.[807] One commenter took the view that these provisions should be expanded across multiple netting agreements to the extent that offsets are permitted.[808] One commenter asked for clarification as to the scope of the netting provisions,[809] and one commenter expressed general support for the proposed netting provisions.[810]

Allocation of uncollateralized exposure—Some commenters requested that the final rules incorporate the principles, articulated in the Proposing Release, for allocating any uncollateralized exposure that remains following netting.[811] Other commenters raised concerns that those principles were based on an unwarranted assumption that collateral is specifically earmarked to particular transactions.[812]

d. Potential Future Exposure Test

General concerns and suggested alternative approaches—Some commenters disagreed with the Proposing Release's statement that the potential future exposure analysis would evaluate potential changes in the value of a swap or security-based swap over the remaining life of the contract; those commenters stated that the test instead should focus on potential volatility during the time it would take for a non-defaulting party to close out a defaulting party's positions.[813]

Some commenters criticized the tables setting forth the risk adjustments used to calculate potential future exposure.[814] Commenters further suggested using, as alternatives, value-at-risk measures or other models,[815] or the ''standardized method'' under Basel II.[816] Commenters also argued that risk adjustments should provide a greater discount to credit swaps on ''investment grade'' instruments than to other credit swaps, that index CDS should be subject to a greater discount than single name CDS, and that there should be a lower discount factor for CDS of shorter maturity.[817] One commenter generally supported the proposed conversion factors and adjustments.[818]

Some commenters expressed the view that measures of potential future exposure should be superseded by negotiated independent amounts or regulator-required initial margin.[819] Some commenters also argued that

[794] *See* letters from Black Rock I (suggesting a two-step process that accounts for the reduced risk associated with entities whose positions are distributed among several counterparties); CCMR I and APG Algemene Pensioen Groep NV (''APG'').

[795] *See* letter from NYCBA Committee.

[796] *See* letters from ABC/CIEBA (indirectly referring to AIG Financial Products, and noting that it had $400 billion in notional positions and defaulted when it was required to post approximately $100 billion in collateral); BG LNG I (alluding to lack of systemic impact associated with Enron's failure, and suggesting that the Commissions convene an advisory committee to develop thresholds); NCGA/NGSA I (alluding to corporate financial losses involving derivatives that have exceeded the proposed thresholds without significantly impacting the U.S. financial system); ACLI (supporting increase in proposed thresholds under the CEA to $4 billion current uncollateralized exposure and $8 billion current uncollateralized exposure plus potential future exposure); and Chesapeake Energy.

[797] *See* letters from MFA dated February 25, 2011 (''MFA II'') (stating that thresholds initially should be set higher, while later survey-based thresholds should be based on potential systemic risk impact and the cost of performing the calculations); CCMR I (stating that the Commissions presently have insufficient data to determine appropriate thresholds, and that thresholds initially should be high); BlackRock I (stating that the Commissions should refrain from establishing thresholds if sufficient information is not available); and Freddie Mac. Two commenters particularly addressed the proposed thresholds applicable to rate swaps. *See* letters from ACLI and MetLife.

[798] *See, e.g.,* letters from ACLI, Fidelity, SIFMA AMG dated Feb. 22, 2011 (''SIFMA AMG II'') and Vanguard (supporting proposed limits for credit swaps, equity swaps and other commodity swaps, but not rate swaps).

[799] *See* letters from AFR (supporting use of a $500 million uncollateralized exposure threshold, or a $1 billion current exposure plus potential future exposure threshold, with higher thresholds for rate swaps) and Greenberger.

[800] *See, e.g.,* letters from MFA I (referring to inflation and measures such as the amount of equity in the U.S. banking system) and ISDA I (referring to evolution of the size and fundamental characteristics of the markets, and changes to valuation methodologies and economic conditions).

[801] *See* letters from Fidelity, ICI I, ISDA I and MFA I.

[802] *See* letter from BlackRock I. Consistent with the proposal, the final rules contemplate the use of industry standard practices in the calculation of current exposure and potential future exposure. As with other rules adopted by the Commissions, a market participant may raise questions with the Commissions about the participant's approach to addressing the final rules—including its use of particular methodologies—for further guidance as may be necessary or appropriate.

[803] *See* letter from FSR I (particularly noting difficulty of valuing illiquid or bespoke positions).

[804] *See* letter from Better Markets I.

[805] *See, e.g.,* letters from ACLI, CDEU and MetLife.

[806] *See* letters from SIFMA AMG II and Vanguard.

[807] *See* letters from ISDA I (specifically addressing securities contracts and forward contracts); NRG Energy (specifically addressing forwards); and APG (specifically addressing securities options and forwards).

[808] *See* letter from FSR I.

[809] *See* letter from Fidelity (seeking confirmation that ''master netting agreement'' can include an ISDA Master Agreement).

[810] *See* letter from ACLI.

[811] *See* letters from SIFMA AMG II and Vanguard.

[812] *See* letters from FSR I and ISDA I; *see also* letter from MetLife (suggesting pro rata allocation of uncollateralized current exposure among each major category with current exposure).

[813] *See* letters from SIFMA AMG II and Vanguard.

[814] *See* letters from Riverside Risk Advisors LLC (''Riverside Risk Advisors'') (criticizing, among other aspects, discontinuities in table, a failure to account for how far a swap is in or out of the money, the use of a single discount factor for credit default swaps, the fact that the risk factor for short-term equity swaps is lower than the risk factor for credit swaps, and the fact that equity swaps do not distinguish between high-volatility and low-volatility stocks, as well as the failure to address portfolio effects of diversification and correlation, and ''wrong-way'' risk in the form of ''an adverse correlation between counterparty default risk and the value of its derivatives contracts''); and ISDA I (noting that the conversion factors were calibrated more than 15 years ago and were not designed for later instruments such as credit products).

[815] *See* letters from Riverside Risk Advisors (supporting giving end-users the option to use a model-based approach); and Better Markets I (supporting use of a value-at-risk calculation).

[816] *See* letter from ISDA I.

[817] *See* letters from AIMA I and MFA I.

[818] *See* letter from MetLife.

[819] *See* letters from SIFMA AMG II and Vanguard.

excess posted collateral or net in-the-money positions should be offset against potential future exposure.[820]

Potential future exposure measures for lower-risk positions—Some commenters stated that the proposal to cap potential future exposure when a person buys credit protection using a credit default swap should be expanded to apply to any position with a fixed downside risk.[821] Commenters also suggested that the potential future exposure associated with purchases of credit protection be further discounted,[822] while one commenter took the position that purchases of credit default swaps should be excluded from the potential future exposure test.[823] Commenters also addressed the appropriate discount rate for calculating the net present value of unpaid premiums.[824]

Netting issues—One commenter stated that the proposal's netting provisions did not adequately account for the risk mitigation associated with hedged positions,[825] while another commenter asked that the proposed netting provisions be clarified and simplified.[826] One commenter supported the proposed netting approach.[827]

Discount for cleared or margined positions—Several commenters took the view that cleared positions should be excluded entirely from the potential future exposure analysis, rather than only being subject to an 80 percent discount,[828] and some commenters also supported a complete exclusion for positions subject to daily mark-to-market margining.[829] One commenter suggested a minimum 98 percent reduction for positions subject to central clearing or mark-to-market margining,[830] while one commenter suggested that there be a higher discount for positions subject to the posting of initial margin.[831]

Some commenters also stated that there should be a partial discount provided in connection with positions for which mark-to-market margining is done less than daily,[832] and that there should be a discount for positions that are margined using security interests or liens.[833] On the other hand, one commenter stated that there is no basis for providing any discount for marked-to-market positions.[834]

One commenter requested that the rule language codify language in the Proposing Release as to when a position is subject to daily mark-to-market margining.[835] A number of commenters addressed proposed rule language that was intended to clarify that the discount for daily mark-to-market margining would be available even in the presence of thresholds and minimum transfer amounts.[836]

Two commenters supported the proposed approach in general.[837] One commenter specifically supported the proposed 80 percent reduction for positions subject to daily mark-to-market margining,[838] and one commenter specifically supported a reduction for cleared positions.[839]

Additional issues regarding the potential future exposure test—Some commenters argued that the Commissions should clarify how the categories in the proposed potential future exposure tables would be applied, given how those differ from the proposed ''major'' categories of swaps and security-based swaps.[840]

Some commenters raised concerns that the proposed use of an instrument's ''effective notional'' amount is ambiguous.[841] Commenters also took the position that for purposes of the potential future exposure calculation, notional amounts should be adjusted to reflect delta weighting,[842] that the measure of duration for options on swaps should consider whether the underlying swap is cash-settled,[843] and that the adopting release should set forth examples of potential future exposure calculations.[844]

e. Cost Concerns

Some commenters emphasized the need to avoid an overbroad major participant definition, [845] and highlighted concerns about being subject to unnecessary regulation.[846]

f. Additional Issues

One commenter suggested there be an explicit presumption against imposing major participant (or dealer) regulation on end-users.[847] Some commenters requested that the current uncollateralized exposure test explicitly exclude cleared positions, net in-the-money positions, and fully collateralized out-of-the-money positions,[848] and one commenter also supported excluding those positions from the potential future exposure analysis.[849] That commenter also supported excluding swaps on government securities from the substantial position analysis.[850]

One commenter requested confirmation that dealers and major participants would not be required to compute, assist with, or verify computations for counterparties that may be major participants, and also that market participants can enlist third-party services to assist in performing the calculations.[851] One commenter requested clarification that the proposed focus on uncollateralized exposure does not mean that end-users themselves

[820] *See, e.g.,* letters from AIMA I, Fidelity, MFA I, SIFMA AMG II and Vanguard.

[821] *See* letters from MFA I (citing fixed portions of interest rate swaps), MetLife (citing purchased options as well as CDS), ACLI and Ropes & Gray.

[822] *See* letters from MFA I (arguing that the tightening of credit spreads would imply a healthy credit environment) and AIMA; *see also* meeting with MFA on February 14, 2011.

[823] *See* letter from Vanguard.

[824] *See* letter from MFA I (suggesting the possible use of the LIBOR/Swap rate) and AIMA I.

[825] *See* letter from ISDA I.

[826] *See* letter from SIFMA AMG II.

[827] *See* letters from ACLI.

[828] *See, e.g.,* letters from MFA I, SIFMA AMG II and Vanguard.

[829] *See* letters from BG LNG I, Fidelity and ICI I.

[830] *See* letter from ISDA I.

[831] *See* letter from FHLB I (suggesting 90 percent discount for cleared swaps and for uncleared swaps for which initial margin has been posted; alternatively suggesting that posted initial margin be subtracted from the calculated amount).

[832] *See* letters from Fidelity and Canadian Master Asset Vehicle I and Master Asset Vehicle II (''Canadian MAVs'').

[833] *See* letter from FHLB I (giving as an example swaps collateralized by security interests in real estate, oil or gas interests, or by first liens on financial assets).

[834] *See* letter from Better Markets I; *see also* letter from AFR (generally opposing use of risk adjustments, but suggesting that any such discounts should be larger for cleared positions).

[835] *See* letter from SIFMA AMG II.

[836] *See* letter from CDEU (stating that the proposal could overstate an entity's future exposure, and favoring use of the lower of the calculated potential future exposure or the CSA threshold); *see also* letters from SIFMA AMG II and Vanguard.

[837] *See* letters from ACLI and MetLife.

[838] *See* letter from Vanguard.

[839] *See* letter from Better Markets I.

[840] *See* letters from SIFMA AMG II and Vanguard.

[841] *See* letters from FSR I, SIFMA AMG II and Vanguard.

[842] *See* letters from MFA I and Ropes & Gray.

[843] *See* letter from MFA I.

[844] *See id.*

[845] *See* joint letter from Representatives Bachus and Lucas.

[846] *See, e.g.,* letters from SIFMA AMG II (stating that the commenter's suggested changes in connection with the substantial position analysis would reduce burdens and costs to market participants, and more closely align the tests with the objectives they are meant to achieve) and ABC/CIEBA; *see also* letter from NFPEEU (reserving the right to dispute the cost-benefit analysis associated with the proposed dealer and major participant rules until all relevant Dodd-Frank Act releases could be analyzed as a whole).

[847] *See* letter from CDEU.

[848] *See* letters from ICI I, SIFMA AMG II and Vanguard.

[849] *See* letter from ICI I.

[850] *See* letter from ICI I (noting size of government security market and Federal Reserve control over supply and demand, and stating that the proposed thresholds are ill-suited to address the ''vast'' government securities market).

[851] *See* letter from ISDA I.

should not demand collateral from dealers.[852]

3. Final Rules

a. Guiding Principles

The final rules defining ''substantial position'' focus on identifying persons whose large swap and security-based swap positions pose market risks that are significant enough that it would be ''prudent'' to regulate those persons. In developing these rules we have been mindful of the costs associated with regulating major participants, and have considered cost and benefit principles as part of the analysis of what level of swap and security-based swap positions reasonably form the lower bounds for identifying when it would be ''prudent'' that particular entities be subject to monitoring, management and oversight of entities that may be systemically important or may significantly impact the U.S. financial system.[853]

The final rules implementing the ''substantial position'' definition follow the basic approach that the Commissions proposed, including the combined use of current exposure and potential future exposure tests.[854] While we have carefully considered the views of commenters who suggested alternative approaches, we have concluded that it is appropriate to adopt the basic approach that was proposed, as described below.

• *Focus on default-related credit risks.* The final rules implement tests that seek to reflect the credit risk that a person's swap or security-based swap positions would pose in the event of default. In arguing that the analysis should consider factors in addition to default-related risks, commenters have noted that certain regulations applicable to major participants address business conduct issues that are distinct from systemic risk issues.[855] We nonetheless believe that the statutory definition of ''substantial position'' indicates that the analysis should focus on default-related credit risks, because a default-related approach is more closely linked to the statutory criteria that the definition focus on entities that are ''systemically important'' or can ''significantly impact'' the U.S. financial system than would be an approach that focuses on the potential for disruptive market movements.[856]

• *Failure of multiple entities close in time.* The final rules that implement the ''substantial position'' definition seek to reflect the risks that would be posed by the default of multiple entities close in time. Although one commenter took the view that the purpose of major participant regulation is to prevent the credit exposure of a *single* person from having a systemic impact,[857] we do not believe that the major participant definitions should be construed so narrowly. The events of recent years demonstrate that market stress may lead to the failure and near-failure of multiple entities with large financial positions over a relatively short time period. We do not believe that it would be prudent or well-reasoned to presume that recent history cannot repeat itself, and to assume that future failures of entities with large financial positions will be isolated events.

• *Aggregate risk.* The final rules address the aggregate risk posed by an entity's swap or security-based swap positions, rather than seeking to focus on principles of concentration (such as by using a threshold that addresses an entity's largest exposure to an individual counterparty) or on converse principles of interconnection. The statutory ''substantial position'' definition is specifically written in terms of market risk concerns (*i.e.,* ''systemically important'' and ''can significantly impact the financial system of the United States''), and measures of aggregate risk appear to be best geared to reflect this standard.[858]

• *Use of objective, quantitative criteria.* The final rules provide for a ''substantial position'' analysis that is based on objective, quantitative criteria that would permit a market participant to determine which level of swap or security-based swap positions would cause it to be a major participant. Although one commenter has suggested the use of a two-step approach that uses thresholds as a safe harbor and that would be accompanied by a second-level determination,[859] we do not believe that such an approach would be consistent with the statutory language or with principles of regulatory efficiency.[860] Accordingly, a person whose swap or security-based swap positions satisfy the applicable thresholds will be a major participant, with no further layer of review provided.[861]

b. Current Uncollateralized Exposure Test

Consistent with the proposal, the final rules implementing the ''substantial position'' definition include a test that accounts for the current uncollateralized exposure posed by an entity's swap or security-based swap positions in a major

[852] *See* letter from FHLB I.

[853] At the same time, as discussed above in the context of the *de minimis* exception to the dealer definitions, we are mindful that the benefits of financial regulation cannot be quantified. For example, while the regulation of major participants will comprise one component of Title VII's comprehensive regulatory framework that should be expected to help lessen the amount and frequency of financial crises, we cannot place a dollar figure on the contribution of major participant regulation to those benefits. In light of those factors, we believe that it would be ''prudent'' to regulate, as major participants, those persons whose swap or security-based swap positions are large enough to pose a material potential of causing significant counterparty impacts, consistent with the levels set forth in the final rules. The Commissions will further address the comparative costs and benefits associated with regulating major participants in the context of the substantive rules applicable to major participants.

[854] As with the proposal, the final rules apply these tests to swap and security-based swap positions in a ''major'' category. *See* CFTC Regulation § 1.3(jjj)(1); Exchange Act rule 3a67–3(a). The final rules have been modified from the proposal, however, by removing a reference to ''positions excluded from consideration.'' We have concluded that this reference is unnecessary because the first statutory major participant test explicitly provides that positions that are subject to the commercial risk hedging and the ERISA hedging exclusions of the first major participant test need not be considered for purposes of that test.

[855] *See, e.g.,* letter from Better Markets I.

[856] We also believe that the statutory definition should focus on all default-related credit risks associated with swap or security-based swap positions. We do not see a basis for excluding any class of risks (*e.g.,* risks associated with swaps based on government securities) from the analysis.

[857] *See* letter from BlackRock I.

[858] Moreover, a test that focuses on the concentration of an entity's swap or security-based swap exposure toward one or a few individual parties potentially poses a tension with the view that interconnections of exposure among multiple parties are important to establishing systemic risk.

[859] *See* letter from BlackRock I.

[860] The major participant definitions specifically require that the term ''substantial position'' be defined ''by rule or regulation'' via a ''threshold.'' That language would not appear to anticipate the use of a multi-tier approach that accounts for subjective criteria.

In this respect, the major participant definitions may be compared with section 113 of the Dodd-Frank Act, which authorizes the Financial Stability Oversight Council (''FSOC'') to provide for a non-bank financial company to be supervised by the Board if the FSOC ''determines that material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States.'' Section 113 further provides that these designations will result from a vote of the FSOC based on a variety of factors. The ''major participant'' definition does not provide for this type of entity-specific determination, and we believe that the ''major participant'' definition more appropriately is implemented by objective factors that allow market participants to determine whether they will fall within the definition.

[861] In addition, the final rules provide that the ''substantial position'' analysis that implements the first (and third) major participant test will be based on the ''major'' categories of swaps and security-based swaps. Notwithstanding commenter concerns that this approach will require market participants to analyze their swaps and security-based swaps in new ways and will result in additional costs, this focus on ''major'' categories is dictated by the plain language of the statute.

category.[862] This provides a measure of the amount of potential risk that an entity would pose to its counterparties if the entity currently were to default.[863]

As with the proposal, a person would apply this test by examining the positions it maintains with each of its counterparties in a particular major category of swaps or security-based swaps. For each counterparty, the person would determine the dollar value of the aggregate current exposure arising from each of its swap or security-based swap positions with negative value in that major category by marking-to-market using industry standard practices, and deduct from that amount the aggregate value of the collateral the entity has posted with respect to the swap or security-based swap positions.[864] The ''aggregate uncollateralized outward exposure'' would be the sum of those uncollateralized amounts over all counterparties with which the person has entered into swaps or security-based swaps in that major category.[865]

The final rules implementing this test largely are the same as the rules the Commissions proposed, but with certain modifications to address issues raised by commenters.

i. Measure of Exposure and Valuation of Collateral

Consistent with the proposal, the final rules do not prescribe any particular methodology for measuring current exposure or for valuing collateral posted, but instead require the use of industry standard practices.[866] In this regard we do not concur with commenter requests that we approve or prescribe particular methodologies, or provide a safe harbor for measures or valuations made in good faith.[867] Instead, it is appropriate that the final rules provide market participants with the flexibility to use the same methodologies that they use in connection with their business activities. Accordingly, we would expect entities to value current uncollateralized exposure based on the amounts that would be payable if the transaction were terminated.

To the extent the measure of exposure or the valuation of collateral is subject to other rules or regulations, we also would expect those measures and valuations for purposes of the major participant calculations to be consistent with those other applicable rules.[868] In addition, the ''substantial position'' analysis may take into account the posting of non-cash collateral to the extent that the posting of such collateral, and the valuation of that collateral, is consistent with industry standard practices or applicable regulation.[869]

ii. Netting

The final rules build upon the proposal with regard to the measure of uncollateralized current exposure in the presence of netting arrangements. In particular, to address commenter concerns these provisions have been modified from the proposal to account for the fact that two counterparties may have multiple netting agreements for which offsets are permitted, and to extend the netting principles to any financial instruments that may be netted for purposes of applicable bankruptcy law (rather than limiting those instruments to swaps, security-based swaps and securities financing transactions).

Accordingly, the final rules provide that an entity may calculate its exposure on a net basis by applying the terms of one or more master netting agreements with a counterparty. The entity may account for offsetting positions entered into with that particular counterparty involving swaps or security-based swaps as well as securities financing transactions (consisting of securities lending and borrowing, securities margin lending and repurchase and reverse repurchase agreements), and other financial instruments and agreements that are subject to netting offsets for purposes of applicable bankruptcy law, to the extent consistent with the offsets provided by those master netting agreements.[870] These revisions should permit the current uncollateralized exposure test to more accurately reflect the degree of credit risk that an entity poses to its counterparty in the event of default.

As discussed in the proposal, these netting provisions apply only to offsetting positions with a single counterparty.[871] The provisions do not extend to the market risk offsets associated with an entity's positions with multiple counterparties, because such offsets would not directly mitigate the risks that an individual counterparty would face in the event of the entity's default.[872]

iii. Allocation of Uncollateralized Exposure Following Netting

The final rules build upon the proposal by codifying the method, discussed in the Proposing Release, related to the allocation of any uncollateralized exposure that remains following netting and the posting of collateral. This type of allocation can be necessary because, with netting, it otherwise may not be possible to directly attribute residual uncollateralized exposure to a particular major category of swap or security-based

[862] CFTC Regulation § 1.3(jjj)(1); Exchange Act rule 3a67–3(b)(2). The final rules contain technical changes from the proposal to clarify the steps entailed by this calculation.

[863] *See* Proposing Release, 75 FR at 80188.

[864] As we noted in the Proposing Release, we recognize that there may be operational delays between changes in exposure and the resulting exchanges of collateral, and in general we would not expect that operational delays associated with the daily exchange of collateral would be considered to lead to uncollateralized exposure for these purposes. *See* Proposing Release, 75 FR at 80189 n.92. Although we are not codifying this principle within the final rules, we will be mindful of the principle when enforcing those rules.

[865] CFTC Regulation § 1.3(jjj)(2); Exchange Act rule 3a67–3(b)(2).

[866] CFTC Regulation § 1.3(jjj)(2); Exchange Act rule 3a67–3(b)(1). As we noted in the Proposing Release, collateral may be posted to a third-party custodian, directly to the counterparty, or in accordance with the rules of a derivatives clearing organization or clearing agency. *See* Proposing Release, 75 FR at 80189 n.94.

[867] *See* letters from BlackRock I, Better Markets I and FSR I.

[868] These principles should apply even in the case of valuing illiquid or bespoke positions. Market participants have the flexibility to use commercially reasonable approaches that are consistent with their financial statements, tax calculations and compliance with other regulations.

[869] For non-cash collateral to be considered for purposes of these calculations, the collateral must be available for the counterparty's use if the entity posting the collateral were to default. At a minimum, this would require that the counterparty possess a perfected security interest in that collateral. As we noted in the Proposing Release, while we expect that other regulatory requirements applicable to the valuation of swap or security-based swap positions and collateral would be relevant to certain calculations relating to major participant status, these rules would not necessarily be relevant for other purposes, such as in the context of capital and margin requirements. *See* Proposing Release, 75 FR at 80189 n.95.

[870] CFTC Regulation § 1.3(jjj)(2)(iii); Exchange Act rule 3a67–3(b)(3)(i). This provision provides for netting under the master netting agreement of any instruments, contracts or agreements (including contracts on physical commodities), that would qualify for netting under applicable bankruptcy law. As we noted in the Proposing Release, the proposed rules regarding possible offsets of various positions are for purposes of determining major participant status only. Other rules proposed by the Commissions may address the extent to which, if any, persons such as dealers and major participants may offset positions for other purposes. *See* Proposing Release, 75 FR at 80189 n.98. As proposed, Exchange Act rule 3a67–3(b)(3)(i) referred to ''security-based swaps (in any swap category)''; this reference has been revised in the final rule to ''security-based swaps (in any security-based category).''

[871] CFTC Regulation § 1.3(jjj)(2)(iii); Exchange Act rule 3a67–3(b)(3)(ii).

[872] The fact that positions with third parties do not offset exposure to a particular counterparty was recently highlighted by a decision finding that the Bankruptcy Code does not permit excess collateral held by one creditor to offset amounts that the debtor owed to the creditor's affiliates. *See In re Lehman Brothers Inc.,* Case No. 08–01420 (JMP) (SIPA), slip op. (Bankr. S.D.N.Y Oct. 4, 2011).

swap.[873] Some commenters have requested that the final rules codify this method to provide more certainty to market participants.[874]

Accordingly, the final rules incorporate a formula which, for purposes of the substantial position analysis, provides that the amount of net uncollateralized exposure that is attributable to a particular major category of swap or security-based swap would be allocated *pro rata* in a manner that compares the amount of the entity's out-of-the-money positions in that major category to its total out-of-the-money positions in all categories that are subject to the netting arrangements with that counterparty.[875] This approach does not require that any collateral be specifically earmarked to particular swaps or security-based swaps, and can be followed so long as collateral is posted based on the net exposure associated with all instruments subject to the applicable netting agreements with that particular counterparty.[876]

iv. Application of Current Exposure Test to Cleared, Fully Collateralized or Net In-the-Money Positions

Although certain commenters have requested that the current uncollateralized exposure test explicitly exclude swap or security-based swap positions that are cleared, fully collateralized or net in-the-money,[877] the final rules do not provide such exclusions. As we recognized in the Proposing Release, centrally cleared swaps and security-based swaps are subject to mark-to-market margining that would largely eliminate the uncollateralized exposure associated with a position, effectively resulting in the cleared position being excluded from the analysis.[878] Also, by definition, fully collateralized positions are not associated with current uncollateralized exposure, and thus would be excluded from the analysis. As such, we do not believe that it would be necessary to explicitly exclude such positions from the analysis.[879]

Similarly, we do not believe that it is necessary for the rules to explicitly exclude net in-the-money swap or security-based swap positions. If an entity does not have any current uncollateralized exposure to a particular counterparty—after accounting for the entity's netting agreement with that counterparty and the posting of collateral—then the entity may disregard its positions with that counterparty for purposes of calculating current uncollateralized exposure. Otherwise, it is appropriate to consider the contribution of all swaps or security-based swaps to current uncollateralized exposure, as determined by the allocation methodology discussed above.[880]

c. Potential Future Exposure Analysis

The ''substantial position'' analysis also will consider an entity's ''aggregate potential outward exposure,'' which would reflect the potential exposure of the entity's swap or security-based swap positions in the applicable ''major'' category of swap or security-based swaps, subject to certain adjustments.[881] The final rules implementing this test in general follow the proposed approach, but have been revised to address commenter concerns.

i. Purpose Underlying the Potential Future Exposure Test

As discussed in the proposal, a potential future exposure test addresses the fact that a sole focus on current uncollateralized exposure could fail to identify risky entities until some time after they begin to pose the level of risk that should subject them to regulation as major participants.[882] A potential future exposure test would allow the substantial position analysis to account for this risk by addressing how the value of an entity's swap or security-based swap positions may move against the entity over time.[883]

Accordingly, consistent with the proposal, the final rules incorporate a potential future exposure test that seeks to estimate how much the value of swaps or security-based swaps might change against an entity over the remaining life of the contract. Although some commenters took the view that this test should only address potential volatility during the period of time it would take for a non-defaulting party to close out positions and liquidate collateral,[884] we believe that it is more appropriate for the analysis to consider the risks that swaps or security-based swap positions pose over the lives of those positions. An exclusive focus on short-term risks would fail to account for the possibility that an entity's large swap or security-based swap positions can readily produce large losses in adverse market circumstances, potentially leading either to large uncollateralized exposure (if the posting of collateral is not required), or to large collateral calls that may lead to the entity's default (or to calls for extraordinary action) and that can threaten non-defaulting parties with significant costs and challenges in connection with liquidating and replacing those positions. The analysis should give appropriate weight to those risks.

ii. Risk Multipliers

Subject to modifications addressed below, the final rules implementing the ''substantial position'' analysis incorporate a potential future exposure test based on the proposal's general approach of adjusting notional positions using risk multipliers.[885] This approach incorporates and builds upon tests used by bank regulators for the purposes of setting prudential capital.[886] Through

[873] Such allocation would not be necessary, of course, to the extent that an entity has no current uncollateralized exposure to a counterparty following netting and the posting of collateral.

[874] *See* letters from SIFMA AMG II and Vanguard.

[875] CFTC Regulation § 1.3(jjj)(2)(iii)(A); Exchange Act rule 3a67–3(b)(4). Under this formula, for example, if an entity's exposure to a particular counterparty is $120 million after accounting for netting and the posting of collateral, and, subject to netting, the entity has $40 million in out-of-the-money positions in security-based credit derivatives, $90 million in out-of-the-money positions in other security-based swaps, and $120 million in out-of-the money positions in swaps and other instruments subject to the netting agreements, then $19.2 million in net uncollateralized exposure would be attributed to the ''security-based credit derivatives'' category (equal to $120 million · ($40 million/($40 million + $90 million + $120 million)), and $43.2 million in net uncollateralized exposure would be attributed to the ''other security-based swaps'' category (equal to $120 million · ($90 million/($40 million + $90 million + $120 million)).

[876] Although one commenter suggested that the analysis should further consider whether there are collateral posting requirements that are specific to a particular position, we believe that the test we are adopting is flexible enough to address that possibility. To the extent that the parties' collateral arrangements provide that collateral be earmarked to particular swap or security-based swap positions, an entity may calculate its potential future exposure with respect to that counterparty with regard to the applicable major category of swaps or security-based swaps, without accounting for netting across categories or instruments.

[877] *See* letters from ICI I, SIFMA AMG II and Vanguard.

[878] *See* Proposing Release, 75 FR at 80189 n.92.

[879] Moreover, to the extent that such positions are associated with uncollateralized amounts, such as those that arise from thresholds or minimum transfer amounts pursuant to the applicable credit support annex, then those amounts present counterparty risk that should be considered as part of the major participant analysis.

[880] Under that allocation approach, if none of the entity's swap or security-based swap positions in a major category with that counterparty are out-of-the-money, then none of the current exposure resulting from the netting agreement would be attributed to that major category.

[881] CFTC Regulation § 1.3(jjj)(3); Exchange Act rule 3a67–3(c).

[882] *See* Proposing Release, 75 FR at 80188.

[883] *See id.* at 80191.

[884] *See* letters from SIFMA AMG II and Vanguard.

[885] *See* CFTC Regulation § 1.3(jjj)(3)(ii)(A)(1); Exchange Act rule 3a67–3(c)(2)(i).

[886] *See* 12 CFR part 3, app. C, section 32 (Office of the Comptroller of the Currency capital adequacy guidelines for banks); 12 CFR part 325, app. D, section 32 (Federal Deposit Insurance Corp. capital adequacy guidelines for banks); 12 CFR part 208, app. F, section 32 (Federal Reserve System capital

this methodology, the final rules implement an objective approach that readily can be replicated by market participants.

Although some commenters have suggested the use of value-at-risk measures or internal models to evaluate potential future exposure,[887] we do not believe that such approaches would be well tailored to be implemented by a range of market participants, or would lead to comparable results across market participants with identical swap or security-based swap portfolios.

In adopting this approach, we are mindful of the significance of commenter concerns about the adequacy of the tables that set forth the risk multipliers that would be applied to notional positions. These comments address, among other issues: discontinuities in the tables; the failure to account for whether, and how much, a swap or security-based swap is in-the-money or out-of-the money; the failure of the multipliers applicable to interest rate swaps to distinguish between counterparties who pay floating rates and counterparties who pay fixed rates; the failure of the multipliers in the credit category to account for the volatility of the underlying instrument or the duration of the swap or security-based swap; the failure of the multipliers for equity and commodity swaps to distinguish between high-volatility and low-volatility stocks and commodities; the adequacy of how the test addresses diversification and correlation; the fact that the approach does not provide for delta weighting of options positions; and the fact that the factors do not distinguish between index and single-name credit default swaps.[888] While we acknowledge that it may be possible to develop revised risk multipliers that are more finely tuned to reflect relevant risk factors, at this time we believe that it would be most appropriate to implement the ''substantial position'' analysis by building upon an existing regulatory approach that is comparatively simpler to implement and leads to reproducible results, rather than seeking to develop a brand new approach.[889]

The final rules implementing the ''major security-based swap participant'' definition, however, modify the proposed risk multipliers in response to commenter concerns about how the ''major'' categories of security-based swaps should be applied to the risk multiplier categories. In particular, the final risk multiplier category for security-based swaps in the ''equity and other'' category encompasses all security-based swaps that are not credit derivatives, and the final rules eliminate the proposed category for ''other'' types of security-based swaps.[890]

iii. Potential Future Exposure Measures for Certain Lower-Risk Positions

Consistent with the proposal, the potential future exposure calculation will exclude purchases of options and other positions for which a person has prepaid or otherwise satisfied its payment obligations.[891] Also, in response to commenter concerns, the final rules expand on the proposal with regard to capping the potential future exposure associated with certain lower-risk swap and security-based swap positions. The final rules particularly cap—at the net present value of the unpaid premiums—the potential future exposure associated with positions by which a person buys credit protection using a credit default swap, and positions by which a person purchases an option for which the person retains additional payment obligations under the position.[892] This reflects the reduced risk associated with such positions. The final rules do not prescribe a particular discount rate for purposes of this analysis, and market participants instead should use a commercially appropriate discount rate.

In addition, to better align the results of the potential future exposure analysis with the risks that a person presents, the final rules have been modified from the proposal to also exclude swap or security-based swap positions for which, pursuant to regulatory requirement, a person has placed in reserve an amount of cash or Treasury securities that is sufficient to pay the person's maximum possible liability under the position, when the person is prohibited from using that cash or those securities without also liquidating the swap or security-based swap position.[893]

iv. Adjustments for Netting

Consistent with the proposal, and with the bank regulator standards that form the basis for these potential future exposure measures, the final rules provide that an entity may reduce the measure of its potential future exposure in a major category by up to 60 percent to reflect the risk mitigation effects of master netting agreements. We believe that this approach appropriately reflects the risk mitigating attributes of netting on potential future exposure. Moreover, in light of commenter requests for clarification of how these netting provisions would be applied,[894] the final rules have been revised from the proposal to provide that the risk reduction associated with netting should be estimated using the same *pro rata* allocation methodology that will be used to measure current exposure.[895]

adequacy guidelines for banks); 12 CFR part 225, app. G, section 32 (Federal Reserve System capital adequacy guidelines for bank holding companies).

[887] *See* letters from Riverside Risk Advisors and Better Markets I.

[888] *See, e.g.,* letters from Riverside Risk Advisors and MFA I.

[889] We also are not following a commenter suggestion to incorporate the ''standardized method'' prescribed as part of the ''Basel II'' bank capital methodology. *See* letter from ISDA I. The standardized method relies on counterparty credit ratings provided by external credit rating agencies for purposes of calculating risk-weighted capital measurements. *See* ''International Convergence of Capital Measurement and Capital Standards, A Revised Framework, Comprehensive Version,'' the Basel Committee on Banking Supervision, June 2006. Incorporating this reliance on credit ratings provided by external credit rating agencies into these final rules would be inconsistent with Section 939A of the Dodd-Frank Act, which required all Federal agencies to review and modify existing regulations ''to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations.''

[890] *See* Exchange Act rule 3a67–3(c)(2)(i). Aside from making the risk multipliers consistent with the ''major'' categories of security-based swaps, this change also should allow total return swaps on debt to be subject to the same risk multipliers as total return swaps on equity, rather than causing the debt swaps to be subject to higher multipliers (which may not accurately reflect the comparative risks of those instruments).

[891] *See* CFTC Regulation § 1.3(jjj)(3)(ii)(A)(3)(ii); Exchange Act rule 3a67–3(c)(2)(i)(C).

[892] *See* CFTC Regulation § 1.3(jjj)(3)(ii)(A)(4); Exchange Act rule 3a67–3(c)(2)(i)(D). The proposed rules would have applied this net present value caps only to the purchase of credit protection. The final rules expand this provision by also capping the potential future exposure associated with the purchases of options in which an entity retains payment obligations, to reflect the reduced risk associated with those positions.

[893] CFTC Regulation § 1.3(jjj)(3)(ii)(A)(3)(iii); Exchange Act rule 3a67–3(c)(2)(i)(C)(*3*). This exclusion of such positions from the major participant analysis may apply, for example, to certain swap or security-based swap positions of insurers where applicable law requires an amount equal to the maximum possible exposure of the insurer be segregated.

[894] *See* letter from SIFMA AMG II.

[895] Consistent with the proposal, the effects of netting are to be estimated using the formula: $P\ Net = 0.4 \times P\ Gross + 0.6 \times NGR \times P\ Gross$. Under that equation, *P Net* is the potential exposure adjusted for bilateral netting; *P Gross* is that potential outward exposure without adjustment for bilateral netting; and *NGR* is the net to gross ratio. The final rule has been revised from the proposal to clarify that the net to gross ratio equals the current exposure associated with the major category as calculated using the *pro rata* methodology discussed above, divided by what the measure of current exposure in connection with those out-of-the-money positions would be in the absence of that methodology.

Accordingly, for the example set forth in note 875, *supra,* the *NGR* for ''security-based credit derivatives'' and ''other security-based swaps'' both would equal 0.48 (equal to $19.2 million net

Continued

v. Adjustments for Cleared and Margined Positions

The final rules also provide for the measure of potential future exposure to be adjusted in the case of swap and security-based swap positions that are centrally cleared or that are subject to daily mark-to-market margining. This is consistent with the purpose of the potential future exposure test, which is to account for the extent to which the current outward exposure of positions (though possibly low or even zero at the time of measurement) might grow to levels that can lead to high counterparty risk to counterparties or to the markets generally. The practice of the periodic exchange of mark-to-market margin between counterparties helps to mitigate the potential for large future increases in current exposure.

Consistent with the proposal, the final rules reflect this ability to mitigate risk by providing that the potential future exposure associated with positions that are subject to daily mark-to-market margining will equal 0.2 times the amount that otherwise would be calculated. However, in response to commenters' opinions about the risk-mitigating effects of central clearing, and the additional level of rigor that clearing agencies may have with regards to the process and procedures for collecting daily margin, the final rules further provide that the potential future exposure associated with positions that are subject to central clearing will equal 0.1 (rather than the proposed 0.2) times the potential future exposure that would otherwise be calculated.[896]

Although some commenters supported the complete exclusion of cleared positions from the potential future exposure analysis,[897] and we are mindful of the risk mitigating attributes of central clearing, we also recognize that central clearing cannot reasonably be expected to entirely eliminate counterparty risk.[898] We conclude, however, that the use of a 0.1 factor (in lieu of the proposed 0.2) would be appropriate for cleared positions, reflecting the strong risk mitigation features associated with central clearing, particularly the procedures regarding the collection of daily margin and the use of counterparty risk limits, while recognizing the presence of some remaining counterparty risk.

Moreover, although some commenters opposed any deduction from the measure of potential future exposure for uncleared positions that are margined on a daily basis,[899] we believe that the risk-mitigating attributes of daily margining warrant an adjustment given that the goal of the potential future exposure test is to account for price movements over the remaining life of the contract.[900] The use of a 0.2 factor also reflects our expectation that the risk mitigation associated with uncleared but margined positions would be less than the risk mitigation associated with cleared positions.

While higher or lower alternatives to the 0.1 and 0.2 factors may also be reasonable for positions that are cleared or margined on a daily basis, we believe that the factors of the final rules reasonably reflects the risk mitigating (but not risk eliminating) features of those practices. The final rules also retain and clarify provisions addressing when daily mark-to-market margining occurs for purposes of this discount.[901]

vi. Application of ''Effective Notional'' Amounts

Consistent with the proposal (as well as the rules implementing the *de minimis* exception to the dealer definitions), the potential future exposure test is based on the ''effective notional'' amount of the swap or security-based swap when the stated notional is leveraged or enhanced by the structure of the swap or security-based swap.[902]

Moreover, as discussed in the Proposing Release,[903] in the case of positions that represent the sale of an option on a swap or security-based swap (other than the sale of an option permitting the person exercising the option to purchase a credit default swap), we would view the effective notional amount of the option as being equal to the effective notional amount of the underlying swap or security-based swap, and in general we would view the duration used for purposes of the formula as being equal to the sum of the duration of the option and the duration of the underlying swap or security-based swap.[904]

exposure divided by $40 million in out-of-the-money positions in the case of ''security-based credit derivatives,'' or $43.2 million net exposure divided by $90 million in out-of-the-money positions in the case of ''other security-based swaps''). If an entity has no current exposure to a counterparty following the application of netting arrangements and collateralization, the *NGR* for those positions would equal zero, and the potential exposure would equal 40 percent of what it would equal otherwise.

[896] *See* CFTC Regulation § 1.3(jjj)(3)(iii)(A); Exchange Act rule 3a67–3(c)(3)(i). The final rules further have been revised to clarify that the 0.1 factor applies to positions cleared by a registered clearing agency or by a clearing agency that has been exempted from registration.

[897] *See, e.g.,* letters from MFA I and SIFMA AMG II.

[898] Central clearing helps to mitigate counterparty credit risk by improving risk management and, among other things, mutualizing the risk of counterparty failure. If multiple members of a central counterparty fail beyond the level to which such risk is managed, however, the central counterparty would also be at risk of failure. *Cf.* Basel Committee on Banking Supervision, Consultative Document, ''Capitalisation of bank exposures to central counterparties,'' Nov. 25, 2011 (available at: *http://www.bis.org/publ/bcbs206.pdf*) (proposing that the capital charge for trade exposures to a qualifying central counterparty should carry a low risk weight, reflecting the relatively low risk of default of the qualifying central counterparty). In addition, as we discussed in the Proposing Release, *see* 75 FR at 80192 n.115, for example, central counterparties that clear credit default swaps do not necessarily become the counterparties of their members' customers (although even absent direct privity those central counterparties benefit customers by providing for protection of collateral they post as margin, and by providing procedures for the portability of customer positions in the event of a member's default). As a result, central clearing may not eliminate the counterparty risk that the customer poses to the member, although required mark-to-market margining should help control that risk, and central clearing would be expected to reduce the likelihood that an entity's default would lead to broader market impacts.

[899] *See* letter from Better Markets I; *see also* letter from AFR.

[900] We do not believe that it is appropriate to have this type of discount when mark-to-market margining is done less than daily, however.

[901] We recognize that at times, market participants whose agreements provide for the daily exchange of variation margin in connection with swaps or security-based swaps in practice may not exchange collateral daily, if the amounts at issue are relatively small (such as through the use of collateral thresholds and minimum transfer amounts). We do not believe that such practices would be inconsistent with providing a discount for daily margining practices. The proposed rules sought to accommodate those practices by providing that positions would be considered to be subject to daily mark-to-market margining for purposes of the ''uncollateralized outward exposure'' plus ''potential outward exposure'' analysis, so long as the total of such thresholds, and the total of such minimum transfer amounts above $1 million are deemed to be ''uncollateralized outward exposure'' for those purposes.

In light of commenter concerns, which indicated that the proposal was not fully clear about the mechanics and purpose of this approach, the relevant rule language has been revised to clarify that this attribution of thresholds and minimum transfer amounts is solely for the purpose of determining whether certain positions are subject to daily mark-to-market margining for purposes of the analysis. In addition, the final rules have been revised from the proposal to provide that the attribution of thresholds as ''uncollateralized outward exposure'' for these purposes will be reduced by initial margin posted, up to the amount of the threshold. *See* CFTC Regulation § 1.3(jjj)(iii)(B); Exchange Act rule 3a67–3(c)(3)(ii).

[902] As discussed above, this may occur, for example, if the exchange of payments associated with an equity swap is based on a multiple of the return associated with the underlying equity. As is the case for measuring current exposure, the final rules do not prescribe any particular methodology for calculating the notional amount or effective notional amount used in the calculation of potential future exposure, but instead contemplate the use of industry standard practices.

[903] *See* Proposing Release, 75 FR 80192 n.110.

[904] The effective notional amount of the underlying instrument is used for these purposes because that amount fairly reflects the basis for measuring the potential counterparty risk associated with the instrument. The sum of the

vii. Treatment of Initial Margin or Overcollateralization

The final rules retain the proposed approach of not modifying the measure of potential future exposure to reflect collateral that a person has posted to its counterparty in excess of current exposure. Although we recognize that the posting of excess collateral may mitigate the future credit risk that the potential future exposure measure is intended to estimate, that mitigating effect is not certain, and any such mitigation may not reflect the full value of the excess collateral. Moreover, while we believe that the measure of potential future exposure associated with swap or security-based swap positions reasonably estimates the credit risk that may be posed by those positions for purposes of the substantial position analysis, we also recognize that particular positions may prove to pose a far higher amount of credit risk.[905] Given how the credit risk associated with a swap or security-based swap position can far exceed the associated measure of potential future exposure, we do not believe that it would be appropriate to offset that measure to account for overcollateralization.[906]

d. Thresholds

The final rules retain the proposed thresholds for the amount of current uncollateralized exposure and potential future exposure that will cause an entity to be deemed to be a major participant. Accordingly, for a person to have a ''substantial position'' in a major category of swaps, it would be necessary for that person to have a daily average current uncollateralized exposure of at least $1 billion (or $3 billion for the rate swap category), or a daily average current uncollateralized exposure plus potential future exposure of $2 billion (or $6 billion for the rate swap category).[907] To have a ''substantial position'' in a major category of security-based swaps, it would be necessary for the person to have a daily average current uncollateralized exposure of at least $1 billion, or a daily average current uncollateralized exposure plus potential future exposure of at least $2 billion.[908]

As the Proposing Release noted, the proposed thresholds sought to reflect: (i) The financial system's ability to absorb losses of a particular size; (ii) the recognition that it would not be appropriate for the substantial position test to encompass entities only after they pose significant risks to the market through their swap or security-based swap activity; and (iii) the need to account for the possibility that multiple market participants may fail close in time.[909] While some commenters took the position that the proposed thresholds were inappropriately low, those commenters did not present empirical data or analysis in support of that view. Moreover, the Commissions do not concur with the suggestion [910] that the major participant definitions can reasonably be read to require that we defer this rulemaking until we have gathered additional data. Instead, the definitions direct us to set a standard that is ''prudent,'' which is what we have sought to do.

Some commenters who supported an increase in the proposed thresholds attempted to support their positions via analogy to past events, with the most significant of these being an analogy to AIG Financial Products (''AIG FP'').[911] The analogy to AIG FP [912] actually argues against an increase in these thresholds, however, particularly given that the credit derivative portfolio that significantly contributed to the liquidity problems that AIG FP faced amounted to $72 billion in notional amount.[913] Under the final rules, in the presence of central clearing or daily marking to market it would take a credit derivative portfolio in excess of that amount to trigger the potential future exposure threshold under the ''substantial position'' analysis.[914] This indicates that the thresholds are not inappropriately low, particularly given our view that the major participant definition is intended to encompass entities before their swap or security-based swap positions pose significant market threats.[915] Conversely, while

duration of the option and the underlying instrument is used for these purposes because that sum reflects the length of time of the potential counterparty risk associated with the instrument.

At the same time, we agree with a commenter's view that if the underlying swap or security-based swap is cash settled, the calculation of duration will only include the duration of the option, and not the duration of the swap, because counterparty exposure would exist only until the option expiration date. *See* letter from MFA I.

[905] For example, if a person writes a CDS that provides $10 billion in protection on a reference entity, with the CDS being subject to daily mark-to-market margining, then for purposes of the substantial position analysis that CDS would be associated with a potential future exposure measure of no more than $200 million (reflecting the 0.1 conversion factor and the additional 0.2 multiplier for margined positions), even before accounting for netting. Yet if the reference entity were to default, the writer of the CDS could pose up to $10 billion in credit risk to its counterparty.

[906] However, as discussed above, *see* note 901, *supra,* initial margin may be considered when determining if a collateral threshold is to be attributed to current uncollateralized exposure for purposes of determining whether certain positions are subject to daily mark-to-market margining for purposes of the substantial position analysis.

[907] CFTC Regulation § 1.3(jjj)(1).

[908] Exchange Act rule 3a67–3(a).

[909] As discussed above, we do not believe it would be prudent to presume that entity failures will be separated in time during periods of financial stress.

[910] *See* letters from BlackRock I and CCMR I.

[911] *See* letter from ABC/CIEBA. One commenter's analogy to Enron also is unpersuasive. *See* letter from BG LNG I. In particular, the $18.7 billion in Enron derivatives exposure cited by that commenter does not account for collateral posted in connection with those positions. Also, the market impact of Enron's bankruptcy was substantially mitigated by the sale of Enron's derivatives trading arm to a third party.

Moreover, although one commenter generally alluded to corporate financial losses in the derivatives markets that exceeded the proposed $1 billion and $2 billion thresholds, *see* letter from NCGA/NGSA II, the relevant question does not focus on losses that market participants have incurred, but instead focuses on what degree of credit risk to counterparties in the swap and security-based swap markets presents such a potential to cause significant market impact that it would be prudent to regulate persons who pose that degree of credit risk in connection with their swap or security-based swap positions.

[912] Our discussion of how the major participant analysis may apply to an entity that has a portfolio of a size equivalent to that of AIG FP should not be read to imply that a person may engage in swap and security-based swap activities akin to those of AIG FP without registering as a swap dealer or security-based swap dealer.

[913] *See, e.g.,* Congressional Oversight Panel, *The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy* 22–24 (2010) (discussing how the risk in AIG's CDS business largely was the result of a ''multi-sector'' CDO book that amounted to $72 billion notional as of September 2008, and how the losses to AIG were driven by 125 of the roughly 44,000 contracts entered into by AIG FP).

[914] For cleared security-based credit default swaps (in which we assume daily margining requirements result in no current uncollateralized exposure) achieving $2 billion of potential future exposure would require writing $200 billion notional of credit default swap protection (reflecting the 0.10 multiplier in the risk adjustment tables, and the additional 0.10 multiplier for positions that are cleared). Similarly, it would take a $100 billion notional portfolio of uncleared but marked-to-market security-based credit default swaps to meet that same threshold (reflecting the 0.20 multiplier for positions that are subject to daily mark-to-market margining). The total might be even higher if such instruments were subject to counterparty netting agreements.

Even in the absence of clearing or daily mark-to-market margining, it would take a minimum $20 billion notional portfolio of written protection on credit (reflecting the 0.10 multiplier in the risk adjustment tables) to meet the $2 billion potential future exposure threshold. Accounting for netting (which can reduce potential future exposure measures by up to 60 percent) could materially increase that required amount.

[915] The case of Long-Term Capital Management (''LTCM'') also is instructive in connection with the current exposure thresholds of the major participant analysis. Had LTCM failed, its top 17 counterparties would have suffered estimated total losses of between $3 and $5 billion. *See* President's Working Group on Financial Markets, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management* (April 1999) at 17 (*http://www.treasury.gov/resource-center/fin-mkts/Documents/hedgfund.pdf*). The government acted in connection with LTCM because the rushed close-

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additional data and analysis may warrant a reduction of these thresholds in the future, commenters who supported a reduction in those thresholds have not persuaded us that the proposed thresholds should be lowered.

e. Additional Issues

The final rules applying the ''substantial position'' analysis and the major participant definitions generally apply to all types of swaps or security-based swaps that a person maintains. Although one commenter suggested that swaps on government securities should be excluded from the analysis, the rules will not provide such an exclusion. To the extent that a person presents credit risk as a result of swaps referencing government securities, there is no basis for disregarding that risk when determining whether the person is a major participant.

In addition, in light of one commenter's concern,[916] the Commissions believe that it is important to emphasize that these rules should not be interpreted to deter end-users from requesting margin from dealers or major participants who are their counterparties to swaps or security-based swaps.

Also, in light of a point raised by another commenter,[917] the Commissions note that these rules implementing the major participant definitions do not place any independent calculation or other obligations upon counterparties to potential major participants, and that the rules do not preclude a potential major participant from seeking the assistance of a third party to perform the relevant calculation.

C. ''Hedging or Mitigating Commercial Risk''

1. Proposed Approach

a. General Availability of the Proposed Exclusion

The first test of the major participant definitions excludes positions held for ''hedging or mitigating commercial risk'' from the substantial position analysis.[918] In the Proposing Release, we preliminarily concluded that positions that hedge or mitigate a person's commercial risk may qualify for this exclusion regardless of whether the entity is financial or non-financial in nature.[919] That conclusion in part was prompted by the fact that the statutory major participant definitions do not explicitly make the exclusion unavailable to financial entities; in contrast to the Title VII exceptions from mandatory clearing requirements in connection with hedging commercial risk,[920] which explicitly are unavailable to financial entities.[921] The conclusion also was prompted by the presence of the third major participant test—which specifically applies the substantial position analysis to certain non-bank financial entities but (unlike the first test) does not exclude commercial risk hedging positions from the analysis.[922]

In the Proposing Release, we also preliminarily concluded that the question of whether an activity is commercial in nature should not be determined solely by a person's organizational status as a for-profit, non-profit or governmental entity, but instead should depend on whether the underlying activity is commercial in nature.[923]

The proposal did not preclude the exclusion from being available in connection with hedges of a person's ''financial'' or ''balance sheet'' risks. In addition, the proposal solicited comment as to whether the exclusion should extend to activities in which a person hedges an affiliate's risk.

b. Proposed Definition Under the CEA Exception

The proposed interpretation of ''hedging or mitigating commercial risk'' for purposes of the CEA's definition of ''major swap participant'' premised the exclusion on the principle that swaps necessary to the conduct or management of a person's commercial activities should not be included in the calculation of the entity's substantial position.[924]

The CFTC noted first that the phrase ''hedging or mitigating commercial risk'' as used with respect to the major swap participant definition is virtually identical to Dodd-Frank provisions granting an exception from the mandatory clearing requirement to non-financial entities that are using swaps to hedge or mitigate commercial risk.[925] Also noted was that although only non-financial entities that use swaps or security-based swaps to hedge or mitigate commercial risk generally may qualify for the clearing exemption, no such statutory restriction applies with respect to the exclusion for hedging positions in the first test of a major participant. We therefore concluded that positions established to hedge or mitigate commercial risk may qualify for the exclusion, regardless of the nature of the entity—*i.e.,* whether or not the entity is financial (including a bank) or non-financial.[926]

The CFTC preliminarily believed that whether a position hedges or mitigates commercial risk should be determined by the facts and circumstances at the time the swap is entered into, and should take into account the entity's overall hedging and risk mitigation strategies. However, the swap could not be held for a purpose that is in the nature of speculation, investing or trading. We anticipated that a person's overall hedging and risk management strategies would help inform whether or not a particular position is properly considered to hedge or mitigate commercial risk. Further, the exclusion under the Proposing Release included swaps hedging or mitigating any of a person's business risks, regardless of the

out of LTCM's positions would have affected other market participants, and the spread of losses would have led to market uncertainty, likely causing a number of credit and interest rate markets to experience extreme price moves and possibly not function for a period of time. *See* Statement by William J. McDonough, President Federal Reserve Bank of New York before the Committee on Banking and Financial Services U.S. House of Representatives (October 1, 1998) (*http://www.newyorkfed.org/newsevents/speeches_archive/1998/mcd981001.html*).

[916] *See* letter from FHLB I.

[917] *See* letter from ISDA I.

[918] *See* CEA section 1a(33)(A)(i)(I); Exchange Act section 3(a)(67)(A)(i)(I).

[919] *See* Proposing Release, 75 FR at 80194.

[920] *See* CEA section 2(h)(7)(A); Exchange Act section 3C(g)(1)(B).

[921] As we discussed in the Proposing Release, had the Dodd-Frank Act intended the phrase ''hedge or mitigate commercial risk'' to apply only to activities of, or positions held by, non-financial entities, it would not have been necessary for the mandatory clearing exceptions to include additional provisions generally restricting the availability of the exceptions to non-financial entities. *See* Proposing Release, 75 FR at 80194.

[922] As we discussed in the Proposing Release, the third statutory major participant test would be redundant if the hedging exclusion in the first major participant test were entirely unavailable to financial entities. *See* Proposing Release, 75 FR at 80194 n.125.

[923] *See* Proposing Release, 75 FR at 80194.

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

[925] *See* CEA section 2(h)(7)(A); Exchange Act section 3C(g)(1)(B) (exception from mandatory clearing requirements when one or more counterparties are not ''financial entities'' and are using swaps or security-based swaps to ''hedge or mitigate commercial risk'').

[926] The presence of the third major participant test suggests that financial entities generally may not be precluded from taking advantage of the hedging exclusion in the first test. The third test, which does not account for hedging, specifically applies to non-bank financial entities that are highly leveraged and have a substantial position in a major category of swaps or security-based swaps. That test would be redundant if the hedging exclusion in the first major participant test were entirely unavailable to financial entities.

swap's status under accounting guidelines or the bona fide hedging exemption.

c. Proposed Definition Under the Exchange Act Exception

For purposes of the Exchange Act's ''major security-based swap participant'' definition, the proposed rule defining ''hedging or mitigating commercial risk'' would require that a security-based swap position be ''economically appropriate'' to the reduction of risks in the conduct and management of a commercial enterprise, where those risks arise from the potential change in the value of assets, liabilities and services connected with the ordinary course of business of the enterprise.[927] The Proposing Release stated that the SEC preliminarily planned to interpret the concept of ''economically appropriate'' based on whether a reasonably prudent person would consider the security-based swap to be appropriate for managing the identified commercial risk. It further stated that the SEC also preliminarily believed that for a security-based swap to be deemed ''economically appropriate'' in this context, it should not introduce any new material quantum of risks (*i.e.,* it could not reflect over-hedging that could reasonably have a speculative effect) and it should not introduce any basis risk or other new types of risk (other than the counterparty risk that is attendant to all security-based swaps) more than reasonably necessary to manage the identified risk.[928]

The proposed rules further provided that the security-based swap position could not be held for a purpose that is in the nature of speculation or trading—a limitation that would make the exclusion unavailable to security-based swap positions that are held intentionally for the short term and/or with the intent of benefiting from actual or expected short-term price movements or to lock in arbitrage profits, including security-based swap positions that hedge other positions that themselves are held for the purpose of speculation or trading.[929] The proposal also provided that a security-based swap position could not be held to hedge or mitigate the risk of another security-based swap position or swap position unless that other position itself is held for the purpose of hedging or mitigating commercial risk.[930] Finally, the proposal would have conditioned the entity's ability to exclude these security-based swap positions on the entity engaging in certain specified activities related to documenting the underlying risks and assessing the effectiveness of the hedge in connection with the security-based swap positions.[931]

2. Commenters' Views

a. In General

Several commenters generally supported the broad concepts underlying the proposed rules for identifying hedges of commercial risk, and particularly supported the proposed use of an ''economically appropriate'' standard instead of the ''highly effective'' standard that is used to identify hedges for accounting purposes.[932] On the other hand, one commenter stated that the definition should incorporate all manner of risks associated with commercial operations, including interest rate and currency risks, risks from incidental activities to commercial activities and risks from financial commodities.[933] One commenter further stated that the definition should encompass positions that facilitate asset optimization and dynamic hedging.[934]

Commenters further stated that the exception should include any position taken as part of a bona fide risk mitigation strategy,[935] and that Congress included ''mitigation'' in the exception for the purpose of covering risk reduction strategies that may not clearly be hedges but mitigate risk.[936] Some commenters also criticized the Proposing Release's position equating the terms ''hedging'' and ''mitigating.''[937] One commenter also expressed concern that entities would find it difficult to analyze their positions with respect to the Proposing Release's statement, in the context of the Exchange Act definition, that ''economically appropriate'' security-based swaps would not add a new quantum of risk.[938]

Conversely, some commenters suggested that the proposed interpretation was too broad,[939] and that a broad interpretation could allow evasion,[940] or permit corporate end users to accumulate very large positions without becoming major swap participants.[941] One commenter stated that to include ''financial risks'' within the exclusion's scope would be improper because a ''commercial risk'' is one that is inherent in a person's commercial activities, while interest rate and currency risks arise from choices about how a person structures and finances its operations.[942] Some commenters stated that the rule should not include hedging of financial risks because Congress deleted the reference in an earlier version of the Dodd-Frank Act to hedging of ''balance sheet risk.''[943] One commenter urged that we consider using accounting hedge treatment or the bona fide hedging exemption as guideposts for determining the availability of the exclusion.[944] Commenters also raised concerns about differences between the proposed approaches under the CEA and Exchange Act definitions of the terms.[945]

One commenter suggested that the definition should be expanded to include as commercial risks the risks faced by government entities because their need to manage risk is no different than the need of commercial firms.[946] Additional commenters suggested that commercial risk be interpreted to include risks faced by non-profit firms.[947]

Some commenters also supported modification of the rule text for specific purposes such as including risks from ''transmitting'' to cover activities of electricity companies,[948] to encompass risks ''arising from'' an asset rather than just risks arising from changes in value

[927] *See* proposed Exchange Act rule 3a67–4(a).

[928] *See* Proposing Release, 75 FR at 80195 n.129.

[929] *See* proposed Exchange Act rule 3a67–4(b)(1), and Proposing Release, 75 FR at 80195 n.131.

[930] *See* proposed Exchange Act rule 3a67–4(b)(2).

[931] *See* proposed Exchange Act rule 3a67–4(c).

[932] *See* letters from ACLI, Barnard, CDEU, COPE I, EEI/EPSA, FSR I, ISDA I, Kraft, MetLife, NAIC, Philip Morris International Inc. (''Philip Morris'') and Utility Group.

[933] *See* letter from CDEU.

[934] *See* letter from Peabody.

[935] *See* letter from ISDA I.

[936] *See* letter from CDEU.

[937] *See* letters from APG, CDEU and ISDA I.

[938] *See* letter from SIFMA AMG II.

[939] *See* letters from AFR and AFSCME. The CFTC also received submissions of a substantially identical letter from approximately 193 individuals and small businesses urging the CFTC to define commercial risk narrowly to include only risks arising from physical commodity price fluctuations, and not financial risks, and to construe the exception for captive finance companies narrowly. *See, e.g.,* letter from Needham Oil & Air, LLC. In addition, the CFTC received submissions from approximately 535 individuals of a different letter, which also urged the CFTC to define commercial risk narrowly. *See, e.g.,* letter from Christie Hakim.

[940] *See* letters from Sen. Carl Levin (''Senator Levin''), Commodity Markets Oversight Coalition (''CMOC'') and Greenberger and meeting with MFA on February 14, 2011.

[941] *See* meeting with SIFMA AMG on February 4, 2011.

[942] *See* meeting with AFR and Better Markets on March 17, 2011.

[943] *See* letters from AFR and CMOC, and meeting with Duffie on February 2, 2011.

[944] *See* letter from Senator Levin.

[945] *See* letters from Senator Levin, NAIC and SIFMA AMG II.

[946] *See* letter from Milbank, Tweed, Hadley & McCloy LLP (''Milbank'').

[947] *See* letters from CDEU and NFPEEU.

[948] *See* letter from Edison Int'l.

of the asset,[949] and to encompass the use of swaps by structured finance special purpose vehicles to hedge interest rate risk in structured financing.[950]

b. Availability of Exclusion to Financial Entities

Several commenters supported making the exclusion available to financial companies.[951] Some commenters further stated that there should be no special limits on financial entities with regard to the exclusion,[952] and that commercial risk should be defined broadly to include all of the commercial activities of a person, whether or not those activities relate to financial or non-financial commodities.[953] Two commenters discussing the use of swaps by insurance companies stated that making the exclusion available to financial companies is consistent with CFTC practice in the futures markets, that there is no fundamental difference in how an insurance company or a commercial enterprise uses swaps to reduce its risk, and that commercial risk encompasses financial risk.[954] In addition, these commenters noted that insurance regulators allow insurance companies to use swaps to hedge risk.[955]

On the other hand, some commenters opposed allowing financial entities to avail themselves of the exclusion, arguing that there is no benefit from allowing a financial firm to avoid major participant regulation through the hedging exclusion,[956] that the exclusion would allow financial companies to engage in risky trades,[957] and that the exclusion should be narrowly interpreted to cover hedging of only risks related to products.[958]

c. Hedging Risks of Affiliates and Third Parties

Some commenters expressed support for allowing persons to take advantage of the hedging exclusion when they use swaps to hedge the commercial risks of affiliates or third parties. Some commenters suggested that a person that aggregates and hedges risk within a corporate group should be allowed to use the exclusion despite the fact that it is the affiliates' risks that are hedged.[959] One commenter further stated that providers of risk management services should be allowed to take advantage of the exclusion because they are hedging commercial risk on behalf of their clients.[960]

One commenter, on the other hand, stated that the exclusion should be read narrowly for captive finance companies because the hedging entity may have to liquidate positions rapidly without access to affiliate's funds.[961]

d. Hedge Effectiveness and Documentation

Many commenters suggested that the rule should not test hedge effectiveness, explaining that requiring demonstration of hedge effectiveness would impose a subjective standard and would not reduce systemic risk.[962] In this regard, some commenters that addressed the proposed procedural requirements in the Exchange Act definition argued that these procedures would place unnecessary regulatory burdens on entities not regulated under the Dodd-Frank Act.[963] Conversely, one commenter that supported testing hedge effectiveness stated that the subdivided parts of a hedge should line up exactly with the subdivided parts of the risk.[964]

Some commenters agreed that the relationship between hedging and risk should be documented. One commenter expressed the view that documentation would facilitate audits.[965] Others took the view that a person should be required to demonstrate that the hedge does not create additional risk, that the risk may be hedged by swaps, and that there is a link between the swap and the risk.[966]

Several commenters suggested that once initiated, a hedge should not be retested over time, regardless of whether the position continues to serve a hedging purpose.[967] Other commenters disagreed, stating that a position that is no longer a hedge should not be covered by the exclusion.[968]

e. Swaps That Hedge Positions Held for Speculative, Investment or Trading Purposes

Many commenters took the view that swaps or security-based swaps used to hedge positions held for speculative, investment or trading purposes should qualify as hedges of commercial risk.[969] A few commenters stated that speculation, investment and trading are fundamental to commercial activity, and thus cannot be differentiated from other types of commercial activity.[970] Other commenters suggested the exclusion should cover swap positions that hedge other swap or security-based swap positions that are not themselves hedging positions.[971] Some commenters asserted that trading is different from speculating (taking an outright view on market direction) and investing (entering into a swap for appreciation in value of the swap position), and that swaps held for ''trading'' should be able to qualify for the exclusion.[972]

Some commenters requested that the definition under the CEA clarify how swaps that qualify as bona fide hedges are treated for the major swap participant definition if the underlying position had a speculative, investment or trading purpose,[973] and clarify that while the hedging exclusion would not apply to swap positions that hedge other swap positions that are held for speculation or trading, the hedging provision would apply to swap positions that hedge other non-swap positions held for speculation or trading.[974] Commenters also requested that the final rules provide that the hedging exclusion be available for physical positions in exempt or agricultural commodities and arbitrage positions relating to price differences between physical commodities at

[949] *See* letter from Milbank.

[950] *See* letter from American Securitization Forum (''ASR'').

[951] *See* letters from ACLI, American Express Company (''Amex''), California State Teachers' Retirement System (''CalSTRS'') dated Feb. 28, 2011 (''CalSTRS I''), ISDA I, MetLife, NAIC and Peabody.

[952] *See* letters from Amex, CalSTRS I and Peabody.

[953] *See* letter from Amex.

[954] *See* letters from ACLI and MetLife.

[955] *Id.*

[956] *See* letter from Senator Levin (further highlighting the need to add strict standards and controls to prevent evasion).

[957] *See* letters cited in note 939, *supra.*

[958] *See* letter from AFR.

[959] *See* letters from CDEU, EDF Trading, Kraft, Metlife and Philip Morris.

[960] *See* letter from EDF Trading.

[961] *See* meeting with Duffie on February 2, 2011.

[962] *See* letters from EEI/EPSA and EDF Trading; *see also* letters from CDEU, Kraft Metlife, NRG Energy and Philip Morris (that such a test would be overly prescriptive).

[963] *See* letters from FSR I and SIFMA AMG I.

[964] *See* letter from Better Markets I.

[965] *See* letter from Metlife (but opposing ongoing evaluation of hedge effectiveness).

[966] *See* letters from AFR and Senator Levin.

[967] *See* letters from CDEU, EDF Trading, EEI/EPSA, Kraft, Metlife, NRG Energy and Philip Morris.

[968] *See* letters from Better Markets I and Senator Levin.

[969] *See* letters from BG LNG II, COPE I, EPSA, FSR I, Metlife, Peabody, Vitol and WGCEF dated February 22, 2011 regarding the major swap participant definition (''WGECF II''), and meeting with Bunge; *see also* letter from ISDA I (taking the view that swaps and security-based swaps used to hedge speculative positions should qualify as hedges and stating that failure to treat them as hedges would ''invariably result in there being more unhedged speculative risk in the market'').

[970] *See* letters from Vitol and WGCEF II and meeting with Bunge.

[971] *See* letters from BG LNG II, FSR I, ISDA I and Metlife.

[972] *See* letters from COPE I, EPSA and Peabody.

[973] *See* letters from Vitol and WGCEF dated June 3, 2011 regarding the major swap participant definition (''WGECF VI'').

[974] *See* letter from BG LNG II.

different locations.[975] One commenter, on the other hand, suggested that even swap positions that hedge other swap positions which are not hedging positions should be treated as hedging commercial risk because they are risk reducing.[976]

Four commenters took the position that swaps held for a purpose that is in the nature of speculation, investing or trading should not qualify as hedges of commercial risk.[977] One commenter pointed out that experience has shown that market participants sometimes inaccurately characterize positions as hedges (*e.g.,* the inaccurate characterization occurs because the nature of positions change over time), and that excluding swap positions that hedge speculative, investment or trading positions would be especially inappropriate for financial firms that frequently use swaps to speculate, invest or trade.[978] One commenter stated that any swap position hedging another swap position could never be considered to be hedging commercial risk because the second swap is only adjusting the first swap position, meaning that neither swap would be congruent with risk reduction.[979] Another commenter stated that the hedging exclusion should not cover any swap hedging a speculative position.[980]

3. Final Rules—General Availability of the Exclusions

As with the proposed rules, the final CEA and Exchange Act rules implementing this exclusion are different in certain regards to reflect the different ways that swaps and security-based swaps may be expected to be used to hedge commercial risk, as well as differences in existing regulations under the CEA and the Exchange Act. Notwithstanding these differences, the two rules follow parallel approaches and address certain key issues in similar ways.

a. Availability to Financial Entities

Consistent with the position we took in the Proposing Release, the final rules with regard to both major participant definitions do not foreclose financial entities from being able to take advantage of the commercial risk hedging exclusion in the first major participant test. This conclusion in part is guided by the fact that the statutory text implementing this hedging exclusion does not explicitly foreclose financial entities from taking advantage of the exclusion—in contrast to Title VII's exceptions from mandatory clearing requirements for commercial risk hedging activities. The conclusion also results from the need to avoid an interpretation that would cause the third major participant test to be redundant.[981]

In reaching this conclusion, we recognize that some commenters stated that there would be no benefit from allowing financial firms to avoid regulation as a major swap participant through the hedging exclusion, and that the exclusion should cover only risks related to non-financial commercial activities, or else the exclusion would allow financial companies to engage in risky transactions.[982] We believe that not allowing the exclusion to cover swaps or security-based swaps used for speculation or trading (or investments, in the case of swaps) will be sufficient to limit financial entities' ability to engage in risky transactions. We also are not persuaded that ''commercial risk'' should be limited to only risks related to non-financial activities.

We nonetheless recognize the significance of concerns that financial entities may seek to depict speculative positions as hedges to take advantage of the exclusion. We also are mindful of the need to give appropriate meaning to the term ''commercial risk'' within the exclusion. We believe that the standard set forth in the final rules, including the provisions that make the exclusions unavailable to swap or security-based swap positions of a speculative or trading nature (or investment purposes, in the case of swaps), apply the statutory test in a manner that appropriately addresses those other concerns. As discussed below, those standards limit the ability of financial entities to take advantage of the exclusion.[983]

b. Availability to Non-Profit and Governmental Entities

Under the final rules, a person's organizational status will not determine the availability of this hedging exclusion. The exclusion thus may be available to non-profit or governmental entities, as well as to for-profit entities, if the underlying activity to which the swap or security-based swap relates is commercial in nature.

c. Hedges of ''Financial'' or ''Balance Sheet'' Risks

Under the final rules, the exclusion is available to positions that hedge ''financial'' or ''balance sheet'' risks. While we recognize that some commenters oppose the exclusion of those positions,[984] we nonetheless believe that the exclusion would be impermissibly narrow if it failed to extend to the ''financial'' or ''balance sheet'' risks that entities may face as part of their commercial operations, given that those types of risks (*e.g.,* interest rate and foreign exchange risks) may be expected to arise from the commercial operations of non-financial end-users of swaps and security-based swaps. We do not believe the exclusion was intended to address those risks differently from other commercial risks, such as risks associated with the cost of physical inputs or the price received for selling products.[985]

d. Hedging on Behalf of an Affiliate

The final rules further provide that the exclusion is not limited to the hedging of a person's own risks, but also would extend to the hedging of the risks of a person's majority-owned affiliate.[986]

[975] *See* letters from BGLNG II and WGCEF VI.

[976] *See* letters from MetLife.

[977] *See* letters from AFR, Better Markets I and Senator Levin and meeting with Duffie on February 2, 2011.

[978] *See* letter from Senator Levin.

[979] *See* letter from Better Markets I.

[980] *See* meeting with Duffie on February 2, 2011.

[981] While we recognize that commenters have identified policy reasons as to why financial entities should be entirely excluded from being able to take advantage of the hedging exclusion, we continue to believe the language of the major participant definitions dictates a contrary approach.

[982] *See* letters from AFR and Senator Levin.

[983] We also do not believe that the size of an entity or an entity's position is determinative of whether a position hedges commercial risk. Moreover, given that the major participant definitions implicitly require large swap or security-based swap positions as triggers, a rule that made the hedging exclusion unavailable to entities with large positions could negate the statutory hedging exclusion.

[984] *See* notes 942 and 943, *supra.*

[985] Moreover, it is questionable as to what types of security-based swap positions—if any—would fall within the exclusion for purposes of the ''major security-based swap participant'' definition if the exclusion did not extend to hedges of ''financial'' or ''balance sheet'' risks. Security-based swaps such as single-name credit default swaps and equity swaps would not appear amenable to hedging a commercial entity's non-financial risks, such as price risks associated with non-financial inputs or sales. We do not believe that it would be appropriate to interpret the exclusion in such a way as to make it a nullity in the context of the ''major security-based swap participant'' definition.

[986] *See* CFTC Regulation § 1.3(kkk)(1)(i); Exchange Act rule 3a67–4(a)(1). For these purposes—consistent with the standards regarding the application of the dealer and major participant definitions to inter-affiliate swaps and security based swaps, *see* parts II.C and IV.G—we would view the counterparties to be majority-owned affiliates if one party directly or indirectly holds a majority ownership interest in the other, or if a third party directly or indirectly holds a majority interest in both, based on holding a majority of the equity securities of an entity, or the right to receive upon dissolution or the contribution of a majority of the capital of a partnership. *See* note 348, *supra.*

This approach reflects the fact that a corporate group may use a single entity to face the market to engage in hedging activities on behalf of entities within the group. In our view, it would not be appropriate for the swap or security-based swap positions of the market-facing entity to be encompassed within the first major participant test if those same positions could have been excluded from the analysis if entered into directly by the affiliate.[987] Of course, the exclusion will only be available to the market-facing entity if the position would have been subject to the exclusion—*e.g.,* not for a speculative or trading purpose—had the affiliate directly entered into the position.

4. Final Rules—''Major Swap Participant'' Definition Under the CEA

a. In General

The general scope of the rule regarding ''hedging or mitigating risk'' will be adopted substantially as proposed.[988] The CFTC, however, is adopting CFTC Regulation § 1.3(kkk) with a modification to paragraph (1)(iii) to include a reference to qualified hedging treatment for positions meeting Government Accounting Standards Board (''GASB'') Statement 53, Accounting and Financial Reporting for Derivative Instruments. The CFTC believes that this minor modification to CFTC Regulation § 1.3(kkk) is necessary in order to include swaps that qualify for hedging treatment issued by GASB.[989]

As noted above, the CFTC will not prohibit financial companies from using the hedging exclusion because the exclusion for positions held for hedging or mitigating commercial risk set forth in CEA section 1a(33)(A)(i)(1) does not limit its application based on the characterization or status of the person or entity. Unlike the end-user clearing exemption of section 2(h)(7), the major swap participant hedging exclusion is not foreclosed to financial entities.[990] In addition, the hedging exclusion will extend to entities hedging the risks of affiliates in a corporate group, but not to third parties outside of a corporate group.

Like the proposed rule, the final rule under the CEA does not require a demonstration of hedge effectiveness, periodic retesting or specific documentation in order to apply the hedging exclusion from the definition of major swap participant.

b. Swaps That Hedge Positions Held for Speculation, Investment, or Trading

Swaps that hedge positions held for speculation, investment or trading will not qualify for the exclusion. In the Proposing Release, the CFTC explained that swap positions held for the purpose of speculation, investment or trading are those held primarily to take an outright view on market direction, including positions held for short term resale, or to obtain arbitrage profits.[991] Additionally, the Proposing Release stated that swap positions that hedge other positions that themselves are held for the purpose of speculation, investment or trading are also speculative, investment or trading positions.[992]

We note that some commenters suggested that swaps that hedge speculative, investment or trading positions should qualify for the exclusion because speculation, investment or trading are fundamental to commercial activity and cannot be differentiated from other types of commercial activity. Similarly, commenters that support allowing speculative, investment or trading positions to qualify for the exception stated that a swap hedging the risk of another swap (regardless of that swap's nature) is risk reducing and therefore hedges commercial risk. We believe that these commenters' interpretation of ''commercial'' is not consistent with congressional intent or the meaning of ''commercial'' in the Dodd-Frank Act with respect to the first test of the major participant definition or the end-user exception to the clearing mandate. We are unconvinced that allowing swap positions to qualify for the exception would be appropriate when used to hedge speculative, investment or trading positions because the swap would not hedge or mitigate the risks associated with the underlying position, or at least not in the manner intended by Congress. In addition, we believe that doing so would undermine the effectiveness of the major participant definition in that entities would be able to characterize positions for speculative, investment or trading purposes as hedges and therefore evade regulation as major participants.

Under CFTC Regulation § 1.3(kkk)(2)(i), swap positions executed for the purpose of speculating, investing, or trading are those positions executed primarily to take an outright view on market direction or to obtain an appreciation in value of the swap position itself, and not primarily for hedging or mitigating underlying commercial risks.[993] For example, swaps positions held primarily for the purpose of generating profits directly upon closeout of the swap, and not to hedge or mitigate underlying commercial risk, are speculative or serve as investments. Further, as an alternative example, swaps executed for the purpose of offsetting potential future increases in the price of inputs that the entity reasonably expects to purchase for its commercial activities serve to hedge a commercial risk.

The CFTC notes that the use of ''trading'' in this context is not used to mean simply buying and selling. Rather, a party is using a swap for the purpose of trading under the rule when the party is entering and exiting swap positions for purposes that have little or no connection to hedging or mitigating commercial risks incurred in the ordinary course of business. ''Trading,'' as used in CFTC Regulation § 1.3(kkk)(2)(i), therefore would not include simply the act of entering into or exiting swaps if the swaps are used for the purpose of hedging or mitigating commercial risks incurred in the ordinary course of business.[994]

[987] The exclusion, however, would not be available to the extent that a person enters into swaps or security-based swaps in connection with the hedging activities of an unaffiliated third party. Such activities, moreover, may indicate that the person is acting as a swap dealer or security-based swap dealer.

[988] The final rule text of CFTC Regulation § 1.3(kkk)(2) has been revised to include the conjunction ''and'' between clauses (i) and (ii). In the proposed text of this rule, there was no conjunction between these two clauses, while the conjunction ''and'' was used in the parallel rule, § 240.3a67–4(b), under the Exchange Act. Thus, the revision of the final rule text conforms the CEA rule to the Exchange Act rule.

Also, the final rule text of CFTC Regulation § 1.3(kkk)(1)(E) has been revised to include interest and currency rates to be consistent with § 1.3(kkk)(1)(F). Both provisions address similar financial risks arising from rate ''movements'' and ''exposures,'' respectively.

[989] Local government entities that use GASB accounting standards may not be able to use comparable FASB hedge accounting as a demonstration that a swap is a hedge. Although the two standards are not the same, they are similar in effect and degree in respect of determining whether a swap hedges a risk.

[990] Although CEA section 1a(33)(A)(iii), 7 U.S.C. 1a(33)(A)(iii) provides that financial entities that are highly leveraged and not subject to capital requirements established by a Federal banking agency are effectively precluded from applying the hedging exclusion, other financial entities are not so precluded. Thus, availability of the hedging exclusion to some financial entities for purposes of the major swap participant definition is contemplated in the statutory text.

[991] *See* 75 FR at 80195 n.128.

[992] *Id.*

[993] The Commissions note that the SEC interprets the availability of the hedging exclusion differently in the context of the ''major security-based swap participant'' definition, and that the SEC's guidance in this area controls for purposes of that definition.

[994] The CFTC further clarifies that merchandising activity in the physical marketing channel qualifies as commercial activity, consistent with the Commission's longstanding bona fide hedging exemption to speculative position limits. *See* § 1.3(kkk)(1)(ii).

The CFTC acknowledges that some swaps that may be characterized as ''arbitrage'' transactions in certain contexts may also reduce commercial risks enumerated in CFTC Regulation § 1.3(kkk)(1). The discussion in footnote 128 of the Proposing Release was intended to focus on clarifying that swaps are speculative for purposes of the rule if entered into principally and directly for profit and not principally to hedge or mitigate commercial risk. The reference to ''arbitrage profits'' in footnote 128 was intended to provide an example of what is commonly a speculative swap, not to characterize all arbitrage swaps as speculative.

c. ''Economically Appropriate'' Standard

The CFTC has determined to adopt the ''economically appropriate'' standard as proposed. We believe that this standard will help the CFTC and market participants distinguish which swaps are, or are not, commercial hedges thereby reducing regulatory uncertainty and helping prevent abuse of the hedging exclusion. CFTC Regulation 1.3(kkk)(1)(i) of the final rules enumerates specific risk shifting practices that are deemed to qualify for purposes of the hedging exclusion.[995] Whether a swap is economically appropriate to the reduction of risks will be determined by the facts and circumstances applicable to the swap at the time a swap is entered into. While we acknowledge that this standard leaves room for judgment in its application, we believe this flexibility is needed given the wide variety of swaps and hedging strategies the rule applies to. We believe the economically appropriate standard together with the identification of the six different categories of permissible commercial risks listed in final CFTC Regulation § 1.3(kkk)(1)(i) is specific enough, when reasonably applied, to distinguish whether a swap is being used to hedge or mitigate commercial risk.

The Commission has determined not to adopt a ''congruence'' standard because that standard may be too restrictive and difficult to use given the range of potential types of swaps and hedging strategies available.

5. Final Rules—''Major Security-Based Swap Participant'' Definition Under the Exchange Act

a. ''Economically Appropriate'' Standard

The final rules retain the proposed ''economically appropriate'' standard, by which a security-based swap position that is used for hedging purposes[996] would be eligible for exclusion from the first major participant analysis if the position is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, when those risks arise from the potential change in the value of assets, liabilities and services in connection with the ordinary course of business of the enterprise.[997]

Consistent with the Proposing Release, we interpret the concept of ''economically appropriate'' to mean that the security-based swap position cannot materially over-hedge the underlying risk such that it could reasonably have a speculative effect,[998] and that the position cannot introduce any new basis risk or other type of risk (other than counterparty risk that is attendant to all security-based swaps) more than reasonably is necessary to manage the identified risks.

For example, a manufacturer that wishes to hedge the risk associated with a customer's long-term lease of a product may purchase credit protection using a single-name credit default swap on which the customer is the reference entity. The credit default swap may be excluded from the first major participant analysis even if it is for a shorter term than the anticipated duration of the lease so long as the use of such a shorter-term instrument is reasonable as a hedge, such as due to cost or liquidity reasons.[999] Also, the credit default swap may be excluded from the first major participant test if it hedges an amount of risk that is lower than the total amount of risk associated with the long-term contract.[1000]

In adopting this rule, we have considered commenter views that we should consider limiting the exclusion to positions that are recognized as hedges for accounting purposes.[1001] We nonetheless do not believe that the requirements that are appropriate to identifying hedging for accounting purposes are needed to limit the availability of the hedging exclusion. Moreover, linking the availability of the exclusion to accounting standards—which themselves may evolve over time—may lead the availability of the exclusion to evolve over time in unforeseen ways. We accordingly believe that the exclusion should be available if a security-based swap position is economically appropriate for hedging purposes (and not otherwise precluded from taking advantage of the exclusion).

We also have considered commenter concerns that the ''economically appropriate'' standard is too broad,[1002] and the additional suggestion that the exclusion instead should be limited to circumstances in which the hedge is ''congruent'' to the underlying risk.[1003]

[995] In the alternative to meeting the requirements of CFTC Regulation § 1.3(kkk)(1)(i), a swap may also be eligible for the hedging exclusion if the swap qualifies as a bona fide hedge for purposes of an exception from position limits under the CEA as provided in CFTC Regulation § 1.3(kkk)(1)(ii), or if it qualifies for hedging treatment under FASB Accounting Standards Codification Topic 815 or under GASB Statement 53 as provided in CFTC Regulation § 1.3(kkk)(1) (iii). Consequently, the universe of swaps that can qualify for the hedging exclusion is broader than the universe of swaps that qualify as bona fide hedges for purposes of an exception from position limits under the CEA as provided in CFTC Regulation § 1.3(kkk)(1)(ii).

[996] In the Proposing Release we stated that we did not believe the use of the term ''mitigating'' in the exclusion to mean something significantly more than ''hedging.'' *See* Proposing Release, 75 FR 80194 n.127. As noted above, some commenters disagreed, and argued that ''mitigating'' should be interpreted more broadly to encompass general risk mitigation strategies. *See, e.g.,* letters from ISDA and CDEU. In our view, the final rules we are adopting—including the use of ''economically appropriate'' standards and the exclusions for certain positions—encompass positions that may reasonably be described as ''hedging'' or ''mitigating'' commercial risk.

[997] Exchange Act rule 3a67–4(a)(1). Under this standard, the first major participant analysis need not account for security-based swap positions that pose limited risk to the market and to counterparties because the positions are substantially related to offsetting risks from a person's commercial operations. These hedging positions would include activities, such as the management of receivables, that arise out of the ordinary course of a person's commercial operations, including activities that are incidental to those operations. *See* Proposing Release, 75 FR at 80195.

In addition, the security-based swap positions included within the rule would not be limited to those recognized as hedges for accounting purposes. *See id.*

[998] In the Proposing Release, we described the ''economically appropriate'' standard as excluding positions that introduce ''any new material quantum of risks.'' *See* Proposing Release, 75 FR 80194 n. 129. The interpretation in this release is consistent with that approach, but does not make use of the same ''quantum of risks'' terminology.

[999] In other words, the entity may determine that the use of a credit default swap for a term that is shorter than the lease is justified if that shorter-term instrument costs less or is more liquid than a bespoke instrument that matches the duration of the contract. While the shorter-term credit default swap does not eliminate the underlying commercial risk, the instrument's use may be commercially reasonable for hedging purposes, and hence appropriately excluded from the first major participant test.

[1000] The use of a credit default swap for an amount that is smaller than the underlying risk may be justified as part of an entity's risk management strategy. For example, an entity may choose to engage in a partial hedge because a credit default swap for a smaller amount than the underlying risk may cost less or be more liquid than a bespoke instrument that more closely matches the amount of the risk.

[1001] *See* letter from Senator Levin.

[1002] *See* letters from AFR and AFSCME.

[1003] *See* letter from Better Markets I. We nonetheless do not believe that such a requirement would be consistent with the exclusion's

Continued

We recognize the significance of commenters' concerns as to the practical application of the ''economically appropriate'' standard, particularly with regard to hedges that are not perfectly correlated with the underlying risk.[1004] The standard embeds principles of commercial reasonableness that should assuage those implementation concerns, however. These principles necessarily account for the fact that the reasonable use of security-based swaps to hedge a person's commercial risk may result in residual basis risk, and that the mere presence of this basis risk should not preclude the availability of the exclusion. Moreover, the mere presence of residual basis risk need not run afoul of the restriction against materially over-hedging the underlying risk, which is instead intended to prevent the hedging exclusion from applying to positions that are entered into for speculative purposes or that have speculative effect (such as by being based on a notional amount that is disproportionate to the underlying risk).[1005]

We also acknowledge that an ''economically appropriate'' standard does not provide the compliance assurance that would accompany quantitative tests or safe harbors. Nonetheless, grounding the hedging exclusion in principles of commercial reasonableness permits the standard to be sufficiently flexible to appropriately address an end-user's particular circumstances and hedging needs. Use of an ''economically appropriate'' standard also is consistent with the fact that entities should be expected to use their reasonable business judgment when hedging their commercial risks.

To provide additional guidance to entities hedging commercial risk, moreover, the final rule incorporates examples of security-based swap positions that, depending on the applicable facts and circumstances, may satisfy the ''economically appropriate'' standard.[1006] These are:

- Positions established to manage the risk posed by a customer's, supplier's or counterparty's potential default in connection with: financing provided to a customer in connection with the sale of real property or a good, product or service; a customer's lease of real property or a good, product or service; a customer's agreement to purchase real property or a good, product or service in the future; or a supplier's commitment to provide or sell a good, product or service in the future.[1007]
- Positions established to manage the default risk posed by a financial counterparty (different from the counterparty to the hedging position at issue) in connection with a separate transaction (including a position involving a credit derivative, equity swap, other security-based swap, interest rate swap, commodity swap, foreign exchange swap or other swap, option, or future that itself is for the purpose of hedging or mitigating commercial risk pursuant to the rule or the counterpart rule under the Commodity Exchange Act);
- Positions established to manage equity or market risk associated with certain employee compensation plans, including the risk associated with market price variations in connection with stock-based compensation plans, such as deferred compensation plans and stock appreciation rights;
- Positions established to manage equity market price risks connected with certain business combinations, such as a corporate merger or consolidation or similar plan or acquisition in which securities of a person are exchanged for securities of any other person (unless the sole purpose of the transaction is to change an issuer's domicile solely within the United States), or a transfer of assets of a person to another person in consideration of the issuance of securities of such other person or any of its affiliates;
- Positions established by a bank to manage counterparty risks in connection with loans the bank has made; and
- Positions to close out or reduce any of the positions addressed above.

b. Treatment of Speculative or Trading Positions

The final rule, consistent with the proposal, provides that this hedging exclusion does not extend to security-based swap positions that are in the nature of speculation or trading.[1008] The exclusion thus does not extend to security-based swap positions that are held for short-term resale and/or with the intent of benefiting from actual or expected short-term price movements or to lock in arbitrage profits, or to security-based swap positions that hedge other positions that themselves are held for the purpose of speculation or trading.[1009]

The Commissions recognize that some commenters take the position that the exclusion should extend to security-based swap positions that hedge speculative or trading positions.[1010] In support, these commenters have stated that the proposed approach would lead to more unhedged risk in the market, and that the proposed approach could lead entities that use security-based swaps to hedge speculative positions to be major participants, in contrast to unhedged (and presumably riskier) entities. Commenters further requested clarification regarding how entities may distinguish speculative or trading positions from other security-based swap positions.[1011]

The Commissions nonetheless do not believe that it would be appropriate to extend the hedging exclusion to speculative or trading positions, including security-based swap positions that themselves hedge other positions that are for speculative or trading

''commercial risk'' terminology or underlying intent. A congruence standard particularly would not appear to adequately reflect the fact that commercially reasonable hedging activities can leave residual basis risk.

[1004] *See* letter from SIFMA AMG II.

[1005] For example, non-material basis risk or a non-material over-hedge may occur due to the use of a standardized instrument. A commercial entity may reasonably determine that it is cost effective to use a standardized security-based swap to hedge the underlying risk, even if use of the standardized instrument introduces non-material basis risk or reflects a non-material amount of over-hedging compared to what would be the result of using a bespoke security-based swap to hedge that risk.

[1006] Exchange Act rule 3a67–4(a)(2). We previously noted that the proposed definition would facilitate those types of security-based swap positions. *See* Proposing Release, 75 FR at 80196.

[1007] As discussed in the Proposing Release, *see* 75 FR at 80196 n.135, the references here to customers and counterparties do not include swap or security-based swap counterparties.

[1008] Exchange Act rule 3a67–4(b)(1). The commercial risk hedging exclusion for the purposes of the ''major security-based swap participant'' definition (in contrast to the commercial risk hedging exclusion in connection with the ''security-based swap dealer'' definition) does not turn upon whether a position is ''primarily'' for speculative or trading purposes. For the ''major security-based swap participant'' definition, a security-based swap position with any speculative or trading purpose cannot take advantage of the commercial risk hedging exclusion regardless of whether speculation or trading constitutes the ''primary'' purpose of the position.

[1009] *See generally* Basel Committee on Banking Supervision, ''International Convergence of Capital Measurement and Capital Standards, A Revised Framework, Comprehensive Version'' (June 2006) at ¶¶ 685–689(iii) (defining the term ''trading book'' for purposes of international bank capital standards, and stating that positions that are held for short-term resale and/or with the intent of benefiting from actual or expected short-term price movements or to lock in arbitrage profits are typically considered part of an entity's trading book).

In contrast to the CEA rule implementing the commercial risk hedging definition in the context of the ''major swap participant'' definition, the Exchange Act rule does not explicitly exclude security-based swaps held for the purpose of investing. We note, however, that security-based swaps held for the purpose of investing (*i.e.,* held primarily to obtain an appreciation in value of the security-based swap position) would not meet the ''economically appropriate'' standard set forth above, and hence would not be eligible for the exclusion.

[1010] *See, e.g.,* letters from FSR I and ISDA I.

[1011] *See, e.g.,* letter from CDEU.

purposes. Those limitations are appropriate to help give meaning to the concept of ''commercial'' risk, and to reflect the legislative intent to limit the impact of Title VII on commercial end-users of security-based swaps.[1012] Indeed, the use of security-based swap positions in connection with speculative and trading activity often may be expected either to have the purpose of locking-in arbitrage profits associated with those activities or producing an adjusted risk profile in connection with perceptions of future market behavior—neither of which would eliminate the speculative or trading purpose of the activity.[1013] We do not believe that it would be appropriate, or consistent with the Dodd-Frank Act, to interpret the term ''commercial risk'' to accord the same regulatory treatment to security-based swap positions for speculative or trading purposes as is accorded to the use of security-based swap positions in connection with commercial activities such as producing goods or providing services to customers.[1014]

Moreover, the Commissions believe that it would undermine the major participant definition to attribute a non-speculative or non-trading purpose to security-based swap positions that hedge speculative or trading positions. When a person uses a security-based swap position to help lock in profits or otherwise control the volatility associated with speculative or trading activity, or to cause that speculative or trading activity to reflect a particular market outlook or risk profile, the security-based swap position serves as an integral part of that speculative or trading activity. It thus would not appear appropriate or consistent with economic reality to seek to distinguish the security-based swap component from the other speculative or trading aspects of that activity. In fact, if ''hedges'' of speculative or trading positions were excluded from the first major participant test, entities could readily label a wide range of security-based swap positions entered into for speculative or trading purposes as being excluded hedges.[1015] Taken to its natural conclusion, such an approach largely may exclude security-based swap positions from the first major participant test, effectively writing that test out of the statutory definition.

We are aware of commenters' views that regulation of major participants has the potential to create a disincentive against certain entities' use of security-based swaps to manage risk in connection with their speculative or trading activities.[1016] Under this view, regulation potentially could result in those entities electing not to reduce the risks that they otherwise would seek to hedge, to avoid being regulated as major participants.[1017] That potential result, however, is an unavoidable consequence of the legislative decision to regulate persons whose security-based swap positions cause them to be major participants. It would not be appropriate to use the hedging exclusion to negate part of the underlying statutory definition simply to avoid disincentives that are an unavoidable consequence of the legislative decision to regulate major participants.

At the same time, we are mindful that market participants have requested further guidance as to how to distinguish between hedging positions that are subject to this exclusion, and speculative or trading positions that fall outside the exclusion. In our view, analysis of this issue is simplified by the nature of security-based swaps, and by the limited circumstances in which a person may be expected to have a commercial risk such that the use of a security-based swap may be economically appropriate for managing that commercial risk (rather than being for speculation or trading purposes).

In the case of security-based swaps that are credit derivatives, the final rule provides examples of the use of credit default swaps to purchase credit protection that, depending on the applicable facts and circumstances, may appropriately be excluded from the first major participant test (*e.g.,* the use of a credit default swap to purchase credit protection in connection with the potential default of a customer, supplier or counterparty, or in connection with loans made by a bank). Certain other purchases of credit protection using credit default swaps—such as the purchase of credit protection to manage the risks associated with securities that a non-financial company holds in a corporate treasury and that are not held for speculative or trading purposes—may also meet the standard under these rules.[1018] The sale of offsetting credit protection may also reasonably be expected to fall within the exclusion to the extent that this sale is reasonably necessary to address changes (particularly reductions) in the amount of underlying commercial risk hedged by the initial security-based swap position.[1019]

[1012] In addition, this limitation is consistent with the exclusion from the first major participant test in connection with ERISA plans. That exclusion particularly addresses security-based swap positions with the primary purpose of ''hedging or mitigating any risk directly associated with the operation of the plan.'' It is not clear why that scope of the ERISA exclusion would need to be incorporated into the first major participant test if the ''commercial risk'' exclusion already were broad enough to encompass hedges of trading or speculative positions.

[1013] As an example, one speculative/trading strategy involving security-based swaps can be to purchase short-dated credit protection in conjunction with a long-dated bond, to reflect a view that a particular company is likely to fail in the current credit environment. Combined, those positions can produce losses if the current credit environment did not change or if spreads were to widen, but could produce profits either if the company were to default or if spreads were to narrow and funding costs were to decrease. *See* Morgan Stanley, *Credit Derivatives Insights* 156–58 (4th ed., 2008). In other words, under that strategy the purchase of the credit protection would offset a portion of the risks associated with the ownership of the bond, but for the purpose of taking a directional view of the market with the hope for profit if the purchaser's view of future market dynamics is correct (and the reality of losses if the purchaser's view of the market is wrong). It would require an extraordinarily liberal construction of ''commercial risk'' to subsume this type of speculative security-based swap activity.

At the same time, we recognize that an entity hedging a commercial risk (in contrast to a risk arising from a speculative or trading strategy) reasonably may choose to use a security-based swap that is shorter-dated than the underlying risk, with the security-based swap appropriately excluded from the first major participant definition.

[1014] This approach does not reflect any value judgment about the role of speculation in the market for security-based swaps, or about the relative market benefits or risks associated with speculation. This position simply represents an attempt to give meaning to the statutory use of the term ''commercial risk'' in a way that reflects Title VII's special treatment of commercial end-users, and (as discussed below) avoid an interpretation that effectively undermines the first major participant test.

[1015] As noted by one participant to the roundtable on these definitions: ''[B]eing a hedge fund manager, there's nothing in my portfolio I can't claim to be hedging a risk. There's nothing. There's not a trade I do ever that I can't claim it to be a hedge against interest rates, or inflation, or against equity. You know, the fact of the matter is, if you're a capital market participant, your business is taking risks.'' Roundtable Transcript at 325 (remarks of Michael Masters, Better Markets).

[1016] *See* letter from ISDA I.

[1017] Of course, this would only be the case where the entity's hedging and speculative activities combined were at a level in excess of the major participant thresholds.

[1018] This is not to say that the purchase of credit protection on a security that a person owns would necessarily be entitled to the hedging exclusion. If the underlying security itself is held for speculative or trading purposes, the credit protection would not be excluded from the first major participant analysis, and in any event would not reasonably be construed as hedging ''commercial risk.''

[1019] Apart from that example, it is more difficult to foresee circumstances in which the sale of credit protection using a credit default swap would be expected to fall within the exclusion. We recognize, for example, that a person that has a short position in a security of a reference entity may have an incentive to sell credit protection on that reference entity to offset movements in the price or value of that short position (and/or lock in arbitrage profits in connection with that short position). While that sale of credit protection may mitigate the risks

Continued

As for security-based swaps that are not credit derivatives—such as equity swaps and total return swaps—the final rule provides examples of how the use of those security-based swaps in connection with certain business combinations may, depending on the applicable facts and circumstances, appropriately be excluded from the first major participant test. The use of equity swaps or total return swaps to manage the risks associated with securities that are held in a corporate treasury (and that are not held for speculative or trading purposes) may also appropriately be subject to the exclusion. Other uses of equity swaps or total return swaps to offset risks associated with long or short positions in securities, however, may not appropriately be excluded from the first major participant test, because such positions would be expected to have an arbitrage purpose or other speculative or trading purpose, and would be inconsistent with the ''commercial risk'' limitation to the hedging exclusion.

c. Treatment of Positions That Hedge Other Swap or Security-Based Swap Positions

The final rule, consistent with the proposal, provides that the hedging exclusion does not extend to a security-based swap position that hedges another swap or security-based swap position, unless that other position itself is held for the purposing of hedging or mitigating commercial risk.[1020] This provision allows the first major participant analysis to exclude a person's purchase of credit protection to help address the risk of default by a counterparty in connection with an interest rate swap, foreign exchange swap or other swap or security-based swap that the person has entered into for the purpose of hedging or mitigating commercial risk.

d. Procedural Conditions

In contrast to the proposal, the final rule does not incorporate procedural requirements in connection with the hedging exclusion from the first test of the major security-based swap participant definition.[1021] In making this change, we have been mindful of concerns that have been expressed that such procedural requirements would lead to undue costs in connection with hedging activity.[1022]

We understand, however, that many entities engaging in legitimate hedging of commercial risks do, as a matter of business practice, identify and document those risks and evaluate the effectiveness of the hedge from time to time. The presence of supporting documentation consistent with such procedures would help support a person's assertion that a security-based swap position should be excluded from the first major participant analysis, should the legitimacy of the exclusion become an issue.

Also, although we are not requiring the entity to monitor the effectiveness of the hedge over time, that absence of this requirement does not change the underlying need for a security-based swap position to be economically appropriate for the commercial risks facing the entity to be excluded from the first major participant definition. Thus, for example, if a person's underlying commercial risk materially diminishes or is eliminated over time, a security-based swap position that may have been economically appropriate to the reduction of risk at inception at a certain point in time may, depending on the facts and circumstances, no longer be reasonably included within the exclusion.[1023] As part of the reports required in connection with possible future changes to the major participant definitions,[1024] the staffs are directed to address whether the continued availability of the hedging exclusion should be conditioned on assessment of hedging effectiveness and related documentation.

D. Exclusion for Positions Held by Certain Plans Defined Under ERISA

1. Proposed Approach

The first statutory test of the major participant definitions excludes swap and security-based swap positions that are ''maintained'' by any employee benefit plan as defined in sections 3(3)[1025] and 3(32)[1026] of ERISA ''for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan.''[1027]

The proposed rules incorporated that statutory exclusion without additional interpretation or refinement.[1028] In the Proposing Release, moreover, the Commissions expressed the preliminary view that we did not ''believe that it is necessary to propose a rule to further define the scope of this exclusion.'' We further noted that the exclusion for those plans identified in the statutory definition is not strictly limited to ''commercial'' risk, and that this may be construed to mean that hedging by those ERISA plans should be broadly excluded. The Commissions also solicited comment as to whether this exclusion should be made available to additional types of entities.[1029]

2. Commenters' Views

Some commenters requested clarification that the ERISA hedging exclusion is broader than the commercial risk hedging exclusion, and that the ERISA hedging exclusion can encompass positions that are not solely for hedging purposes.[1030] One

associated with that short position, or produce an arbitrage profit in connection with that short position, that security-based swap position would not appear to constitute the hedging of ''commercial risk'' for purposes of the exclusion.

[1020] Exchange Act rule 3a67–4(b)(2).

[1021] Those proposed provisions would have conditioned the exclusion on the person identifying and documenting the underlying risks, establishing and documenting a method of assessing the hedge effectiveness, and regularly assessing the effectiveness of the security-based swap as a hedge. *See* proposed Exchange Act rule 3a67–4(c).

[1022] *See, e.g.,* letter from FSR I.

[1023] Factors that may be relevant to determining whether a security-based swap position is economically appropriate to the reduction of risk may include the costs associated with terminating or reducing that position.

[1024] *See* part V, *infra.*

[1025] Section 3(3) of Title I of ERISA defines the term ''employee benefit plan'' to include ''an employee welfare benefit plan or an employee pension benefit plan or a plan which is both an employee welfare benefit plan and an employee pension benefit plan.'' *See* 29 U.S.C. 1002(3). The terms ''employee welfare benefit plan'' and ''employee pension benefit plan'' are further defined in Sections 3(1) and (2) of ERISA. *See* 29 U.S.C. 1002(1) and (2).

[1026] Section 3(32) of Title I of ERISA defines the term ''governmental plan'' to mean a plan that the U.S. government, state or political subdivision, or agencies and instrumentalities establish or maintain for its employees, as well as plans governed by the Railroad Retirement Acts of 1935 and 1937, plans of international organizations that are exempt from taxation pursuant to the International Organizations Immunities Act, and certain plans established and maintained by tribal governments or their subdivisions, agencies or instrumentalities. *See* 29 U.S.C. 1002(32).

[1027] CEA section 1a(33)(A)(i)(I); Exchange Act section 3(a)(67)(A)(ii)(I).

[1028] *See* proposed CFTC Regulation § 1.3(hhh)(1)(ii)(A); proposed Exchange Act rule 3a67–1(a)(2)(i).

[1029] *See* Proposing Release, 75 FR at 80201, *supra.*

[1030] *See* letters from BlackRock I (noting that the ERISA hedging exclusion applies to positions with the ''primary purpose'' of hedging, ''which suggests plans may exclude swap positions even if they serve a purpose in addition to hedging or mitigating''), the ERISA Industry Committee (''ERISA Industry Committee'') (stating that if ERISA Title I plans are not excluded from the major participant definition, the rules should clarify that the ERISA hedging exclusion is broader than the commercial hedging exclusion and encompasses a variety of risks associated with the value of a plan's assets or the measures of its liabilities; also stating that the ERISA exclusion should not omit positions in the nature of investing, and particularly discussing the use of swaps to provide diversification), ABC/CIEBA (expressing the view

commenter cautioned against interpreting the ERISA hedging exclusion broadly.[1031]

Commenters also requested that the Commissions clarify that the ERISA hedging exclusion applies to positions maintained by trusts that hold plan assets,[1032] or by pooled funds.[1033] One commenter, in contrast, stated that the exclusion should not be available to trusts holding plan assets.[1034]

One commenter stated that the exception should be extended to all public pension plans,[1035] and one commenter particularly took the view that the exclusion should be available to church plans.[1036] Some commenters stated that the exclusion should be available to non-U.S. plans.[1037]

3. Final Rules

Consistent with the position expressed in the Proposing Release, the Commissions interpret the ERISA hedging exclusion in the first statutory major participant test to be broader than that test's commercial risk hedging exclusion. This reflects the facts that the ERISA hedging exclusion is not limited to ''commercial'' risk, and that the ERISA hedging exclusion addresses positions that have a ''primary'' hedging purpose (which suggests that those positions may have a secondary non-hedging purpose).

a. Types of Excluded Hedging Activities

The Commissions are mindful of commenters' request for additional clarity regarding the scope of the ERISA hedging exclusion. In that regard, we note that we generally would expect swap or security-based swap positions to have a primary purpose of hedging or mitigating risks directly associated with the operation of the types of plans identified in the statutory definition—and hence eligible for the exclusion—when those positions are intended to reduce disruptions or costs in connection with, among others, the anticipated inflows or outflows of plan assets, interest rate risk, and changes in portfolio management or strategies.

Conversely, we believe that certain other types of positions would less likely have the primary purpose of hedging or mitigating risks directly associated with the operation of the plan, as anticipated by the statutory definition.[1038]

b. Availability of Exclusion

The Commissions recognize the significance of comments that these plans may use separate entities such as trusts or pooled vehicles to hold plan assets, and that the exclusion should not be interpreted in a way that deters the use of those vehicles. We believe that the same principles that underpin the exclusion for hedging positions directly entered into by the types of plans identified in the statutory definition also warrant making the exclusion applicable to plan hedging positions that are entered into by those other parties that hold assets of those types of plans. Otherwise, the major participant analysis would have the effect of deterring efficiencies in plan operations for no apparent regulatory purpose.

Accordingly, the Commissions interpret the meaning of the term ''maintain''—in the context of the statutory provision that the swap or security-based swap position be ''maintained by'' an employee benefit plan—not only to include positions in which the plan is a counterparty, but also to include positions in which the counterparty is a trust or pooled vehicle that holds plan assets. Thus, for example, the exclusion would be available to trusts or pooled vehicles that solely hold assets of the types of plans identified in the statutory definition.[1039] The exclusion further may be available to entities that hold such plan assets in conjunction with other assets, but only to the extent that the entity enters into swap or security-based swap positions for the purpose of hedging risks associated with the plan assets. The exclusion does not extend to positions that hedge risks of other assets, even if those are managed in conjunction with plan assets.[1040]

The Commissions also are mindful of commenter concerns that the exclusion should explicitly be made available to other plans, such as church plans and non-U.S. plans.[1041] In this regard, the Commissions believe that the boundaries of the exclusion are set by the explicit statutory language, which states that it applies to any employee benefit plan as defined in paragraphs (3) and (32) of section 3 of ERISA. This reference is disjunctive—that is, a plan is eligible for the exclusion if it is within the scope of paragraph (3) (which refers to employee benefit plans)

that the ERISA hedging exclusion extends beyond ''traditional'' hedges, and stating that the exclusion should encompass swaps with purposes in addition to hedging, and that the exclusion should encompass positions for the purpose of rebalancing, diversification and gaining asset class exposure) and CalSTRS I (requesting that regulations provide for an ERISA hedging exclusion that is broader than the commercial risk hedging exclusion, and that encompasses positions for the purpose of investing).

One commenter alluded to the incorporation of efficient portfolio theory principles within the exception. *See* letter from Russell Investments.

[1031] *See* letter from AFSCME (stating that while the statutory exclusion may encompass swaps to mitigate currency risk of cash market investments, the exclusion should not encompass swaps used for investment purposes such as to gain asset class exposure or avoid transaction costs associated with a direct investment).

[1032] *See* letters from ERISA Industry Committee (stating that the rules should provide that the exclusion applies to positions maintained by any trust holding plan assets) and ABC/CIEBA (stating that the rules should provide the relevant entity for purposes of the exclusion is the counterparty to the swap, further stating that if a trust enters into a swap as a counterparty, it is the trust that should be tested as a possible major participant, even if the trust also holds non-ERISA assets).

[1033] *See* letters from BlackRock I (discussing how plan fiduciaries may invest plan assets ''in pooled investment vehicles such as registered investment companies, private funds and bank maintained collective trust funds,'' and stating that not including pooled funds within the exclusion would limit plans' ability to avail themselves of the efficiencies associated with pooling), ERISA Industry Committee (stating that there is ''no reason'' why the exception should not also extend to position held by a pooled investment trust on behalf of multiple employee benefit plans) and ABC/CIEBA (stating that if a pool within a trust is the counterparty, it is that pool that should be tested as a possible major participant, and noting Department of Labor regulations providing that a collective investment vehicle would be viewed as holding plan assets if the vehicle is not a registered investment company, and plans hold at least 25 percent of the interests in the vehicle).

[1034] *See* letter from AFSCME (stating that ''it is important to limit the exemption to plans themselves, not to entities holding 'plan assets' '').

[1035] *See* letter from Russell Investments.

[1036] *See* letter from Church Alliance (stating that the exclusion also should encompass church plans defined in paragraph 3(33) of ERISA, on the grounds that Congress would not have intended to discriminate against church plans, and that church plans are considered ''special entities'' that should be the beneficiaries of extra protection).

[1037] *See* letters from ABC/CIEBA, APG and BTPS.

The Commissions intend to issue separate releases that address the application of the major participant definitions, and Title VII generally, to non-U.S. entities.

[1038] For example, we do not foresee that the use of a swap or security-based swap position to replicate exposure to a foreign market or to a particular asset class to be for the primary purpose of hedging risks directly associated with the operation of these types of plans. While we recognize that an asset manager may perceive benefits in using swaps or security-based swaps in that manner, it also is necessary to give effect to the statutory language limiting the exclusion to positions that have a ''primary purpose'' of hedging risks ''directly associated'' with the ''operations'' of a plan. We recognize that lack of diversification may be viewed as a risk, but it is not an ''operations'' risk.

[1039] This interpretive guidance is intended solely in the context of the interpretation of the first test of the statutory major participant definitions. The guidance is not based on or relevant to the interpretation of other regulations relating to ERISA.

[1040] As appropriate, for purposes of the first major participant analysis an entity may need to allocate the exposure associated with swap or security-based swap positions between the amount that is attributable to plan assets (and hence eligible for exclusion) and the amount that is attributable to other assets.

[1041] As previously noted, the Commissions intend to issue separate releases that address the application of the major participant definitions, and Title VII generally, to non-U.S. entities.

or of paragraph (32) (which applies to government plans). Accordingly, the scope of the cited definitions in paragraphs (3) and (32) should be determined in accordance with all law that applies in the interpretation of ERISA.[1042]

E. ''Substantial Counterparty Exposure''

1. Proposed Approach

The major participant definitions' second statutory test encompasses persons whose outstanding swaps or security-based swaps ''create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets.'' [1043] In contrast to those definitions' first statutory test, which relates to persons with a ''substantial position'' in swaps or security-based swaps in a ''major'' category,[1044] this second test is not limited to positions in a single category. Also, unlike the first test, the second statutory test does not explicitly exclude certain commercial risk hedging positions or ERISA hedging positions.

For the ''major swap participant'' definition, the Proposing Release provided that a person's swap positions pose ''substantial counterparty exposure'' if those positions present a daily average current uncollateralized exposure of $5 billion or more, or present daily average current uncollateralized exposure plus potential future exposure of $8 billion or more.[1045] For the ''major security-based swap'' definition, the proposal provided that a person's security-based swap positions pose ''substantial counterparty exposure'' if those positions present daily average current uncollateralized exposure of $2 billion or more, or present daily average current uncollateralized exposure plus potential future exposure of $4 billion or more.[1046]

Under the proposal, those measures would be calculated in the same manner as would be used for the first major participant test, except that the ''substantial counterparty exposure'' analysis would consider all of a person's swap or security-based swap positions rather than solely considering positions in a particular ''major'' category, and that the ''substantial counterparty exposure'' analysis would not exclude positions to hedge commercial risks or ERISA plan risks.

The proposed ''substantial counterparty exposure'' thresholds were set higher than the proposed ''substantial position'' thresholds in part to reflect the fact that the former test accounts for a person's positions across four major swap categories or two major security-based swap categories.[1047] The proposed ''substantial counterparty exposure'' thresholds also reflected the fact that this second test (unlike the first major participant test) encompasses certain hedging positions that, in general, we would expect to pose a lesser degree of risk to counterparties and the markets.

2. Commenters' Views

a. General Comments

In light of the similarity between the proposed tests, a number of the concerns that commenters expressed with regard to the proposed ''substantial position'' definition also apply to the proposed ''substantial counterparty exposure'' definition. In addition, some commenters took the view that the proposed ''substantial counterparty exposure'' thresholds were too low,[1048] with several of those commenters stating that the thresholds should be raised to a level that reflects systemic risk.[1049] A few commenters took the view that the proposed thresholds were too high.[1050] Some commenters generally supported the approach to the definition of ''substantial counterparty exposure'' proposed by the Commissions.[1051]

Some commenters took the view that the ''substantial counterparty exposure'' test should focus on the size of an entity's exposure to specific counterparties.[1052] Several commenters suggested that the thresholds should be adjusted over time for inflation and changes in the swap and security-based swap markets.[1053] One commenter urged that the analysis consider the interconnectedness of the entity.[1054]

One commenter addressed the application of the second major participant test to insurance companies, arguing that substantial counterparty exposure should be decided by the FSOC in consultation with the relevant state insurance commissioner, and that hedges should be excluded from the calculation for insurers.[1055]

b. Lack of Exclusion for Hedging Positions

A number of commenters took the view that the second major participant

[1042] We are not taking a view as to whether church plans or non-U.S. plans constitute employee benefit plans as defined by section 3(3) of ERISA.

[1043] CEA section 1a(33)(A)(ii); Exchange Act section 3(a)(67)(A)(ii)(II).

[1044] CEA section 1a(33)(A)(i); Exchange Act section 3(a)(67)(A)(ii)(I).

[1045] *See* proposed CFTC Regulation § 1.3(lll).

[1046] *See* proposed Exchange Act rule 3a67–5.

[1047] Thus, these proposed thresholds in part would account for a person that has large positions in more than one major category of swaps or security-based swaps, but that does not meet the substantial position threshold for any single category of swaps or security-based swaps.

[1048] *See, e.g.,* letters from ATAA (supporting higher thresholds to measure substantial counterparty exposure), CCMR I (suggesting that the thresholds be set high initially, capturing only a few entities until the Commissions are able to collect and analyze data that supports lowering the thresholds), BG LNG I (stating that proposed threshold should be increased substantially), WGCEF II (stating that the Commissions should adopt substantial position and substantial counterparty exposure tests that account for current conditions in swap markets), ABC/CIEBA (requesting that the Commissions raise the thresholds to better target persons creating or causing systemic risk as set forth in the a major swap participant and major security-based swap participant definitions), BlackRock I (stating that proposed thresholds for the substantial counterparty exposure test are too low so that they could encompass market participants that do not have systemically important swap positions) and ACLI (supporting increasing the thresholds under the CEA definition to $7 billion in daily average aggregate uncollateralized outward exposure or $14 billion in daily average aggregate uncollateralized outward exposure plus daily average aggregate potential outward exposure), and meeting with MFA on February 14, 2011 (requesting that the Commissions raise the thresholds for measuring substantial counterparty exposure until the Commissions conduct a market survey to determine how many entities would need to perform the calculations regularly and whether those entities have characteristics capable of causing systemic risk).

[1049] *See* letters from ABC/CIEBA, BlackRock I, ISDA I, WGCEF II, and meeting with MFA on February 14, 2011.

[1050] *See* letters from Greenberger (in connection with thresholds relating to substantial position) and AFR (Commissions should define a major swap participant or major security-based swap participant as any person that maintains $500 million in daily average, uncollateralized exposure for any category of swaps other than rate swaps, for which the daily average could be up to $1.5 billion).

[1051] *See, e.g.,* letters from ATAA (supporting the proposed definitions of ''substantial position'' and ''substantial counterparty exposure,'' with the caveat that higher thresholds be used to measure ''substantial counterparty exposure''), Dominion Resources (supporting the Commissions proposed definitions of ''substantial position'' and ''substantial counterparty exposure''), Fidelity (threshold levels set at appropriate levels but should be periodically reviewed for adjustment), and Kraft (thresholds as proposed are appropriate).

[1052] *See* letters from MFA (stating that the calculation of substantial counterparty exposure should measure the exposure that a person has to each individual counterparty that is a systemically important financial institution excluding cleared swap transactions) and CCMR I (stating that the ''substantial counterparty exposure'' and ''substantial position'' thresholds should apply to the largest exposure that a person has to another market participant, with any aggregate test being set at a higher level).

[1053] *See* letters from CDEU, COPE I, Fidelity, ISDA I, and MFA I.

[1054] *See* letter from CDEU.

[1055] *See* letter from NAIC (stating that the Commissions should defer to FSOC when considering the designation of insurers under the second test, and should exclude from the analysis swaps and security-based swap positions used for hedging provided that such positions are subject to state investment laws and ongoing monitoring by a state insurance regulatory authority).

test should exclude commercial risk hedging positions from the analysis.[1056] Some commenters also supported excluding ERISA hedging positions from the analysis.[1057] One commenter opposed any such exclusions for hedging positions.[1058]

3. Final Rules

Consistent with the Proposing Release, the final rules defining the term ''substantial counterparty exposure'' generally are based on the same current uncollateralized exposure and potential future exposure tests that are used to identify a ''substantial position.''[1059] As with the Proposing Release, moreover, the ''substantial counterparty exposure'' analysis addresses all of a person's swap or security-based swap positions (rather than being limited to positions in a ''major'' category), and does not exclude hedging positions.[1060] The final rules also incorporate the quantitative thresholds that were proposed for those tests.[1061]

In adopting these final rules we have considered commenter views that the ''substantial counterparty exposure'' analysis should exclude certain commercial risk and ERISA hedging positions. We nonetheless believe that the structure of the major participant definitions—particularly the fact that those definitions specifically exclude hedging positions from the first statutory test but not from the second test—necessitates the conclusion that the second test not exclude those hedging positions.

We also have considered commenter views that the ''substantial counterparty exposure'' analysis should account for the maximum exposure that a person poses to any single counterparty. We nonetheless believe that the statutory test—particularly its focus on serious adverse effects on financial stability or financial markets—more appropriately is addressed by measures of the aggregate counterparty risk that an entity poses through its swap or security-based swap positions. Also, consistent with our views regarding the ''substantial position'' definition, we believe that the ''substantial counterparty exposure'' analysis appropriately is addressed via objective and quantitative criteria (rather than a multi-tier approach), and appropriately takes into account current uncollateralized exposure and potential future exposure.

Consistent with the Proposing Release, the thresholds to implement the second major participant test are higher than the corresponding thresholds for the first major participant test. These differences reflect the fact that the second test encompasses four ''major'' categories of swaps or two ''major'' categories of security-based swaps, as well as the fact that this second test does not exclude hedging positions that would appear to pose a lesser degree of counterparty risk than non-hedging positions.

While we are mindful of commenter views that the proposed ''substantial counterparty exposure'' thresholds were too low,[1062] we believe that the same principles that support the proposed standards in the context of the ''substantial position'' definition also support the proposed standards for this second test. As with the ''substantial position'' analysis, the ''substantial counterparty exposure'' analysis seeks to reflect a standard that encompasses large market participants before the counterparty risk posed by their swap and security-based swap positions present too large a problem, as well as the financial system's ability to absorb losses of a particular size, and the need to account for the possibility that multiple market participants may fail close in time.[1063] Commenters have not presented empirical or analytical evidence in support of a different standard. In the future, the Commissions may review and potentially adjust these thresholds to reflect evolving market structures and additional data.

F. ''Highly Leveraged'' and ''Financial Entity''

1. Proposed Approach

The third statutory test of the major participant definitions encompasses any non-dealer that: (i) Is a ''financial entity'' (other than one that is ''subject to capital requirements established by an appropriate Federal banking agency''), (ii) is ''highly leveraged relative to the amount of capital it holds,'' and (iii) maintains a ''substantial position'' in any ''major'' category of swaps or security-based swaps.[1064] In contrast to the first statutory test—which also encompasses persons with a ''substantial position'' in swaps or security-based swaps in a ''major'' category—this third test does not exclude positions that hedge commercial risk or ERISA risks.

a. ''Financial Entity''

The Proposing Release defined the term ''financial entity'' for purposes of the major participant definition in the same general manner as Title VII defines that term for purposes of the end-user exemption from mandatory clearing,[1065] but with certain technical changes to avoid circularity.[1066]

[1056] *See* letters from SIFMA AMG II (noting that the Commissions have suggested that hedging positions may not raise the same degree of risk as other swap positions), NAIC (supporting exclusion of commercial risk hedging positions subject to state investment laws and ongoing monitoring by state insurance regulators), AIA (supporting hedging exclusion to avoid capturing entities such as property-casualty insurers), CDEU (suggesting that inclusion of hedging positions is inconsistent with goal of mitigating systemic risk), APG (supporting exclusion of positions held by regulated foreign pension plans), and NRG Energy (suggesting that a lack of an exclusion would cause end-users to curtail hedging activities and increase systemic risk); *see also* letter from AIMA I (supporting an exemption or discount if the swap transaction is cleared, an off-set for the value and quality of any collateral, and consideration of the directional moves of particular swap contracts).

[1057] *See* letters from ABC/CIEBA and SIFMA AMG II. One commenter further requested that ERISA Title I plans be explicitly excluded from the second test. *See* letter from ERISA Industry Committee. Another commenter requested an exclusion for ERISA plans generally. *See* letter from CalSTRS I.

[1058] *See* letter from Better Markets I (stating that excluding hedging positions would be inappropriate because the Dodd-Frank Act did not provide for any such exclusion in the second test, hedge positions may still contribute to counterparty exposure, and the thresholds already reflect the lower level of risk posed by hedge positions).

[1059] Accordingly, changes that the final rules made to the proposal with regard to the ''substantial position'' definition, *see* part IV.B.3, *supra,* also are carried over to the definition of ''substantial counterparty exposure.''

[1060] *See* CFTC Regulation § 1.3(lll); Exchange Act rule 3a67–5.

[1061] Accordingly, consistent with the proposal, the threshold for the ''major swap participant'' definition is $5 billion or more in daily average current uncollateralized exposure, or $8 billion or more in daily average uncollateralized exposure plus potential future exposure. The threshold for the ''major security-based swap participant'' is $2 billion or more in daily average current uncollateralized exposure, or $4 billion or more in daily average uncollateralized exposure plus potential future exposure.

[1062] *See* notes 1051 and 1052, *supra.*

[1063] As with the ''substantial position'' analysis, our decision to adopt these thresholds is informed by events related to AIG Financial Products and LTCM. *See* part IV.B.3.d, *supra.*

[1064] CEA section 1a(33); Exchange Act section 3(a)(67).

[1065] CEA section 2(h)(7); Exchange Act section 3C(g)(3)(A).

[1066] *See* proposed CFTC Regulation § 1.3(mmm)(1); proposed Exchange Act rule 3a67–6(a). For both sets of rules, the ''financial entity'' definition would include any: commodity pool (as defined in section 1a(10) of the CEA); private fund (as defined in section 202(a) of the Investment Advisers Act of 1940); employee benefit plan as defined in paragraphs (3) and (32) of section 3 of ERISA; and person predominantly engaged in activities that are in the business of banking or financial in nature (as defined in section 4(k) of the Bank Holding Company Act of 1956).

To avoid circularity, the use of the term ''financial entity'' in the context of the ''major swap participant'' definition also would encompass any ''security-based swap dealer'' and ''major security-based swap participant,'' but would not include any ''swap dealer'' or ''major swap participant'' (even though the latter terms also are found in the

Continued

b. ''Highly Leveraged''

The Proposing Release set forth two alternative approaches for determining whether a particular entity would be deemed ''highly leveraged.'' [1067] Under one approach, an entity would be ''highly leveraged'' if the ratio of its liabilities to equity exceeded 8 to 1; this proposed alternative reflected the fact that the third statutory major participant test excludes certain types of entities.[1068] Under the alternative approach, an entity would be ''highly leveraged'' if the ratio of its liabilities to equity exceeded 15 to 1; this proposed alternative reflected standards for maximum leverage in certain circumstances found in Title I of the Dodd-Frank Act.[1069] The proposal further provided that leverage would be measured at the close of business on the last business day of the applicable fiscal quarter, and that liabilities and equity would be determined in accordance with U.S. generally accepted accounting principles (''GAAP'').[1070]

In proposing these alternative standards for identifying ''highly leveraged'' entities, the Commissions recognized that traditional balance sheet measures of leverage are limited as tools for evaluating an entity's ability to meet its obligations—in part because such measures do not directly account for potential risks posed by specific instruments held on the balance sheet, or for financial instruments held off of the balance sheet. At the same time, the Commissions preliminarily concluded that it was not necessary to use more complex measures of risk-adjusted leverage for these purposes, in part because the third test's ''substantial position'' analysis already accounts for such risks. The Commissions also noted the costs that would be associated with causing entities to engage in complex calculations of risk-adjusted leverage.[1071]

The Proposing Release solicited comment on a variety of issues related to the proposed leverage ratios, including the relative merits of the alternative 8 to 1 and 15 to 1 standards, and potential alternative standards.[1072]

2. Commenters' Views

a. ''Financial Entity''

Some commenters recommended that certain types of entities should be excluded from the definition of ''financial entity,'' on the grounds that those types of entities are more appropriately treated as non-financial end users of swaps for purposes of the Dodd-Frank Act.[1073] Commenters specifically suggested that the ''financial entity'' definition exclude: (i) Centralized hedging and treasury subsidiaries in corporate groups; [1074] (ii) employee benefit plans; [1075] and (iii) cooperative structures.[1076] Commenters also requested clarification as to which entities would not be ''subject to capital requirements established by an appropriate Federal banking agency,'' and hence not subject to the third statutory test.[1077] In addition, commenters addressed the application of the ''financial entity'' definition to non-U.S. persons.[1078]

b. ''Highly Leveraged''

A number of commenters supported the proposed 15 to 1 alternative leverage ratio over the 8 to 1 alternative, with some commenters further suggesting that the final rule should set a leverage ratio higher than 15 to 1, or that the ratio should be reconsidered when more information is available regarding leverage among swap users.[1079] One commenter supported the proposed 8 to 1 alternative,[1080] and one commenter

''financial entity'' definition used for purposes of the end-user clearing exception). *See* proposed CFTC Regulation § 1.3(mmm)(1). In the context of the ''major security-based swap participant'' definition, the term ''financial entity'' also would encompass any ''swap dealer'' or ''major swap participant,'' but would not include any ''security-based swap dealer'' and ''major security-based swap participant.'' *See* proposed Exchange Act rule 3a67–6(a).

[1067] *See* proposed CFTC Regulation § 1.3(mmm)(2); proposed Exchange Act rule 3a67–6(b).

[1068] The Proposing Release particularly noted that the third statutory major participant test excludes financial institutions subject to capital requirements set by Federal banking agencies, and recognized the possibility those entities were excluded based on the presumption that they generally are highly leveraged. The Proposing Release noted, based on analysis of financial statements, that it appears that those institutions generally have a leverage ratio of 10 to 1, and that this suggested that the ''highly leveraged'' threshold would have to be lower for those institutions to potentially be subject to the third test. *See* Proposing Release, 75 FR at 80199.

[1069] The Proposing Release noted that Title I provides that the Board must require a bank holding company with total consolidated assets equal to or greater than $50 billion, or a nonbank financial company supervised by the Board, to maintain a debt to equity ratio of no more than 15 to 1 if the FSOC determines ''that such company poses a grave threat to the financial stability of the United States and that the imposition of such requirement is necessary to mitigate the risk that such company poses to the financial stability of the United States.'' *See* Dodd-Frank Act section 165(j)(1). The Proposing Release further noted that this 15 to 1 ratio may represent an upper limit to acceptable leverage and that the major participant analysis should use a lower threshold, or, alternatively, that the 15 to 1 ratio provides an appropriate test of whether an entity poses the systemic risk concerns implicated by the major participant definitions. *See* Proposing Release, 75 FR at 80199.

[1070] The Proposing Release also stated that entities that file quarterly reports on Form 10–Q and annual reports on Form 10–K with the SEC would determine their total liabilities and equity based on the financial statements included with such filings while all other entities would calculate the value of total liabilities and equity consistent with the proper application of U.S. GAAP. *See id.*

[1071] *See id.* at 80198–99.

[1072] *See id.* at 80199–200.

[1073] *See, e.g.,* letters from CalSTRS dated June 15, 2011 (''CalSTRS II''), Kraft, Newedge, NRU CFC I and Philip Morris.

[1074] *See* letters from Kraft and Philip Morris.

[1075] *See* letter from CalSTRS II (asserting that there is not a basis to treat ERISA plans as ''financial entities'' for purposes of the major participant definitions solely to maintain consistency with an ''anomalous'' statutory provision).

[1076] *See* letter from NRU CFC I.

[1077] *See* letters from ACLI (requesting confirmation that the exclusion from the third statutory test extends to entities subject to bank or financial holding companies, entities deemed systemically important under Title I of the Dodd-Frank Act, and any other persons subject to capital regulation established by a Federal banking regulator) and MetLife (requesting clarification that the exclusion extends to persons subject to regulation and capital requirements on a consolidated basis under federal banking law, and persons that are individually or systemically important financial institutions under Title I).

[1078] One commenter took the view that non-U.S. governments and their agencies should be excluded from the ''financial entity'' definition for purposes of the major participant definition and the Title VII end-user exemption from mandatory clearing. *See* letter from Milbank. On the other hand, one commenter favored the inclusion of non-U.S. governments in the ''financial entity'' definition. *See* meeting with Duffie on February 2, 2011 (suggesting that foreign governments and other foreign jurisdictions, such as municipalities, should be treated as ''financial entities'' for purposes of the major swap participant definition and other requirements under the Dodd-Frank Act on the grounds that such entities could become sources of systemic risk).

The Commissions intend to issue separate releases addressing the application of Title VII to non-U.S. persons.

[1079] *See* letters from ISDA I (suggesting that the wide use of leverage by financial institutions means that the definition should capture only entities with the ''very highest'' leverage ratios, and that the 15 to 1 ratio should be viewed as a floor for identifying highly leveraged entities given that it is used in Title I to address entities that have already been determined to pose a ''grave threat'' to the stability of the U.S. financial system), MFA I (stating that 15 to 1 is the more appropriate of the two choices, and that the Commissions could subsequently adjust the ratio after receiving market data on the use of leverage), AIMA I (encouraging the Commissions to adopt the 15 to 1 leverage threshold until an assessment of the impact of the major participant definitions can be completed); Amex (supporting the use of the 15 to 1 ratio, noting that it is consistent with the maximum leverage allowed to entities designated as a grave threat to financial stability under Title I of the Dodd-Frank Act) and CDEU (recommending use of the 15 to 1 standard, based on its consistency with the leverage limit in Title I of the Dodd-Frank Act for entities posing a grave threat to the United States financial system and that ''it would be unreasonable to propose a stricter leverage threshold under the major participant test for nonbank financial end-users,'' and expressing concern that entities comfortably falling under the 8 to 1 ratio could unexpectedly exceed this threshold during periods of market stress and that sudden designation as a major participant ''could seriously hinder a company from meeting its obligations'').

[1080] *See* letter from Better Markets I (stating that the 8 to 1 threshold would better serve the purposes

suggested that the final rule should set a leverage ratio lower than 8 to 1.[1081] One commenter suggested a ratio of 12 to 1, consistent with certain capital requirements.[1082]

Commenters also suggested a variety of methods and adjustments for calculating leverage ratios.[1083]

Some commenters further suggested that specific leverage tests be applied to particular types of financial entities. For employee benefit plans, commenters particularly stated that a plan's obligations to pay benefits should not be considered a liability for purposes of the analysis, and the value of the plan's assets should be used as the denominator for the ratio in lieu of using the non-applicable term ''equity.'' [1084] Another commenter—which obtains a substantial amount of funding by issuing subordinated debt, rather than equity—expressed the view that the leverage calculation should allow it to treat subordinated debt as equity.[1085]

Several commenters addressed the application of the leverage ratio to insurance companies in light of the applicable regulatory regimes and their use of statutorily required accounting methods rather than GAAP.[1086] Those commenters took the view that an insurance company's leverage should be tested based on its risk-based capital ratio or on its statutory accounting statements, with certain adjustments to account for different types of liabilities,[1087] or based on whether its insurance regulator believes that it is adequately capitalized.[1088] One commenter said that the leverage ratio test should not apply to insurance companies,[1089] and another said that application of the leverage ratio test to insurance companies should be coordinated with the FSOC.[1090]

3. Final Rules

a. ''Financial Entity''

Consistent with the Proposing Release, the final rules defining ''financial entity'' for purposes of the third major participant test are based on the corresponding ''financial entity'' definition used in the Title VII exception from mandatory clearing for end users, with certain adjustments to avoid circularity.[1091] In this regard, while we are mindful of one commenter's views that the differences between the major participant definitions and the end-user clearing exception necessitate different ''financial entity'' definitions,[1092] we do not concur with the view that the term ''financial entity'' should be interpreted independently in these two contexts. Both sets of provisions distinguish between financial and non-financial entities in a way that limits the impact of Title VII on the latter set of entities, and we believe that the definitions should be consistent in light of those parallel purposes.

The Commissions are aware, however, that the major participant definitions differ from the mandatory clearing requirements in how they address affiliates. The mandatory clearing requirements include a provision that specifically addresses affiliates of persons that qualify for the exception from mandatory clearing for end users,[1093] while no such specific provision is included in the major participant definitions. Given this absence, the Commissions believe it is appropriate to modify the final rules defining ''financial entity'' for purposes of the major participant definitions from the proposal to exclude certain centralized hedging and treasury entities.[1094] The Commissions understand that a primary function of such centralized hedging and treasury entities is to assist in hedging or mitigating the commercial risks of other entities within their corporate groups. Although those entities' activities could constitute being ''in the business of banking or financial in nature,'' we do not believe that it would be appropriate to treat a person as a ''financial entity'' for the purposes of the major participant definitions if the person would fall within that definition solely because it facilitates hedging activities involving swaps or security-based swaps by majority-owned affiliates that themselves are not ''financial entities.'' [1095] Absent this change, the major participant analysis would exclude hedging positions that do not use centralized hedging facilities, but would not exclude identical hedging positions that make use of a centralized hedging facility.[1096] Such a result would inappropriately discourage the use of centralized hedging and treasury entities.

While the Commissions also have considered the views of commenters that the ''financial entity'' definition should exclude certain other types of entities—such as employee benefit plans, and cooperatives—the final rules do not provide any such exclusions. As a general matter, the Commissions believe that the ''financial entity'' definition should be the same for purposes of the major participant

of the Dodd-Frank Act by ''ensuring that more, rather than fewer, financial entities are covered by the risk mitigation and business conduct standards that Congress established'' for major participants, and that use of the 15 to 1 leverage ratio from Title I of the Dodd-Frank Act is inappropriate because the Title I ratio is used for the ''relatively draconian'' purpose of imposing leverage limits, while this ratio would be used for ''the more modest purpose of imposing registration requirements'').

[1081] *See* letter from Greenberger (suggesting that the leverage test should be set at a ratio that is lower than either of the two proposed levels).

[1082] *See* meeting with MFA on February 14, 2011 (MFA representatives making point that ''highly leveraged'' should be defined in coordination with other regulations under the Dodd-Frank Act, and for example, a requirement that banks hold 8% capital implies a leverage ratio of approximately 12:1).

[1083] The suggested adjustments were: to measure the ratio of net current credit exposure to Tier I capital, in a manner similar to that used by bank regulators (*see* letter from Greenberger); to include as liabilities all unfunded exposures on swaps, both current and potential (*see* letter from Better Markets I); and to account for the different risk levels of various classes of assets and liabilities and for other factors affecting a person's riskiness (*see* letters from CCMR I and MFA I).

[1084] *See* letters from CalSTRS I (also stating that for purposes of determining leverage ratios, the value of the plan's assets should be determined as of most recent annual valuation rather than quarterly) and APG (stating that only investment-related liabilities, rather than anticipated shortfalls in benefit obligations, should be considered in the leverage calculation, and the test should be adjusted to take into account legally binding investment restrictions and other constraints that could be just as effective, or more effective, at reducing insolvency risk as capital requirements that would limit leverage).

[1085] *See* letter from NRU CFC I (stating that this application of the leverage test would be consistent with its financial statements).

[1086] *See* letters from ACLI, FSR I, MetLife and NAIC.

[1087] *See* letters from ACLI, FSR I and NAIC.

[1088] *See* letter from MetLife.

[1089] *See* letter from FSR I.

[1090] *See* letter from NAIC.

[1091] *See* CFTC Regulation § 1.3(mmm)(1); Exchange Act rule 3a67–6(a). Accordingly, this general definition encompasses commodity pools, private funds, ERISA plans, and persons predominately engaged in activities that are in the business of banking or financial in nature, as well as certain dealers or major participants. *See* note 1066, *supra.*

[1092] *See* letter from CalSTRS II (ERISA plans should not be included in the definition of ''financial entity'' for purposes of the major participant definitions).

[1093] *See* CEA section 2(h)(7)(D); Exchange Act section 3C(g)(4).

[1094] *See* CFTC Regulation § 1.3(mmm)(2); Exchange Act rule 3a67–6(b).

[1095] Consistent with the general inter-affiliate exceptions from the dealer and major participant definitions, *see* parts II.C and IV.G, for purposes of these rules, the counterparties are majority-owned affiliates if one party directly or indirectly holds a majority ownership interest in the other, or if a third party directly or indirectly holds a majority interest in both, based on holding a majority of the equity securities of an entity, or the right to receive upon dissolution or the contribution of a majority of the capital of a partnership. *See* CFTC Regulation § 1.3(mmm)(1); Exchange Act rule 3a71–6(b)(2).

[1096] We also note that this result is parallel to the Title VII end-user exception from mandatory clearing, which extends to hedging activities of financial entities on behalf of non-financial affiliates. *See* CEA section 2(h)(7)(D); Exchange Act section 3C(g)(4).

definition as it is for purposes of the end-user exception from mandatory clearing.[1097]

We also have considered the views of some commenters that subsidiaries of bank holding companies, financial holding companies or systemically important financial institutions should be considered to be ''subject to capital requirements established by an appropriate Federal banking agency,'' and hence not subject to the third statutory major participant test. We nonetheless interpret the term ''subject to capital requirements established by an appropriate Federal banking agency'' to specifically apply to persons for whom a Federal banking agency directly sets capital requirements. We do not believe that the term should be interpreted to apply to other persons by virtue of their being part of a holding company that is subject to those capital requirements, or otherwise being affiliated with persons subject to those capital requirements, because we do not believe that the mere fact of that relationship is sufficient to control or mitigate the credit risk that those persons pose to their counterparties.

b. ''Highly Leveraged''

i. Leverage Ratio Level

After considering commenters' views, the Commissions are adopting final rules that define ''highly leveraged'' to generally mean a ratio of liabilities to equity in excess of 12 to 1.[1098] Our adoption of this 12 to 1 standard, rather than the proposed 8 to 1 or 15 to 1 alternatives, takes into account commenters' views on the alternatives, as well as one commenter's support for a 12 to 1 ratio.[1099]

In general, we believe that the structure of the third statutory major participant test—which, unlike the first statutory test, does not permit the exclusion of certain hedging positions—reasonably may be interpreted as reflecting the determination that: (a) higher leverage indicates that an entity poses a heightened risk of being unable to meet its obligations; and (b) such entities should not be permitted to exclude hedging positions from the ''substantial position'' analysis in light of the counterparty risks those positions pose (even recognizing that these may be lower than counterparty risks posed by comparable non-hedging positions).

Commenters who addressed the proposed leverage ratio raised diverse points of view in support of the 8 to 1 and 15 to 1 alternatives, or other standards. A number of those commenters, however, appeared to focus on the outcome of particular leverage ratios—*i.e.,* that a lower leverage ratio likely would lead to more major participants, and that a higher leverage ratio likely would lead to fewer major participants—and to base their conclusions on their views of that outcome. In general, the comments did not reflect an attempt to identify typical leverage ratios for financial entities, or to address the link between leverage and risk.

Some commenters specifically supported the use of a 15 to 1 leverage ratio in light of Title I's use of that ratio.[1100] While considering this perspective, we believe it also is appropriate to consider the different purposes for which leverage is addressed in the Title I and major participant contexts. The 15 to 1 leverage provision in Title I reflects a maximum allowable threshold of leverage for certain bank holding companies and nonbank financial companies when a determination has been made that such entities pose a ''grave threat to the financial stability of the United States'' and that the imposition of this limitation is necessary to mitigate the risks posed by such entities—in essence serving as a hard leverage cap for certain entities that have been deemed risky to the U.S. financial system.[1101] In contrast, leverage serves a type of gatekeeper function in the major participant definitions by identifying the amount of leverage that will require a non-bank financial entity to engage in the ''substantial position'' analysis without excluding hedging positions, rather than seeking to limit the maximum leverage available to those entities. Just as concepts of ''maximum leverage'' are distinct from concepts of ''high leverage,'' the use of a 15 to 1 maximum leverage ratio in Title I does not mandate the conclusion that the same 15 to 1 ratio must be used for interpreting the meaning of ''highly leveraged'' in the major participant definitions.[1102]

In considering the definition of the term ''highly leveraged'' based on the reasoning outlined above, we also are mindful that, as the Proposing Release noted,[1103] broker-dealer capital regulations include special provisions that apply when a broker-dealer's leverage exceeds 12 to 1.[1104] While we recognize that these capital regulations have limitations as tools for defining ''highly leveraged'' for purposes of the major participant definitions due to differences in how leverage would be calculated,[1105] we also believe that these regulations are informative regarding the use of leverage in the major participant context given that they highlight an existing link between increased regulatory oversight and the amount of leverage an entity maintains.

In light of the reasons noted above for using a leverage ratio below 15 to 1, commenter concerns that a ratio of 8 to 1 would be too low, one commenter's suggestion of a 12 to 1 leverage ratio, and leverage tests found in broker-dealer capital regulations, the Commissions have determined that a 12 to 1 leverage ratio reflects an appropriate basis for identifying ''highly leveraged'' financial entities. In making this determination we recognize that other approaches also may be reasonable (*e.g.,* lower thresholds based on the analysis of the leverage of certain financial entities also may be reasonable, as may higher thresholds based on Title I and on other aspects of broker-dealer capital rules). We also recognize, however, that the need to implement the major participant definitions requires that we draw a line. In our view, a 12 to 1 ratio reflects a

[1097] Similarly, the Commissions in general are not adopting categorical requests for exclusions from the major participant definitions. *See* part IV.J, *infra.*

[1098] *See* CFTC Regulation § 1.3(mmm)(2); Exchange Act rule 3a67–7(a). The final rules defining ''highly leveraged'' have been renumbered from the proposal for the sake of clarity.

[1099] *See* note 1082, *supra,* and accompanying text.

[1100] *See, e.g.,* letters from Amex and CDEU.

[1101] *See* Dodd-Frank Act section 165(j)(1).

[1102] We also note that the use of the 15 to 1 ratio of Title I in this context could lead to potentially incongruous results. In particular, if the Commissions were to use the 15 to 1 leverage ratio for the ''highly leveraged'' definition, then an entity that is deemed to be such a threat to the United States financial system that its leverage has been capped pursuant to Title I also would effectively be excepted from the third statutory test of the major participant definitions due to that cap. The 12 to 1 leverage ratio that we are adopting today does not give rise to the same result and therefore does not present the same question of interpretation as to whether this result would be appropriate.

[1103] *See* Proposing Release, 75 FR at 80199 n.152.

[1104] Exchange Act rule 15c3–1 provides that a broker-dealer may determine its required minimum net capital, among other ways, by applying a financial ratio that provides that its aggregate indebtedness shall not exceed 1500 percent of its net capital (*i.e.,* a 15 to 1 aggregate indebtedness to net capital ratio). In addition, Exchange Act rule 17a–11 further requires that broker-dealers that use such method to establish their required minimum net capital must provide notice to regulators if their aggregate indebtedness exceeds 1200 percent of their net capital (*i.e.,* a 12 to 1 aggregate indebtedness to net capital ratio).

[1105] The measure of aggregate indebtedness in rule 15c3–1 excludes certain secured liabilities, and the measure of net capital excludes certain illiquid assets but includes certain subordinated debt. As a result, the ratios discussed above would not necessarily be equivalent to 15:1 or 12:1 ratios when converted to a balance sheet ratio of liabilities to equity.

reasonable location for this line that is appropriate for purposes of the third major participant test, and that reasonably accounts for commenter concerns and the other considerations discussed above.

ii. Leverage Ratio Calculation

Consistent with the proposal, the final rules defining ''highly leveraged'' generally measure leverage as a ratio of a person's liabilities to equity, as determined in accordance with GAAP.[1106] Also, consistent with the proposal, these leverage ratios should be calculated as of the close of business on the last business day of the applicable fiscal quarter, as we do not believe there is any relevant difference among financial entities that would require timing variations.

In general, moreover, the Commissions believe that all types of financial entities should be subject to the same methods of measuring leverage, to facilitate the even application of the leverage test. At the same time, we are mindful of the significance of commenter concerns that calculating leverage as a ratio of liabilities to equity consistent with GAAP would lead to inappropriate results for certain types of financial instruments or financial entities.

We believe that these concerns are significant enough to warrant one modification of the proposed approach to measuring leverage. In particular, the final rules provide that certain employee benefit plans may: (i) Exclude obligations to pay benefits to plan participants from their measure of liabilities for purposes of the leverage calculation; and (ii) substitute the total value of plan assets for equity for purposes of the leverage calculation.[1107] We believe that this change will allow the measure of leverage to more appropriately reflect the risk that those entities pose.

Otherwise, we do not believe that it would be appropriate to depart from GAAP measures of equity and liabilities for purposes of identifying highly leveraged entities.[1108]

G. Application to Inter-Affiliate Swaps and Security-Based Swaps

1. Proposed Approach and Commenters' Views

In the Proposing Release, we stated that the major participant analysis should consider the economic reality of swaps and security-based swaps between affiliates, and preliminarily concluded that swaps or security-based swaps among wholly owned affiliates ''may not pose the exceptional risks to the U.S. financial system that are the basis for the major participant definitions.''[1109]

A number of commenters concurred that swaps among affiliates should be excluded from the major participant analysis.[1110] At the same time, no commenters expressed support for the Proposing Release's suggestion that this interpretation be limited to transactions among wholly owned subsidiaries. Instead, several commenters expressed the view that the swaps or security-based swaps should not be counted for purposes of the major participant analysis when the counterparties are under common control,[1111] or otherwise are affiliates.[1112] One commenter suggested that the analysis exclude swaps or security-based swaps between entities that are under common control and whose financial statements are consolidated.[1113]

2. Final Rule

After considering commenters' views, we have concluded that the major participant definitions should not encompass a person's swaps or security-based swaps for which the counterparty is a majority-owned affiliate. As noted in our discussion of inter-affiliate activities in the context of the dealer definitions, market participants may enter into such inter-affiliate swaps or security-based swaps for a variety of purposes. When swaps and security-based swaps are entered into to allocate risk within a corporate group and do not pose a high likelihood of risk to the broader market—as we believe would be the case with majority ownership—we do not believe that their swaps and security-based swaps raise the systemic risk and other concerns that major participant regulation is intended to address. For this reason, we do not believe that this interpretation needs to be limited to swaps or security-based swaps among wholly owned affiliates, as the Proposing Release had indicated.

Accordingly, the final rules provide that a person may exclude particular swaps or security-based swaps from the analysis of whether the person is a major participant, so long as the counterparties to those swaps or security-based swaps are majority-owned affiliates.[1114]

In taking this approach, we have also considered alternatives suggested by commenters. For example, while one commenter suggested that we allow the exclusion of all swaps or security-based swaps between entities under common control, we believe that such an approach would be overly inclusive for the purpose of identifying transactions that should be excluded from the major participant analysis, given that common control by itself does not ensure that two entities' economic interests are sufficiently aligned.[1115] Also, one commenter suggested that the inter-affiliate exclusion should apply to swaps and security-based swaps between affiliates whose financial statements are consolidated, but, as we

[1106] *See* CFTC Regulation § 1.3(mmm)(2); Exchange Act rule 3a67–7(b). The accounting standard setters are currently working on a number of projects that may impact how leverage would be calculated using GAAP. The Commissions will review and potentially adjust their rules in the future to reflect changes in GAAP.

[1107] *See* CFTC Regulation § 1.3(mmm)(2)(ii); Exchange Act rule 3a67–7(b). These provisions specifically apply to employee benefit plans as defined by paragraph (3) and (32) of section 3 of ERISA, consistent with the ERISA exclusion from the first statutory major participant test.

[1108] Although commenters raised issues with regard to the application of leverage ratios to insurers, *see, e.g.,* letter from FSR I, we do not believe that it would be appropriate to create a special leverage test for insurers. We note that insurers that are publicly traded companies already file financial statements consistent with GAAP. Also, smaller insurers that do not file GAAP-based financial statements would be able to take advantage of the safe harbor from the major participant calculations. *See* part IV.M, *infra.*

[1109] *See* Proposing Release, 75 FR at 80202.

[1110] *See, e.g.,* letters from COPE I, FSR I and Encana Marketing (USA) Inc. dated February 22, 2011 (''Encana I'').

Some commenters explained the widespread use of central hedging desks to allocate risk within affiliate groups or to gather risk from within a group and lay off that risk on the market. *See, e.g.,* letters from CDEU, EEI/EPSA, Encana I and FSR I. Also, some commenters noted that including these inter-affiliate transactions within the major participant analysis would result in many cases in double-counting of an entity's swap or security-based swap activity. *See* letters from CDEU and FSR I.

[1111] *See* letter from Amex and CDEU. One commenter specifically suggested that we adopt the definition of ''control'' found in the Bank Holding Company Act. *See* joint letter from The Bank of Tokyo-Mitsubishi UFJ, Ltd., Mizuho Corporate Bank, Ltd. and Sumitomo Mitsui Banking Corporation.

[1112] *See, e.g.,* letters from COPE I, EEI/EPSA, FSR I, Encana I and Utility Group.

[1113] *See* joint letter from ABA Securities Association, ACLI, FSR, FIA, Institute of International Bankers, ISDA and SIFMA.

[1114] *See* CFTC Regulation § 1.3(hhh)(4); Exchange Act rule 3a67–3(e). A person's market-facing swap or security-based swap positions, including those taken to lay off risk assumed from a majority-owned affiliate, must still be included in the person's substantial position and counterparty exposure calculations.

For the purposes of this rule, and consistent with the general inter-affiliate exception from the dealer definitions, *see* part II.C, *supra,* counterparties are majority-owned affiliates if one party directly or indirectly owns a majority interest in the other, or if a third party directly or indirectly owns a majority interest in both, based on the right to vote or direct the vote of a majority of a class of voting securities of an entity, the power to sell or direct the sale of a majority of a class of voting securities of an entity, or the right to receive upon dissolution or the contribution of a majority of the capital of a partnership.

[1115] *See* part II.C.2, *supra.*

addressed in the context of the dealer definitions, we do not believe that the scope of this exclusion should be exposed to the risk of future changes in accounting standards.[1116]

H. Application to Positions of Affiliated Entities and to Guarantees

1. Proposed Approach

The Proposing Release expressed the preliminary view that when a parent is the majority owner of a subsidiary entity, the subsidiary's swap or security-based swap positions may be aggregated at the parent for purposes of the major participant analysis, on the grounds that the parent effectively is the beneficiary of the transaction. At the same time, the Proposing Release acknowledged that there could remain questions as to whether the requirements applicable to major participants—such as capital, margin and business conduct requirements—should be placed upon the parent or the subsidiary.[1117]

The Proposing Release solicited comment on a number of aspects of these issues, including whether attribution would be appropriate when there is less than majority ownership, or when a parent provides guarantees on behalf of its subsidiaries. The Proposing Release also solicited comment with regard to implementation issues.[1118]

2. Commenters' Views

A number of commenters expressed the view that the Commissions should not aggregate the positions of affiliates to the parent, arguing that legal separation should be respected unless there is some evidence that separate affiliates are being used to evade regulation.[1119] Other commenters took the view that aggregation of affiliates' positions may be appropriate in some circumstances, such as when aggregation would accurately reflect the structure of a corporate group or its participation in the derivatives market.[1120] One commenter recommended that if the Commissions choose to require the aggregation of affiliate positions for purposes of the major participant test, the Commissions also should provide a mechanism for entities to receive ''disaggregation'' relief upon a showing that the affiliates are acting autonomously.[1121]

Some commenters argued that positions should not be consolidated for purposes of the major participant analysis even when a parent guarantees the obligations of a subsidiary.[1122] Other commenters, however, expressed less opposition to aggregation in the presence of a guarantee or credit support.[1123]

Commenters also addressed the application of these principles to particular types of entities. Some commenters took the view that positions guaranteed by financial guarantors should not be attributed to those entities for purposes of the major participant analysis.[1124] Other commenters stated that the positions of a special purpose vehicle should not be aggregated with its sponsor where there is no recourse to the sponsor for the vehicle's obligations.[1125] One commenter requested clarification that positions of joint ventures would not be aggregated with those of another entity if the positions are not consolidated on the other entity's balance sheet.[1126] Commenters further took the view that ERISA plans should not be aggregated with those of plan sponsors for purposes of the major participant tests, noting that plans and sponsors are separate legal entities, file separate financial statements, are subject to separate regulatory schemes, and that plan sponsors are prohibited from providing credit support or guarantees to ERISA Title I plans.[1127]

Two commenters addressed operational compliance issues that would be raised if positions are aggregated for purposes of the major participant analysis. One commenter suggested that a corporate group that falls within the major participant definition due to its aggregate positions should be able to designate a single entity to undertake compliance on behalf of the other affiliates.[1128] Another commenter stated that when the aggregated positions of a corporate group results in major participant designation, the Commissions should

[1116] *See* text accompanying note 350, *supra.*

[1117] The Proposing Release further recognized that it may be appropriate at times to place the requirements upon the subsidiary to the extent the subsidiary is acting on behalf of the parent. *See* Proposing Release, 75 FR at 80202.

[1118] *See id.*

[1119] *See* letters from FSR I, ISDA, MetLife and Newedge. Certain of those commenters also warned of problems that could arise if the positions of international affiliates were aggregated, due to conflicting regulations potentially applicable to such entities. *See* letters from ISDA I, MetLife and Newedge. The Commissions are addressing issues related to the application of the major participant definitions to non-U.S. persons in separate releases.

[1120] *See* letters from CDEU (suggesting that control should be interpreted narrowly for purposes of the major participant test such that affiliated positions would only be aggregated if there is whole ownership or consolidation for accounting purposes, and exercise of actual control in terms of ownership and management) and ACLI (suggesting flexibility such that an entity with independent credit and no guarantee or credit support from a parent could be treated separately, but a corporate group could consolidate its affiliates' positions if that would accurately reflect its participation in the derivatives market).

[1121] *See* letter from Newedge.

[1122] *See* letters from APG (stating that the aggregation of inter-affiliate guaranteed transactions would raise costs without providing a corresponding benefit to the financial system, and that principal obligors and guarantors pose separate credit risks, which are already priced into the positions, and that guarantees are not traditionally regulated as swaps), CDEU (objecting to attributing the positions of an end-user affiliate that relies on a parent for credit support, primarily out of concern that an end-user that might otherwise avail itself of the end-user clearing exception might be forced to clear its transactions if they were attributed to the major participant parent), ISDA I and Twelve Firms (stating that the statutory major participant definitions do not indicate that they encompass contingent credit support arrangements, and that credit exposures of subsidiaries already will be addressed through regulation of the subsidiary).

[1123] *See* letters from FSR I (suggesting that there may be some situations in which the positions of different entities in a corporate group should be aggregated, such as when ''a parent entity guarantees the obligations of its subsidiaries that are engaging in swaps'') and MetLife (stating that ''it is not appropriate to require aggregation of subsidiaries' swaps at the parent level unless the parent is providing a guarantee or credit support for the subsidiaries' obligations''); *see also* letter from ACLI (stating that the positions of entities that do not have a guarantee or credit support from a parent are entitled to an individualized determination of their status under the major participant test).

[1124] *See* letters from AFGI (arguing against attribution on the grounds that the guarantors are typically not exposed to a fluctuating termination value of interest rate swaps for these types of transactions due to the fact that they do not guarantee that amount, but rather only guarantee continued payments of these policies, and also that they are subject to the standard underwriting process and thus are subject to comprehensive regulation) and joint letter from MBIA Inc., MBIA Insurance Corp. and National Public Finance Guarantee Corp. (''MBIA'') (arguing against attribution on the grounds that the economic exposure to the financial guarantor is the equivalent of having underwritten a fixed rate bond issued by the particular municipal entity, and such exposures are subject to the normal underwriting process and significant risk management and regulatory oversight).

[1125] *See* letters from American Securitization Forum (suggesting that aggregation is not appropriate when the risk is contained within the special purpose vehicle, and noting that special purpose vehicles often bear the entire economic risk of a security-based swap transaction and are bankruptcy remote, so the failure of a special purpose vehicle to meet its obligations would not have a rippling effect onto its sponsor) and FSR I (stating that the major participant determination should focus on a special purpose entity itself, and not its sponsor or transferor, in circumstances where securitization vehicles have been consolidated with sponsors or transferors for financial accounting purposes but a counterparty would have to conduct a separate credit analysis on the special purpose entity, and its obligations are nonrecourse to the sponsor or transferor).

[1126] *See* letter from CDEU (noting that non-consolidated joint ventures typically enter into their own swaps and these transactions are not included on the balance sheet of a minority holder in a joint venture).

[1127] *See* letters from CDEU and ERISA Industry Committee.

[1128] *See* letter from FSR I (suggesting that a corporate group should be permitted to designate a single entity or a small number of entities as the registered major participant, with other entities in the group relying on that entity for compliance).

exempt from major participant regulation all affiliates in the corporate group that otherwise would qualify for the end-user clearing exception.[1129]

3. Final Interpretation

After considering commenter concerns and the underlying issues, we are revising certain of the preliminary views we expressed in the Proposing Release. In particular, we no longer take the position that a subsidiary's swap or security-based swap position as a matter of course should be attributed to the subsidiary's majority-owner parent. Instead, consistent with the approach discussed below with regard to managed accounts,[1130] an entity's swap or security-based swap positions in general would be attributed to a parent, other affiliate or guarantor for purposes of the major participant analysis to the extent that the counterparties to those positions would have recourse to that other entity in connection with the position. Positions would not be attributed in the absence of recourse.[1131] We believe this approach in general appropriately reflects the risk focus of the major participant definitions by providing that entities will be regulated as major participants when they pose a high level of risk in connection with the swap and security-based swap positions they guarantee.[1132] Indeed, the events surrounding the failure of AIG FP highlights how the guarantees can cause major risks to flow to the guarantor.[1133]

Even in the presence of a guarantee, however, we do not believe that it is necessary to attribute a person's swap or security-based swap positions to a parent or other guarantor if the person already is subject to capital regulation by the CFTC or SEC (*i.e.,* swap dealers, security-based swap dealers, major swap participants, major security-based swap participants, FCMs and broker-dealers) or if the person is a U.S. entity regulated as a bank in the United States. Positions of those regulated entities already will be subject to capital and other requirements, making it unnecessary to separately address, via major participant regulations, the risks associated with guarantees of those positions.[1134]

We recognize that attribution of swap or security-based swap positions to a parent or guarantor for purposes of the major participant analysis can raise special issues with regard to operational compliance. These include, for example, issues as to the application of the transaction-focused requirements applicable to registered major participants (*e.g.,* certain requirements related to trading records and transaction confirmations), given that the entity that directly is the party to the swap or security-based swap may be better positioned to comply with those requirements. For those transaction-focused requirements, we believe that an entity that becomes a major participant by virtue of swaps or security-based swaps directly entered into by others must be responsible for compliance with all applicable major participant requirements with respect to those swaps or security-based swaps (and must be liable for failures to comply), but may delegate operational compliance with transaction-focused requirements to entities that directly are party to the transactions. The entity that is the major participant, however, cannot delegate compliance duties with the entity-level requirements applicable to major participants (*e.g.,* requirements related to registration and capital).[1135]

I. Application to Managed Accounts

1. Proposed Approach

The Proposing Release expressed the preliminary view that the major participant definitions should not be interpreted to cause asset managers or investment advisers to be major participants by virtue of the swap and security-based swap positions of the accounts that they manage.[1136] In addition, the Proposing Release expressed the preliminary view that the managed positions for which a person is a beneficial owner should be aggregated with the person's other positions for the purpose of determining whether the beneficial owner is a major participant.[1137]

2. Commenters' Views

Numerous commenters supported the view that the major participant definitions should not be construed to aggregate the accounts managed by asset managers or investment advisers when determining whether a manager or adviser itself is a major participant.[1138] One commenter requested that the final rules codify this principle.[1139]

Some commenters opposed the possibility that the swap or security-based swap positions of mutual funds would be attributed to fund investors for purposes of the major participant analysis, emphasizing that the fund is the entity that bears the credit exposure.[1140] Some commenters also opposed the possibility that a swap or security-based swap position of a managed account may be attributed to the account's beneficial owner when the counterparty to the position does not

[1129] *See* letter from CDEU.

[1130] *See* part IV.I, *infra.*

[1131] In taking this position, we are not suggesting that the presence of a guarantee would be determinative of other issues arising under Title VII. For example, the fact that a parent that is a ''financial entity'' guarantees a subsidiary's swap or security-based swap positions would not foreclose the subsidiary from taking advantage of the exception from mandatory clearing that is available to commercial end-users.

[1132] In reaching this conclusion, we have been mindful of views expressed by some commenters that the mere fact of a guarantee should not be enough to require the attribution of a position to a guarantor. We believe, however, that this approach is best suited to address the risk focus of the major participant definitions. We further believe that the statutory definition's language that addresses persons who ''maintain'' substantial positions or ''whose'' positions create substantial counterparty exposure is consistent with this approach.

We also have considered arguments that the major participant definition should not extend to financial guarantee insurers. We nonetheless believe that when an insurer guarantees the performance of other parties' swap or security-based swap positions, in an amount that is greater than the applicable major participant thresholds, it would be appropriate to regulate that entity as a major participant. When the guaranteed positions are large enough, the risks associated with those positions and the repercussions of the guarantor's default would appear to be within the ambit of the risks that that the major participant definitions were intended to capture. In reaching this conclusion, the Commissions are not expressing a view regarding whether financial guarantee insurance is a swap or security-based swap. *See* Product Definitions Proposal, note 3, *supra.*

[1133] ''AIGFP's obligations were guaranteed by its highly-rated parent company * * * an arrangement that facilitated easy money via much lower interest rates from the public markets, but ultimately made it difficult to isolate AIGFP from its parent, with disastrous consequences.'' *The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy,* note 913, *supra,* at 20.

[1134] As a result of this interpretation, holding companies will not be deemed to be major participants as a result of guarantees to certain U.S. entities that already are subject to capital regulation. The Commissions intend to address guarantees provided to non-U.S. entities, and guarantees by non-U.S. holding companies, in separate releases.

[1135] This type of attribution may also be expected to raise special issues of application in the context of guarantees involving swap or security-based swap positions of non-U.S. entities. The Commissions intend to address those issues in separate releases.

[1136] In reaching this preliminary conclusion, we considered the text of the major participant definitions, as well as a colloquy on the Senate floor that addressed the status of managed accounts for purposes of the major participant definitions. *See* Proposing Release, 75 FR at 80201 & n.162.

The Proposing Release also noted that the Commissions have anti-evasion authority to the extent that persons seek to allocate swaps or security-based swaps among different accounts to seek to evade the regulations applicable to major participants. *See id.* at 80201.

[1137] *See id.*

[1138] *See, e.g.,* letters from BlackRock I and Fidelity.

[1139] *See* letter from Fidelity (particularly addressing fund managers).

[1140] *See* letter from BlackRock and joint letter from ICI and SIFMA AMG.

have recourse to the beneficial owner's assets.[1141]

One commenter encouraged the Commissions to consider developing anti-evasion measures if necessary, but cautioned that the rules should recognize that there are legitimate business reasons to structure separate, individually managed funds.[1142] Another commenter dismissed concerns that entities may spread assets among many asset managers or use separate trading agreements to avoid regulation.[1143]

In addition, commenters raised related issues regarding the potential attribution of positions for purposes of the major participant analysis. Some commenters expressed the view that insurance company separate accounts should be excluded from the major participant determination for the insurer, because those separate accounts generally are segregated from the insurance company's other accounts.[1144] Two commenters requested clarification as to how swap and security-based swap positions of funds with a ''master-feeder'' structure should be allocated for the major participant determinations.[1145]

3. Final Interpretation

Consistent with the approach set forth in the Proposing Release, the Commissions do not believe that it is necessary to consider the swap or security-based swap positions of the client accounts managed by asset managers or investment advisers when determining whether those entities are major participants. In reaching this conclusion we particularly are influenced by the fact that the statutory definitions specifically address entities that ''maintain'' substantial positions or ''whose'' outstanding swaps and security-based swaps create substantial counterparty exposure. Our conclusion also is influenced by the fact that it would not appear appropriate to impose certain regulations applicable to major participants (*e.g.,* capital) upon those entities.[1146]

Separately, after carefully considering commenters' views and the purposes of major participant regulation, we are modifying the preliminary views expressed in the Proposing Release regarding the application of the major participant analyses to the beneficial owners of managed swap and security-based swap positions. In particular, we conclude that the major participant analysis that applies to the beneficial owners of those positions should focus on where the risk associated with those positions ultimately resides, given how the statutory major participant definitions focus on the risks posed by large swap or security-based swap positions. Thus, for example, if the counterparties to a swap or security-based swap position within a managed account have recourse only to the assets of that account in the event of default—and lack recourse to other assets of the beneficial owners—we do not believe that it would be appropriate to attribute that position to its beneficial owner. [1147] Conversely, to the extent that the counterparty to that position also has recourse to the beneficial owner, it would be appropriate to attribute the positions to the beneficial owner for purposes of the major participant analysis.[1148]

We believe that this general approach of attributing positions when recourse is possible also is applicable with respect to related issues raised by commenters, including issues related to insurance company separate accounts and master-feeder fund arrangements. For those situations the same principle would apply—positions within an account or entity may be attributed to another entity for purposes of the major participant analysis if the counterparties to those positions can seek recourse from that other entity.

J. Requests for Exclusion of Certain Entities From the Major Participant Definitions

1. Proposed Approach

In advance of the Proposing Release, a number of commenters argued that the Commissions should exclude various types of entities from the major participant definitions.[1149] While the proposed rules did not incorporate any such exclusions, the Proposing Release solicited comment as to potential exclusions for: Entities that maintain legacy portfolios, investment companies, ERISA plans, registered broker-dealers and/or registered FCMs, sovereign wealth funds, banks, state-regulated insurers, private and state pension plans, and registered DCOs or clearing agencies.[1150]

2. Commenters' Views

Several commenters supported categorical exclusions from the major participant definitions for various types of entities. Commenters particularly urged the Commissions to provide exclusions for:

- Entities that maintain legacy portfolios of swaps and security-based swaps that are in run-off;[1151]
- Registered investment companies and related investment advisers;[1152]
- ERISA plans, other pension funds, and endowments;[1153]

[1141] *See* letters from SIFMA AMG II (stating that ISDA Master Agreements commonly provide that the counterparty to the transaction does not have recourse to the accountholder's other assets held in different accounts) and Fidelity (stating that when counterparties look solely to the credit and assets of an individual account, the actual risks to the counterparty are tied to and limited by the activities of the account; also stating that requiring aggregation of separate accounts based on beneficial ownership would be complicated, costly, and present substantial operational and legal complexities); *see also* letter from BlackRock I (stating the understanding that the Proposing Release's reference to beneficial ownership to require that separate account positions be attributed to the owner of the separate account, and stating that this result would be consistent with the definitions' focus on the persons whose positions create credit risk).

Commenters also emphasized potential impracticalities of requiring asset managers to be responsible for making major participant determinations on behalf of beneficial owners. *See, e.g.,* letter from SIFMA AMG II.

[1142] *See* letter from AIMA I.

[1143] *See* letter from SIFMA AMG II (arguing that it would be unlikely for this sort of evasion to actually occur since such tactics would be prohibitively expensive and operationally burdensome, and further stating that the Commissions could address such concerns through their anti-evasion authority).

Also, one commenter suggested that major participant obligations should be limited in their territorial scope and should only apply to U.S. funds or those funds that are otherwise regulated in the U.S. *See* letter from AIMA I. The Commissions are addressing issues related to the application of the major participant definitions to non-U.S. persons in separate releases.

[1144] *See* letters from ACLI, FSR I and MetLife.

[1145] *See* letters from MFA I (stating that in master-feeder fund structures, money that is invested flows to the master fund for actual investing or trading, and further explaining that the master fund: Is the party to the master trading agreements; negotiates the individual transactions; holds assets; receives the margin calls; is ultimately responsible for posting collateral; and is the entity to whom recourse is generally limited) and CCMR I.

[1146] We do not believe that it is necessary to codify this interpretation.

[1147] Thus, for example, there would not be recourse to the owners of shares in a registered investment company that maintains swap or security-based swap positions.

[1148] For example, under some circumstances the positions within the managed account may make use of a credit support annex entered into by the beneficial owner. In that case, the counterparty to the account's swaps and security-based swaps may have legal recourse to the beneficial owner, making it appropriate to attribute the position to the beneficial owner for purposes of the major participant analysis.

[1149] These comments were submitted in response to the ANPRM. *See* notes 4 and 5, *supra.*

[1150] *See* Proposing Release, 75 FR at 80202–03.

[1151] *See, e.g.,* letters from Canadian MAVs, ISDA I and MBIA.

[1152] *See* letters from Fidelity and Vanguard and joint letter from ICI and SIFMA AMG.

[1153] *See* letters from CDEU, ERISA Industry Committee and SIFMA AMG II (addressing ERISA plans); *see also* letters from ABC/CIEBA, CalSTRS I, Fidelity and SIFMA AMG II, (addressing government plans) and letter from Government of Singapore Investment Corp. (''GIC'') (addressing other pension plans and endowments). *But see* letter from AFSCME (urging caution with respect to

- Insurance companies;[1154]
- Certain registered FCMs and broker-dealers.[1155]
- End users; [1156] and
- Various types of non-U.S. persons, including: foreign governments and their agencies and instrumentalities (such as central banks, treasury ministries, export agencies and governmental financing authorities),[1157] international organizations and multilateral development banks,[1158] sovereign wealth funds,[1159] and non-U.S. entities subject to comparable foreign regulation.[1160]

Commenters articulated a range of rationales in support of such exclusions. These included arguments that particular types of entities: (i) Are unlikely to meet one or more of the major participant tests; [1161] (ii) already are subject to regulation (and in some cases are subject to prudential limits on their use of swaps or security-based swaps);[1162] (iii) do not pose systemic risk [1163] and/or the type of counterparty risk contemplated by Title VII; [1164] or (iv) do not raise concerns given that they would remain subject to the clearing, exchange trading, and reporting requirements of Title VII.[1165] Also, some commenters maintained that regulating non-U.S. entities as major participants would raise issues with respect to extra-territoriality, international comity and sovereignty.[1166]

In contrast to these requests, one commenter urged that the benefits arising from regulation of major participants be considered in determining whether to create carve-outs from the participant definitions that are not provided in the statute.[1167]

3. Final Rules

After considering the comments received and the underlying issues, the Commissions have determined not to provide categorical exclusions from the major participant definitions for the types of entities discussed by commenters.

a. Entities That Maintain Legacy Portfolios

Commenters that supported the exclusion of entities with legacy portfolios of swaps or security-based swaps emphasized that those portfolios are in run-off, and that those entities generally do not engage in ongoing swap or security-based swap activity.[1168] Several of those commenters further expressed concerns that imposing the regulations applicable to major participants—particularly margin and capital rules—upon these entities could cause them to default on their obligations and lead to market disruption.[1169]

In the view of the Commissions, the fact that these entities no longer engage in new swap or security-based swap transactions does not overcome the fact that entities that are major participants will have portfolios that are quite large and could pose systemic risk to the U.S. financial system.

We are mindful of the significance of concerns that regulating entities that maintain legacy portfolios has the potential to lead to defaults and disruption. We do not believe, however, that these concerns are best addressed by excluding those entities from major participant regulation. Instead, in adopting substantive rules applicable to major participants, the Commissions intend to pay particular attention to the special issues raised by the application of those rules to legacy portfolios.[1170] Moreover, to the extent that these types of concerns remain following the promulgation of those final substantive rules, the Commissions may entertain requests for relief or guidance on a case-by-case basis.

b. Other Domestic Entities

Commenters also raised concerns regarding duplicative regulation for entities that already are subject to other types of regulation (*e.g.,* state-regulated insurers, SEC-regulated registered investment companies and broker-dealers, and CFTC-regulated registered FCMs). The final rules nonetheless provide no such exclusion. The Dodd-Frank Act provided for the regulation of major participants against the backdrop of existing state and federal regulation, without opting to categorically exclude particular types of entities. Indeed, the definitions explicitly anticipate that

a full exclusion of plan swaps from major participant consideration).

[1154] *See* letters from AFGI (supporting exclusion for state-regulated insurers), NAIC (supporting exclusion for state-regulated insurers to the extent they are using derivatives for the purpose of hedging and not engaging in systemically significant derivatives activities determined by the Financial Stability Oversight Counsel), ACLI (supporting exclusion for life insurers) and AIA (supporting exclusion for property-casualty insurers).

[1155] *See* letter from Newedge (supporting exclusion for registered FCMs and broker-dealers that engage principally in customer swap facilitation activities but not in other activities of swap or security-based swap dealers).

[1156] Commenters making this point varied in their phrasing of the requested exclusion. One request asked for the exclusion of any company (regardless of its primary business) that uses swaps predominantly to hedge business risks and that does not pose systemic risk. *See* letter from CDEU. Another commenter asked for the exclusion of any end user employing prudent risk management. *See* letter from NAIC. And one commenter asked for the exclusion of energy companies that use swaps to hedge commercial risks. *See* letter from EDF Trading.

[1157] *See* letters from Milbank Tweed and Norges Bank Investment Management and meeting with Kreditanstalt für Wiederaufbau (''KfW'').

[1158] *See* letter from World Bank Group.

[1159] *See* letters from China Investment Corporation (''CIC'') and GIC.

[1160] *See* letters from Newedge and SIFMA AMG II.

[1161] *See* letters from AIMA I (addressing hedge fund managers registered as investment advisers); AIA (addressing property-casualty insurers) and Newedge (addressing FCMs and broker-dealers).

[1162] *See* letters from Fidelity and Vanguard and joint letter from ICI and SIFMA AMG (addressing registered investment companies and their advisors), ABC/CIEBA, CDEU, ERISA Industry Committee and Fidelity (addressing ERISA plans and government benefit plans), ACLI (addressing life insurers), AIA (addressing property-casualty insurers), NAIC (addressing state-regulated insurers), Newedge (addressing FCMs and broker-dealers) and GIC (addressing sovereign wealth funds).

[1163] *See* letters from ABC/CIEBA and CDEU (addressing ERISA plans), ICI I and Vanguard (addressing registered investment companies), ACLI (addressing life insurers), CDEU and NAIC (addressing end users), and letter from CIC and meeting with Weil (addressing sovereign wealth funds).

[1164] *See* letters from CDEU and ERISA Industry Committee (addressing ERISA plans) and letter from GIC and meeting with Weil (addressing sovereign wealth funds).

[1165] *See* letters from Vanguard (addressing registered investment companies), Newedge (addressing FCMs and broker-dealers), and CIC (addressing sovereign wealth funds).

[1166] *See* letters from CIC, GIC, and Milbank Tweed and meeting with KfW (addressing foreign governments and their agencies and instrumentalities), meeting with Weil (addressing sovereign wealth funds)and letter from World Bank Group (addressing international organizations and multilateral development banks).

[1167] *See* letter from AFSCME.

[1168] *See* letters from AFGI, BlackRock I, Canadian MAVs, ISDA I and MBIA and meetings with Athilon Structured Investment Advisors (''Athilon'') on April 18, 2011 and with Cypress Group, Invicta Financial Group, Primus Asset Management, Inc., and Quadrant Structured Investment Advisors on April 7, 2011.

Although the Proposing Release specifically addressed granting an exclusion in connection with legacy positions entered into by monoline insurers and credit derivative product companies, commenters expressed the view that such an exclusion should apply to other types of entities that maintain legacy portfolios, such as certain special purpose vehicles. *See* letters from BlackRock I, Canadian MAVs and ISDA.

[1169] *See* letters from Athilon, BlackRock I, Canadian MAVs, and ISDA I.

[1170] For example, in conjunction with the SEC's proposed margin and capital rules applicable to major participants, the SEC expects to request comment on how the rules should apply to entities with legacy portfolios.

pension plans [1171] and banks [1172]—both of which are subject to existing regulation—may be major participants. Major participant regulation provides a regulatory structure prescribed by the Dodd-Frank Act to address the risks posed by entities whose swap or security-based swap positions are large enough to satisfy the major participant definitions. Other types of regulations to which these entities may be subject serve different objectives [1173] that are not substitutes for major participant regulation.[1174]

The Commissions expect that only a very few entities within a given category may meet the test of being a major swap participant—or even be close to the various thresholds for meeting that test. Entities that do not meet the thresholds of the major participant definitions do not need an exclusion from those definitions. Further, as noted elsewhere in this Adopting Release, the Commissions are permitting entities to rely on a ''safe harbor'' when their positions are far below any threshold for any particular quarter. Some of the entities for which exclusion has been sought may be expected to fall within the safe harbor. Those comparatively fewer entities that will be closer to a particular threshold, by contrast, should not be excused on a *per se* basis from completing the calculations set forth in these rules and, if the calculations demonstrate that the entity meets the test of a major participant, from compliance with the requirements for major participants set forth by Congress.

At the same time, the Commissions recognize the benefits of efficiently regulating major participants that are separately registered with and regulated by the CFTC or SEC (such as registered FCMs or broker-dealers).[1175] If any such registrants are required also to register as major participants, the CFTC and SEC would seek to coordinate their regulatory oversight as appropriate to achieve the independent purposes of major participant regulation and those separate regulatory requirements, while avoiding unnecessary duplication.[1176]

c. Foreign Entities

Commenters [1177] discussed the major participant definitions in the context of foreign governments and various entities related to foreign governments [1178] (*i.e.,* foreign central banks,[1179] international financial institutions [1180] and sovereign wealth funds). The CFTC provides the following guidance with respect to the major swap participant definition and the swap dealer definition.[1181]

As an initial matter, foreign entities are not necessarily immune from U.S. jurisdiction for commercial activities undertaken with U.S. counterparties or in U.S. markets.[1182] In accordance with

[1171] The first major participant test (but not the second or third tests) excludes positions maintained by certain employee benefit plans for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan. *See* CEA section 1a(33)(A)(i)(II); Exchange Act section 3(a)(67)(A)(ii)(I). This tailored exclusion of certain pension plan positions suggests that Congress did not intend to broadly exclude such plans from the other two prongs or from the major participant definitions as a whole. The fact that, as two commenters noted (*see* letters from ABC/CIEFA and CDEU), the CFTC previously has relied on the regulatory structure already governing ERISA plans as a basis to not regulate these plans in other certain unrelated contexts does not alter this conclusion.

[1172] The third major participant test excludes entities that are subject to bank capital standards, which suggests that such entities may be eligible to be major participants under the first and second tests. Also, the capital and margin requirements applicable to major swap participants and major security-based swap participants (*see* Dodd-Frank Act sections 731 and 764, respectively) do not apply to major participants subject to capital rules set by bank regulators, which further indicates that such entities may be major participants.

[1173] As some commenters noted, entities excluded from the major participant definitions nonetheless may be subject to other requirements of general applicability imposed by Title VII, such as clearing, trade execution, and reporting requirements. Even where that is the case, though, these requirements serve separate and independent purposes. They do not stand as a substitute for the protections that Congress has prescribed with respect to major participants in particular.

[1174] For example, as noted above, some commenters stated that the major participant definitions should not apply to investment companies registered under the ICA. *See, e.g.,* letters from Fidelity, ICI I and Vanguard. However, we are not adopting any such exclusions in part because the major participant definitions focus on the market impacts of an entity's swap and security-based swap positions and the risk to the U.S. financial system generally, areas that are not the focus of the regulation of investment companies under the ICA. Moreover, based on our understanding of the swap and security-based swap activity of registered investment companies, we believe that registered investment companies generally are not likely to meet the thresholds of the major participant definitions. We will continue to monitor the effects of the rules we are adopting today to help ensure that they do not result in any inadvertent consequences for registered investment companies, or other entities registered with the SEC or CFTC.

[1175] The Commissions also sought comment as to whether the major participant definitions should apply to derivatives clearing organizations or clearing agencies, but received no comments in response to this inquiry. Nonetheless, the Commissions do not believe that Congress intended derivatives clearing organizations registered with the CFTC or clearing agencies registered with the SEC to be registered or regulated as major participants. The CFTC and the SEC already exercise substantive regulatory oversight over these clearinghouses, authority that was enhanced by Title VII. Further, Title VIII of the Dodd-Frank Act provides for the supervision of systemically important derivatives clearing organizations and clearing agencies. *See* Dodd-Frank Act Title VIII. We do not believe that Congress intended to place a third layer of oversight on those entities by subjecting them to additional regulation as major participants, and we do not interpret the major participant definitions to do so.

[1176] For many years, the Commissions have coordinated their examination of dually-registered FCM/BDs through working groups including the Joint Audit Committee and the Intermarket Financial Surveillance Group. Moreover, pursuant to Title IV of the Dodd-Frank Act, the CFTC and SEC have issued joint reporting rules for advisors to private funds that are dually registered with the SEC as investment advisers and with the CFTC as commodity pool operators or commodity trading advisors. *See* CFTC and SEC, Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF; Final Rule, 76 FR 71127 (Nov. 16, 2011).

[1177] *See* letters from CIC, GIC, Milbank Tweed, Norges Bank Investment Management and the World Bank, and meetings with KfW and Weil.

[1178] For this purpose, we consider that the term ''foreign government'' includes KfW, which is a non-profit, public sector entity responsible to and owned by the federal and state authorities in Germany, mandated to serve a public purpose, and backed by an explicit, full, statutory guarantee provided by the German federal government.

[1179] For this purpose, we consider the Bank for International Settlements, in which the Federal Reserve and foreign central banks are members, to be a foreign central bank. *See http://www.bis.org/about/orggov.htm.*

[1180] For this purpose, we consider the ''international financial institutions'' to be those institutions defined as such in 22 U.S.C. 262r(c)(2) and the institutions defined as ''multilateral development banks'' in the Proposal for the Regulation of the European Parliament and of the Council on OTC Derivative Transactions, Central Counterparties and Trade Repositories, Council of the European Union Final Compromise Text, Article 1(4a(a)) (March 19, 2012). There is overlap between the two definitions, but together they include the following institutions: the International Monetary Fund, International Bank for Reconstruction and Development, European Bank for Reconstruction and Development, International Development Association, International Finance Corporation, Multilateral Investment Guarantee Agency, African Development Bank, African Development Fund, Asian Development Bank, Inter-American Development Bank, Bank for Economic Cooperation and Development in the Middle East and North Africa, Inter-American Investment Corporation, Council of Europe Development Bank, Nordic Investment Bank, Caribbean Development Bank, European Investment Bank and European Investment Fund. (The term international financial institution includes entities referred to as multilateral development banks. The International Bank for Reconstruction and Development, the International Finance Corporation and the Multilateral Investment Guarantee Agency are parts of the World Bank Group.)

[1181] The SEC intends to address issues related to the application of the major security-based swap participant definition to non-U.S. entities as part of a separate release that the SEC is issuing in connection with the application of Title VII to non-U.S. persons. The SEC is also able to address concerns related to the individual substantive rules applicable to major security-based swap participants on a case-by-case basis.

[1182] *See* Foreign Sovereign Immunities Act of 1976, 28 U.S.C. 1602 (''under international law, states are not immune from the jurisdiction of foreign courts insofar as their commercial activities are concerned * * * Claims of foreign states to

the general rule, a per se exclusion for foreign entities from the CEA's major swap participant or swap dealer definition, therefore, is inappropriate. A foreign entity's swap activity may be commercial in nature and may qualify it as a swap dealer or major swap participant. Registration and regulation as a swap dealer or major swap participant under such circumstances may be warranted.[1183] This is particularly true for foreign corporate entities and sovereign wealth funds, which act in the market in the same manner as private asset managers.

On the other hand, the sovereign or international status of foreign governments, foreign central banks and international financial institutions that themselves participate in the swap markets in a commercial manner is relevant in determining whether such entities are subject to registration and regulation as a major swap participant or swap dealer. Canons of statutory construction ''assume that legislators take account of the legitimate sovereign interests of other nations when they write American laws.'' [1184] There is nothing in the text or history of the swap-related provisions of Title VII to establish that Congress intended to deviate from the traditions of the international system by including foreign governments, foreign central banks and international financial institutions within the definitions of the terms ''swap dealer'' or ''major swap participant,'' thereby requiring that they affirmatively register as swap dealers or major swap participants with the CFTC and be regulated as such.[1185] The CFTC does not believe that foreign governments, foreign central banks and international financial institutions should be required to register as swap dealers or major swap participants.

K. Financing Subsidiary Exclusion From Major Swap Participant Definition

In connection with the definition of major swap participant, CEA section 1a(33)(D) excludes certain entities from the definition of a major swap participant whose primary business is providing financing and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company (the ''captive finance company exception'').[1186] This provision of the Dodd-Frank Act is not applicable to major security-based swap participants.

1. Proposal

The Proposing Release restated the statutory captive finance company exception but did not further define or detail its scope or parameters. Accordingly, the CFTC did not propose a specific rule excluding certain financing subsidiaries from the definition of major swap participant in the Proposing Release.

2. Commenters' Views

Commenters generally believed that the captive finance company exception should be broadly construed to cover financing of products being sold by the parent company or its authorized dealers, financing of service and labor, financing of component parts and attachments, and other general financing of the distribution network.[1187] One commenter said the exception should be read narrowly, because the physical positions (in inventory, etc.) related to swaps may not be able to be liquidated to mitigate the risks of the swaps.[1188]

3. Final Rules

The CFTC believes that the exception set forth in CEA section 1a(33)(D) should be construed (consistent with the statute) to provide practical relief to those captive finance companies whose ''primary business'' is financing and who uses swaps for the purpose of hedging named underlying commercial risks related to interest rate and foreign currency exposures. As an initial matter, the Commission notes that a captive finance subsidiary or other similar entity is required to provide financing as its primary business, *i.e.,* this is not a supplementary or complementary activity of the entity.[1189]

In connection with the exception, commenters generally focused on the second part of Section 1a(33)(D) of the CEA, requesting the CFTC to interpret the phrase ''90% or more of which are manufactured by the parent company or another subsidiary of the parent company'' to include component parts, attachments, systems and other products that may be manufactured by others but sold together with the company's products as well as attachments and labor costs that are incidental to the primary purchase.[1190]

The CFTC believes that the captive finance exception must be interpreted in a manner consistent with the intention of Congress. As a result, a person that seeks to fall within the exemption must be in the ''primary business'' of providing financing of purchases from its parent company. Consistent with this initial requirement, the CFTC maintains that the captive finance exception can be applied when this financing activity finances the purchase of the products sold by the parent company in a broad sense, including service, labor, component parts and attachments that are related to the products.

immunity should henceforth be decided by courts of the United States and of the States in conformity with the principles set forth in this chapter.''). *See also Mendaro* v. *World Bank,* 717 F.2d 610 (DC Cir. 1983) (multilateral development banks generally do not have immunity in connection with their commercial dealings in the United States); *Osseiran* v. *International Financial Corp.,* 552 F.3d 836 (DC Cir. 2009) (same); *Vila* v. *Inter-American Investment Corp.,* 570 F.3d 274 (DC Cir. 2009) (same).

[1183] Such a registration requirement would have to satisfy the requirements of CEA section 2(i), 7 U.S.C. 2(i), which provides that the provisions of Title VII relating to swaps ''shall not apply to activities outside the United States unless those activities—(1) Have a direct and significant connection with activities in, or effect on, commerce of the United States; or (2) contravene such rules or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of [the CEA] that was enacted by'' Title VII of the Dodd-Frank Act.

[1184] *See F. Hoffman-LaRoche, Ltd.* v. *Empagran S.A.,* 542 U.S. 155, 164 (2004), *citing Murray* v. *Schooner Charming Betsy,* 2 Cranch 64, 118, 2 L.Ed. 208 (1804) (''[A]n act of congress ought never to be construed to violate the law of nations if any other possible construction remains''); *Hartford Fire Insurance Co.* v. *California,* 509 U.S. 764 (1993) (Scalia, J., dissenting). *See also* Restatement (Third) Foreign Relations Law § 403 (scope of a statutory grant of authority must be construed in the context of international law and comity including, as appropriate, the extent to which regulation is consistent with the traditions of the international system).

[1185] To the contrary, section 752(a) of the Dodd-Frank Act requires the CFTC to consult and coordinate with other regulators ''on the establishment of consistent international standards with respect to the regulation (including fees) of swaps [and] swap entities * * *''

[1186] 7 U.S.C. 1a(33)(D).

[1187] *See* letters from CDEU, U.S. Chamber of Commerce, Center for Capital Markets Competiveness (''Chamber'') dated December 30, 2011 (''Chamber II'') and NRU CFC I.

[1188] *See* meeting with Duffie on February 2, 2011. In addition, another commenter also suggested that the exception not be interpreted broadly due to concerns regarding potential abuse. *See* letter from CMOC.

[1189] Commenters generally did not focus on this initial requirement instead commenting on other issues relating to application of the exception.

[1190] *See* letters from CDEU and Chamber II. Another commenter suggested that it should be viewed as a captive finance subsidiary of the entities that own it in a cooperative structure. *See* letter from NRU CFC I. This commenter also discussed whether the captive finance company exception should be available when it provides financing to its member-owners to support their general business activities, rather than to finance purchases from its member-owners. The CFTC does not believe it would be appropriate to apply the captive finance company exception in this situation.

L. Implementation Standard, Re-Evaluation Period and Minimum Period of Status

1. Proposed Approach

The proposed rules provided that a person would be deemed to be a major participant upon the earlier of: (i) The date on which it submits a complete application for registration, or (ii) two months after the end of the quarter in which a person meets the definition of major participant.[1191]

The proposed rules also provided that a person that has met the criteria for designation as a major participant as a result of its swap or security-based swap activities in a fiscal quarter, but without exceeding any applicable threshold by more than 20 percent, would not immediately be subject to the timing requirements discussed above. Instead, the person would be subject to the timing requirements noted above as soon as its daily average swap or security-based swap positions over any fiscal quarter exceed any of the applicable daily average thresholds.[1192]

Finally, the proposed rules provided that a person would retain the status of a major participant if its swap positions or security-based swap positions do not fall below all of the thresholds for four consecutive quarters.[1193] At that time, such entity may de-register as a major swap participant or major security-based swap participant.

2. Commenters' Views

Some commenters took the view that the time for compliance should be more than two months.[1194] One commenter suggested that entities be given the flexibility to have an additional evaluation period if abnormal market events or price movements cause the failure of the first reevaluation.[1195] Some commenters further expressed the view that the minimum amount of time a person would have to be registered as a major participant would be two quarters, rather than four quarters.[1196]

3. Final Rules

a. Timing

Consistent with the proposal, the final rules provide that a person would be deemed to be a major participant upon the earlier of the date on which it submits a complete application for registration, or two months after the end of the quarter in which it meets the criteria to be a major participant.[1197] In adopting these rules, the Commissions are mindful of commenters' concerns that market entities be given an adequate amount of time to come into compliance with the requirements applicable to major participants. At the same time, it is important to recognize that a person may submit a completed application for major participant registration prior to the time in which it must come into compliance with the requirements applicable to major participants.[1198] We believe that two months provides a reasonable amount of time for a person to submit a completed application for registration as a major participant.[1199]

b. Re-Evaluation Period

Consistent with the proposal, the final rules provide that if any entity meets the criteria for qualifying as a major participant, but does not exceed any applicable threshold by more than 20 percent in that particular quarter, the entity will not immediately be subject to the timing requirements noted above, but will become subject to the timing requirements at the end of the next fiscal quarter if such entity exceeds any of the applicable daily average thresholds in that next fiscal quarter.[1200] We believe that this standard will appropriately help to avoid applying major participant requirements to entities that meet the major participant criteria for only a short time due to unusual activity.[1201]

c. Minimum Period of Status

Consistent with the proposal, the final rules provide that a person would retain major participant status until it does not exceed any of the applicable thresholds for four consecutive quarters following registration.[1202] We believe that this time period appropriately addresses the concern that persons may move in and out of major participant status on a rapid basis. While we recognize that some commenters requested that this period be reduced to two quarters, we believe that a shorter period likely would lead to administrative confusion and burdens, as a shorter time period may be expected to lead entities to move in and out of major participant status more frequently.

M. Calculation Safe Harbor

1. Proposed Approach and Commenters' Views

In the Proposing Release, we expressed the understanding that only a limited number of persons currently have swap or security-based swap positions of a size that potentially could cause them to fall within the major participant definitions.[1203] Without disagreeing with that view, some commenters expressed concern about the costs and burdens associated with performing the applicable calculations on a daily basis, particularly citing the calculations' complex nature.[1204] Certain commenters further suggested

[1191] *See* proposed CFTC Regulation § 1.3(hhh)(3); proposed Exchange Act rule 3a67–7(a).

[1192] *See* proposed CFTC Regulation § 1.3(hhh)(4); proposed Exchange Act rule 3a67–7(b).

[1193] *See* proposed CFTC Regulation § 1.3(hhh)(5); proposed Exchange Act rule 3a67–7(c).

[1194] *See* letters from BlackRock I (requesting that market participants have eight months after they have exceeded any of the applicable thresholds to complete the registration process and come into compliance with applicable rules) and MetLife (suggesting that one year would be an adequate amount of time to come into compliance with the applicable rules); *see also* letters from ISDA I (suggesting a grace period of three quarters following the effectiveness of the proposed rules to permit analysis of whether a person is a major participant) and Capital One (recommending establishment of an 18 month provisional registration period for major participants and for dealers, as well as a phase-in period for applicable regulatory requirements).

[1195] *See* letter from MFA I.

[1196] *See, e.g.,* letters from ACLI, BG LNG I, MetLife and MFA I (also suggesting that there be an alternative method of termination if an entity falls below an applicable threshold by more than 20 percent).

[1197] *See* CFTC Regulation § 1.3(hhh)(3); Exchange Act rule 3a67–8(a).

[1198] The proposed rules regarding the registration of major security-based swap participants would provide that a person who files a completed registration application will be conditionally registered as a major security-based swap participant for four months (unless a person files a certification with the SEC, which would extend the conditional registration for an additional 30 days). *See* proposed Exchange Act rules 15Fb2–1(d)(1) and 15Fb3–1(b)(2), 76 FR 65784, 65821, 65823 (Oct. 24, 2012). In other words, under this proposal, a person who meets the criteria for being a major security-based swap participant may have up to six months, or longer, to come into compliance with the requirements applicable to major security-based swap participants.

[1199] The SEC has estimated that it would take an entity approximately one week to be able to complete and file Form SBSE, the most complex application form for registration as a major security-based swap participant. The other forms for application as a major security-based swap participant are simpler, and the SEC estimates that they would take less time to complete. *See* 76 FR at 65814 at nn.130, 131, 133.

[1200] *See* CFTC Regulation § 1.3(hhh)(4); Exchange Act rule 3a67–8(b).

[1201] While we are mindful that one commenter suggested that this standard be extended from one quarter to four quarters, *see* letter from ISDA I, we do not believe that approach would be consistent with the goal of not causing persons to become major participants as a result of short-term unusual activity.

[1202] *See* CFTC Regulation § 1.3 (hhh)(5); Exchange Act rule 3a67–8(c).

[1203] For example, in connection with the major security-based swap participant definition, we preliminarily estimated that no more than ten entities that would not otherwise be security-based swap dealers would have uncollateralized mark-to-market positions or combined uncollateralized exposure and potential future exposure that may rise close enough to the proposed thresholds to necessitate monitoring to determine whether they meet those thresholds. *See* Proposing Release, 75 FR at 80207–08.

[1204] *See* letters from MFA I and Vanguard.

that participants in the swap and security-based swap markets may perceive an obligation to conduct the relevant calculations on a daily basis even if they are not reasonably likely to be major participants. Those commenters requested that the Commission adopt a safe harbor by which persons with swap or security-based swap positions below a certain notional threshold would not have to perform the major participant calculations, or by which persons would not have to perform those calculations more than monthly when the results of those calculations are significantly below the levels required to be a major participant.[1205]

2. Final Rule

We continue to believe that under the rules we are adopting only a limited number of persons potentially may be major participants. Nonetheless, we recognize the significance of commenter concerns that some persons may perceive an obligation to conduct the major participant calculations as part of their compliance procedures even when there is not a significant likelihood that they would be major participants. We thus believe that a safe harbor can promote certainty and regulatory efficiency by helping market participants appropriately focus their compliance efforts and avoid undue compliance costs in circumstances when they would be highly unlikely to be major participants.

Accordingly, the Commissions are adopting a rule to incorporate a safe harbor into the major participant analysis. A person may take advantage of this safe harbor in any of three situations. First, a person will not be deemed to be a major participant if: (i) the express terms of the person's arrangements relating to swaps and security-based swaps with its counterparties at no time would permit the person to maintain a total uncollateralized exposure of more than $100 million to all such counterparties, including any exposure that may result from the application of thresholds or minimum transfer amounts established by credit support annexes or similar arrangements;[1206] and (ii) the person does not maintain notional swap or security-based swap positions of more than $2 billion in any major category of swaps or security-based swaps, or more than $4 billion in aggregate.[1207]

Alternatively, a person will not be deemed to be a major participant if: (i) The express terms of the person's arrangements relating to swaps and security-based swaps with its counterparties at no time would permit the person to maintain a total uncollateralized exposure of more than $200 million to all such counterparties, including any exposure that may result from thresholds or minimum transfer amounts;[1208] and (ii) the person performs the major participant calculations (*e.g.,* the ''substantial position'' and ''substantial counterparty exposure'' calculations associated with the major participant tests) as of the end of every month, and the results of each of those monthly calculations indicate that the person's swap or security-based swap positions lead to no more than one-half of the level of current exposure plus potential future exposure that would cause the person to be a major participant.[1209]

Finally, a person will not be deemed to be a major participant if the person's current uncollateralized exposure is in connection with a major category of swaps or security-based swaps is less than $500 million (or less than $1.5 billion with regard to the rate swap category) and the person performs certain modified major participant calculations (*e.g.,* the ''substantial position'' and ''substantial counterparty exposure'' calculations, simplified based on assumptions that are adverse to the person)[1210] as of the end of every month, and the results of each of those monthly calculations indicate that the person's swap or security-based swap positions in each major category of swaps or security-based swaps are less than one-half of the substantial position threshold.[1211] This test addresses the commenter suggestion that a safe harbor be set at one-half of the threshold triggering major participant designation.[1212] In addition, we have provided a more simplified alternate version of this test whereby a person will not be deemed to be a major participant if its monthly calculations indicate that the person's swap or security-based swap positions across all major categories of swaps or security-based swaps are significantly less than the substantial counterparty exposure threshold.[1213] This alternative provides a simple safe harbor for entities to apply without undertaking additional analysis to divide their swap or security-based

[1205] *See* letters from SIFMA AMG I (recommending safe harbor when the notional amount of a person's positions is less than the applicable thresholds for current uncollateralized exposure plus potential future exposure, or when a person's end-of-month analysis indicates exposures that are at least 50 percent below the definitions' applicable current exposure plus potential future exposure thresholds), Association of Institutional Investors (''AII'') and Vanguard.

[1206] *See* CFTC Regulation § 1.3(hhh)(6)(i)(A); Exchange Act rule 3a67–8(a)(1)(i).

[1207] *See* CFTC Regulation § 1.3(hhh)(6)(i)(B); Exchange Act rule 3a67–8(a)(1)(ii). For purposes of this second condition, the measure of swap or security-based swap positions in a major category shall include all positions in that major category. This measure shall not exclude the hedging or ERISA positions that are excluded from the first major participant test.

[1208] *See* CFTC Regulation § 1.3(hhh)(6)(ii)(A); Exchange Act rule 3a67–8(a)(2)(i).

[1209] *See* CFTC Regulation § 1.3(hhh)(6)(ii)(B); Exchange Act rule 3a67–8(a)(2). In the case of security-based swaps, for example, the monthly test must indicate that the person has no more than $1 billion in aggregate uncollateralized current exposure plus potential future exposure in a major category (equal to one-half the thresholds of the first and third major participant tests). A person also must have no more than $2 billion in aggregate uncollateralized current exposure plus potential future exposure with regard to all of its security-based swap positions (equal to one-half the thresholds of the second major participant test).

For purposes of conducting this analysis with regard to positions in a major category, if the person is subject to the third major participant test (*i.e.,* the person is a highly leveraged financial entity that is not subject to bank capital requirements), the analysis must account for all of the person's swap or security-based swap positions in that major category (without excluding hedging positions). If the person is not subject to the third major participant test (*i.e.,* the person is not ''highly leveraged'' or is not a ''financial entity'' potentially subject to the test) the analysis may exclude those hedging positions that also are excluded from the first major participant test.

For purposes of conducting this analysis with regard to all of its swap or security-based swap positions, the analysis may not exclude hedging positions (consistent with the lack of a hedging exclusion in the second major participant test).

[1210] *See* CFTC Regulation § 1.3(hhh)(6))iii)(A); Exchange Act rule 3a67–9(a)(3). The simplifications and assumptions applied to this portion of the safe harbor include the fact that a person must use the exposure reports of its dealer counterparties when calculating aggregate uncollateralized outward exposure to such entities, and that potential future exposure must be calculated without taking into account offsets for clearing, mark-to-market margining, or netting.

[1211] *See* CFTC Regulation § 1.3(hhh)(6)(iii)(A); Exchange Act rule 3a67–9(a)(3)(i)(A).

[1212] As identified above, three commenters requested that the Commissions provide a ''safe harbor'' in connection with the status of a major participant. *See* letters from AII, SIFMA AMG II and Vanguard. For example, one commenter stated that ''market participants that are otherwise required to perform the calculations should be able to do so on a less frequent basis if the entity is below every applicable threshold by at least 50%.'' *See* letter from SIFMA AMG I at 5.

[1213] *See* CFTC Regulation § 1.3(hhh)(6)(iii)(B); Exchange Act rule 3a67–9(a)(3)(i)(B). The thresholds for this version of the safe harbor are consistent with the thresholds for the safe harbor set forth in CFTC Regulation § 1.3(hhh)(6)(iii)(A) and Exchange Act rule 3a67–9(a)(3)(i)(A), other than with respect to interest rate swaps. We recognize that the major participant thresholds for swaps and security-based swaps across all major categories (*i.e.,* substantial counterparty exposure) are much larger than those for each individual major category (*i.e.,* substantial position). However, given the purposes of the safe harbor, we do not believe that it is appropriate to use a higher level for the test related to all major categories as compared to the test for each individual category.

swap positions into major categories.[1214]

In each of these circumstances, we believe that a safe harbor would be warranted because it would be sufficiently unlikely that the person's swap or security-based swap positions would cause the entity to be a major participant.[1215] The Commissions believe that for compliance purposes, persons should be able to rely on the proposed safe harbors noted above. This would benefit the swap and security-based swap marketplace and related market participants by avoiding unnecessary costs for various entities that, because of compliance concerns, would engage in major participant calculations even though it would be very unlikely that the major participant thresholds would be met.

The rule further provides that even if a person does not meet the conditions required to take advantage of the safe harbor, that fact by itself will not lead to a presumption that a person is required to perform the calculations required to determine if it is a major participant.[1216] This is consistent with the safe harbor's intent to promote certainty and efficiency in compliance efforts. While we are not prescribing when a person should perform the major participant calculations, participants in the swap and security-based swap markets should be mindful that they are responsible for determining whether they meet the major participant definitions, and that they will face liability if they knowingly or unknowingly meet one of those definitions without registering as a major participant.

N. Limited Designation as a Major Swap Participant or Major Security-Based Swap Participant

1. Proposed Approach

The ''major swap participant'' and ''major security-based swap participant'' definitions provide that the Commissions may designate a person as a major participant for a single category of swap or security-based swap.[1217] Unlike the limited designation provisions of the dealer definitions, the major participant definitions do not refer to limited designations in connection with particular swap and security-based swap activities. Also, unlike the dealer definitions (which refer to limited designations in connection with a particular ''type,'' ''class'' or ''category'' of swap or security-based swap), the major participant definitions specifically state that a person may be designated as a major participant for one or more ''categories'' of swap or security-based swap, without being a major participant for all ''classes'' of swap or security-based swap.

The proposal provided that a person who is a major participant in general would be considered to be a major participant with respect to all categories of swaps or security-based swaps, unless the person's designation is limited.[1218] We further stated that we anticipated that a major participant could seek a limited designation at the same time as its initial registration or at a later time, and we observed the difficulty of setting out the conditions that would allow a person to receive a major participant limited designation.[1219]

2. Commenters' Views

As discussed above, commenters generally addressed concerns regarding limited purpose major participant designations in conjunction with comments regarding limited purpose dealer designations.[1220] A few comments addressed these issues specifically in the context of the major participant definitions.

One commenter recommended that persons that exceed the first major participant threshold in a major category should presumptively be considered a limited major participant only for those categories of swaps or security-based swaps for which they crossed the threshold.[1221] Another suggested a similar approach when a major participant's swaps are concentrated in one major category.[1222] Two commenters suggested that limited major participant designations should not be confined to the proposed major swap categories.[1223]

3. Final Rules and General Principles Applicable to Limited Major Participant Designations

Consistent with the proposal, the final rules retain the presumption that a person that meets one of the major participant definitions will be deemed to be a major participant in connection with all categories of swaps or security-based swaps.[1224] As discussed in the Proposing Release, a person may apply for a limited designation when it submits a registration application, or later.[1225] The final rules also contain one change from the proposal, in that the provisions of the final rules related to limited major participant designation do not refer to the major participant's activities in connection with swaps or security-based swaps, in contrast to the proposal, because the relevant statutory provisions do not refer to limited designations related to activities.

Many of the principles discussed above in the context of limited designation of dealers also are relevant to the limited designation of major participants. Significantly, as with limited dealer designations, it is appropriate for major participants to be subject to a default presumption that they should be regulated as major

[1214] When calculating its potential future exposure across all major swap or security-based swap categories for purposes of this portion of the safe harbor, the person must use the same specified conversion factor for all swaps or security-based swaps, with such factor reflecting the highest risk weight applied to a major category of swaps or security-based swaps, as applicable. *See* CFTC Regulation § 1.3(hhh)(6)(iii)(B)(*2*); Exchange Act rule 3a67–9(a)(3)(i)(B)(*2*).

Also, for all three tests within the safe harbor, the person should use the effective notional amount of a position rather than the stated notional amount of that position if the stated notional amount is leveraged or enhanced by the structure of the position. *See* CFTC Regulation § 1.3(hhh)(6)(iv); Exchange Act rule 3a67–9(b).

[1215] Although commenters suggested a safe harbor based on a notional standard or on monthly testing, the rule we are adopting also accounts for the maximum exposure that is possible under a person's counterparty arrangements (including the aggregate amount of thresholds and minimum transfer amounts provided for by the applicable credit support annexes). This is intended to better focus the application of the safe harbor toward those entities that are highly unlikely to be, or become, major participants.

[1216] *See* CFTC Regulation § 1.3(hhh)(6)(v); Exchange Act rule 3a67–8(c).

[1217] *See* CEA section 1a(33)(C); Exchange Act section 3(a)(67)(C).

[1218] *See* proposed CFTC Regulation § 1.3(hhh)(2); proposed Exchange Act rule 3a71–1(c).

[1219] *See* Proposing Release, 75 FR at 80200–80201.

[1220] *See* part II.E.2, *supra.*

[1221] *See* letter from ICI I (recommending that entities that exceed the thresholds of the first major participant test be registered as major participants only for the relevant major category, while those entities qualifying as major participants under the other tests would be designated as major participants for all categories, but would still be able to apply for limited designations).

[1222] *See* letter from BG LNG I (recommending that if 50 percent of a major participant's swaps fall within one category of swaps, and its swaps in other categories would not separately exceed any of the proposed thresholds, that should be presumed to be a major participant for only that one category of swap).

[1223] *See* letters from BG LNG I (specifically addressing energy firms); and NCGA/NGSA I (asserting that while the major participant definition is to be based on the major categories, the limited designations should be based on a finer set of categories).

[1224] *See* CFTC Regulation § 1.3(hhh)(2); Exchange Act rule 3a71–1(c).

[1225] *See* Proposing Release, 75 FR at 80200. The SEC expects to address the process for submitting an application for limited designation as a major security-based swap participant, along with principles to be used by the SEC in analyzing such applications, as part of separate rulemakings.

participants for all of their swaps or security-based swaps.[1226]

Although a commenter suggested that different principles should apply in the context of the first major participant test[1227]—which is based on an entity's swap or security-based swap position in a single major category—we do not concur. The substantive requirements applicable to major participants do not contemplate treating entities that exceed the first and third thresholds of the major participant definition differently than those exceeding the second threshold. Instead, those requirements indicate that each entity that falls within the major participant definition must comply with registration and other substantive requirements triggered by such designation for all of its swap or security-based swap positions and activities. This conclusion also is supported by the fact that the limited designation authority provided to the Commissions is permissive rather than mandatory, and by the challenges of demonstrating compliance with the substantive requirements applicable to major participants in the context of a limited designation.

Indeed, as with limited dealer designation, one of the key requirements to overcoming the default presumption of full designation is an applicant's ability to comply with major participant regulation in the context of a limited designation. As with limited dealer designation, the Commissions will not designate a person as a limited purpose major participant unless the person can demonstrate compliance with the statutory and regulatory requirements applicable to major participants. Accordingly, an applicant to limited purpose designations must not only demonstrate the ability to comply with the transaction-level major participant requirements (*e.g.,* certain business conduct standards and requirements related to trading records, documentation and confirmations) in the context of a limited designation, but also to entity-level major participant requirements (*e.g.,* requirements related to registration, capital, risk management, supervision, and chief compliance officer).

V. Commission Staff Reports

To review and evaluate the operation of the ''swap dealer,'' ''security-based swap dealer,'' ''major swap participant'' and ''major security-based swap participant'' definitions, the CFTC and SEC are directing their respective staffs to undertake future studies regarding the rules being adopted in connection with these definitions and the related interpretations. These studies will include the analysis of market data and the input of public comment.

The CFTC staff is further directed to report the results of this study to the CFTC on a date that is no later than 30 months following the date that a swap data repository first receives swap data under the CFTC's regulations.[1228] The SEC staff is further directed to report the results of this study to the SEC no later than three years following the later of: (i) the last compliance date for the registration and regulatory requirements for security-based swap dealers and major security-based swap participants under Section 15F of the Exchange Act; and (ii) the first date on which compliance with the trade-by-trade reporting rules for credit-related and equity-related security-based swaps to a registered security-based swap data repository is required.[1229] These staff reports will be made available for public comment.

A. Objectives of the CFTC Staff Report

In general, the CFTC's staff report—together with the associated public comment—is intended to help the CFTC thoroughly evaluate the practical implications and effects of the ''swap dealer'' and ''major swap participant'' definitions following the regulation of dealers and major participants under Title VII. In addition, the staff report is intended to assist the CFTC in evaluating whether new or revised tests or approaches would be appropriate for identifying swap dealers and major swap participants or for providing greater clarity as to whether particular entities do or do not fall within these definitions. The staff report is also intended to assist the CFTC more specifically in evaluating the potential implications of terminating the phase-in thresholds associated with the *de minimis* exception to the definition of a ''swap dealer.''

To this end, the staff report generally should review each significant aspect of the rules being adopted in connection with the definitions and related interpretations. With respect to the ''swap dealer'' definition, such aspects include: (i) the factors associated with the definition (including the application of the dealer-trader distinction for identifying swap dealing activity); (ii) the extent of the exclusion of swaps entered into in connection with the origination of loans; (iii) the exclusion of certain swaps from the dealer analysis (*i.e.,* swaps between affiliated parties, swaps between a cooperative and its members and swaps entered into for the purpose of hedging as defined in the rule); and (iv) the tests and thresholds used to implement the *de minimis* exception. With respect to the ''major swap participant'' definition, such aspects include: (i) The tests and thresholds associated with the ''substantial position'' definition; (ii) the definition of ''hedging or mitigating commercial risk''; (iii) the tests and thresholds associated with the ''substantial counterparty exposure'' definition; and (iv) the definition of ''highly leveraged''.

To facilitate this review, the CFTC staff report should address—as may be practicable in light of the data made available under the swap regulatory reporting regime or otherwise—a range of descriptive analytics that may be helpful in characterizing the nature of the swap market, its participants, and their activities. Such descriptive analytics could help inform the CFTC as to how the definitions in the final rules are being applied in practice and whether any adjustments to such definitions should be considered. For example, these analytics could indicate whether the population of registered swap dealers and major swap participants is substantially larger or smaller than expected, and, to some extent, what elements of the definitions are responsible for any significant differences. These analytics could also illuminate dynamics in the market that may require new or different treatment in the definitions. These analytics may also assist the CFTC in considering whether it would be practical and appropriate to apply new or different objective and readily verifiable tests or standards for determining whether particular entities are or are not swap dealers or major swap participants,

[1226] *See* part II.E.3.a, *supra,* discussing the statutory and policy basis for this presumption.

[1227] *See* letter from ICI I.

[1228] The CFTC has designated a period of 30 months to ensure that the report reflects two years of security-based swap transaction data, and six months for the staff to analyze the data and prepare the report. The Commissions expect that swap data repositories and security-based swap data repositories will begin to receive data at different times. Currently, swap data repositories are expected to begin to receive swap data approximately 60 days after publication of the rules further defining the term ''swap.'' *See* CFTC, Final Rule: Swap Data Recordkeeping and Reporting Requirements, 77 FR 2136 (Jan. 13, 2012); CFTC, Final Rule: Swap Data Repositories: Registration Standards, Duties and Core Principles, 76 FR 54538 (Sept. 1, 2011). The SEC has not yet adopted final rules for the receipt of security-based swap data by security-based swap data repositories. Because of this difference, the timing of the changes to the *de minimis* thresholds for swaps and security-based swaps will be different.

[1229] The SEC has designated a period of three years to ensure that the report reflects two years of security-based swap transaction data, and one year for the staff to analyze the data and prepare the report.

including through the possible use of safe harbors, presumptions, thresholds, or defaults based on these tests or standards.

Depending on the availability and reliability of data and the developments in the market and regulatory framework, among other factors, the CFTC staff report could consider: how swaps differ among registered swap dealers, registered major swap participants and unregistered entities; differences among swaps in the major swap categories; differences among swap dealing activity of entities at various levels, including around the *de minimis* threshold; and estimates of quantitative information regarding use of swaps, including notional values, effective notional values, and collateralized and uncollateralized exposure.

The CFTC staff report should also address, as may be practicable, the nature and extent of the impact that the final rules and interpretations implementing the definitions have had on certain aspects of the swap market. Depending on the available information and other factors, the CFTC staff report could address the impact of these final rules and interpretations on competition in the swap market, market participants' ability to enter into swaps with various registered and unregistered entities, including IDIs, and the terms of swaps.

B. Objectives of the SEC Staff Report

In general, the report of the SEC staff—together with the associated public comment—is intended to help the SEC thoroughly evaluate the practical implications and effects of the dealer and major participant definitions following the regulation of dealers and major participants pursuant to Title VII. In addition, the staff report is intended to assist the SEC in evaluating whether new or revised tests or approaches would be appropriate for identifying dealers and major participants or for providing greater clarity as to whether particular entities do or do not fall within these definitions. The staff report also is intended to assist the SEC more specifically in evaluating whether it is necessary or appropriate to set higher or lower thresholds for the *de minimis* exception to the definition of ''security-based swap dealer.''

To this end, the staff report generally should review each significant aspect of the rules being adopted in connection with the definitions and related interpretations. With respect to the security-based swap dealer definition, such aspects include: (i) The factors associated with the definition (including the application of the dealer-trader distinction for identifying dealing activity); (ii) the exclusion of inter-affiliate transactions from the dealer analysis (including the provisions limiting that exclusion to transactions among majority-owned affiliates); and (iii) the tests and thresholds used to implement the *de minimis* exception. With respect to the major security-based swap participant definition, such aspects include: (i) The tests and thresholds associated with the ''substantial position'' and ''substantial counterparty exposure'' definitions; (ii) the definition of ''hedging or mitigating commercial risk'' (including whether the definition inappropriately permits the exclusion of certain positions from the first test of the major participant definitions, and whether the continued availability of the exclusion should be conditioned on assessments of hedging effectiveness and related documentation); (iii) the definition of ''highly leveraged''; and (iv) the exclusion of inter-affiliate transactions from the major participant analysis (including the provision limiting that exclusion to transactions among majority-owned affiliates).

C. Descriptive Analytics in the SEC Report

To facilitate this review, the report of the SEC staff should address—as may be practicable in light of the data made available under the applicable regulatory reporting regime or otherwise [1230]—a range of descriptive analytics that may be helpful in characterizing the nature of the security-based swap market, as well as entities within that market and those entities' activities. Such descriptive analytics could help inform the SEC as to how the definitions in the final rules are being applied in practice and whether any adjustments to such definitions should be considered. For example, these analytics could indicate whether the populations of dealers and major participants are substantially larger or smaller than expected, and, to some extent, what elements of the definitions are responsible for any significant differences. These analytics could also illuminate dynamics in the security-based swap market that may require new or different treatment in the definitions. For example, the analytics could indicate that the activity in certain segments of the security-based swap market—*e.g.,* equity swaps—has significantly increased or decreased since the adoption of the final rules. These analytics may also assist the SEC in considering whether it would be practical and appropriate to apply new or different objective and readily verifiable tests or standards for determining whether particular entities are or are not dealers or major participants, including through the possible use of safe harbors, presumptions, thresholds or defaults based on these tests or standards.

The precise nature of the descriptive analytics included in the SEC staff report of course will depend on a number of considerations, including the availability and reliability of data and the developments in the market and regulatory framework. However, some salient candidates for descriptive analysis that could be considered at the time of the staff report include:

- Characteristics of, and differences among, the security-based swap transactions and positions of three segments of participants in those respective markets—registered dealers, any registered major participants, and unregistered entities.[1231]
- Characteristics of, and differences among, security-based swap transactions and positions connected with the broad product segments identified in the final rules (*e.g.,* credit default swaps and other security-based swaps).[1232]
- Characteristics of, and differences among, the apparent dealing activity of entities at various levels (including the $3 billion and $150 million *de minimis* levels established in the final rule in connection with the security-based swap dealer definition) based on their transactions and positions; [1233]

[1230] The Dodd-Frank Act mandates that market participants publicly report certain security-based swap transaction and pricing data. *See* Exchange Act section 13(m). The SEC has proposed rules to implement these requirements, which will give the Commissions and the general public additional insight into the security-based swap markets. *See* Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information, 75 FR 75208 (Dec. 2, 2010).

[1231] Such characteristics could include: (i) The types of market participants in each segment; (ii) their activity and positions (in terms of notional value, number of transactions, average aggregate uncollateralized outward exposures, and average aggregate potential outward exposure); (iii) the type and number of their counterparties (including the registered/unregistered status of such counterparties); and (iv) a network analysis of the concentration of activity by counterparty.

[1232] Such characteristics could include: (i) The types of market participants in each segment, including their registration status; (ii) the amount of their activity (in terms of notional value and number of transactions); and (iii) the type and number of their counterparties.

[1233] Such characteristics could include a range of quantitative criteria indicative of apparent dealing activity, similar in some respects to the approach taken in the CDS Data Analysis. Differences that could be reviewed include variations in the number and size of trades and counterparties.

• Characteristics of the security-based swap trading activity of ''special entities''; [1234]

• Characteristics of entities entering and exiting the security-based swap markets, using a variety of baselines; [1235]

• Estimates of security-based swap entities' current uncollateralized exposure and potential future exposure at various levels of security-based swap positions; [1236] and

• Estimates of security-based swap entities' ratios of total liabilities to equity.[1237]

D. Additional Analyses in the SEC Staff Report

To further facilitate this review, the SEC staff report should also address, as may be practicable, the nature and extent of the impact that the final rules and interpretations implementing the definitions have had on certain aspects of the security-based swap market. However, many economic, regulatory, and other factors—both related and unrelated to the implementation of Title VII—could impact the market going forward. The extent to which the staff report will be able to provide retrospective analyses regarding the effect of the definitions on the security-based swap markets (and the robustness of any such analysis) in significant part will be based on the nature and role of future exogenous factors that have also affected the market. Depending on these future factors and the potential challenges associated with addressing them in the staff reports, some salient candidates for retrospective impact analysis that could be considered at the time of the report include:

• *Effects on competition.* The report may be able to explore connections between the definitions and the entry and exit of various entities in the security-based swap markets. For example, to what extent is an entity's entry or exit correlated with its registration status or its approaching or crossing any of the thresholds established by the definitions (*e.g.,* the *de minimis* thresholds for dealers or the ''substantial position'' thresholds for major participants)? Has the current concentration of the dealer market dissipated, persisted, or strengthened over time? [1238]

• *Effects on investor protection.* The report may be able to explore connections between the definitions and the nature and scope of transactions with certain classes of counterparties. For example, to what extent do unregistered entities in the security-based swap markets transact with counterparties such as ''special entities,'' natural persons, small businesses, or commercial entities? Have the nature and scope of trades by special entities or other classes of counterparties changed since 2011? Have unregistered entities—such as dealers operating under the *de minimis* threshold—emerged to engage in transactions with special entities or other particular classes of counterparties?

• *Effects on access.* The report may be able to explore connections between the definitions and the ability of certain classes of counterparties to access products in the security-based swap market. For example, to what extent is an entity's registration status or its approaching or crossing any of the thresholds established by the definitions correlated with the entity ceasing transactions with certain classes or sizes of counterparties?

• *Effects of the dealer-trader distinction.* The report may be able to explore connections between market dynamics and quantifiable metrics indicative of dealing activity. For example, are there identifiable, objective differences between the registered security-based swap dealers and unregistered market participant populations in terms of number of counterparties, buy/sell ratios, posting of initial margin, concentrations by counterparty or otherwise? If so, how does the amount of the activity (in terms of notional value and number of transactions) of those entities change when they move above or below the thresholds implied by those differences? How do the characteristics of their counterparties (in terms of number and nature) change?

• *Effects of de minimis thresholds.* The report may be able to explore connections between market dynamics and the *de minimis* thresholds established by the definitions. For example, how does the amount of the activity (in terms of notional value and number of transactions) of security-based swap entities change when they move above or below the *de minimis* thresholds? How do the characteristics of their counterparties (in terms of number and nature) change?

• *Effects of major participant thresholds.* The report may be able to explore connections between market dynamics and the major participant thresholds established by the definitions. For example, how have total notional security-based swap positions changed over time for large market participants that are not registered and that do not bear any indicia of dealing activity? For those large participants, have overall notional levels moved toward, or away from, the levels required to trigger the major participant thresholds?

• *Other effects of the definitions.* To what extent do entities registered security-based swap dealers have overall trading characteristics suggesting that they may not be dealers? To what extent have entities *not* registered as dealers have trading characteristics suggesting that they may be acting as dealers? In either case, do any discrepancies between firms' registration status and their trading characteristics suggest any gaps or areas of uncertainty regarding the scope of the dealer definitions that may require potential modifications?

VI. Effective Date and Implementation

Consistent with sections 754 and 774 of the Dodd-Frank Act, these final rules will be effective on 60 days following publication in the **Federal Register**. The Commissions, however, are providing for a phase-in period for persons engaged in dealing activity below certain amounts.

If any provision of these joint rules, or the application thereof to any person or circumstance, is held to be invalid, such invalidity shall not affect other provisions or application of such provisions to other persons or circumstances that can be given effect without the invalid provision or application.

A. CEA Rules

As explained below and as noted elsewhere in this Adopting Release, the compliance date for various regulatory requirements is contingent upon the adoption and effectiveness of other,

[1234] Such characteristics could include: (i) The size and nature of their counterparties; (ii) the registration status of their counterparties; and (iii) the size and number of their transactions.

[1235] Such characteristics could include: (i) The extent to which those entities bear indicia of dealing activity, including those identified in the CDS Data Analysis; and (ii) the extent to which those entities have registered as security-based swap dealers. Potential baseline could include, for example: (i) The adoption of these final rules; (ii) December 31, 2011, the end of the time period considered by the CDS Data Analysis; and (iii) the last effective date of the registration and regulatory requirements for security-based swap dealers and major security-based swap participants under Section 15F of the Exchange Act.

[1236] Such estimates could be useful in ascertaining the application of the various ''substantial position'' thresholds used in connection with the ''major security-based swap participant'' definition.

[1237] Such estimates could be useful in connection with evaluating the operation of the third prong of the major participant definition.

[1238] *See* notes 478 through 485 and accompanying text, *supra.*

related, regulatory provisions and definitions. Because the CFTC believes that the suite of rules implementing the Dodd-Frank Act are complex and interconnected, it has determined that implementation in certain cases can best be accomplished through separate rulemakings. The Commissions received comments related to implementation and phase-in that largely resulted from the CFTC's re-opening of the comment period for several rulemakings, and a request for comment on the order in which it should consider final rulemakings made under the Dodd-Frank Act.[1239] The CFTC notes that swap dealers and major swap participants will require an implementation or compliance period based on separate registration and regulatory requirements that are the subject of separate rulemakings by the Commission.[1240]

As the CFTC stated recently in another rulemaking related to CPOs:

> [while t]he [CFTC] recognizes that entities will need time to come into compliance with the [CFTC]'s regulations * * * [b]ased on the comments received indicating that a certain portion of entities currently claiming relief [from CPO registration] under § 4.13(a)(4) already have robust controls in place independent of [CFTC] oversight, the [CFTC] believes that entities currently claiming relief under § 4.13(a)(4) should be capable of becoming registered and complying with the [CFTC]'s regulations within 12 months following the issuance of the final rule. For entities that are formed after the effective date of the rescission, the Commission expects the CPOs of such entities to comply with the Commission's regulations upon formation and commencement of operations.[1241]

The Commissions are taking the same approach with respect to implementing CFTC Regulations §§ 1.3(m)(5) and 1.3(m)(6). The loss of ECP status for Forex Pools currently operating other than pursuant to the retail forex regime of a federal regulator described in CEA section 2(c)(2)(E)(i) [1242] may involve significant structural and operational changes. The loss of a commodity pool's ability to rely on CEA section 1a(18)(A)(v) if it does not fall within CEA section 1a(18)(A)(iv) may require significant structural and operational changes. Because additional time may enable a Forex Pool affected by CFTC Regulation § 1.3(m)(5) to restructure to avoid being subject to the retail forex regime (*e.g.,* by redeeming U.S. non-ECP participants) and may allow a commodity pool affected by CFTC Regulation § 1.3(m)(6) time to satisfy the terms of CEA section 1a(18)(A)(iv) (*e.g.,* by the pool's CPO registering as such or claiming an exemption therefrom or by the pool raising its level of total assets above $5 million), the Commissions are delaying the effective date of CFTC Regulations §§ 1.3(m)(5) and 1.3(m)(6) until December 31, 2012, which is the compliance date for commodity pools no longer permitted to claim exemption from CPO registration pursuant to recently withdrawn CFTC Regulation 4.13(a)(4).[1243]

CFTC Regulation § 1.3(m)(8) conditions ECP status in part on a requirement that a commodity pool be ''formed and operated'' by a registered CPO or by a CPO who is exempt from registration as such pursuant to CFTC Regulation § 4.13(a)(3). Due to the revocation of CFTC Regulation § 4.13(a)(4), the Commissions anticipate that many CPOs will be registering as such in the future. However, the compliance date for registration for CPOs required to register as such due to the withdrawal of CFTC Regulation § 4.13(a)(4) is December 31, 2012. Furthermore, such CPOs may have formed the commodity pools that they currently operate when such CPOs were not registered as such.

Consequently, compliance with the formation element of CFTC Regulation § 1.3(m)(8)(iii) is not required with respect to a commodity pool formed prior to December 31, 2012. To be clear, however, while pools in existence before December 31, 2012 need not have been formed by a registered CPO, or by a CPO who is exempt from registration as such pursuant to CFTC Regulation § 4.13(a)(3), in order to satisfy the formation aspect of CFTC Regulation § 1.3(m)(8)(iii), such commodity pools nevertheless must be operated by a registered CPO, or by a CPO who is exempt from registration as such pursuant to CFTC Regulation § 4.13(a)(3), on December 31, 2012 to satisfy the ''operated by a registered CPO'' element of CFTC Regulation § 1.3(m)(8)(iii).

B. Exchange Act Rules

Because the SEC has not yet promulgated final rules implementing the substantive requirements imposed on dealers and major participants by Title VII of the Dodd-Frank Act, persons determined to be dealers or major participants under the regulations adopted in this Adopting Release need not register as such until the dates provided in the SEC's final rules regarding security-based swap dealer and major security-based swap participant registration requirements, and will not be subject to the requirements applicable to those dealers and major participants until the dates provided in the applicable final rules.[1244]

Moreover, as discussed above in the context of the *de minimis* exception to the security-based swap dealer definition,[1245] the SEC is making an extended compliance period available to persons engaged in dealing activity involving credit default swaps between $3 billion and $8 billion in trailing annual notional amount, and to persons engaged in dealing activity involving other types of security-based swaps between $150 million and $400 million in trailing annual notional amount. Persons taking advantage of that extended compliance period will be deemed not to be security-based swap dealers during that period, and will not be subject to registration requirements and other requirements associated with status as a security-based swap dealer during that period.

The SEC previously provided limited exemptive relief in connection with Exchange Act section 6(l),[1246] added by the Dodd-Frank Act, which prohibits any person from effecting a security-based swap transaction with a person that is not an ECP, unless effected on a national securities exchange. That relief expires as of the effective date of final rules further defining ECP.[1247] Accordingly, following the effective date of these final rules, dealers and major participants—and all other persons—will be subject to the prohibition of section 6(l) under the definition of ECP as amended by Title VII and as further defined by the rules.[1248]

[1239] *See* CFTC, Reopening and Extension of Comment Periods for Rulemakings Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR 25274 (May 4, 2011).

[1240] *See* CFTC, Final Rule: Registration of Swap Dealers and Major Swap Participants, 775 FR 713792613 (Jan. 19, 2012).

[1241] CPO/CTA Compliance Release at 11265.

[1242] 7 U.S.C. 2(c)(2)(E)(i).

[1243] *See* CPO/CTA Compliance Release.

[1244] *See* Securities Exchange Act Release No. 64678 (June 15, 2011), 76 FR 36287 (June 22, 2011) (''Effective Date Release'') (granting exemptive relief and providing guidance in connection with Exchange Act provisions concerning security-based swaps that were added or amended by Title VII).

[1245] *See* part II.D.5, *supra.*

[1246] 15 U.S.C. 78f(l).

[1247] *See* Effective Date Release, 76 FR at 36307.

[1248] Because the exemptive relief that the SEC granted in connection with section 6(l) will expire as of the effectiveness of the ECP definition, the relief that the SEC provided from the rescission provisions of Exchange Act section 29(b) in connection with section 6(l) also will expire at that time. *See id.*

VII. Administrative Law Matters—CEA Revisions (Definitions of ''Swap Dealer'' and ''Major Swap Participant,'' and Amendments to Definition of ''Eligible Contract Participant'')

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (''RFA'') requires Federal agencies to consider the impact of its rules on ''small entities.'' [1249] A regulatory flexibility analysis or certification typically is required for ''any rule for which the agency publishes a general notice of proposed rulemaking pursuant to'' the notice-and-comment provisions of the Administrative Procedure Act, 5 U.S.C. 553(b).[1250] In its proposal, the CFTC stated that ''[t]he rules proposed by the CFTC provide definitions that will largely be used in future rulemakings and which, by themselves, impose no significant new regulatory requirements. Accordingly, the Chairman, on behalf of the CFTC, hereby certifies pursuant to 5 U.S.C. 605(b) that the proposed rules will not have a significant economic impact on a substantial number of small entities.''[1251]

In response to the Proposing Release, one commenter stated that the CFTC's ''rule-makings [are] an accumulation of interrelated regulatory burdens and costs on non-financial small entities like the NFPEEU members, who seek to transact in energy commodity swaps only to hedge the commercial risks of their not-for-profit public service activities.'' [1252] In general, the commenter said that since the Small Business Administration (''SBA'') has determined that many rural electric cooperatives are ''small entities'' for purposes of the RFA, if the definition of swap dealer were to cover a substantial number of rural electric cooperatives the rule further defining swap dealer may have a significant economic impact on a substantial number of small entities.[1253] Thus, the commenter concluded that the CFTC should conduct a regulatory flexibility analysis for each of its rulemakings under the Dodd-Frank Act, including this rulemaking.

The commenter also said that the requirement in section 2(e) of the CEA, as amended by the Dodd-Frank Act, that a person who is not an ECP must execute swaps on a designated contract market would have the potential to have a significant economic impact on a substantial number of small entities if a substantial number of rural electric cooperatives were not covered by the definition of ECP.[1254] Another commenter said that in considering the economic impact on small entities of the swap dealer definition rules, the CFTC should consider whether the availability and cost of swaps to small entities could be affected by potential uncertainty among persons who engage in the activities covered by the definition about whether they are required to register as swap dealers.[1255]

The commenters did not provide specific information on how the further defining swap dealer would have a significant economic effect on a substantial number of small entities. Nonetheless, the CFTC has reevaluated this rulemaking in light of the statements made to it by these commenters. After further consideration of those statements, the CFTC has again determined that this final rulemaking will not have a significant economic effect on a substantial number of small businesses. With regard to the definition of swap dealer, the CFTC expects that if any small entity were to engage in the activities covered by the definition, most such entities would be eligible for the *de minimis* exception from the definition.[1256] Additionally, the Commission does not expect that the small entities identified by NFPEEU will be subject to registration with the Commission as a major swap participant, as most entities with total electric output not exceeding 4 million megawatt hours are not expected to maintain outstanding swap positions that would exceed the applicable thresholds. In general, the major swap participant definition applies only to persons with very large swap positions, and therefore the definition of major swap participant is incompatible with small entity status.

With regard to the definition of ECP, the CFTC notes that the costs of executing swaps on a designated contract market raised by the commenter arise from a requirement of the CEA, and not from any rule promulgated by the CFTC. Last, regarding the comment that there may be an economic impact on small entities in terms of the availability and cost of swaps, the definition of swap dealer is being adopted to limit uncertainty with respect to which entities will be required to register as a swap dealer. Thus, the definition of swap dealer is intended to avoid creating the substantial economic effect which concerns the commenter.

Accordingly, the Chairman, on behalf of the CFTC, certifies, pursuant to 5 U.S.C. 605(b), that the actions to be taken herein will not have a significant economic impact on a substantial number of small entities.

B. Paperwork Reduction Act

The Paperwork Reduction Act (''PRA'') [1257] imposes certain requirements on Federal agencies in connection with their conducting or sponsoring any collection of information as defined by the PRA. The Proposing Release stated that the proposed rules would not impose any new recordkeeping or information collection requirements, or other collections of information that require approval of the Office of Management and Budget (''OMB'') under the PRA, and invited public comment on the accuracy of the CFTC's estimate that no additional recordkeeping or information collection requirements or changes to existing collection requirements would result from the proposed rules.[1258]

One commenter said that the regulatory requirements imposed on swap dealers and major swap participants (including swap end users that may potentially be misclassified as swap dealers or major swap participants) will entail reporting and record keeping requirements.[1259] Specifically, the commenter noted that the CFTC stated in the Proposing Release that ''any entity determined to be a swap dealer or major swap participant would be subject to registration, margin, capital, and business conduct requirements * * * all activities that will have associated reporting and additional recordkeeping requirements.'' [1260] Another commenter said that the CFTC should consider the implications under the PRA of all of its rulemakings under the Dodd-Frank Act as a whole.[1261]

As with the proposed rules, these final rules will not impose any new information collection requirements that require approval of OMB under the PRA. All reporting and recordkeeping

[1249] 5 U.S.C. 601 *et seq.*

[1250] 5 U.S.C. sections 601(2), 603, 604 and 605.

[1251] 75 FR 80203.

[1252] *See* letter from NFPEEU.

[1253] *See* letter from NFPEEU and meeting with NFPEEU on January 19, 2011.

[1254] *See* letter from NFPEEU.

[1255] *See* letter from Dominion Resources.

[1256] The number of small entities that could conceivably be covered by the definition of swap dealer is likely to be further reduced if transactions between entities described in section 201(f) of the Federal Power Act (which generally includes rural electric cooperatives) are exempted from the requirements of the CEA, as contemplated by section 4(c)(6) of the CEA.

[1257] 44 U.S.C. 3501 *et seq.*

[1258] 75 FR 80203.

[1259] *See* letter from Dominion Resources.

[1260] *See id.* at 6.

[1261] *See* letter from NFPEEU.

requirements applicable to swap dealers and major swap participants instead result from other rulemakings, for which the CFTC has sought OMB approval. The CFTC submitted an information collection request to OMB for each proposed rulemaking containing reporting or recordkeeping requirements, including the recordkeeping and reporting requirements referenced by the first commenter,[1262] which estimated the implications of the proposed collections on prospective respondents.[1263]

Moreover, in appropriate rulemakings, the CFTC sought to rely upon information collections that already had been proposed, in order to avoid imposing unnecessary additional burdens upon prospective respondents.[1264] Parties wishing to review the CFTC's information collections on a global basis may do so at *www.reginfo.gov*, at which OMB maintains an inventory aggregating each of the CFTC's currently approved information collections, as well as the information collections that presently are under review.

C. Cost Benefit Considerations

CEA section 15(a) requires the CFTC to consider the costs and benefits of its action before promulgating a regulation under the CEA, specifying that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (i) Protection of market participants and the public; (ii) efficiency, competitiveness and financial integrity of futures markets; (iii) price discovery; (iv) sound risk management practices; and (v) other public interest considerations.[1265]

1. Introduction

The terms ''major swap participant'' and ''swap dealer'' are defined in CEA sections 1a(33) and 1a(49), as added by the Dodd-Frank Act, to include any person that holds swap positions above a certain level (in the case of the term ''major swap participant'') or that engages in certain activities (in the case of the term ''swap dealer''), with certain exclusions and exceptions, all as discussed in parts II and IV of this Adopting Release. Section 712(d)(1) of the Dodd-Frank Act directs the CFTC and the SEC, in consultation with the Board, jointly to further define these and other terms. Also, CEA section 1a(49)(D) directs the CFTC to promulgate regulations to establish factors with respect to the making of the determination to apply the *de minimis* exception to the definition of the term ''swap dealer.''

The provisions of the Dodd-Frank Act that direct the further definition of the terms ''swap dealer'' and ''major swap participant'' should be viewed in the context of Congress' consideration of the consequences that would arise from regulating persons and activities that were previously free from regulation. The Dodd-Frank Act is, in part, a response to a financial crisis in which unregulated swaps played a major role.[1266] It includes provisions to regulate swap dealers and major swap participants in order to address concerns about this previously unregulated market. In this context, the Dodd-Frank Act requires that rules should ''further define'' the terms ''swap dealer'' and ''major swap participant'' by establishing and providing guidance with respect to the criteria for determining if a person is covered by one of the statutory definitions and therefore should be subject to certain regulatory requirements under Title VII; the Dodd-Frank Act does not direct the Commissions to define those terms in a vacuum. So, even in the absence of these rules, Title VII would require the regulation of persons that act as swap dealers or hold positions causing them to be major swap participants. Consequently, a large part of the costs and benefits resulting from the regulation of swap dealers and major swap participants result from the Dodd-Frank Act itself and not from these definitional rules.

2. General Cost and Benefit Considerations

In considering the comments on the proposed rules and the various alternatives available for the final rules, the CFTC sought to promulgate final rules that will help swap market participants and the public to apply the statutory definitions of the terms ''swap dealer'' and ''major swap participant'' in an efficient, uniform and accurate manner. We believe that doing so will protect market participants and the public, promote the efficiency, competitiveness and financial integrity of the swap markets, facilitate price discovery, encourage sound risk management practices and advance the public interest in general. That is, by providing direction and guidance as to which factors are relevant in applying the statutory definitions, and how to apply those factors to particular situations in the swap markets, the CFTC believes the final rules will provide benefits by reducing the cost of determining whether a particular person is covered by the statutory definitions, helping to make similar determinations for persons that are similarly situated, and promoting application of the terms ''swap dealer'' and ''major swap participant'' in conformity with the statutory definitions.

The costs and benefits considered in this final rule fall in two categories: First, those an entity will experience in determining whether it is a ''swap dealer'' or ''major swap participant'' as further defined in this rulemaking; and second, those attributable to the fact that, as interpreted in this rule, a greater or fewer number of entities at the boundaries of the statutory definitions may be deemed within them.

With respect to the first category, and as discussed further in sections V.A.3.j. and V.A.4.b. below, the CFTC has endeavored to approximate the costs of making these determinations. At the same time, the CFTC believes that the careful consideration of, and detailed response in this Adopting Release to, comments regarding the application of the statutory definitions will provide useful, practical guidance, yielding a substantial if unquantifiable benefit to entities making such determinations.

The costs and benefits in the second category—those associated with the rules being more or less inclusive—were a primary concern of the CFTC and commenters throughout this rulemaking. Commenters stated that if the CFTC's final rules were to lead to interpretations of the statutory definitions that are over-inclusive, the result would be that entities would likely incur significant, unjustifiable costs attributable to various regulatory requirements intended for actual swap dealers and major swap participants.[1267] Other commenters were concerned that if the rules were to lead to under-inclusive interpretations, the benefits expected from Title VII would be dampened.[1268]

The CFTC does not dismiss these potential unintended results and we

[1262] *See, e.g.,* 75 FR 71379, 71386 (Nov. 23, 2010) (proposed registration rules); 75 FR 70881, 70884 (Nov. 19, 2010), 75 FR 71397, 71401 (Nov. 23, 2010), 75 FR 71391, 71394 (Nov. 23, 2010), 75 FR 80638, 80656 (Dec. 22, 2010), and 76 FR 33066, 33076 (Jun. 7, 2011); and 76 FR 27802, 27819 (May 12, 2011) (collectively, the information collection requests for the proposed business conduct rules).

[1263] *See* 44 U.S.C. 3506 (PRA program requirements) and 3507 (PRA submission requirements).

[1264] *See, e.g.,* 75 FR 80638, 80656 (Dec. 22, 2010).

[1265] 7 U.S.C. 19(a).

[1266] *See, e.g.,* S.Rep. 111–176, *The Restoring American Financial Stability Act of 2010* at 29.

[1267] *See* letters from API I, Atmos Energy, BG LNG I, Dominion Resources, Hess, NCGA/NGSA I, NFPEEU, Vitol and WGCEF VIII.

[1268] *See* letters from AFR, Better Markets I and Greenberger.

have responded to these comments in the policy determinations made above.[1269] We recognize that these definitional rules are ''gating'' rules, and that this gating function will affect whether entities at the boundaries of the statutory definitions incur costs attributable to the regulatory regime that Congress has prescribed and the CFTC has implemented through other substantive regulations. Correspondingly, these definitional rules will also affect the extent of benefits for the swap market and the public resulting from those regulations. It is important to also recognize, however, that as stated above, the regulation of persons acting as swap dealers or who hold positions causing them to be major swap participants is required by the Dodd-Frank Act. For entities that are not on the boundaries of the statutory definitions, but rather squarely within them or entirely outside of them, these rules will not affect the costs and benefits that result from their inclusion or exclusion. The latter group of costs and benefits are a consequence of the statutory definitions prescribed by Congress.

In this rulemaking, we considered that more inclusive rules and guidance would cause some entities at the boundaries of the definitions to be covered by one of the definitions and therefore incur both initial and recurring direct costs of complying with Dodd-Frank Act requirements, while less inclusive rules and guidance would have the opposite effect.[1270] Thus, as more or fewer entities are covered by the definitions, the amount of such direct compliance costs incurred by entities in the aggregate will vary. However, this variance in the aggregate compliance costs resulting from the CFTC's definitional guidance in this rulemaking must be distinguished from the compliance costs that any particular entity will incur stemming from the other rulemakings prescribing regulations applicable to swap dealers and major swap participants. Consideration of the specific costs and benefits attendant to various substantive regulations applicable to swap dealers and major swap participants is beyond the limited scope of this rulemaking.

Moreover, the variance in aggregate compliance costs resulting from this rulemaking will not track, on a ''one for one'' basis, the number of entities included in the definitions as the rules are more or less inclusive. This is because the initial and recurring compliance costs for any particular swap dealer or major swap participant will depend on the size, existing infrastructure, level of swap activity, practices and cost structure of the entity designated as such.[1271] Another reason that the aggregate costs resulting as more or fewer entities are included in the definitions will not precisely track the number of such entities is that indirect costs are likely to result as market participants seek to avoid the regulations attendant to swap dealer or major swap participant status by, among other things, reducing their swap activities.[1272] We do not expect that the extent of these indirect costs will be directly related to the number of entities included in the definitions.

The CFTC likewise acknowledges that more or less inclusive definitions may increase or decrease the systemic benefits expected from the composite regulation of swap dealers and major swap participants. These include improved transparency and market orderliness, as well as the reduction of excess leverage and systemic risk. The CFTC believes that less inclusive final rules could negatively impact these interests in several ways: Those who engage in swaps with entities that elude swap dealer or major swap participant status and the attendant regulations could be exposed to increased counterparty risk; customer protection and market orderliness benefits that the regulations are intended to provide could be muted or sacrificed, resulting in increased costs through reduced market integrity and efficiency;[1273] and entities that elude swap dealer or major swap participant status may gain an unwarranted competitive advantage over other market participants.[1274]

Generally, rules that capture more entities are likely to increase these benefits, while rules that capture fewer entities are likely to have the opposite effect, though there are several additional factors that also have a bearing on the presence and magnitude of increased or decreased benefits. These factors include the number and size of entities whose status changes

[1269] *See, e.g.,* parts II.A.4.g, II.D.3.a and IV.B.3.a.

[1270] For example, the final rules specify criteria related to application of the *de minimis* exception, the range of transactions that are eligible for the exclusion of swaps in connection with the origination of loans, and the requirements for limited designation as a swap dealer, each of which will impact the total number of entities that are subject to swap dealer regulation. The final rules also specify criteria related to the thresholds for major swap participant status, factors that may be considered in the major swap participant calculations, and the threshold for ''highly leveraged'' status, each of which will impact the number of entities that are major swap participants.

[1271] It is likely that a swap dealer or major swap participant would incur direct compliance costs related to technology, personnel and capital. *See* CFTC, Registration of Swap Dealers and Major Swap Participants; Final Rule, 77 FR 2613 (January 19, 2012); CFTC, Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties; Final Rule, 77 FR 9733 (February 17, 2012) and CFTC, Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants; Final Rule, 77 FR 20128 (April 3, 2012).

[1272] For example, those entities would lose the profits they may have gained from those activities, and potentially from related business activities if their customers cut back their business relationships because the abstaining entities no longer engage in those swap activities.

We recognize that small entities are more likely than large entities to abstain from swap activities in order to avoid being covered by the swap dealer definition. Smaller entities are less likely to have existing technology and procedures that would comply with new regulations and therefore their initial costs of compliance with the requirements applicable to swap dealers are likely to be larger. Moreover, the same fixed costs will have a proportionally greater effect on small entities.

Other market participants may also bear some costs if entities abstain from dealing activities or if large users of swaps reduce their activities to avoid major swap participant status. These costs could include transition costs as the other market participants identify new counterparties with which to enter into the same swaps. In addition, and likely more important, as more entities abstain from swap activities, other entities that are seeking to enter into swaps may have a reduced choice of counterparties, which may lead to unfavorable financial terms for swaps and imperfect matches between risks and the swaps that are available. These factors may increase the cost of risk mitigation in general, as entities use more costly risk management strategies in place of swaps.

See generally letters from API I, BG LNG I, BOK dated February 22, 2011 (''BOK III''), COPE I, Midsize Banks, NEM, NCGA/NGSA I, NGFA I, Chevron Federal Credit Union, M&T I, Sidley and WGCEF I. *See also* Roundtable Transcript at 39 (remarks of Eric Chern, Chicago Trading Company), 133–34 (remarks of Brenda Boultwood, Constellation).

[1273] More uniform compliance with regulations leads to more uniform expectations that market participants may reasonably have about the financial integrity of various swap dealers and major swap participants. Less uniform compliance, on the other hand, could introduce additional uncertainty about the financial integrity of an individual swap dealer or major swap participant. This could result in reduced market efficiency. Moreover, foreseeable ''network effects'' could magnify these costs. That is, since requirements promoting transparency and orderly documentation are expected to increase market participants' general level of certainty about the swap positions held by others in the market, the wider the market application the greater the benefit. For example, in the 2008 financial crisis, uncertainty about the potential obligations of various market participants led to actions to restrict credit and reduce leverage that may not have been taken if there was greater confidence about market participants in general; this uncertainty also hampered regulatory efforts. Significant pockets of unregulated swap activity attributable to less inclusive definitions of the terms ''swap dealer'' and ''major swap participant'' may result in costs related to uncertainty and lack of information.

[1274] The extent of any such competitive advantage would depend on the number of entities that are inaccurately not covered by the definitions and the extent of their swap activities relative to the market in which they are active.

under more or less inclusive rules, the number of swaps they engage in, their connectedness to other institutions and role in the financial system, and the types of financial instruments they would have utilized in the absence of swap dealer and major swap participant regulations.

At this time, it is also not possible to quantify the impact of these rules on the direct and indirect costs and benefits that result from changing the status of an entity that is on the boundaries of the Dodd-Frank Act's definitions of the terms ''swap dealer'' or ''major swap participant.'' The CFTC does not have adequate information about market participants' swap activities to determine which entities will change their activities in response to the definitions, which would be necessary in order to determine the significance of the impact on costs and benefits of including or excluding those entities from the regulations pertaining to swap dealers and major swap participants. Costs may not be estimated in an accurate or meaningful way for many reasons, including because all of the regulations pertaining to swap dealers and major swap participants have not yet been issued in their final form, and because the CFTC does not have adequate information about market participants' existing technology, infrastructure, use of swaps, or cost structure.[1275] Changes in the total benefits resulting from the definitional regulations are also difficult to quantify, since many of the benefits of the swap dealer and major swap participant regulations are indirect, rather than direct. As a consequence, the CFTC may recognize and describe the impact of these rules on the overall costs and benefits deriving from swap dealer and major swap participant regulations, but it is not possible to quantify them at this time.

The applicable provisions of the Dodd-Frank Act regarding the term ''eligible contract participant'' are somewhat different, in that the statute modifies a particular clause in the pre-existing statutory definition of the term and also provides general authority to further define the term. The final rules adopted in this regard provide guidance for the application of these provisions.

3. Comments on the Discussion of Costs and Benefits in the Proposing Release

Some commenters suggested that the discussion in the Proposing Release of the costs and benefits of the proposed rules further defining the terms ''swap dealer, '' ''major swap participant'' and ''eligible contract participant'' was inaccurate or inadequate.[1276] For example, commenters suggested that in considering the final rules, the CFTC should consider empirical data regarding the costs and benefits flowing from the rules,[1277] opportunity costs associated with regulatory uncertainty,[1278] and alternatives that would impose fewer costs.[1279] One commenter suggested that the CFTC should issue a second analysis of the costs and benefits of the rules for public comment,[1280] while another commenter said that the consideration of cost and benefits should include the cumulative cost of interrelated regulatory burdens arising from all the rules proposed under the Dodd-Frank Act.[1281]

Another commenter said that the cost-benefit analyses in the Proposing Release may have understated the benefits of the proposed rules, because focusing on individual aspects of all the rules proposed under the Dodd-Frank Act prevents consideration of the full range of benefits that arise from the rules as a whole, in terms of providing greater financial stability, reducing systemic risk and avoiding the expense of assistance to financial institutions in the future.[1282] This commenter said the consideration of benefits of the proposed rules should include the mitigated risk of a financial crisis.[1283]

We have endeavored to address the commenters' concerns in this Adopting Release by undertaking careful consideration of various alternatives proposed by commenters as described in this section. With regard to the comments suggesting that we consider empirical data, the CFTC found that no comprehensive, publicly available empirical data related to the usage of swaps in all markets is available, and commenters provided very little empirical data to aid us in this rulemaking.

4. Costs and Benefits of the Rules Further Defining ''Swap Dealer''

The Proposing Release proposed certain factors that could be relevant to market participants when determining whether they are covered by the statutory definition of the term ''swap dealer.'' The CFTC received comments in response to numerous issues and considered a variety of alternatives in light of those comments, weighing the costs and benefits of each. In particular, we considered alternatives with respect to the activities indicative of holding oneself out as, or being commonly known as, a dealer in swaps, making a market in swaps, entering into swaps as a ''regular business,'' the exclusion available to IDIs for swaps offered in connection with the origination of loans, inter-affiliate swaps, swaps hedging physical positions, limited dealer status, and the possibility of providing particularized treatment under the definition for various types of entities.

As noted above, in considering these alternatives the CFTC's primary objective was to promulgate a rule under which market participants could efficiently and accurately determine whether they are engaged in any of the activities that are included in the statutory definition of swap dealer, and whether they are covered by any of the exclusions in the statutory definition. The scope of our consideration of these alternatives included the five factors specified in section 15(a) of the CEA. That is, we considered how the promulgation of final rules that would promote application of the definition of the term ''swap dealer'' in a manner that is consistent with the statutory definition would protect market participants and the public, promote the efficiency, competitiveness and financial integrity of the markets,[1284] facilitate price discovery, encourage sound risk management practices and serve the public interest. Rather than describing in a separate section how we applied the elements of section 15(a) in the final rule further defining the term ''swap dealer,'' the discussion below highlights the application of those elements where appropriate.

[1275] Currently, prior to the implementation of Title VII, the U.S. swap market generally is not subject to substantive regulation, and market participants generally do not disclose detailed information about their swap activities and positions. This lack of data reduces our ability to analyze the swap activities of individual market participants, as well as the market as a whole, and thus impacts our ability to analyze the costs and benefits of these rules. Our analysis, out of necessity, is based on data that currently is available.

[1276] *See* letters from API I, NFPEEU, Regional Banks, Sidley and WGCEF I, II and VIII; *see also* letter from FSR III.

[1277] *See* letters from WGCEF I and II.

[1278] *See* letter from Dominion Resources.

[1279] *See* letters from NextEra I and NFPEEU.

[1280] *See* letters from WGCEF I and II.

[1281] *See* letter from NFPEEU.

[1282] *See* letter from Better Markets II.

[1283] Better Markets cited estimates that the worldwide cost of the 2008 financial crisis in terms of lost output was between $60 trillion and $200 trillion, depending primarily on the long term persistence of the effects. *See id.*

[1284] Although by its terms, CEA section 15(a)(2)(B) applies to the futures (not swaps) markets, the CFTC finds this factor useful in analyzing the costs and benefits of these regulations further defining the terms ''swap dealer,'' ''major swap participant'' and ''eligible contract participant'' as well.

a. Indicia of Holding Oneself Out as a Dealer in Swaps or Being Commonly Known in the Trade as a Dealer in Swaps

As discussed above, the Proposing Release set forth activities that could indicate that a person is holding oneself out as a dealer or is commonly known in the trade as a dealer in swaps.[1285] Commenters on this point said that persons who are not swap dealers also engage in some of the activities identified in the proposed rule. In other words, these commenters asserted that these activities are not accurate indicators of swap dealer status.[1286]

Commenters were concerned that if the rule included, as bright-line tests of swap dealer status, the proposed indicators of holding oneself out as, or being commonly known as, a swap dealer, then the rule would lead to an interpretation of the statutory definition that would be more inclusive. This, in turn, would lead to the costs of a more inclusive rule, and possibly the costs of entities abstaining from swap activities to avoid being covered by the definition, as discussed above.[1287]

While we are cognizant that providing no guidance about how to apply the statutory provision stating that the term ''swap dealer'' includes any person who holds itself out as a dealer in swaps or is commonly known in the trade as a dealer or market maker in swaps would deprive market participants of interpretive guidance—thus increasing the direct and indirect costs to apply the rule—we considered the commenters' concern that use of the proposed characteristics as bright-line indicators of swap dealer status could potentially result in significant costs. Therefore, to mitigate the costs of applying the rule and the costs that would result if the rule were more inclusive, the Adopting Release clarifies that the identified activities are not per se conclusive, and could be countered by other facts and circumstances indicating that an entity is not a swap dealer. The CFTC believes that providing guidance about the factors that are correlated with holding oneself out as or being commonly known as a swap dealer—even if not perfectly so—mitigates the risk that the rule would include entities that are not actually covered by the statutory definition and provides benefits in reducing the costs of application of the rule.

[1285] *See* part II.A.1, *supra.*

[1286] *See* part II.A.2.a, *supra.*

[1287] *See* part VII.C.2, *supra.*

b. Making a Market in Swaps

Commenters on this point provided several perspectives on what does and does not constitute market making.[1288] With those comments in view, we considered a number of characteristics for potential inclusion in the rule, and evaluated potential costs and benefits of each before determining that making a market in swaps is best described as ''routinely standing ready to enter into swaps at the request or demand of a counterparty.'' We also further described various activities that constitute routinely standing ready, such as routinely quoting bid or offer prices for swaps, routinely responding to requests made directly by potential counterparties for bid or offer prices, etc. The alternative options we considered are discussed below in light of the five broad areas specified in section 15(a) of the CEA.

Offer swaps on both sides of the market. The proposed rule stated our view that an entity may be a market maker in swaps even if the entity does not enter into swaps on both sides of the market. Several commenters suggested the rule should require that an entity enter into swaps on both sides of the market as a prerequisite to market maker status.[1289] We have considered these comments and concluded that an entity could be a market maker by offering swaps on one side of the market, while entering into transactions on the other side of the market using other financial instruments.

Accordingly, using presence on both sides of the market as a determinative factor in applying the definition of the term ''swap dealer'' could cause the final rule to be under-inclusive by excluding entities that function as market makers by entering into swaps on one side of the market. In addition, some entities may limit their swap dealing activities to one side of the market in an attempt to avoid being covered by the definition, again leading to the rule being under-inclusive.

Excluding cleared swaps from consideration. Some commenters said cleared swaps should not be considered in determining whether an entity is a swap dealer.[1290] Moreover, they suggested that dealers operating through clearinghouses might choose to exit the market if required to register as swap dealers, which would reduce liquidity.[1291]

It is possible that some entities whose swap dealing activities are limited to cleared swaps will abstain from those activities in order to avoid being covered by the definition, leading to costs associated with entities abstaining from the market, as described above. Other such entities may continue their swap dealing activities and incur the initial and ongoing costs of compliance with swap dealer regulations. Benefits are linked to these compliance costs, however. For example, the swap dealer business conduct requirements are expected to provide benefits in terms of protecting market participants and the public. In any case, we note that the statutory definition of the term ''swap dealer'' does not include any factor considering whether the swaps that an entity enters into are cleared as opposed to not cleared. Therefore, the costs raised by commenters resulting from the absence of an exclusion of cleared swaps are costs that result from the statutory definition and not the final rule.

c. Regularly Entering Into Swaps With Counterparties as an Ordinary Course of Business

The final rule incorporates the statutory provisions that the term swap dealer includes a person that ''regularly enters into swaps with counterparties as an ordinary course of business for its own account'' and ''does not include a person that enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business.'' The CFTC believes that the determinative issue in interpreting these provisions is whether an entity's activity of entering into swaps is part of its usual and normal course of business and is identifiable as a swap dealing business, as discussed above.[1292] This Adopting Release also describes certain activities that constitute both entering into swaps ''as an ordinary course of business'' and ''as a part of a regular business.''[1293]

The CFTC believes that dealers frequently engage in the activities described in this Adopting Release, while non-dealers do not.[1294] As a consequence, such activities are useful indicators of swap dealing activity and it is appropriate to incorporate them in

[1288] *See* part II.A.2.b, *supra.*

[1289] *See* letters cited in notes 52 to 54, *supra.*

[1290] *See* letters from Newedge and Traders Coalition. The commenters said that considering cleared swaps in determining if an entity is a swap dealer may cause entities to reduce their use of cleared swaps, which would be contrary to the general purpose of the Dodd-Frank Act to encourage clearing.

[1291] *See* letters from CMC and Traders Coalition.

[1292] *See* part II.A.4.c, *supra.*

[1293] *See id.*

[1294] For example, commenters suggested that these types of activities are indicative of swap dealing. *See* letters from EEI/EPSA, Hess, NextEra I, Utility Group and Vitol.

the guidance interpreting the final rule in order to properly apply the statutory definition.

d. The Dealer-Trader Distinction

The Adopting Release incorporates the dealer-trader distinction as a consideration when identifying swap dealers. While not dispositive, the CFTC anticipates that the dealer-trader distinction will be useful as a consideration, particularly in light of the degree to which it overlaps with many of the other characteristics identified in the Adopting Release that are indicative of dealing activity. The dealer-trader distinction is likely to be familiar to some market participants that must determine whether they are swap dealers, and to the extent that this is true, the CFTC believes that its incorporation as a factor in the swap dealer analysis will help to reduce uncertainty for those entities, thereby reducing their costs of determining whether they are dealers.[1295] By incorporating the dealer-trader distinction as one consideration within a broader facts and circumstances approach, the CFTC has minimized the costs of under inclusion that could arise if the distinction were used as a bright line test to exempt entities that would otherwise be subject to regulation as swap dealers.[1296]

e. Limited Designation as a Swap Dealer

The Proposing Release provided that ''a person who is a swap dealer shall be deemed to be a swap dealer with respect to each swap it enters into'' but explained that an entity could apply for limited designation. Several commenters suggested that the CFTC should allow for the possibility of ''presumptive limited designation'' as a swap dealer in order to reduce costs.[1297] We have decided, however, not to provide for a presumptive limited designation in the final rule. While a presumptive limited designation would, for the entities that seek it, mitigate the costs of applying for limited designation and any costs related to uncertainty about whether limited designation will be granted,[1298] it could also lead to costs arising from the rule being less inclusive. Persons engaged in a broad range of activities that are all covered by the definition of the term ''swap dealer'' would have a significant incentive to improperly claim eligibility for a presumptive limited designation. This would hinder the application of swap dealer regulations to all of their swap dealing activities and thereby increase costs in terms of lesser protection of market participants and the public, as well as impairment of sound risk management practices.

Commenters suggested that to reduce the costs of determining whether a particular person is eligible for a limited designation as a swap dealer, the CFTC should set out certain criteria that would be relevant to that determination, such as the degree of complexity of an entity's swap activities, what percentage of an entity's total swap activities are dealing activities, the relationship between the entity and its swap counterparties, and how difficult it would be to distinguish between its ''designated'' and ''non-designated'' swaps.[1299]

Rather than setting forth specific factors to be considered with respect to limited designation as a swap dealer, this Adopting Release takes a facts and circumstances approach, stating that all relevant factors will be considered in the determination. This Adopting Release also states that an important factor in determining whether a swap dealer qualifies for a limited designation is whether the swap dealer can demonstrate that the internal structure to which the limited designation applies (*e.g.,* a division or business unit) complies with the swap dealer requirements. If such a structure is not pre-existing, the swap dealer will incur costs in creating a structure for its swap dealing activity in a manner that would qualify for limited designation. These costs depend on the circumstances of that swap dealer and cannot be quantified at this time; however, such costs are likely to be significant for at least some swap dealers. On the other hand, swap dealers who do qualify for the limited designation will benefit from reduced ongoing compliance costs since some swap dealer requirements are expected to apply to only those activities encompassed by the limited designation.[1300] This flexible approach will allow entities to organize themselves in a manner that allows them to maximize the value of limited designation, so long as they are able to demonstrate that they will comply with swap dealer requirements. In settling on this flexible approach, we considered how the use of a limited designation would allow entities to minimize the effect of swap dealer registration on their swap activities, which fosters efficiency while also promoting sound risk management practices through swap dealer regulation.

The facts and circumstances approach to limited designation will likely lead to some costs arising from uncertainty among market participants about whether steps they have taken or may take will permit them to qualify for a limited designation. However, we believe that market participants may mitigate such uncertainty costs by contacting staff to discuss changes under consideration, or by applying for limited designation on the basis of planned changes (rather than making the changes and then submitting the application).

f. *De Minimis* Exception

The Dodd-Frank Act requires that the CFTC exempt from designation as a swap dealer any entity ''that engages in a *de minimis* quantity of swap dealing in connection with transactions with or on behalf of customers,'' and that the CFTC ''promulgate regulations to establish factors with respect to the making of this determination to exempt.''[1301]

The proposed rule set out certain quantitative standards for identifying those entities whose swap activities were sufficiently small that applying swap dealer regulations to them would not be warranted.[1302] Commenters raised several points regarding the potential costs and benefits of the proposed approach. We considered these points, addressed below, in preparing the final rule, which provides

[1295] *See* letters from CCMR I and MFA I.

[1296] *See* letter from AFSCME.

[1297] *See* part II.E.2.a, *supra.* Several commenters stated that it is unduly burdensome to require swap dealers to apply swap dealer requirements to all of their swaps (including swaps not resulting from dealing activity) while they pursue limited designation. *See, e.g.,* letters from Capital One, Farm Credit Council I and FHLB I. Another commenter suggested that not allowing for a presumptive limited designation could cause some community lenders to cease offering swaps. *See* letter from Capital One.

Another commenter suggested that to reduce costs, presumptive limited designation should be available for any formal division of an entity, to avoid the costs that would arise if any entity were to reorganize its operations without certainty that limited designation would be available to the reorganized entity. *See* letter from WGCEF VII.

[1298] Entities that apply for limited designation as a swap dealer will be required to prepare a submission to the CFTC demonstrating their compliance with swap dealer regulations in the context of limited designation.

[1299] *See* letters from Capital One and FHLB I.

[1300] Some swap dealer regulations may be applied at the transactional level, while others may affect the operations and capital structure of the entity beyond the swaps or activities for which it has a limited designation. On this topic, some commenters suggested that limited designation should allow the swap dealer to limit operational compliance with swap dealer requirements to the portion of the business that is designated as a swap dealer. *See* letters from FSR I and WGCEF VII. Another commenter stated that the CFTC should not require additional reporting regarding the non-dealing activities. *See* letter from Cargill.

[1301] CEA section 1a(49)(D), 7 U.S.C. 1(a)(49)(D).

[1302] *See* part II.D.1, *supra.*

that an entity qualifies for the *de minimis* exception if the notional amount of its swap positions or security-based swap positions over the prior 12 months arising from its dealing activity is $3 billion or less, and the notional amount of such positions with ''special entities'' is $25 million or less. However, during a phase-in period following the effective date of the final rules, an entity will not be required to register as a swap dealer if the notional amount of the swap positions it enters into over the prior 12 months arising from its dealing activities is $8 billion or less.[1303]

In determining the level of the notional amount thresholds for the *de minimis* exception, we considered comments stating that if the thresholds were set inappropriately low, persons engaged in a smaller quantity of swap dealing would face a choice between reducing their swap dealing activities to a level below the thresholds or registering as a swap dealer and incurring the costs of compliance with swap dealer regulation.[1304] It follows from these comments that these entities would incur costs in making a decision about the extent to which they should engage in swap dealing, although none of the commenters specifically quantified the costs of making that decision. Commenters also expressed a concern that if many entities chose to reduce or cease their swap dealing activities in response to the *de minimis* thresholds, the availability of swaps may be reduced, particularly to the smaller swap users that typically engage in swaps with such entities, which could lead to costs for those smaller swap users.[1305] Some commenters said that the CFTC should justify the final thresholds for the *de minimis* exception with an economic analysis; however, these commenters did not propose specific analyses the CFTC should perform or provide specific information that should be included in the analysis.[1306]

The CFTC evaluated data regarding index CDS that was provided by the SEC, and made that analysis available to the public.[1307] The data showed that 80.8% of all participants in the index CDS market entered into index CDS with an aggregate notional amount of less than $3 billion during 2011, and 88.7% of such market participants entered into index CDS with an aggregate notional amount of less than $8 billion during the same period of time. However, the 19.2% and 11.3% of market participants above those respective thresholds, accounted for 98.9% and 97.8% of the total notional amount of index CDS entered into during that time, which suggests that a relatively small number of entities are responsible for a large majority of activity in the index CDS market. The data also showed that 91.7% of all entities with 3 or more counterparties that are not recognized by ISDA as dealers entered into index CDS with an aggregate notional amount of $9 billion or more during 2011, suggesting that a large majority of dealers in index CDS likely enter into index CDS with an aggregate notional amount of $9 billion or more per year.

These observations, and any conclusions derived from them, however, must be qualified by limitations of the data, including: (i) Although we expect that the data covers a very large part of the index CDS market, we cannot verify what percentage of all index CDS are represented in the data; (ii) the data is not filtered to reflect activity that would constitute swap dealing under the Dodd-Frank Act, so it is not possible to use the data to draw conclusions regarding any specific entity's status as a swap dealer and (iii) the data does not cover other classes of swaps that are relevant to the *de minimis* threshold for swap dealers, such as interest rate swaps, equity swaps, foreign exchange swaps or other commodity swaps.[1308] In light of these limitations, any conclusions drawn from the index CDS data must be regarded as provisional.

We note that no matter the level at which the *de minimis* thresholds are set, there will always be some entities engaged in a quantity of swap dealing at or above the threshold level that will face the choice described by the commenters. As noted above, we considered the costs and benefits of dealer regulation in determining the notional amount standards in the final rule.[1309] Among the costs we considered were those that would result if entities reduce or cease their swap dealing activities in response to the *de minimis* threshold and swaps become less available in smaller or niche markets. We considered that this could impact the competitiveness of those markets and undermine the ability of market participants to practice sound, cost-effective risk management.[1310] In principle, a higher threshold would promote a larger pool of swap-dealing entities (since entities with swap dealing activity below the threshold need not incur costs to comply with swap dealer regulations), meaning more potential counterparties available to swap users. On the other hand, a greater quantity of swap dealing would be undertaken without the customer protection, market orderliness and market transparency benefits of dealer regulation. This, in turn would impair the protection of market participants and the public, and undermine sound risk management practices, as described above.[1311] We considered these factors in determining the level of the notional amount standard in the final rule.

Some commenters advocated use of alternative measures (such as an entity's current uncollateralized exposure from swaps, or the number or frequency of swaps) as the *de minimis* gauge.[1312] Some commenters suggested that various types of entities should be subject to different *de minimis* thresholds,[1313] or that the rule should vary the *de minimis* threshold by type of swap.[1314] Some commenters suggested that the *de minimis* exception should take into account the purpose of an entity's swap dealing activities or the entity's general characteristics.[1315]

The CFTC believes that these proposed alternatives are unlikely to better promote the efficiency, competitiveness and financial integrity of the markets, or yield other benefits to a greater extent than the approach adopted in the final rule.[1316] On the

[1303] *See* CFTC Regulation § 1.3(ggg)(4)(ii).

[1304] *See, e.g.,* letters and meetings cited in notes 377 to 381, *supra.*

[1305] *See, e.g.,* letters and meetings cited in note 378, *supra. See also* Roundtable Transcript at 201 (remarks of John Janney, Large Public Power Council).

[1306] *See* letters from API I, FSR VI, Midsize Banks, Regional Banks and WGCEF I.

[1307] *See* memorandum to the public comment file from the CFTC Office of the Chief Economist.

[1308] *See id.*

[1309] *See* part II.D.3.a, *supra.* In particular, we note here that the higher notional amount standard in the final rule, as compared to the proposed rule, should reduce the number entities that will face the choice described by the commenters.

[1310] As noted above, it is not possible to quantify these potential costs with mathematical precision. *See* note 421, *supra.* The commenters on these points did not provide quantifications of such costs.

[1311] Commenters expressed various views as to what level of benefits flow from dealer regulation. *See, e.g.,* Roundtable Transcript at 137–43 (remarks of John Janney, Large Public Power Council, Bella Sanevich, NISA Investment Advisors, LLC, and Brenda Boultwood, Constellation)

[1312] *See* letters cited in notes 384 and 385, *supra.*

[1313] *See* letters from COPE I, Farm Credit Council I and MFX II and meeting with Electric Companies on April 13, 2011.

[1314] *See* letters from Gavilon II and ISDA I.

[1315] *See* letters from Farm Credit Council I, FHLB I and MFX II.

[1316] We considered the proposed options in terms of whether they would promote: protection of market participants and the public; financial integrity and efficiency of swap markets; price discovery; sound risk management principles; and other public interest considerations. The commenters suggesting other measures did not offer

Continued

other hand, requiring market participants to consider more variables in evaluating application of the *de minimis* exception would likely increase their costs to make this determination. In light of these considerations, we concluded that to establish a single notional threshold for all of an entity's swap dealing would best protect the markets and the public, foster efficiency and competitiveness and serve the public interest.

We believe that using a *de minimis* threshold based on current uncollateralized exposure would lead to costs of calculation, which are discussed below in connection with the definition of major swap participant. Also, while current uncollateralized exposure may be a useful measure of the risk arising from a swap position, it fails to address the significance of an entity's swap dealing activity in terms of customer protection and market orderliness, which are significant elements in the determination of whether an entity is engaged in a *de minimis* quantity of swap dealing.[1317]

In response to commenters' suggestions, we considered the feasibility of assessing the breakeven point at which a potential swap dealer would earn enough profit from its swap dealing to support the costs to comply with swap dealer regulation.[1318] However, this assessment would require access to non-public, proprietary data regarding the gross margins associated with the swap dealing activity of a wide variety of market participants. Such data is not available to the CFTC.

One commenter suggested that the *de minimis* threshold for swaps related to a particular physical commodity should increase if the general price of the commodity increases, so that a constant quantity of the commodity could be hedged through a particular swap dealing entity without that entity exceeding the threshold.[1319] However, this approach, which eschews reliance on the dollar value of swaps, would raise the complex question of when the level of dealing in swaps relating to the physical quantity of various commodities becomes more than *de minimis.* We do not believe that this approach would provide sufficient additional benefits beyond those resulting from the final rule to justify the additional costs of application.

Commenters also suggested that, in order to simplify application of the *de minimis* exception and thereby reduce costs, the final rule should include an overall threshold that considers an entity's swaps and its security-based swaps.[1320] However, the statute includes two different *de minimis* exceptions regarding the quantity of an entity's swap dealing and its security-based swap dealing. Therefore, the suggested approach would be contrary to the statute.

The final rule provides for a lower *de minimis* gross notional threshold (*i.e.,* $25 million over the course of twelve months) for swaps in which the counterparty is a ''special entity,'' as that term is defined in CEA section 4s(h)(2)(C) and CFTC Regulation § 23.401(c)). While it is possible that, for the reasons noted above, this lower threshold could reduce the number of potential providers of swaps to special entities, which may constrain the ability of special entities to practice sound risk management strategies in a cost-effective manner, we note that the Dodd-Frank Act provides special entities with additional protections from market practices that could increase the risks they face in using swaps.[1321] We believe the threshold in the final rule reflects an appropriate consideration of these potential costs and the benefits that result in terms of serving the public interest.

Several commenters responded to the proposed *de minimis* thresholds limiting the number of an entity's counterparties and swaps, suggesting that the factors would not be useful in identifying entities engaged in a *de minimis* quantity of swap dealing.[1322] The final rule omits these factors. We believe that, in general, entities which will restrict their activities so as to remain under the *de minimis* notional amount threshold are likely to be those entities that are most willing to provide swaps with lower notional values. Counting an entity's number of counterparties or swaps as *de minimis* factors could inappropriately discourage entities from providing swaps in smaller notional amounts. This, in turn, would likely make it more difficult for persons seeking small notional amount swaps to find dealers willing to provide them, which may increase their costs of hedging and discourage sound risk management practices.

g. Exclusion of Swaps Entered Into by IDIs in Connection With the Origination of Loans

The statutory definition of the term ''swap dealer'' excludes an IDI ''to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer.'' [1323] The proposed rule would implement this statutory exclusion by providing that an IDI's swaps with a customer in connection with originating a loan to that customer are disregarded in determining if the IDI is a swap dealer. To prevent evasion, the proposed rule further provided that the statutory exclusion does not apply where the purpose of the swap is not linked to the financial terms of the loan, the IDI enters into a ''sham'' loan, or the purported ''loan'' is actually a synthetic loan such as a loan credit default swap or loan total return swap.

Commenters on the costs and benefits of the proposed approach focused on the benefits of a flexible application of the exclusion, which they asserted would promote the offering of swaps by IDIs in connection with loans and thereby more closely tailor the risks of a loan to the borrower's and the lender's needs, and promote the risk-mitigating effects of swaps.[1324] In terms of costs, commenters were concerned that a narrow application of the loan origination exclusion would cause IDIs to seek to avoid being covered by the definition of the term ''swap dealer'' by limiting their offering of swaps in connection with the origination of loans. Commenters said that the IDIs' limitation of their swap offerings could lead borrowers to take steps with negative ramifications, such as reduced usage of swaps for risk mitigation (which could lead to costs from an increased risk of default by the borrower), shifting from the lending institution to another institution for the swap (which could lead to inefficiency costs since two different institutions would be involved), or shifting to

a systematic analysis of whether the measures would lead to more accurate determinations in all or even most cases, and we do not believe such an analysis would be possible at this time due to the lack of information regarding how swaps are used in all markets. *See generally* part II.D.4.a, *supra.*

[1317] *See* part II.D.3.e, *supra.*

[1318] *See* Roundtable Transcript at 193–94 (remarks of James Cawley, Javelin Capital Markets, and Camille Rudge, The PrivateBank and Trust Company).

[1319] *See* letter from NCFC I.

[1320] *See* letter from NYCBA Committee.

[1321] *See generally* Roundtable Transcript at 210–15 (remarks of Mary-Margaret Collier, Tennessee Comptroller of the Treasury, John Janney, Large Public Power Council and Bella Sanevich, NISA Investment Advisors, LLC).

[1322] Some commenters suggested that the number of counterparties and the number of swaps are not indicators of systemic risk. *See* letters cited in note 387, *supra.* Others claimed that the *de minimis* standard should not limit the number of an entity's counterparties for policy reasons. *See* letters from Chesapeake Energy and Land O'Lakes I. Commenters also suggested that using number of counterparties or number of swaps as a factor would create an uneven playing field because it would discourage provision of swaps to small end users. *See* letters from EEI/EPSA and NMPF.

[1323] *See* CEA section 1a(49)(A), 7 U.S.C. 1a(49)(A).

[1324] *See, e.g.,* letter from B&F Capital I.

another institution for both the loan and the swap (which could increase risk by increasing concentration in the markets for loans and swaps).[1325] To mitigate these costs, commenters suggested that the loan origination exclusion should be construed broadly, particularly with respect to the range of loans covered,[1326] the type of swaps covered,[1327] the required timing for entering into a swap relative the corresponding loan's origination,[1328] and which financial institutions could be eligible for this exclusion.[1329]

The final rule limits the loan origination exclusion to swaps with terms that are directly related to the financial terms of the associated loan, or are required by loan underwriting criteria to to be in place as a condition of the loan in order to hedge commodity price risks incidental to the borrower's business. We believe that extending the loan origination exclusion further, to encompass a broader range of swaps connected to a borrower's other business activities would expand the exclusion beyond its statutory limits. This would lead to the costs associated with the rule becoming less inclusive, such as decreased protection of market participants and the public, as well as impaired risk management practices and market efficiency, as described above.

This Adopting Release also includes guidance that the term ''loan'' should be construed for this purpose in accordance with the common law definition of the term, in order to efficiently allow all interested parties to determine which transactions and instruments are eligible to be a basis for the exclusion. The CFTC believes that a detailed definition of the term ''loan'' covering all of the potential variations in how loans may be structured would be both costly to apply (because of the level of analysis required to determine if a particular instrument qualifies as a loan) and unnecessary (because a common law definition of the term ''loan'' has already been established).

We believe that extending the loan origination exclusion to cover any swap entered into by an IDI and a borrower at any point during the life of the loan would be contrary to the statutory terms of the exclusion, which focuses specifically on swaps entered into in connection with the ''origination'' of loans, and could lead to the costs of the rule being less inclusive described above. Rather, since a primary element of a loan is the transfer of money from the lender to the borrower, the final rule provides that the loan origination exclusion can cover an otherwise eligible swap if the swap is entered into during a specified period around either the execution of the loan agreement or any draw of principal under the loan. We believe that this aspect of the final rule accurately reflects the statutory terms of the exclusion and will serve the public interest by being neither over-inclusive nor under-inclusive.

Commenters generally agreed with the statement in the Proposing Release that the exclusion should be available to IDIs in a loan syndicate, purchasers of a loan, assignees of a loan, and participants in a loan.[1330] We believe that allowing the loan origination exclusion to extend to IDIs that participate in loans accurately reflects the statutory terms of the exclusion, so long as the IDIs' participations are meaningful. Therefore, the rule includes a minimum participation requirement in order to avoid inappropriate exploitation of the exclusion—*i.e.,* IDIs participating minimally in a loan syndication to gain eligibility for the exclusion — which could lead to costs of under-inclusion. The final rule allows the exclusion to be applied to a swap (which is otherwise covered by the exclusion) even if the notional amount of the swap is different from the amount of the loan tranche assigned to the IDI, so long as the IDI meets the minimum participation requirements in the loan. This provision is expected to facilitate minimization of the number of swaps borrowers enter into, and the number of counterparties they face with respect to those swaps, when entering swaps in connection with loans, thereby reducing the operational costs and risks born by borrowers.

h. Inter-Affiliate Swaps

The Proposing Release stated that the dealer analysis should consider the economic reality of swaps between affiliates, and preliminarily concluded that swaps ''between persons under common control may not involve the interaction with unaffiliated persons that we believe is a hallmark of the elements of the definitions that refer to holding oneself out as a dealer or being commonly known as a dealer.'' Commenters generally agreed with the proposed approach.[1331] Some commenters expressed the view that the proposed approach would facilitate the use by affiliated corporate groups of centralized market-facing conduits, which would promote efficient risk management.[1332]

The final rule interprets the dealer definition not to encompass a person's activities with respect to swaps between legal entities that are under common majority ownership. The final rule also provides that the swap dealer definition does not encompass the activities of a cooperative with respect to swaps between the cooperative and its members. We believe that such swaps generally serve to allocate or transfer risks within an affiliated group, rather than to move those risks out of the group to an unaffiliated third party, and therefore to include such swaps in the determination of whether an entity is a swap dealer would not be consistent with the statutory definition, nor would it serve the public interest or promote the protection of markets or the public. We also agree with commenters that the use of conduit structures to enter into swaps on behalf of commonly controlled entities has the potential to promote sound risk management practices and the efficiency of the swap markets. Therefore, including these swaps in the determination of whether a person is covered by the definition of ''swap dealer'' is not likely to provide significant benefits, but to include entities in the definition by virtue of these swaps would lead to the costs of the rule being overinclusive, as described above.

i. Exclusions of Swaps Entered Into for Hedging Physical Positions

Several commenters said that swaps used to hedge risks should not be considered in determining whether a person is a swap dealer. While the statutory definition of the term ''swap dealer'' does not specifically address hedging activity, the Commissions believe that in certain situations, entering into a swap for the purpose of hedging a physical position is not indicative of, and is not, swap dealing.

[1325] Commenters said that if, because of concern about triggering the *de minimis* threshold, IDIs were not willing to offer swaps at times when the borrower's hedging needs change due to loan related events, borrowers would have an incentive to seek out lenders who are not so constrained, and this incentive would be particularly strong if a borrower was not able to provide collateral to secure both a loan and a related swap from two separate counterparties. *See* letters from BOKIII, FSR VI and Rabobank, New York Branch. One commenter suggested that the impact of a narrow loan origination exclusion should be considered in tandem with the *de minimis* exception, because an expansion of one of the exceptions could offset some of the costs that result from a narrow interpretation of the other. *See* letter from FSR VI.

[1326] *See* letters cited in notes 308 to 313, *supra.*

[1327] *See* letters cited in notes 299 to 301313, *supra.*

[1328] *See* letters cited in notes 302 to 304313, *supra.*

[1329] *See* letters cited in notes 314 to 317304313, *supra.*

[1330] *See* letters cited in note 305313, *supra.*

[1331] *See* letters cited in note 341, *supra.*

[1332] *See* letters from Kraft, ONEOK and Shell Trading II.

An interim final rule provides that the determination of whether a person is a swap dealer will not consider a swap that the person enters into for the purpose of offsetting or mitigating certain price risks as defined in the rule, if the swap meets conditions specified in the rule.

When a person enters into a swap for the purpose of hedging the person's own risks in specified circumstances, an element of the swap dealer definition—the accommodation of the counterparty's needs or demands—is absent. Therefore, consistent with our overall interpretive approach to the definition, the activity of entering into such swaps (in the particular circumstances defined in the rule) does not constitute swap dealing. Providing an exclusion of such swaps from the swap dealer analysis reduces costs that persons using such swaps would incur in determining if they are swap dealers.

j. Exclusions of Certain Swaps Entered Into by Floor Traders

The CFTC believes that it would be inappropriate to require persons who are registered with the CFTC as floor traders to include in the swap dealer analysis swaps that they enter into, using only proprietary funds, on or subject to the rules of a DCM or SEF and submit for clearing to a DCO, and that meet certain other conditions specified in the rule. The CFTC believes that a requirement that these persons register as swap dealers (if the swap dealer registration requirement were to apply) could lead to duplicative regulation, since they are already registered as floor traders.

Providing an exclusion of such swaps from the swap dealer analysis reduces costs that persons using such swaps would incur if such swap activity were to require them to register as swap dealers. Since the swaps are entered into on an exchange, by a person who is registered with the CFTC and cleared, we expect that the potential impact on the transparency, market orderliness and other goals of dealer registration from excluding these swaps from the dealer analysis would be minimal. Importantly, the rule requires that the person comply with the record keeping and risk management requirements of CFTC Regulation §§ 23.201, 23.202, 23.203, and 23.600 with respect to each such swap as if the person. were a swap dealer. The requirement to comply with these important provisions reduces the potential for negative consequences from this rule.

k. Exclusions for Particular Types of Entities

Several commenters said the CFTC should interpret the statutory definition of ''swap dealer'' to include per se exemptions from the definition for certain types of persons or persons who engage in certain activities.[1333] These commenters argued, in general, that there would be little or no benefit from construing the statute as covering these persons or activities because they did not contribute to the causes of the recent financial crisis or they do not pose systemic risk.[1334] These commenters also asserted that to interpret the statutory definition to cover these types of persons or activities would lead to the costs of the rule being more inclusive, as noted above.[1335]

As stated previously, we note that the statutory definition of the term ''swap dealer'' applies to ''any person'' who engages in the activities described in the statute and who does not fall within the specific exceptions and exclusions in the statute. Therefore, the costs of applying the statutory definition to certain types of persons identified by the commenters arise from the provisions of the statute and not from the CFTC's rulemaking. In addition, to provide the requested per se exemptions from the statutory definition could also introduce the costs of the rule being less inclusive discussed above, such as decreased protection of market participants and the public, as well as impaired risk management practices and market efficiency.

Regarding the argument that there is no or little economic benefit from interpreting the statutory definition to cover persons whose failure would not create systemic risk, the commenters making this point did not provide evidence or analysis to indicate whether there would be systemic risk concerns if they were to fail. While some of these commenters asserted that their swap activities are not comparable to the activities of the financial institutions that are generally considered to have had a significant role in the recent crisis, and some asserted that persons eligible for the claimed exemptions did not play a role in the crisis, even if these assertions are taken as true they are not determinative of whether persons of this type could in fact be a source of systemic risk. We emphasize that the relevant question in this regard would not be whether the failure of any one person within the class covered by a suggested exemption would be the source of systemic risk, but rather whether a failure of several or many such persons would impact the efficiency, competitiveness and financial integrity of the markets, impair sound risk management practices or otherwise affect the protection of markets and the public.[1336] To be clear, we do not believe and we are not asserting that any of the types of persons discussed by the commenters in this regard necessarily could be the source of systemic risk concerns, but rather we point out that the comments in this regard were general assertions rather than a presentation of specific evidence or analysis to support the claimed exemptions from the statutory definition. Thus, even if the statute allowed for such exemptions, which we do not believe it does, none of the commenters provided substantial support for their assertions. Also, as noted above we believe that the dealer definitions should be construed in the light of several benefits of dealer regulation (including protection of the markets and the public, encouraging the efficiency, competitiveness and financial integrity of the swap markets, and the overall public interest) and not just in terms of mitigating potential systemic risk.

In any case, we believe that the final rule and the guidance in the Adopting Release provide clarifications that in many respects mitigate the costs that were raised by some of the commenters seeking per se exemptions from the definition.

l. Other Comments on the Rule Further Defining the Term ''Swap Dealer''

Commenters cited other potential costs that could arise from the proposed approach to interpreting the statutory definition of the term ''swap dealer,'' suggesting that the proposed approach was not sufficiently clear, may result in multiple interpretations, and risks

[1333] *See* part II.A.2.f, *supra.*

[1334] *See id.*

[1335] In addition, comments along these lines asserted that to apply dealer regulation to certain persons who are already subject to different financial regulations would be duplicative and could create additional costs. *See* letters from Farm Credit Council I, FERC Staff, Fidelity, GIC, MFA I, and NARUC and joint letter from ICI and SIFMA AMG.

[1336] This is so because the commenters requested per se exemptions for broad classes of persons and activities, rather than for specific persons. Whether a particular type of market participant, as a group, can be the source of systemic risk depends on, among other things, the financial strength of each entity in the group, the number and financial strength of their counterparties, the total amount of swap business conducted, the amount and types of margin posted by the entities in question as well as by their counterparties, what portion of their swap positions are cleared, the volatility of each swap's value as well as the covariance in value for all the swaps in their portfolio, and numerous other economic factors.

covering entities that would not actually be covered by the statutory definition, if it were correctly interpreted.[1337] Other commenters suggested that there could be high costs from application of the swap dealer regulations due to erroneous interpretation of the statutory definition of the term ''swap dealer,'' including high costs of regulatory uncertainty,[1338] and therefore it is particularly important that the final rule provide guidance on the application of the statutory definition.[1339] For example, these commenters said that if the final rule does not adequately clarify application of the statutory definition, market participants may incur unnecessary costs to avoid being covered by the definition of ''swap dealer,'' including by avoiding swap activities that are associated with areas of uncertainty under the rule.[1340]

Some commenters said that the proposed rule captures too broad a range of entities in its further definition of the term ''swap dealer,'' [1341] and that the asserted over-inclusiveness of the proposed rule could lead to direct costs for covered entities as well as indirect costs for covered entities, other swap market participants, and the public.[1342] For example, the commenters assert that as entities change their swap activities in reaction to the rule, the objectives they previously achieved through swaps may either be compromised, accomplished through less suitable means, or both.[1343] As another example, the commenters assert that changes in swap activities may reduce the choice of counterparties available to market participants, which may lead to unfavorable financial terms for swaps and imperfect matches between risks and swaps, which could in turn lead to reduced usage of swaps and lower liquidity in the swap markets, resulting ultimately in increased costs of risk mitigation in general.[1344]

The commenters did not quantify the extent of these costs that may arise when entities change their swap activities in reaction to the rule further defining the term ''swap dealer.''

We believe that by addressing the concerns regarding the costs and benefits of specific aspects of the rule, discussed above in section V.C.5., the final rule will also mitigate the indirect costs that may arise from the rule. While it is impossible to completely eliminate the costs that entities will incur in interpreting the rule and applying it to their particular swap activities, we believe the final rule mitigates these costs by providing detailed guidance. Also, these costs may decrease over time as precedents are established to provide further guidance on the application of the statutory definition.

For example, the final rule and the guidance in this Adopting Release mitigate the costs of uncertainty in application of the statutory definition by providing more detail about the interpretation of the statute's inclusion of any person who ''makes a market in swaps'' and the statute's exclusion of a person that enters into swaps, ''but not as a part of a regular business.'' The guidance describes activities that are indicative of making a market in swaps and of entering into swaps as a part of a regular business. The final rule also provides details regarding the scope of the statutory exclusion of swaps in connection with the origination of loans and the *de minimis* exception. Also, the final rule provides that swaps between majority-owned affiliates, swaps entered into by a cooperative with its members, swaps entered into for hedging physical positions as defined in the rule, and certain swaps entered into by floor traders, are excluded from the swap dealer determination. These provisions will reduce the costs that market participants incur in determining whether they are covered by the statutory definition of the term ''swap dealer.''

While it is possible that some entities could choose to cease or reduce their swap dealing activities to avoid the costs of compliance with swap dealer regulations, which could impair the efficiency and competitiveness of the swap markets, there are also likely to be significant benefits derived from swap dealer regulation, including reduced counterparty risk, better protection of the markets and the public, and more assured financial integrity of the markets and improved market transparency. Moreover, whether such reductions in activity will lead to reduced liquidity in the swap markets, as some commenters assert, is not certain. For example, if such reductions in swap activity occur, new swap dealers may organize themselves or existing swap dealers may expand to accommodate the demand for swaps, although the time that would be required for this to occur and the extent to which it would occur are uncertain.

In addition, indirect costs could arise from the rule being less inclusive. For example, if the rule considered factors that are not relevant to whether an entity is actually covered by the definition, such as by providing that only entities that make a two-sided market in swaps are makers of markets in swaps, then it is possible that entities could change their behavior in response to that aspect of the rule. For example, entities that previously made a two-sided market in swaps may decide to make only a one-sided market in swaps, potentially leading to the types of costs that commenters said would arise if entities reduce their swap activities.

Last, several commenters raised questions and offered suggestions about the timeline for implementation of swap dealer requirements [1345] and the sequencing of the CFTC's rulemaking.[1346] While we understand that appropriate timing of rulemaking and the implementation of the requirements applicable to swap dealers will play a significant role in mitigating inappropriate or avoidable costs flowing from those requirements, this rulemaking is limited to the interpretation of the statutory definition of the term ''swap dealer,'' and so these

[1337] *See* letters from AIMA I, API I, Dominion Resources, FSR III, NRG Energy, Peabody and Utility Group.

[1338] *See* letters from API I, Dominion Resources, FERC Staff, NextEra I and WGCEF VIII.

[1339] *See* letters from API I, FSR III, M&T I, Utility Group and Vitol.

[1340] One area cited by commenters as a potential source of such costs is the application for limited designation as a swap dealer. Commenters were concerned that if the parameters of the limited designation were uncertain, entities may incur opportunity costs from avoiding activities that may be incompatible with a limited designation, planning and operational costs from changing corporate structure in ways that are not actually necessary to obtain a limited designation, and other costs from modifying swap activities in response to uncertainty about the steps necessary for a limited designation. *See* letters from API I, BG LNG I, Dominion Resources, NextEra I, Vitol and WGCEF VII.

[1341] *See* letters from BG LNG I, FSR III, NCGA/NGSA I, and WGCEF I, II and VIII.

[1342] *See* letters from API I, Atmos Energy, BG LNG I, Dominion Resources, Hess, NCGA/NGSA Iand Vitol, and WGCEF VIII.

[1343] For example, an entity using swaps to hedge price risks may choose not to hedge or to use a different instrument to hedge similar positions. If it chooses not to hedge, its risk management objectives may be compromised. If it chooses to hedge using futures or some other instrument, that instrument may be less suitable for various reasons (*e.g.,* basis risk, rollover risk, liquidity risk, less customizability, different fee structure, etc.). However, it is not possible to quantify the costs and benefits resulting from these choices without knowing the terms of the individual swaps the entities would have used and the available alternatives for each of those swaps.

[1344] On the other hand, entities may find that they can achieve their risk management goals using forward contracts, futures and other financial instruments, or they may determine that their financial risks can be reduced in other ways.

[1345] *See* letters from API I, Capital One, COPE dated March 14, 2011 (''COPE II''), FSR III,Société Générale, and Vitol and WGCEF dated March 22, 2011 (''WGCEF III'').

[1346] *See* letters from ABA Securities Association, BlackRock dated June 3, 2011 (''BlackRock III''), CDEU, Hess and WGCEF dated March 23, 2011 (''WGCEF IV'').

comments are beyond the scope of this rulemaking.

In sum, we are cognizant that both direct and indirect costs would arise if the rule further defining the term ''swap dealer'' did not appropriately reflect the statutory definition of the term. Such costs, which would arise as the rule is either more or less inclusive, are detailed above. The Adopting Release provides benefits by interpreting the term ''swap dealer'' in a manner that is as close as possible to the statutory definition of the term, thereby mitigating the potential costs of both over-inclusiveness and under-inclusiveness.

m. Costs of Applying the Rules Further Defining the Term ''Swap Dealer''

In order to apply the rules further defining the term ''swap dealer'' and determine whether or not it is covered by the definition, an entity will incur direct costs in the form of personnel hours devoted to analyzing the entity's activities with respect to swaps and determining whether the entity is covered by the definition. These costs will depend on the nature of the entity's swap activities in the relevant situation. For some entities, it will be relatively clear that they are covered by the definition and they will incur relatively few costs in confirming that. It is expected that for many entities it will be relatively clear that they are not covered by the definition and they will incur little or no cost in confirming that determination. However, for some entities, especially those that enter into swaps in a variety of different ways and circumstances, the determination will be more complex and will require that personnel with financial and legal expertise review the circumstances of the entity's swap activities to make the determination of whether the entity is covered by the definition.

It is important to recognize that this would be the case in the absence of any rule further defining the term ''swap dealer,'' or regardless of the terms of the rule, because entities would have to interpret the statutory definition to determine whether they are covered. Thus, at a minimum, a significant portion of the costs discussed below is attributable to the inclusion in the Dodd-Frank Act of a definition of the term ''swap dealer'' and not from any aspect of the final rules further defining that term. Indeed, the final rule provides benefits by minimizing these costs by providing guidance about the application of the statutory definitions in various situations.

The amount of time and resources that must be expended by an entity in order to determine whether it qualifies as a dealer will vary considerably depending on the complexity of the entity's operations. In addition, the direct costs will vary depending on the determinations the entity must make—reviewing whether or not it is covered by the definition of the term ''swap dealer,'' whether it qualifies for the *de minimis* exception, or whether it seeks to obtain a limited purpose registration as a swap dealer. Depending on an entity's situation, it may incur some or all of these costs. We did not receive any comments quantifying the costs that an entity may incur in applying any aspect of the definition of ''swap dealer,'' nor are we aware of any studies or surveys regarding this particular issue. Therefore, the CFTC staff has estimated the amount of time that entities may require to apply the definition in various situations. These estimations are for informational purposes and require the CFTC to consider the aforementioned highly uncertain criteria.

Regarding the determination of whether an entity is covered by the definition of the term ''swap dealer,'' an entity with a relatively low degree of complexity in its organizational structure (*i.e.,* one legal entity) and in its swap activities (*i.e.,* little variation in the types of swaps they use and the purposes for which they use them) might expect the direct cost of such a determination to be approximately $13,000.[1347] We estimate that approximately 250 entities of this type would be engaged in swap activities that create sufficient uncertainty regarding the application of the definition that they would have to incur these costs. An entity with a moderate degree of complexity in its organizational structure (*i.e.,* a few legal entities) and its swap activities (*i.e.,* some variation in the types of swaps they use and the purposes for which they use them) might expect the cost of such a determination to be approximately $54,000.[1348] We estimate that approximately 150 entities of this type would be sufficiently uncertain regarding the application of the definition that they would have to incur these costs. An entity with a high degree of complexity in its organizational structure (*i.e.,* multiple affiliates in the corporate group) and its swap activities (*i.e.,* using diverse types of swaps for various purposes) could spend approximately $170,000 when making a determination as to whether it is covered by the definition of swap dealer.[1349] We estimate that approximately 50 entities of this type would be sufficiently uncertain regarding the application of the definition that they would have to incur these costs. Thus, the total direct cost for all entities to determine the coverage of the definition of the term ''swap dealer'' would be approximately $20,000,000.

As noted above, we estimate that approximately 450 entities (*i.e.,* 250 with relatively low complexity, 150 with moderate complexity and 50 with high complexity) would be sufficiently uncertain about the application of the definition of the term ''swap dealer'' that they would incur costs in applying the definition. This estimate includes IDIs that apply the loan origination exclusion. It is important to emphasize that since there is no definitive publicly available information about how many entities are engaged in swap activities and how they use swaps in particular situations, it is impossible to be sure how many entities may be uncertain about whether the definition covers

[1347] This estimate is based on the following staff requirements for this determination: 20 hours for a financial analyst at $161/hour, 5 hours of a financial manager at $325/hour, 2 hours of a controller or chief financial officer at $722/hour, 10 hours of a compliance attorney at $355/hour, 2 hours of a senior attorney at $992/hour, and 2 hours of a chief compliance officer at $664/hour. We round to two significant digits. The multiplier of 5.35, which was used in the Proposing Release, is higher than the multiplier that the CFTC has used for similar purposes in other final rules adopted under the Dodd-Frank Act. *See, e.g.,* CFTC, Swap Data Recordkeeping and Reporting Requirements; Final Rule, 77 FR 2135, 2173 (Jan. 13, 2012) (adjustment factor of 1.3 for overhead and other benefits). The CFTC believes that use of a higher multiplier here is appropriate because some persons may retain outside advisors to assist in making the determinations under the rules.

The estimates of the hourly cost for these personnel are from SIFMA's Management & Professional Earnings in the Securities Industry 2010, modified by CFTC staff to account for an 1800-hour work-year and multiplied by 5.35 to account for firm size, employee benefits, and overhead. These estimates are intended to reflect averages for compiling and analyzing the information necessary to apply the definition of the term ''swap dealer.'' We recognize that particular entities within each range of complexity may, based on their circumstances, incur costs substantially greater or less than the estimated averages.

[1348] This estimate is based on the following staff requirements for this determination: 40 hours for a financial analyst at $161/hour, 10 hours of a financial manager at $325/hour, 5 hours of a controller or chief financial officer at $722/hour, 30 hours of a compliance attorney at $355/hour, 20 hours of a mid-level attorney at $608/hour, 15 hours of a senior attorney at $992/hour, and 5 hours of a chief compliance officer at $664/hour.

[1349] This estimate is based on the following staff requirements for this determination: 120 hours for a financial analyst at $161/hour, 40 hours of a financial manager at $325/hour, 20 hours of a controller or chief financial officer at $722/hour, 80 hours of a compliance attorney at $355/hour, 60 hours of a mid-level attorney at $608/hour, 50 hours of a senior attorney at $992/hour, and 20 hours of a chief compliance officer at $664/hour.

them to the point that they would incur such costs. However, we believe that the number of such entities may be estimated based on certain assumptions as discussed below.

In meetings with commenters since publication of the Proposing Release, the CFTC has discussed extensively the universe of potential entities that may be covered by the definition of the term ''swap dealer'' and gathered information on the swap market and its participants. In its FY 2012 budget drafted in February 2011, the CFTC estimated that 140 entities may be covered by the definition of ''swap dealer,'' [1350] and after receiving additional information the CFTC estimates that approximately 125 entities will be covered by the definitions of the terms ''swap dealer'' and ''major swap participant.'' [1351] With these assumptions in mind, we believe it is reasonable to estimate that for every entity covered by the definitions, there will be about four entities (*i.e.,* approximately four times 120, or about 450) that are sufficiently uncertain about the coverage of the definitions that they would incur costs in applying the definitions.

Our estimate that there would be about 450 such entities is also in line with the number of entities that were sufficiently interested in the Proposing Release that they submitted substantive comments to the CFTC. As noted above, we received about 300 substantive comment letters in response to the proposal. Of these, some reflected more than one letter from a single commenter, comments from persons who did not expect to be swap dealers, or comments from persons who were not uncertain about their status under the definition. On the other hand, several letters were from multiple commenters that submitted their comments jointly. Thus, we estimate that about 225 entities were sufficiently interested in the proposed rule further defining the term ''swap dealer'' that they submitted a substantive comment, and for each such entity there was another entity that would also be similarly uncertain about the definition, which supports our estimate that 450 entities in total would incur costs in applying the definition.

Regarding the determination of whether an entity is eligible for the *de minimis* exception from the definition of the term ''swap dealer,'' we note that only an entity that is engaged in some swap dealing activity would be required to make this determination, but it would be required to make the determination regardless of whether it is uncertain about whether its swap activities constitute dealing (*e.g.,* it would incur costs even if there were no doubt that it is engaged in swap dealing). We also note that the number of entities that will apply the *de minimis* exception is expected to be significantly greater than the number of entities that are required to register as swap dealers. Again, we believe that the entities making this determination would have situations that are highly complex (we believe approximately 25 entities would fall in this category), moderately complex (approximately 200 entities) and of low complexity (approximately 400 entities).[1352] The direct cost of making the determination for these entities would be approximately $42,000 in highly complex situations,[1353] $15,000 in moderately complex situations [1354] and $8,000 in situations of low complexity.[1355] The total direct costs for all entities would be approximately $7,300,000.

Third, regarding the determination of whether an entity should apply for a limited purpose swap dealer registration, we believe that relatively few entities would make such an application but that the situation of each of these entities would be highly complex. We believe approximately 20 entities would fall in this category, and the direct cost of making the determination for each would be approximately $250,000,[1356] resulting in a total direct cost of approximately $5,000,000.

Thus, the total initial direct cost of applying the rules further defining the term ''swap dealer'' (including the *de minimis* exception and the possibility of limited purpose registration) for all entities would be approximately $32,000,000.

In addition to these initial costs, we believe that entities would incur recurring costs in applying the definition. Regarding the application of the term ''swap dealer,'' we estimate that approximately 10 percent of the entities noted above would, each year, experience significant changes in their usage of swaps (such as beginning or ending a new line of business) that would require reconsideration of the application of the definition, which would result in costs amounting to one-half of the direct cost of making the initial determination. Applying these factors to the costs noted above, the total recurring direct costs for all entities associated with the application of the term ''swap dealer'' are estimated to be approximately $1,000,000 per year. Regarding the *de minimis* exception, we estimate that entities would have to incur ongoing costs of review to determine whether the exception applies on a yearly basis, and that the annual cost of this review would amount to one-half of the direct cost of making the initial determination. That is, the total recurring direct costs for all entities associated with the *de minimis* exception are estimated to be approximately $3,700,000. Last, we estimate that entities that qualify for a limited purpose swap dealer registration would incur ongoing review costs amounting to one-quarter of the direct

[1350] CFTC, President's Budget and Performance Plan Fiscal Year 2012, p. 13–14 (Feb. 2011), *available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cftcbudget2012.pdf.* The estimated 140 swap dealers includes ''[a]pproximately 80 global and regional banks currently known to offer swaps in the United States;'' ''[a]pproximately 40 non-bank swap dealers currently offering commodity and other swaps;'' and ''[a]pproximately 20 new potential market makers that wish to become swap dealers.'' *Id.*

[1351] *See* CFTC, Registration of Swap Dealers and Major Swap Participants, 77 FR 2613, 2622 (Jan. 19, 2012). The number of persons covered by the definition of ''major swap participant'' is estimated to be quite small, at six or fewer.

[1352] The estimate of approximately 625 entities that will apply the *de minimis* exception is based on our assumption that significantly more (*i.e.,* five times as many) entities will apply the exception as compared to the number of entities registered as swap dealers (which we assume to be approximately 120). This estimate is also in line with information provided by commenters that approximately 100 community and regional banks would potentially apply the *de minimis* exception (*i.e.,* the estimate reflects 100 such banks along with 525 other entities that are involved in the swap markets to a similar extent).

[1353] This estimate is based on the following staff requirements for this determination: 80 hours for a financial analyst at $161/hour, 20 hours of a financial manager at $325/hour, 10 hours of a controller or chief financial officer at $722/hour, 20 hours of a compliance attorney at $355/hour, 5 hours of a senior attorney at $992/hour, and 5 hours of a chief compliance officer at $664/hour.

[1354] This estimate is based on the following staff requirements for this determination: 20 hours for a financial analyst at $161/hour, 5 hours of a financial manager at $325/hour, 5 hours of a controller or chief financial officer at $722/hour, 10 hours of a compliance attorney at $355/hour, 2 hours of a senior attorney at $992/hour, and 2 hours of a chief compliance officer at $664/hour.

[1355] This estimate is based on the following staff requirements for this determination: 10 hours for a financial analyst at $161/hour, 5 hours of a financial manager at $325/hour, 2 hours of a controller or chief financial officer at $722/hour, 5 hours of a compliance attorney at $355/hour, 1 hour of a senior attorney at $992/hour, and 1 hour of a chief compliance officer at $664/hour.

[1356] This estimate is based on the following staff requirements for this determination: 200 hours for a financial analyst at $161/hour, 120 hours of a financial manager at $325/hour, 40 hours of a controller or chief financial officer at $722/hour, 100 hours of a compliance attorney at $355/hour, 60 hours of a mid-level attorney at $608/hour, 50 hours of a senior attorney at $992/hour, and 40 hours of a chief compliance officer at $664/hour. The estimate of approximately 20 entities applying the limited designation reflects an estimate that about one in six swap dealers would apply the designation.

cost of making the initial determination, or approximately $1,300,000 per year. Thus, the total recurring direct cost of applying the swap dealer definition (including the *de minimis* exception and the possibility of limited purpose registration) would be approximately $6,000,000.

5. Costs and Benefits of the Rules Further Defining ''Major Swap Participant''

This Adopting Release further defines a ''major swap participant'' by setting out quantitative thresholds against which a market participant can compare its swaps activities to determine whether it is encompassed by the definition. The rule requires potential major swap participants to analyze their swaps in detail to determine, for example, which of their swaps are subject to netting agreements or mark-to-market collateralization, and the amount of collateral posted with respect to the swaps. The rule includes a general, qualitative definition of the swaps that may be excluded from the calculation because they are used to ''hedge or mitigate commercial risk.'' Like the swap dealer definition, there is a voluntary process by which a person may request that the CFTC limit the major swap participant designation to certain categories of swaps.

a. Background

The definition set forth in CEA section 1a(33) provides that the term ''major swap participant'' means any person who is not a swap dealer and (i) maintains a substantial position in swaps for any of the major swap categories as determined by the CFTC; (ii) whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or (iii) is a financial entity that is highly leveraged relative to the amount of capital it holds, is not subject to capital requirements established by an appropriate Federal banking agency, and maintains a substantial position in outstanding swaps in any major swap category as determined by the CFTC. In connection with the calculation of ''substantial position'' noted above, the statutory definition specifically excludes positions held for hedging or mitigating commercial risk, and positions maintained by any employee benefit plan as defined in sections 3(3) and (32) of ERISA for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan. The statutory definition also provides that major swap participant designations may be limited in scope so that a person may be designated as a major swap participant in certain, but not all, swap categories.

CEA section 1a(33)(D) excludes from the definition of the term ''major swap participant'' certain entities whose primary business is providing financing and who use derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company. There is no analogous statutory provision applicable to major security-based swap participants.

As detailed in this Adopting Release, the definition of the term ''major swap participant'' focuses on the market impacts and risks associated with a person's swap positions. This contrasts to the definition of the term ''swap dealer,'' which focuses on a person's activities and accounts for the amount or significance of those activities only in the context of the *de minimis* exception. Persons that meet the major swap participant definition would, in large part, follow the same statutory requirements applicable to swap dealers.[1357] In this manner, the Dodd-Frank Act regulates entities whose swap activities do not cause them to be swap dealers, but nonetheless could pose a high degree of risk to the U.S. financial system. This regulation of major swap participants is intended to facilitate financial stability by reducing risk, increasing transparency, and promoting market integrity.

b. Costs of Applying the Rules Further Defining the Term ''Major Swap Participant''

The actual cost of applying the rule further defining the term ''major swap participant'' to determine if a person is covered by the definition will depend, in large part, on the nature of the person's swap activities as well as the infrastructure such person already has in place for the analysis and reporting of its swap activities. Many persons will be clearly outside the definition (and a few persons may be clearly covered by the definition) and will incur little cost to confirm that status. However, it is reasonable to expect that a few persons that are not swap dealers but nonetheless engage in significant swap activity will be required to incur costs to determine whether they are covered by the definition. The direct costs such a person would incur would result from the incremental expense of personnel with financial and accounting expertise who would be required to devote time to the review of the size and nature of the person's swap positions to determine whether the person is covered by the definition. Moreover, there will also be technology and legal review costs related to the determination of whether a person is a major swap participant. As is the case for the definition of the term ''swap dealer,'' it is important to recognize that even in the absence of any rule further defining the term ''major swap participant,'' or regardless of the terms of the rule, entities would incur costs in interpreting the statutory definition to determine whether they are covered. Thus, at a minimum, a significant portion of the costs discussed below is attributable to the inclusion in the Dodd-Frank Act of a definition of the term ''major swap participant'' and not from any aspect of the final rules further defining that term. Indeed, the final rules provide benefits by mitigating these costs by providing guidance about the application of the statutory definitions in different situations.

The amount of time and resources that must be expended by a person in order to determine whether it qualifies as a major swap participant may vary considerably depending on the complexity of such person's operations. In addition, direct costs will vary depending on the determinations the person must make relating to the definition, including, but not limited to, whether it engages in swap activity near the thresholds for ''substantial position'' and ''substantial counterparty exposure,'' and whether it is subject to a ''safe harbor'' provision as set forth in the definition. The CFTC did not receive any comments quantifying the costs that a person may incur in applying any aspect of the definition of the term ''major swap participant,'' nor are we aware of any studies or surveys regarding this particular issue. Therefore, the CFTC staff has estimated, based on its experience, the amount of time that a person may require to determine whether it meets the definition. These estimations are for informational purposes and require the CFTC to consider the aforementioned highly uncertain criteria.

The CFTC estimates that approximately 20 persons that are not swap dealers will initially be engaged in swap activity to such an extent that they

[1357] The Dodd-Frank Act provides for the registration and regulation of major swap participants under CEA section 4s. The particular requirements applicable to major swap participants will be established in separate rulemakings. *See* notes 1240 and 425, *supra.*

would be required to apply the calculations in the final rule in determining whether they are covered by the definition.[1358] The direct cost of making such determination for each such person is estimated to be approximately $260,000,[1359] resulting in an initial aggregate direct cost of approximately $5,200,000. We note that the relatively low estimate of only 20 persons that would be required to incur costs at this level, as compared to the many thousands of swap market participants, reflects the relatively high thresholds for major swap participant status. As noted above, the large majority of market participants will be able to readily conclude that they are not covered by the definition.

In addition to these initial costs, we believe that approximately 20 entities would incur recurring direct costs in applying the definition of major swap participant on a daily basis, and such costs would amount to one-third of the direct cost of making the initial determination. Thus, the total recurring direct costs for all entities associated with the application of the term ''major swap participant'' are estimated to be approximately $1,700,000 per year or approximately $83,000 per year for each person.

Although the CFTC believes there will only be a limited number of persons that potentially may be major participants, we recognize the concerns raised by several commenters that major swap participant calculations will be conducted as part of the person's overall compliance function even when there is not a significant likelihood that such person would be a major swap participant. As a result of the potential expense and effort that a person would be required to incur in connection with determining whether it meets the definition of major swap participant, the final rule includes three alternative ''safe harbor'' provisions.[1360] These safe harbor provisions relieve persons that are clearly not major swap participants from incurring the expense of the calculations otherwise required under the final rule.

To apply the safe harbor provisions of the rule, the CFTC estimates that a person would have to incur initial direct costs of approximately $2,900 to determine whether its swap positions are within the safe harbor.[1361] In addition, a person would incur costs of reviewing its swap positions on a monthly basis to monitor whether the safe harbor continues to apply, at an annual cost equal to one-third of the direct cost of making the initial determination, or $960. Our assumption that approximately 1,200 entities would apply the safe harbor provisions of the rule yields an aggregate direct initial cost of approximately $3,500,000 and aggregate annual costs of approximately $1,200,000.[1362]

c. Major Swap Participant Thresholds

The final rule adopts the general approach in the proposed rule of determining whether a person is a major swap participant by comparing the exposure resulting from a person's swap positions to specific, quantitative thresholds. The proposed thresholds for substantial position were $3 billion in current uncollateralized exposure or $6 billion in current uncollateralized exposure plus potential future exposure for rate swaps, and $1 billion in current uncollateralized exposure or $2 billion in current uncollateralized exposure plus potential future exposure for each of the other categories of swaps. The proposed thresholds for substantial counterparty exposure are $5 billion in current uncollateralized exposure across all categories or $8 billion in current uncollateralized exposure plus potential future exposure across all categories.[1363] However, there is a change for the weight in the PFE calculations from the proposal to the final rule of 0.2 to 0.1 for cleared swaps.

Commenters generally did not oppose the proposed thresholds although several thought the thresholds should be raised.[1364] Two commenters supported the adoption of the thresholds as proposed.[1365] In addition, a few other commenters thought that the thresholds were set too high.[1366] Other commenters suggested that the thresholds be raised to a level that reflects systemic risk without suggesting a specific numerical threshold.[1367] One commenter, however, suggested that the threshold be increased to $10 billion.[1368] Several commenters also said that the thresholds should be adjusted for inflation and other changes over time in the swap market.[1369]

As discussed in part IV.B.3.d., the CFTC is adopting the thresholds as proposed. We recognize that the level of the thresholds will have a significant effect on whether the rules further defining the term ''major swap

[1358] As is the case with respect to the definition of the term ''swap dealer,'' we believe that the number of persons that may incur costs in reviewing their activities and the rules will be significantly greater than the number of entities that actually are covered by the definition and will be required to register as major swap participants. Similarly, since there is no definitive publicly available information about how many entities are engaged in swap activities and how they use swaps in particular situations, it is impossible to be sure how many entities may be uncertain about whether the definition covers them to the point that they would incur such costs. Our estimate that approximately 20 entities would be sufficiently uncertain about the application of the definition of the term ''major swap participant'' that they would incur costs in applying the definition is based on our assumption that about six entities would be covered by the definition, and that for each such entity there will be about four entities that will be uncertain about the coverage of the definition. *See* note 1351, *supra.*

[1359] This estimate is based on the following staff requirements for this determination: 200 hours for a financial analyst at $161/hour, 80 hours for a programmer analyst at $196/hour; 120 hours of a financial manager at $325/hour, 40 hours of a controller or chief financial officer at $722/hour, 100 hours of a compliance attorney at $355/hour, 60 hours of a mid-level attorney at $608/hour, 50 hours of a senior attorney at $992/hour, and 40 hours of a chief compliance officer at $664/hour.

The estimates of the hourly cost for these personnel are from SIFMA's Management & Professional Earnings in the Securities Industry 2010, modified by CFTC staff to account for an 1800-hour work-year and multiplied by 5.35 to account for firm size, employee benefits, and overhead. As is the case for the application of the definition of the term ''swap dealer,'' we believe that that use of a higher multiplier here is appropriate because some persons may retain outside advisors to assist in making the determinations under the rules. These estimates are intended to reflect averages for compiling and analyzing the information necessary to apply the definition of the term ''major swap participant.'' We recognize that particular entities within each range of complexity may, based on their circumstances, incur costs substantially greater or less than the estimated averages. We round to two significant digits.

[1360] *See* part IV.M, *supra.*

[1361] This estimate is based on the following staff requirements for this determination: 5 hours for a financial analyst at $161/hour, 2 hours for a financial manager at $325/hour, 1 hour for a comptroller or chief financial officer at $722/hour, 2 hours for a compliance attorney at $355/hour.

[1362] Our estimate of the number of entities that will make the safe harbor calculation includes the following: one-half of the approximately 700 investment company sponsors that are active in the U.S. (*see* the 2011 Investment Company Factbook published by the ICI, page 14, available at *http://www.ici.org/pdf/2011_factbook.pdf*), a similar number of entities (*i.e.,* 350) that have large positions in swaps as part of other investment management activities, one half of the corporate entities in the ''Fortune 500'' (representing corporate entities that have large positions in swaps) and an additional 250 entities representing other holders of large positions in swaps.

[1363] *See* parts IV.B.3.d. and IV.E.3.

[1364] *See, e.g.,* letters cited in notes 796 and 798, *supra.*

[1365] *See* letters from Dominion Resources and Fidelity.

[1366] *See* letters from AFR and Greenberger.

[1367] *See* letters from BlackRock I, ISDA I, MFA I and WGCEF II.

[1368] *See* letter from CCMR I. In addition, ACLI commented that thresholds for rate swaps should be increased to $4 billion for current uncollateralized exposure and $8 billion for current uncollateralized exposure plus potential future exposure, with corresponding increases to substantial counterparty exposure thresholds to $7 billion for current uncollateralized exposure and $14 billion for current uncollateralized exposure plus potential future exposure. *See* letter from ACLI.

[1369] *See* letters from CDEU, COPE I, Fidelity, ISDA I, and MFA I.

participant'' are applied in a manner that is more or less inclusive, and that in setting the thresholds it is possible that we may err on the side of over- or under-inclusion. As noted above in part V.C.2., if the rule were more inclusive, costs could arise when the persons that are classified as major swap participants incur compliance costs, while if the rule is less inclusive the benefits of regulating major swap participants (in terms of reduced risk, increased transparency and market integrity) could be reduced. We also recognize that a more inclusive rule could lead to costs if it causes persons to make changes to their use of swaps in order to avoid being covered by the rule.

One commenter said that the CFTC should conduct an empirical analysis of the proposed thresholds and whether they are suitable for identifying persons whose swap positions entail the risks enumerated in the statutory definition of the term ''major swap participant.'' [1370] However, the CFTC believes it is not feasible to perform such an analysis because the comprehensive and detailed information about how very active swap market participants use swaps that it would require is not available.

The CFTC believes that the threshold levels in the final rule are appropriate to effectively monitor and oversee entities that are systemically important or could significantly impact the U.S. financial system. The CFTC and SEC are consistent in their approach to thresholds. As more data regarding the use of swaps and the importance of very large swap positions in the swap markets become available, the CFTC may consider adjusting the thresholds.

The final rules also provide for the measure of potential future exposure to be adjusted in the case of swap and security-based swap positions that are centrally cleared or that are subject to daily mark-to market margining. This is consistent with the purpose of the potential future exposure test, which is to account for the extent to which the current outward exposure of positions (though possibly low or even zero at the time of measurement) might grow to levels that can lead to high counterparty risk to counterparties or to the markets generally. The practice of the periodic exchange of mark-to-market margin between counterparties helps to mitigate the potential for large future increases in current exposure.

Consistent with the proposal, the final rules reflect this ability to mitigate risk by providing that the potential future exposure associated with positions that are subject to daily mark-to-market margining will equal 0.2 times the amount that otherwise would be calculated. However, in response to commenters assertions about the risk-mitigating effects of central clearing, and the additional level of rigor that clearing agencies may have with regards to the process and procedures for collecting daily margin, the final rules further provide that the potential future exposure associated with positions that are subject to central clearing will equal 0.1 (rather than the proposed 0.2) times the potential future exposure that would otherwise be calculated.[1371]

Although some commenters supported the complete exclusion of cleared positions from the potential future exposure analysis,[1372] the CFTC recognizes that central clearing cannot reasonably be expected to entirely eliminate counterparty risk.[1373] Accordingly, the CFTC concluded that the use of a 0.1 factor (in lieu of the proposed 0.2) is appropriate for cleared positions, reflecting the strong risk mitigation features associated with central clearing, particularly the procedures regarding the collection of daily margin and the use of counterparty risk limits, while recognizing the presence of some remaining counterparty risk.

Moreover, although some commenters opposed any deduction from the measure of potential future exposure for uncleared positions that are margined on a daily basis,[1374] the CFTC believes that the risk-mitigating attributes of daily margining warrant an adjustment given that the goal of the potential future exposure test is to account for price movements over the remaining life of the contract.[1375] The use of a 0.2 factor also reflects the CFTC's expectation that the risk mitigation associated with uncleared but margined positions would be less than the risk mitigation associated with cleared positions.

While higher or lower alternatives to the 0.1 and 0.2 factors may also be reasonable for positions that are cleared or margined on a daily basis, the CFTC believes that the factors of the final rules reasonably reflects the risk mitigating (but not risk eliminating) features of those practices. The final rules also retain and clarify provisions addressing when daily mark-to-market margining occurs for purposes of this discount.[1376]

d. Difficulty in Applying the Major Swap Participant Calculations

While commenters generally acknowledged that the proposed quantitative threshold tests are objective, some said that the proposed tests are difficult to understand and

[1370] *See* letter from WGCEF II.

[1371] *See* CFTC Regulation § 1.3(jjj)(3)(iii)(A); Exchange Act rule 3a67–3(c)(3)(i). The final rules further have been revised to clarify that the 0.1 factor applies to positions cleared by a registered clearing agency or by a clearing agency that has been exempted from registration.

[1372] *See, e.g.,* letters from MFA I and SIFMA AMG II.

[1373] Central clearing helps to mitigate counterparty credit risk by improving risk management and, among other things, mutualizing the risk of counterparty failure. If multiple members of a central counterparty fail beyond the level to which such risk is managed, however, the central counterparty would also be at risk of failure. *Cf.* Basel Committee on Banking Supervision, Consultative Document, ''Capitalisation of bank exposures to central counterparties,'' Nov. 25, 2011 (available at: *http://www.bis.org/publ/bcbs206.pdf*) (proposing that the capital charge for trade exposures to a qualifying central counterparty should carry a low risk weight, reflecting the relatively low risk of default of the qualifying central counterparty). In addition, as the CFTC and SEC discussed in the Proposing Release, *see* 75 FR at 80192 n. 115, for example, central counterparties that clear credit default swaps do not necessarily become the counterparties of their members' customers (although even absent direct privity those central counterparties benefit customers by providing for protection of collateral they post as margin, and by providing procedures for the portability of customer positions in the event of a member's default). As a result, central clearing may not eliminate the counterparty risk that the customer poses to the member, although required mark-to-market margining should help control that risk, and central clearing would be expected to reduce the likelihood that an entity's default would lead to broader market impacts.

[1374] *See* letter from Better Markets I; *see also* letter from AFR.

[1375] The CFTC does not believe that it is appropriate to have this type of discount when mark-to-market margining is done less than daily, however.

[1376] The CFTC recognizes that at times, market participants whose agreements provide for the daily exchange of variation margin in connection with swaps in practice may not exchange collateral daily, if the amounts at issue are relatively small (such through the use of collateral thresholds and minimum transfer amounts). We do not believe that such practices would be inconsistent with providing a discount for daily margining practices. The proposed rules sought to accommodate those practices by providing that positions would be considered to be subject to daily mark-to-market margining for purposes of the ''uncollateralized outward exposure'' plus ''potential outward exposure'' analysis, so long as the total of such thresholds, and the total of such minimum transfer amounts above $1 million are deemed to be ''uncollateralized outward exposure'' for those purposes.

In light of commenter concerns, which indicated that the proposal was not fully clear about the mechanics and purpose of this approach, the relevant rule language has been revised to clarify that this attribution of thresholds and minimum transfer amounts is solely for the purpose of determining whether certain positions are subject to daily mark-to-market margining for purposes of the analysis. In addition, the final rules have been revised from the proposal to provide that the attribution of thresholds as ''uncollateralized outward exposure'' for these purposes will be reduced by initial margin posted, up to the amount of the threshold. *See* CFTC Regulation § 1.3(jjj)(iii)(B); Exchange Act rule 3a67–3(c)(3)(ii).

hard to apply.[1377] Another commenter submitted that ''[the CFTC] should solicit feedback from market participants prior to final rule given the complexity of tests and likely interpretive issues; proposed tests are highly technical, and more challenging to use than may appear at first glance; could also request volunteers to walk-through the tests to ensure they actually function in practice.''[1378] Several commenters suggested means of reducing the costs of applying the proposed tests. Some commenters requested that the CFTC adopt a ''safe harbor'' provision in the final rules for swap users with positions that are substantially below the thresholds.[1379] Another commenter opined that the rule should allow persons to rely on third-party service providers to conduct the required calculations.[1380] In addition, a commenter said the rule should allow swap users to apply standard industry practices in valuing their positions.[1381]

We believe that the guidance in this Adopting Release reduces the costs of determining if a person is covered by the definition. For example, in response to commenters' concerns we clarify that a person may determine the value of its exposure using industry standard practices.[1382] Also, we believe that the daily calculation burdens associated with the proposed thresholds will be addressed by safe harbors that are available if a simplified calculation shows that a person's exposure from its swap position is far below any threshold for any particular month. The final rule includes safe harbors to reduce unnecessary costs for entities that, because of compliance concerns, would engage in major swap participant calculations even though it would be very unlikely that the major swap participant thresholds would be met.[1383] Also, the CFTC will permit third-party service providers to perform major swap participant calculations, although a person that may be a major swap participant is not relieved of potential liability for violations of the CEA if there is a calculation or other error by the third-party.[1384]

e. Exclusions for Particular Types of Entities

Commenters said that exclusions from the major swap participant definition should be available for certain entities including insurance companies, registered investment companies, entities that maintain legacy portfolios of swaps, ERISA plans, and sovereign wealth funds.[1385] Some commenters cited, as the underlying basis for excluding these entities, the existing regulatory regime to which these entities are subject and the potential for dual regulation if they were covered by the definition of the term ''major swap participant.''[1386] One commenter asserted that a lack of clarity with respect to proposed exemptive relief will impose additional costs on market participants due to the uncertainty in determining major swap participant status.[1387]

Several commenters said that sovereign wealth funds should be excluded from the definition of major swap participant based on international principles of comity and sovereign immunity.[1388] These commenters asserted that sovereign wealth funds are regulated in their home country and do not represent the type of counterparty risk contemplated by the Dodd-Frank Act. A commenter asserted that special purpose vehicles for structured finance or securitization should be exempted from the definition of major swap participant so as to not harm liquidity in asset securitizations.[1389] That commenter based its recommendation on the understanding that special purpose vehicles have limited functionality and resources and would accordingly be unable to comply with the burden of regulation as a major swap participant.[1390]

The final rule does not have specific exclusions for certain types of entities. The CFTC believes that a more level playing field is desirable to ensure no particular type of entity gains an unfair competitive advantage in the market.

The appropriate treatment of ''legacy portfolios'' (*e.g.,* the monoline insurers or their special purpose vehicles) will be determined on a case-by-case basis by the CFTC. Legacy portfolio operators specifically commented that they are in ''run-off''/wind down mode, thereby undertaking no new swaps that would increase their risk, with an expectation to shut down or cease operations once their portfolio expires.[1391] As a result, these commenters maintain that margin or capital requirements would likely lead to their insolvency because they do not have the assets to satisfy the proposed requirements. The CFTC notes that many of the compliance obligations imposed by the Dodd-Frank Act and/or the business conduct rules promulgated thereunder will not apply to operators of legacy portfolios because such obligations will not be applicable to swaps executed prior to the enactment of the Dodd-Frank Act such as the swaps in legacy portfolios.[1392] Consequently, the CFTC expects legacy portfolio operators' primary compliance obligation to be related to reporting and risk management.

f. CEA Section 15(a) Discussion

The costs and benefits of the rule further defining the term ''major swap participant'' are evaluated in light of the section 15(a) five broad areas of market and public concern.

Protection of market participants and the public. The rule helps parties to identify when they have substantial positions or substantial counterparty exposures in swap markets that would cause them to be covered by the definition of major swap participant. Under the Dodd-Frank Act, major swap participants are subject to regulations enacted to protect market participants and the public. The costs and benefits of the statutory and regulatory requirements for major swap participants are addressed in the various rulemakings in which they are promulgated.[1393]

[1377] *See, e.g.,* letters from Fidelity, Freddie Mac, ISDA I and SIFMA AMG II.

[1378] *See* letter from WGCEF II at 11.

[1379] *See* letters from AII, Vanguard and SIFMA AMG II. Another commenter submitted that swap dealers will require counterparties to run the major swap participant calculations in order to certify that they are not major swap participants, even in cases where it is readily evident that they are not major swap participants. *See* meeting with CalSTRS on April 15, 2011.

[1380] *See* letter from ISDA I.

[1381] *See id.*

[1382] *See* part IV.B.3.b, *supra.*

[1383] *See* part IV.M.2, *supra.*

[1384] *See* part IV.B.3.e, *supra.*

[1385] *See* part IV.J.2, *supra.*

[1386] *See id.* For example, commenters said that registered investment companies and corresponding registered investment advisers should be excluded from the definition of major swap participant because they are highly regulated by the SEC pursuant to the ICA and the Investment Advisers Act of 1940, and therefore major swap participant regulation would be duplicative. *See* joint letter from ICI and SIFMA AMG.

[1387] *See* letter from MetLife.

[1388] *See* letters from CIC and GIC and meeting with Weil.

[1389] *See* letter from ISDA I.

[1390] *See id.*

[1391] *See* letters from Athilon, Berkshire Hathaway, ISDA I, MBIA and Newedge. As noted in part IV.J.3.a, *supra,* the CFTC understands that legacy portfolios are no longer entering into new transactions other than to novate, amend and hedge their existing positions. In connection with any potential exclusion, however, legacy portfolios would still be required to report to SDRs information about their swap transactions and positions. *See* letters from BlackRock I and Canadian MAVs.

[1392] *See* CFTC, Swap Data Recordkeeping and Reporting Requirements: Pre-Enactment and Transition Swaps; Final Rule, 77 FR 2136 (Jan. 13, 2012).

[1393] *See* part VII.C.2, *supra.*

Efficiency, competitiveness, and financial integrity of markets. To date, potential major swap participants have engaged in swaps in an off-exchange marketplace that has been largely unregulated. Once the regulations required under the Dodd-Frank Act are adopted and effective, major swap participants will be subject to CFTC oversight and comprehensive regulation. The CFTC believes these regulations will improve the financial integrity of swap markets and the U.S. financial system generally. Since the number of persons that are expected to be major swap participants is small, the CFTC believes that these regulations will not have a significant effect on the efficiency or competitiveness of the markets.

Price discovery. The CFTC does not perceive any direct effect on price discovery from the rule further defining the term ''major swap participant.''

Sound risk management practices. The level of the major swap participant thresholds may discourage persons from engaging in swap activities that might cause them to exceed the major swap participant thresholds. This reduction in the use of swaps could be costly if other alternatives are not as suitable for the underlying risks (*e.g.,* futures might have different contract sizes or expiration, and forward contracts introduce physical risks not present in cash settled transactions). The CFTC notes that this concern is mitigated by the relatively high threshold levels for major swap participant status.

Other public interest considerations. The specific quantitative thresholds in the rule set forth definitive tests for determining if a person is covered by the definition of the term ''major swap participant.'' This specific, quantitative threshold serves the public interest by promoting efficient application of the rule. Also, as noted above, major swap participants will be subject to CFTC oversight and comprehensive regulation, which we believe will improve the financial integrity of swap markets and the U.S. financial system generally.

6. Costs and Benefits of the Rules Relating to the Definition of ''Eligible Contract Participant''

a. Background

The ECP regulations and interpretation fall within the following six categories:

- CFTC Regulation § 1.3(m)(5)(i) prevents a commodity pool (i) in which any of the pool's direct participants is not an ECP in its own right and (ii) that directly enters into retail forex transactions from being an ECP under CEA section 1a(18)(A)(iv) or (v), for purposes of retail forex transactions only. CFTC Regulation § 1.3(m)(5)(ii) provides that the CFTC would look through a commodity pool participant that directly participates in a transaction-level commodity pool only if such direct commodity pool participant, any entity holding an interest in such direct commodity pool participant, or any entity in which such direct commodity pool participant holds an interest were structured to evade subtitle A of Title VII of the Dodd-Frank Act by permitting persons that are not ECPs to participate in retail forex transactions. The look-through in CFTC Regulation § 1.3(m)(5)(ii) does not apply to a non-commodity pool participant in a commodity pool.
- CFTC Regulation § 1.3(m)(6) excludes a commodity pool from ECP status if it does not have total assets exceeding $5,000,000 or is not operated by a person described in CEA section 1a(18)(A)(iv)(II).[1394]
- CFTC Regulations § 1.3(m)(1)–(4) define major swap participants, swap dealers, major security-based swap participants and security-based swap dealers, respectively, as ECPs.
- CFTC Regulation § 1.3(m)(7) permits an otherwise non-ECP to qualify as an ECP, with respect to certain swaps, based on the collective net worth of its owners, subject to several conditions, including that the owners are ECPs.
- CFTC Regulation § 1.3(m)(8) permits a Forex Pool to qualify as an ECP notwithstanding that it has one or more direct participants that are not ECPs if the Forex Pool (a) is not formed for the purpose of evading regulation under CEA sections 2(c)(2)(B) or (C) or related rules, regulations or orders, (b) has total assets exceeding $10 million and (c) is formed and operated by a registered CPO or by a CPO who is exempt from registration as such pursuant to CFTC Regulation § 4.13(a)(3).
- Finally, the Commissions have provided an interpretation to address an incorrect statutory cross-reference preventing certain government entities from qualifying as ECPs under CEA section 1a(18)(A)(vii).[1395]

b. Summary of Comments

Commenters stated that commodity pools will incur costs to comply with statutory and regulatory requirements made applicable as a result of the Commissions' narrowing of the ECP definition.[1396] Commenters argued that to apply the look-through at any investment level would be unnecessarily burdensome and disruptive to how commodity pools are structured, with resulting costs.[1397] One commenter advised that, if a trading advisor cannot be sure that all pool participants are ECPs, then it must be cautious and either register as a CPO or decide not to engage in Retail Forex Transactions on behalf of its advised pools.[1398] Another commenter stated that while many existing commodity pools have already obtained accredited investor and QEP representations from participants, virtually none currently obtain ECP representations from their investors.[1399] This commenter argued that obtaining such a representation would impose an operational burden and additional costs, as well as require commodity pools to redeem non-ECPs. The commenter further points out that, given the estimated $1.9 trillion of assets invested in hedge funds, the portion of those assets that use OTC forex is likely to be substantial, and therefore substantial time and expense would be expended in determining eligibility requirements for the thousands of investors in funds that use OTC forex.[1400]

Commenters explained that there are costs to losing ECP status and that the enumerated counterparty list is unclear and subject to uncertainty because it relies on other regulators.[1401] One commenter argues that funds would incur compliance and transaction costs if categorized as non-ECPs because they would have to enter into forex transactions through a DCM and their operators would have to register as CPOs.[1402] That commenter also states that the markets for exchange-traded futures are less liquid than OTC forex markets, and that posting initial margin on a DCM is costly, since it cannot be used to invest in riskier assets and a FOF would have to invest in liquid and low risk (and, commensurately, lower yielding) assets necessary to post variation margin. As another commenter points out, the resulting increased expenses from the requirement to trade on a DCM and comply with retail forex rules may result in higher expenses for hedge and private equity funds, which

[1394] 7 U.S.C. 1a(18)(A)(iv)(II).

[1395] 7 U.S.C. 1a(18)(A)(vii).

[1396] *See* letters from AIMA I, Akin Gump, Sidley, and Willkie Farr.

[1397] *See id.*

[1398] *See* letter from AIMA I.

[1399] *See* letter from Sidley.

[1400] *See id.*

[1401] *See* letters from AIMA I, Akin Gump, and Sidley.

[1402] *See* letter from Sidley.

they would likely pass along to their investors.[1403]

A commenter asserted that the characteristics necessary to avoid non-ECP status may prevent free investment and could reduce liquidity and create volatility in these markets.[1404]

With respect to CFTC Regulation § 1.3(m)(6), a commenter expressed concerns with the expected costs associated with the proposal that commodity pools that do not qualify as ECPs under clause (A)(iv) should not be able to qualify under clause (A)(v), stating that the proposal would be difficult to comply with and would adversely impact investment.[1405]

Two commenters agreed that the proposed addition of swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants to the ECP definition provided a benefit with little or no costs.[1406] No commenter objected.

With respect to CFTC Regulation § 1.3(m)(7), commenters said that non-ECPs have entered into swaps in reliance on the Swap Policy Statement.[1407] Commenters emphasized the importance of the Swap Policy Statement to pass-through entities used by farmers,[1408] operating companies [1409] and commercial property developers,[1410] noting that such entities may not meet the ECP criteria. According to these commenters, these pass-through entities often are small and medium-sized businesses that enter into interest rate swaps with lending financial institutions in reliance on the Swap Policy Statement.[1411] The commenters explained that the loans usually are guaranteed by the principals of the entity entering into the swap, and that the borrower would qualify as an ECP if structured as a single-level corporate entity or sole proprietorship.[1412] Commenters said that if these non-ECP entities were limited to swaps that are available on or subject to the rules of a DCM, many regional bank borrowers would lose the ability to use swaps, real estate companies would have less flexibility in risk management, and smaller lenders would be at a competitive disadvantage.[1413] Another commenter said that Dodd-Frank Act provisions such as the end-user clearing exception indicate that Congress intended to preserve the availability of swaps used for managing risks rather than for investment or speculation.[1414]

To mitigate the impact of restricting non-ECPs to swaps that are available on or subject to the rules of DCMs, some commenters said that an entity should be able to qualify as an ECP based on the financial qualifications of related entities, so long as various conditions proposed by the commenters are satisfied. Some commenters said that an entity should be eligible to be an ECP if its swap obligations are guaranteed by an ECP,[1415] or if its controlling entity qualifies as an ECP under clause (A)(v) of the statutory definition.[1416] Another commenter suggested revisions to the ECP definition that included looking to the ECP status or sophistication of the majority owner of an entity in determining if the entity itself is an ECP.[1417] Other commenters suggested other provisions to allow non-ECPs to enter into swaps other than on or subject to the rules of a DCM, so long as the non-ECP meets various conditions indicating that the swap is used in connection with its line of business.[1418]

With respect to CFTC Regulation § 1.3(m)(8), several commenters asserted that many Forex Pools are operated by sophisticated, professional managers that do not need the protections of a retail forex regime designed to protect non-ECPs that are engaging in retail forex transactions.[1419] More specifically, some commenters, based on CFTC enforcement actions involving Forex Pools, suggested that commodity pools of a sufficient size, and/or operated by a registered or exempt CPO, do not pose the risks of fraud and abuse of non-ECP customers that the statutory look-through provision is intended to address.[1420]

As a result, commenters suggested that the look-through provision should not apply in determining ECP status of commodity pools that meet certain conditions. For example, commenters suggested that the look-through not be applied to a commodity pool with $10 million in total assets if other factors were present—*e.g.,* not structured to evade,[1421] subject to regulation under the CEA [1422] and/or operation by a registered CPO.[1423] Another commenter suggested requiring the total assets or minimum initial investment of a Forex Pool to be sufficiently large that, in general, only legitimate pools would exceed such thresholds.[1424] This commenter suggested a total asset threshold of $50 million.[1425]

Separately, one commenter also claimed that the statutory look-through, if strictly implemented, might inappropriately preclude Forex Pools and their CPOs, many of whom are registered, from engaging in retail forex transactions with swap dealers because swap dealers are not Enumerated Counterparties (and some swap dealers also may not be Enumerated Counterparties in a different capacity, such as being a U.S. financial institution).[1426] This commenter stated that such a result could reduce close out netting opportunities in the event of the insolvency of a counterparty.

Finally, to reduce the adverse effects on government entities that may need to qualify as ECPs based on their swap

[1403] *See* letter for Akin Gump. This commenter also said that these increased expenses could cause funds to terminate their foreign currency hedging, which would increase their investors' currency risk, causing higher volatility in the investment industry.

[1404] *See* letter from AIMA I. *See generally* part III.B.3, *supra.*

[1405] *See* letter from AIMA I.

[1406] *See* letters from Greenberger and Sidley.

[1407] *See* letters from B&F I, CDEU and Capstar. One element of the Swap Policy Statement required that the swap be entered into in connection with each swap counterparty's line of business. *See* Swap Policy Statement at 30697. The CFTC stated when issuing the Swap Policy Statement that it ''reflects the [CFTC]'s view that at this time most swap transactions, although possessing elements of futures or options contracts, are not appropriately regulated as such under the [CEA] and [CFTC] regulations.'' Swap Policy Statement at 30694.

[1408] *See, e.g.,* letter from Rabobank, New York Branch (relating that ''[f]or a variety of estate planning and regulatory purposes, farmers commonly hold their ownership interests in land, buildings and farm equipment indirectly, through a network of legal entities'').

[1409] *See, e.g.,* letter from Fifth Third Bank and Union Bank, N.A. (advising that ''[i]t is common for an operating business to organize a separate limited liability company (for tax and legal reasons) to acquire * * * assets * * * and to lease these assets to the operating company[, which] becomes the borrow[er] * * * for the loan used to acquire those assets'' and that ''[t]he limited liability company often does not maintain sufficient capital to qualify as an ECP'').

[1410] *See, e.g.,* letters from BB&T I, B&F I and Midsize Banks.

[1411] *See* letters from BB&T I and B&F I. Commenters said that these businesses may intentionally maintain less than $1 million in equity primarily for tax and legal reasons. *See* letters from Capital One and Columbia State Bank (stating that over 65% of its borrowers are structured as limited liability companies or S corporations and intentionally maintain less than $1 million in equity at the entity entering into the swap).

[1412] *See* letter from Columbia State Bank. *See also* letter from BB&T I.

[1413] *See* letters from BB&T I, Capital One, Capstar, Columbia State Bank, Midsize Banks, NAREIT and Wells Fargo II.

[1414] *See* letter from FSR I.

[1415] *See* letters from BB&T I, Midsize Banks and Wells Fargo II.

[1416] *See* letters from CDEU and Regional Banks.

[1417] *See* letter from NAREIT.

[1418] *See* letters from APGA, Capital One and Gavilon dated October 28, 2010.

[1419] *See* letters from Millburn and Sidley.

[1420] *See* letters from GXFD I and Sidley.

[1421] *See* letter from GFXD II.

[1422] *See* letters from GFXD II and Skadden.

[1423] *See* meeting with SIFMA on January 20, 2012.

[1424] *See* letter from Sidley.

[1425] *See id.*

[1426] *See* letter from GFXD I.

counterparties but that would be foreclosed from doing so due to an erroneous reference in the definition of ECP, a commenter requested the correction of that erroneous reference.[1427]

c. Response to Comments and Consideration of Costs and Benefits in the Final Rule

CFTC Regulation § 1.3(m)(5)(i) reduces the number of pools that need to determine the ECP status of their natural person participants, and thus reduces related costs, because it limits, absent evasion, the pools the CFTC considers for look-through purposes to transaction-level retail forex pools. The guidance the Commissions provide in the preamble also reduces the scope of the potential look-through, with attendant cost-reductions, by stating expressly that a Retail Forex Pool using retail forex transactions solely to hedge or mitigate currency risk would not be considered structured to evade. Thus, such hedging or mitigation would not be the basis of a look-through. In particular, because, according to a commenter, the typical FOF uses retail forex transactions solely to hedge currency risk related to fluctuations in the exchange rate between non-U.S. dollar subscription currencies and the U.S. dollar, most, if not all, FOFs would not be covered by the look-through. To the extent other commodity pools use retail forex transactions solely to hedge or mitigate their currency risk, such pools also would not be subject to the CFTC Regulation § 1.3(m)(5)(ii) look-through provision. Because Regulation § 1.3(m)(5)(ii) provides a look through only in cases of evasion and the Commissions' guidance narrows considerably the scope of what might otherwise be considered evasion, the CFTC expects the CPO of the typical pool to be able to determine at little or no cost the ECP status of their direct participant commodity pools; such status will be based on CEA section 1a(18)(iv), an analysis with which such CPOs are familiar.[1428]

While the CFTC has provided guidance to reduce the costs of applying the rule, it estimates that each affected CPO may have to spend between 5 and 20 hours of legal time, representing a cost between $1,800 and $7,100,[1429] initially to determine the ECP status of the pools that they operate, and up to 5 hours ($1,800) of additional legal time to determine such status upon each change to the fund's structure, operating guidelines, etc. that might implicate ECP status. Commenters noted that drafting ECP representations and contacting existing participants are part of the costs of determining ECP status. While the CFTC acknowledges such costs, CFTC Regulation § 1.3(m)(5) also provides investor protection benefits to non-ECP participants in pools that are not ECPs by requiring such pools to enter into retail forex transactions with an Enumerated Counterparty. This provides non-ECP participants in such pools the protections of the retail forex regime imposed by such counterparty's federal regulator.

The CFTC also notes that the number of categories of enumerated counterparties available as counterparties to non-ECP commodity pools has increased since the Commissions proposed the regulations, because other regulators have finalized their retail forex regimes, as discussed in greater detail above. While trading with Enumerated Counterparties will entail doing so pursuant to the retail forex regulations of the relevant federal regulator, such regulations will apply to the counterparties, not the CPO. While CPOs of Retail Forex Pools generally must register as such with the CFTC, to the extent an exemption from registration is available under the CFTC's rules, such CPOs need not register as a result of their retail forex transactions, further reducing the potential costs of Regulations §§ 1.3(m)(5)(i) and (ii). Further, commodity pools will not incur any costs to change counterparties (with the accompanying costs of, for example, putting in place new trading documentation) to the extent they already trade with Enumerated Counterparties. Commenters noted that non-ECP pools would incur costs to negotiate new trading documentation with Enumerated Counterparties to the extent that such pools do not currently enter into retail forex transactions with Enumerated Counterparties and wish to continue to engage in retail forex transactions other than on or subject to the rules of a DCM. However, Regulation § 1.3(m)(5) also provides investor protection benefits to non-ECP participants in pools that enter into retail forex transactions by requiring such pools to trade with Enumerated Counterparties and to be operated by registered CPOs, absent an applicable exemption.

To the extent that a commodity pool is precluded by CFTC Regulation § 1.3(m)(6) from achieving ECP status based on prong (A)(v) of the ECP definition, the pool will be limited to trading swaps, if at all, on or subject to the rules of a DCM. This could result in costs to affected commodity pools, including margin, the costs of establishing relationships with future commission merchants (*e.g.,* reviewing new account opening documentation) and opportunity costs from losing the ability to trade swaps customized to pools' needs. Preventing commodity pools that do not qualify under clause (A)(iv) from qualifying pursuant to clause (v), however, closes a loophole that would allow smaller commodity pools that are not able to satisfy the requirements of clause (A)(iv) of the ECP definition to qualify as ECPs. Moreover, by providing additional clarification in the preamble regarding the meaning of CEA section 1a(18)(A)(iv)(II), the Commissions substantially reduced the potential number of commodity pools affected by CFTC Regulation § 1.3(m)(6).

CFTC Regulations §§ 1.3(m)(1)–(4) define major swap participants, swap dealers, major security-based swap participants and security-based swap dealers, respectively, as ECPs. Stating explicitly in regulations that these entities are ECPs avoids the potentially anomalous result of such entities, which are some of the largest and/or most active swap market participants, not being ECPs and is in line with expectations in the market that these entities may engage in a full range of swap and security-based swap activities. The CFTC believes that these regulations will not result in any significant economic costs or benefits.

The CFTC is persuaded by commenters that allowing participants to continue to rely on the line of business element of the Swaps Policy Statement will mitigate unnecessary costs from the regulation but is adding various conditions to retain adequate protection for market participants and the public. As noted above, CFTC Regulation § 1.3(m)(7) permits an entity,

[1427] *See* letter from Wells Fargo I.

[1428] While the Commissions are adding additional detail explaining the scope of CEA section 1a(18)(A)(iv)(II), the Commissions also provide guidance on that explanation. As a result, the CFTC does not believe that the upfront costs of determining ECP status under CEA section 1a(18)(A)(iv) will significantly increase.

[1429] The CFTC computed these totals by assuming from 5 to 20 hours of legal review by a compliance attorney at $355/hour based on the 2010 SIFMA survey. *See* SIFMA, Report on Management and Professional Earnings in the Securities Industry—2010. If we assume that 5,000 potential commodity pools need to make this determination and round to two significant digits, this results in a total approximate cost of $8.9 million to $36 million. As is the case for the application of the definitions of the terms ''swap dealer'' and ''major swap participant,'' these costs reflect a higher multiplier because some persons may retain outside advisors to assist in making the determinations under the rules.

in determining its net worth for purposes of subclause (A)(v)(III) of the ECP definition,[1430] to include the net worth of its owners, solely for purposes of determining its ECP status for swaps used to hedge or mitigate commercial risk, provided that all of its owners are themselves ECPs (disregarding shell companies, as defined above). Under CFTC Regulation § 1.3(m)(7) as adopted, an entity seeking to qualify under subclause (A)(v)(III) of the ECP definition in order to enter into a swap used to hedge or mitigate commercial risk is permitted to count the net worth of its owners in determining its own net worth, so long as all its owners are ECPs. Accordingly, CFTC Regulation § 1.3(m)(7) will allow qualified participants the flexibility to enter into customized swaps.

By limiting the line of business ECP prong to entities owned solely by ECPs, the CFTC is preserving the intent behind the ECP requirement, which is to limit the availability of customized swaps to market participants of sufficient financial sophistication and with sufficient assets or net worth to assess, appreciate and bear the implications and risks of swap transactions. Although commenters proposed various solutions to address the loss of the Swap Policy Statement, the CFTC believes the approach adopted is the best approach; it substantively preserves the ECP requirement and protects the real parties in interest (*i.e.,* the owners). Although banks and non-ECP borrowers might be able to restructure or more highly capitalize borrowing entities or borrow at a higher level in the ownership structure, this regulation will allow banks and qualified businesses to continue to conduct their loan arrangements as usual without incurring the costs, which could include undesirable tax treatment, of such operational changes. Further, because commenters focused on swap related risks, the Commissions limited this regulation's application narrowly, *i.e.,* it does not apply for purposes of determining ECP status for: swaps not meeting the conditions set forth in Regulation § 1.3(m)(7); security-based swaps; security-based swap agreements; mixed swaps; or agreements, contracts or transactions that are not swaps (regardless of the purpose for which they are used).

CFTC Regulation § 1.3(m)(8) permits a Forex Pool to qualify as an ECP notwithstanding that it has one or more direct participants that are not ECPs if the Forex Pool (a) is not formed for the purpose of evading regulation under CEA sections 2(c)(2)(B) or (C) or related rules, regulations or orders, (b) has total assets exceeding $10 million and (c) is formed and operated by a registered CPO or by a CPO who is exempt from registration as such pursuant to CFTC Regulation § 4.13(a)(3). The data presented by commenters, discussed above, demonstrate that registered CPOs [1431] of commodity pools over a certain size ($10 million in total assets) historically have engaged in retail forex misconduct to a much less significant degree than other CPOs. Only one of the 45 unique cases presented by commenters involved a pool with more than $10 million in total assets and a registered CPO. Only two of those cases involved a pool operated by CPOs exempt from registration: in both of those cases, however, the CPO raised less than $10 million.[1432] The CFTC also recognizes that subjecting such commodity pools to the statutory look-through provision to protect non-ECP customers from fraud and abuse would cause them to incur higher costs (*e.g.,* CPO compliance costs for those CPOs required to register as such, and redocumenting trading relationships with new counterparties who are Enumerated Counterparties), for intangible pool participant protections. To further protect pool participants, the Commissions added a requirement that, to be an ECP under the line of business prong, the Forex Pool must not be formed for the purpose of evading CFTC regulation of Retail Forex Pools and retail forex transactions under CEA Section 2(c)(2)(B) or (C). Accordingly, the Commissions have tailored CFTC Regulation § 1.3(m)(8) in a manner they believe preserves its ability to effectively protect market participants and the public, while avoiding significant costs.

As noted above, CEA section 1a(18)(A)(vii)(cc) contains a statutory cross-reference rendered incorrect due to a legislative drafting oversight. Failing to address such error would inappropriately deprive such entities of ECP status, imposing undue costs (*e.g.,* the opportunity costs of being unable to execute a desired hedge or trading strategy using standardized exchange-traded swaps) on such entities. Allowing a government entity the ability to qualify as an ECP based on its counterparty's status will provide, at little or no cost, the benefit of effectuating Congressional intent that government entities satisfying the conditions of CEA section 1a(18)(A)(vii)(cc) be ECPs. Therefore, the CFTC included in the preamble an interpretation treating as an ECP government entities satisfying the conditions of CEA section 1a(18)(A)(vii)(cc) as if such section incorporated the correct cross-reference. The CFTC believes that correcting this incorrect cross-reference will not result in any significant economic costs or benefits.

d. CEA Section 15(a) Discussion

Protection of market participants and the public. Congress determined to protect retail foreign exchange investors from fraudsters by amending the ECP definition to require a pool's participants to qualify as ECPs for the pool to be an ECP under subsection (A)(iv).[1433] As discussed above, this protection, as implemented by CFTC Regulation § 1.3(m)(5) may raise the costs of legitimate foreign exchange transactions. To mitigate these potential increased costs, CFTC Regulations § 1.3(m)(5)(i) limits the look-through to the level of the commodity pool structure that engages in retail forex transactions, subject to CFTC Regulation § 1.3(m)(5)(ii). This limitation provides that, if any level of the pool has been structured to evade, the CFTC would look through the transaction-level commodity pool's direct commodity pool participants indefinitely until reaching non-commodity pool participants. CFTC Regulation § 1.3(m)(5), therefore, protects non-ECP members of the public in appropriate instances.

By limiting the line of business ECP prong to entities owned solely by ECPs, the CFTC is preserving the intent behind the ECP requirement, which is to limit the availability of customized swaps to market participants of sufficient financial sophistication to assess and appreciate the risk and implications of the transactions. Although commenters proposed various solutions to address the loss of the Swap Policy Statement, the CFTC believes the

[1430] CEA section 1a(18)(A)(v)(III) provides that ''a corporation, partnership, proprietorship, organization, trust, or other entity * * * that (aa) has a net worth exceeding $1,000,000; and (bb) enters into an agreement, contract, or transaction in connection with the conduct of the entity's business or to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by the entity in the conduct of the entity's business'' is an ECP. 7 U.S.C. 1a(18)(A)(v)(III).

[1431] CFTC Regulation § 1.3(m)(8) as adopted requires that the CPO of the Forex Pool be registered as a CPO with the CFTC. The Commissions believe that this condition is appropriate because it will ensure that the NFA oversees compliance by those CPOs relying on this new regulation.

[1432] In addition, one of those CPOs relied on the CFTC Regulation § 4.13(a)(4) CPO registration exemption. As discussed above, the CFTC has withdrawn that exemption.

[1433] *Accord* letter from AIMA I.

approach adopted is the best approach because it preserves the substance of the ECP requirement and protects the real parties in interest (*i.e.,* the owners).

Because registered CPOs,[1434] and CPOs exempt from registration, who operate commodity pools over a certain size ($10 million in total assets) historically have engaged in retail forex misconduct to a much less significant degree than CPOs of commodity pools below that threshold, the CFTC believes that imposing this size threshold requirement as a condition of ECP status pursuant to Regulation § 1.3(m)(8) provides some protection to pool participants. The additional requirement that to be an ECP under the line of business prong the Forex Pool must not be formed for the purpose of evading CFTC regulation of Retail Forex Pools and retail forex transactions under CEA Section 2(c)(2)(B) or (C) will further protect pool participants.

Efficiency, competitiveness, and the financial integrity of the market. With respect to CFTC Regulation §§ 1.3(m)(5) and (6), commodity pools that do not qualify as ECPs may have to use products listed on or subject to the rules of a DCM that might not precisely (or at all) match such parties' needs. This may reduce or eliminate a commodity pool's ability to engage in some transactions, but these regulations also seek to prevent unsophisticated parties from entering into certain transactions to prevent repeated abuses and protect members of the public. We believe CFTC Regulations §§ 1.3(m)(1)–(8) do not significantly impact competitiveness or the financial integrity of markets.

Price discovery. CFTC Regulations §§ 1.3(m)(1)–(8) only clarify the status of entities. They do not affect price discovery.

Sound risk management practices. CFTC Regulations §§ 1.3(m)(5) and (6) may restrict investment opportunities for certain non-ECPs that might have otherwise qualified as ECPs.[1435] This may discourage the use of some sound risk management practices and/or investment strategies. For instance, it may become more expensive for CPOs operating non-ECP pools to use such practices and/or strategies if such pools must enter into swaps on or subject to the rules of a DCM or come into compliance with a retail forex regime or choose to redeem non-ECPs to avoid such results. On the other hand, CPOs may not incur the increased expense of such sound risk management practices and/or investment strategies if they are able to pass such costs on to the participants in the pools. Also, with respect to swaps, pools that are not ECPs due to CFTC Regulation § 1.3(m)(6) can enter swaps on or subject to the rules of a DCM to the extent an appropriate swap is listed by such DCM.

In contrast, CFTC Regulations §§ 1.3(m)(7) and (8) allow qualified participants to engage in swaps that are not on a DCM. This gives qualified participants more choices for their hedges, and may provide an opportunity for better risk management.

Other public interest considerations. CFTC Regulations §§ 1.3(m)(1)–(4) state that major swap participants, swap dealers, major security-based swap participants, and security-based swap dealers, respectively, are ECPs. The interpretive guidance regarding certain governmental ECPs remedies an incorrect statutory cross-reference with respect to the ability of a subset of governmental entities to qualify as ECPs under CEA section 1a(18)(A)(vii).[1436]

VIII. Administrative Law Matters—Exchange Act Revisions (Definitions of ''Security-Based Swap Dealer'' and ''Major Security-Based Swap Participant'')

A. Economic Analysis

1. Overview

The SEC is sensitive to the costs and benefits of our rules. Some of these costs and benefits stem from statutory mandates, while others are affected by the discretion we exercise in implementing the mandates. We have requested comment on all aspects of the costs and benefits of the proposal, including any effect our proposed rules may have on efficiency, competition, and capital formation. In considering the economic consequences of these final rules, moreover, we have been mindful of the link between the scope of the persons who are deemed to be dealers or major participants pursuant to these rules and the costs and benefits associated with the regulatory requirements that are applicable to dealers and major participants, as well as the direct assessment costs (as defined below) these rules will impose on certain market participants.

As the SEC noted in the Proposing Release, the definitions of ''security-based swap dealer'' and ''major security-based swap participant'' implicate two categories of potential costs. First, there are costs that arise from the regulatory requirements that will apply to those types of entities (*e.g.,* the registration, margin, capital and business conduct requirements that would apply to dealers and major participants).[1437] The Proposing Release also noted that there are costs that entities will incur in determining whether they fall within the definitions of ''security-based swap dealer'' and ''major security-based swap participant.'' [1438] Commenters that addressed these issues discussed both types of costs.[1439] Our consideration of these issues has been informed by the comments we received.

In adopting these final rules, we have sought to take into account the broader costs and benefits associated with the regulation of security-based swap dealers and major security-based swap participants, which we refer to in this section as ''programmatic'' costs and benefits. We have also considered the direct costs that persons would incur to assess whether they fall within the dealer or major participant definitions or to assess the potential availability of limited registration as a dealer or major participant. We refer to these costs as ''assessment'' costs.[1440] The programmatic costs and benefits and the assessment costs raise distinct analytic issues.

We discuss below certain of the costs and benefits—both programmatic and assessment-related—that we have considered in adopting these rules. These costs and benefits have informed the policy choices described above.

[1434] CFTC Regulation § 1.3(m)(8) as adopted requires that the CPO of the Forex Pool be registered as a CPO with the CFTC. This condition is appropriate because it will ensure that the NFA oversees compliance by those CPOs relying on this new regulation.

[1435] CFTC Regulations § 1.3(m)(1)–(4) and the interpretive guidance regarding certain governmental ECPs have the opposite effect, making investment opportunities available to certain ECPs that might otherwise not have qualified as ECPs.

[1436] 7 U.S.C. 1a(18)(A)(vii).

[1437] *See* Proposing Release, 75 FR at 80206.

[1438] *See* Proposing Release, 75 FR at 80206–07.

[1439] *See, e.g.,* letters from Representatives Bachus and Lucas (''Casting an overly-broad net in defining these terms could force some smaller participants to leave the marketplace as a result of increased costs, or eliminate certain types of contracts used for hedging. If either occurs, businesses will be left exposed to market volatility and the consequences will ultimately be felt by Americans in the forms of increased consumer costs.''); ISDA (suggesting that imposing dealer regulation beyond persons whose business is to make markets would be inconsistent with the Dodd-Frank Act's intent to preserve growth and innovation in the swap markets); ABC/CIEBA (stating that major participant thresholds will cause persons who pose no systemic risk to incur substantial costs associated with major participant registration and regulation); SIFMA–AMG (addressing complexity and burden of analyzing potential status as a major participant, and urging implementation of a calculation safe harbor).

[1440] We expect that the benefits resulting from the identification and registration of dealers and major security-based participants will likely accrue primarily at the programmatic level. To the extent appropriate given the purposes of Title VII, we have sought to mitigate the costs entities will incur in connection with such identification and registration.

Accordingly, the analysis below includes references throughout to the earlier discussions of the policy decisions taken by the Commissions.

In considering the costs and benefits of these rules, we are mindful of the various considerations that must be taken into account in establishing the baseline against which those costs and benefits may be evaluated. A key consideration is that the definitions, while integral to the regulatory requirements that will be imposed on dealers and major participants pursuant to Title VII, do not themselves establish the scope or nature of those substantive requirements or their related costs and benefits. In light of this consideration associated with definitional rulemaking, the baseline we are using to consider the costs and benefits associated with the definitions presumes that the other Title VII rules that implement the statutory requirements applicable to security-based swap dealers and major security-based swap participants will be adopted (and will be the subject of their own economic analysis), but as yet there are no dealers or major participants subject to any of these requirements. The costs and benefits described below are therefore those that may arise in connection with (1) identifying a subset of current and future market participants as either security-based swap dealers or major security-based swap participants (*i.e.,* the assessment costs) and (2) subjecting that subset, through the definitional lines we are drawing, to a complete, fully effective complement of Title VII statutory and regulatory requirements (*i.e.,* the programmatic costs and benefits).

Accordingly, in determining the appropriate scope of the definitions being adopted in these rules, we considered what type of persons should be regulated as dealers and major participants under Title VII, in light of the purposes of the statute, the overall regulatory framework, and the data currently available to us. We thus have sought to adopt regulations that would include entities within the scope of the dealer and major participant definitions to the extent that encompassing persons with their level of security-based swap activities or positions would be necessary and appropriate given the purposes of the statute (for example, because the institution may pose market or other risks of the type addressed by Title VII). Conversely, to the extent that we expect that the regulation of certain types of market participants would not serve the statutory purposes, we have sought to exclude them from the scope of the definitions, thereby reducing unnecessary burdens on entities whose regulation may not be necessary or appropriate to further the purposes of the statute.

We recognize that the costs and benefits arising from these rules will affect competition, efficiency, and capital formation in the security-based swap market broadly, with the impact not being limited to the specific entities that fall within the meaning of the terms ''security-based swap dealer'' and ''major security-based swap participant.'' In the sections that follow we begin with a consideration of the costs and benefits of the rule that affect the regulated market participants that fall within the meaning of these terms, and conclude with a consideration of the potential effects of this rule on competition, efficiency, and capital formation.

2. Programmatic Costs and Benefits Associated With These Definitions' Scope

a. Programmatic Costs

The scope of these definitions will directly affect the number of market participants subject to Title VII and the rules thereunder and thus will directly affect the overall costs associated with the regulation of dealers and major participants pursuant to Title VII. Persons who fall within the statutory definitions of security-based swap dealer and major security-based swap participant, as further defined by these rules, will incur a number of upfront costs and ongoing costs in connection with their status as dealers or major participants. Those include, but are not limited to, costs of complying with requirements related to: registration; reporting, recordkeeping, confirmation and documentation; sales practices; margin, capital and segregation of customer collateral; and maintaining a chief compliance officer.[1441] We expect that the significance of those programmatic costs will outstrip the more discrete and entity-specific assessment costs (discussed in more detail below) that individual entities will incur in determining whether they fall within the dealer and major participant definitions.

The programmatic costs linked to compliance by regulated entities with specific requirements are not the only overall costs associated with the regulation of dealers and major participants. Other potential costs associated with the establishment of a new regulatory structure over dealers and major participants, such as costs related to the potential reduction of competition in the market, the deterrence of new entrants, or reductions in capital formation, are discussed more fully below.[1442]

b. Programmatic Benefits

The regulation of dealers and major participants also will provide a number of programmatic benefits to the security-based swap market and to market participants. As discussed above,[1443] registered security-based swap dealers and major participants will be subject to a number of entity-level and transaction-level requirements that we expect to produce a broad array of benefits consistent with the purposes of Title VII.[1444]

For example, section 15F(e) of the Exchange Act and related rules impose capital and margin requirements on dealers and major participants,[1445] which will reduce the financial risks of these institutions and contribute to the stability of the security-based swap market in particular and the U.S. financial system more generally. Section 3E of the Exchange Act, among other things, requires security-based swap dealers that collect margin from counterparties to cleared security-based swap transactions to maintain that collateral in segregated accounts, as well as providing counterparties to uncleared security-based swap transactions with security-based swap dealers and major

[1441] For example, dealers and major participants will be subject to business conduct requirements of section 15F of the Exchange Act, and thus will be required, among other things, to determine that their counterparty meets certain eligibility standards before entering into security-based swaps with them and to disclose information about material risks and characteristics, material incentives, conflicts of interest, the daily mark, and clearing rights. *See* Securities Exchange Act Release No. 64766 (June 29, 2011), 76 FR 42396, 42406, 42410 (July 18, 2011). Also, for example, in connection with registration requirements we expect security-based swap dealers and major security-based swap participants to incur costs in connection with completing and filing forms, providing related certifications, addressing additional requirements in connection with associated persons, as well as certain additional costs. *See* Securities Exchange Act Release No. 65543 (Oct. 12, 2011), 76 FR 65784, 65813–18 (Oct. 24, 2011). The costs associated with these and other substantive rules applicable to dealers and major participants are being addressed in more detail in connection with the applicable rulemakings.

[1442] *See* part VIII.A.4, *infra.*

[1443] *See* part II.D.3.a, *supra.*

[1444] In application, the programmatic requirements applicable to security-based swap dealers may differ from the programmatic requirements applicable to major security-based swap participants. For example, the proposed business conduct rules applicable to dealers include ''know your customer,'' suitability and ''pay to play'' requirements that would not also apply to major participants. *See* Exchange Act Release No. 64766 (June 29, 2011), 76 FR 42396, 42399–401 (July 18, 2011).

[1445] *See* Exchange Act section 15F(e).

security-based swap participants with the right to require the segregation of assets held as collateral with an independent third-party custodian. These protections provide market participants who enter into transactions with these entities confidence that their collateral accounts will remain separate from the dealer or major participant's assets in the event of bankruptcy.[1446] Title VII also requires registered entities to implement risk management policies and procedures that should allow them to avoid taking on excessive risk and to better deal with market fluctuations that might otherwise endanger the financial health of the entity.[1447]

Title VII further imposes a range of business conduct requirements upon these registered entities, which should deter fraudulent or deceptive conduct and increase information transparency for customers and counterparties seeking to access the security-based swap market. For example, section 15F(h)(3)(B) of the Exchange Act and related rules establish certain disclosure requirements for dealers and major participants,[1448] while section 15F(h)(3)(C) of the Act and related rules require that communications by these entities meet certain standards of fairness and balance.[1449] Section 15F(j)(5) of the Act and related rules introduce requirements intended to address potential conflicts of interest that may arise in transactions between a dealer or major participant and its counterparty.[1450] Title VII also establishes higher levels of protection for special entities entering into transactions with dealers or major participants.[1451] As we discuss in more detail in our analysis of the competitive effects of these rules, these protections, and the related increase in transparency in dealings with registered entities may be expected to improve the competitiveness and efficiency of the market.

Finally, Title VII also imposes requirements that are designed to promote effective market operation and transparency. Sections 15F(f), (g), and (j)(3) of the Exchange Act and related rules impose certain reporting, recordkeeping, and regulatory disclosure requirements upon registered entities, which should enhance the volume and quality of information available in the market and facilitate effective oversight by the Commission.[1452] Section 15F(i) establishes regulatory standards related to the confirmation, processing, netting, documentation and valuation of security-based swaps, which should enhance the efficiency of the procedures surrounding the execution of security-based swap transactions.[1453]

We expect that the regulation of security-based swap dealers and major participants through these provisions will advance the transparency, risk reduction and counterparty protection purposes of Title VII.[1454] While these benefits will be significant, they will not be entirely measurable, as it is not possible to quantify the benefits of mitigating or avoiding a future financial crisis, or the benefits of avoiding an unsuitable security-based swap transaction.[1455] Those benefits, moreover, can be expected to manifest themselves over the long-term and be distributed over the market as a whole.

c. The Relation Between These Rules and the Programmatic Costs and Benefits

In adopting these final rules, we recognize that: (a) The choices reflected by these rules will affect how many persons and which persons ultimately will be deemed to be dealers or major participants; and (b) those results, combined with the substantive requirements that are to be adopted in connection with the dealer and major participant regulatory regime, ultimately will determine the programmatic costs and benefits that will be associated with the substantive regulation of dealers and major participants.

This is not to say that there would be a one-to-one correlation between the regulation (or non-regulation) of any particular entity as a dealer or major participant and the additional (or reduced) programmatic costs and benefits that would be associated with the regulation (or non-regulation) of that entity. Some of the costs of regulating a particular person as a dealer or major participant, such as costs of registration, may largely be fixed. At the same time, other costs associated with regulating that person as a dealer or major participant (*e.g.,* costs associated with margin and capital requirements) may be variable, reflecting the level of the person's security-based swap activity. Similarly, the regulatory benefits that would arise from deeming that person to be a dealer or major participant (*e.g.,* benefits associated with increased transparency and efficiency, and reduced risks faced by customers and counterparties), although not quantifiable, may be expected to be variable in a way that reflects the person's security-based swap activity. In addition, it is reasonable to believe that the implementation of Title VII itself will change the security-based swap market, and, with the full implementation of Title VII—which in part is conditioned on these definitions—more information will be available for this analysis.[1456]

Given these limitations on our ability to conduct a quantitative assessment of the programmatic costs and benefits associated with these definitional terms, we have considered these costs and benefits primarily in qualitative terms. In that framework it is possible to identify a subset of such entities that, because of the volume of their dealing activity or the size of their security-based swap exposure, appear to be the types of entities for which the other statutory requirements of Title VII were created. We have therefore sought to adopt definitions that would capture these entities, as the statute requires us to do, without imposing the costs of Title VII on those entities for which regulation currently may not be justified in light of those purposes. We believe that this approach will maximize the benefits provided by Title VII while minimizing costs to the extent

[1446] *See* Exchange Act section 3E.

[1447] *See* Exchange Act section 15F(j)(2).

[1448] *See* Exchange Act section 15F(h)(3)(B).

[1449] *See* Exchange Act section 15F(h)(3)(C).

[1450] *See* Exchange Act section 15F(j)(5).

[1451] *See* Exchange Act sections 15F(h)(2), (h)(4), (h)(5).

[1452] *See* Exchange Act section 15F(f) (reporting and recordkeeping requirements); Exchange Act section 15F(g) (daily trading records requirements); and Exchange Act section 15F(j)(3) (requirements related to the disclosure of information to regulators).

[1453] *See* Exchange Act section 15F(i).

[1454] Prior to the enactment of the Dodd-Frank Act, a Treasury Department blueprint for financial reform articulated benefits of comprehensive regulation of derivatives: ''OTC derivatives markets, including CDS markets, should be subject to comprehensive regulation that addresses relevant public policy objectives: (1) preventing activities in those markets from posing risk to the financial system; (2) promoting the efficiency and transparency of those markets; (3) preventing market manipulation, fraud, and other market abuses; and (4) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties.'' Department of the Treasury, *Financial Regulatory Reform—A New Foundation* 46–47 (2009).

[1455] *See* note 421, *supra.* The significance of these potential benefits is suggested by the 2008 financial crisis. Better Markets cited estimates that the worldwide cost of the 2008 financial crisis in terms of lost output was between $60 trillion and $200 trillion, depending primarily on the long-term persistence of the effects. *See* letter from Better Markets. We recognize, however, that this estimate addresses the aggregate cost of the financial crisis, and that Title VII is directed to only one aspect of the factors that contributed to the crisis.

[1456] The lack of market data is particularly significant in the context of total return swaps on equity and debt. We do not have the same amount of information regarding those products as we have in connection with the present market for single-name credit default swaps.

consistent with the purposes of the statute.

Moreover, as discussed above, the SEC has directed the staff to report to the Commission on all aspects of the dealer and major participant definitions no later than three years following the later of: (i) the last compliance date for the registration and regulatory requirements for security-based swap dealers and major security-based swap participants under Section 15F of the Exchange Act; and (ii) the first date on which compliance with the trade-by-trade reporting rules for credit-related and equity-related security-based swaps to a registered security-based swap data repository is required. This report will provide the SEC and market participants with more information about the security-based swap market following the implementation of Title VII—including information regarding the business of dealers and major participants, the characteristics of positions they and other market participants hold, the structure of the market, and how Title VII has affected those aspects of the market. This report, which will take into account the additional data from our observations of the security-based swap market and the functioning of the associated regulatory requirements, is intended to help the SEC assess whether to make changes to the scope of the dealer and major participant definitions (as well as to assess future actions related to the extended compliance period in connection to the *de minimis* exception to the security-based swap dealer definition).

d. Analysis of the Effect of Specific Rules on Programmatic Costs and Benefits

We have sought to establish definitions that capture the types of entities whose security-based swap activity or whose security-based swap positions warrant regulation under Title VII as dealers or major participants, and to exclude the types of entities whose activity or positions may not warrant such regulation. The relationship between a given rule and the scope of the persons that ultimately will fall within the dealer or major participant definitions—along with the related costs and benefits—manifests itself in different ways depending on the rule at issue. Some of these rules may be expected to have a close link to the overall programmatic costs and benefits associated with dealer and major participant regulation because they play a significant role in determining the overall scope of the definitions (for example, because they are relevant to the status of relatively more entities). Other rules may be expected to affect the status of relatively fewer entities and thus have a smaller effect on those programmatic costs and benefits.

We anticipate that the report that the SEC staff will make to the Commission following the full implementation of Title VII with regard to these definitions will help us more fully evaluate the programmatic impact of all of these rules, both in terms of the number of potential major participants and dealers that would result from the definition we are adopting as well as potential alternatives, and in terms of the associated programmatic costs and benefits.

i. Core Rules That Implicate Programmatic Costs and Benefits

The core definitional terms with respect to establishing the scope of the dealer and major participant definitions are those relating to: (i) the core dealer definition, (ii) the dealer *de minimis* exception, and (iii) the definitions of ''substantial position'' and ''substantial counterparty exposure'' within the major participant definition.

A. Dealer Definition

Exchange Act rule 3a71–1 defines ''security-based swap dealer'' and thus plays a central role in determining the scope of the Title VII regulatory regime going forward. Based on the available data regarding activity in the market for single-name credit default swaps, including the application of various criteria that may be indicative of dealing activity in that market, and taking into account the availability of the *de minimis* exception to the dealer definition, we estimate that 50 or fewer entities ultimately may have to register with the SEC as security-based swap dealers.[1457] This is consistent with the estimate that accompanied the proposal.[1458]

[1457] This estimate—which potentially overstates the number of potential dealers—is consistent with the data considered in the CDS Data Analysis. That analysis implied a range of alternative estimates—from 16 possible dealers to 93 possible dealers—based on currently available data and reflecting a $3 billion *de minimis* level. *Compare* CDS Data Analysis at table 2a (identifying 16 potential dealers above the $3 billion level based on the criterion of having 20 or more unique counterparties) *with* CDS Data Analysis at table 2c (identifying 93 potential dealers above that level based on the criterion of having 10 or more unique counterparties). However, most of the criteria applied by the CDS Data Analysis as potentially indicative of dealer activity suggested estimates of fewer than 50 possible dealers after accounting for the $3 billion *de minimis* level. *See id.* at table 2b (identifying 32 possible dealers based on the criterion of having 15 or more unique counterparties); *id.* at table 3 (identifying 16, 19, or 25 possible dealers based on the criterion of having a certain number of counterparties not identified as dealers by ISDA); *id.* at table 4 (identifying 32 possible dealers based on the criterion of having a ''flat notional book''); *id.* at table 5 (identifying 33 possible dealers based on the criterion of having ''flat transaction volume''); *id.* at table 7 (identifying 40 possible dealers that meet two or more of the other criteria cited in the analysis); *id.* at table 8 (identifying 27 possible dealers that meet three or more of the other criteria cited in the analysis). Only two criteria suggested estimates in excess of 50 possible dealers above the $3 billion level. *See id.* at table 2c (identifying 93 possible dealers based on the criterion of having 10 or more unique counterparties, which may also be explained by the fact that non-dealers may maintain trading relations with multiple dealers); *id.* at table 6 (identifying 52 possible dealers based on the criterion of posting initial margin with low frequency, which may also be explained by underreporting of margin due to the fact that such reporting was voluntary with respect to the data underlying the CDS Data Analysis).

While recognizing that alternative criteria for identifying possible dealing activity produced varied results, we believe that the results largely are consistent with the estimate of 50 or fewer security-based swap dealer registrants. We further believe that it is appropriate to place particular weight on one criterion that identified possible dealing activity based on whether an entity engaged in security-based swap transactions with three or more counterparties that themselves were not identified as dealers by ISDA. That analysis identified 28 entities possibly engaged in dealing activity (with 25 of those with trailing notional transactions that exceed the $3 billion *de minimis* threshold we are adopting). *See* CDS Data Analysis at table 3c. We believe that this metric serves as a useful proxy for the application of the dealer-trader distinction, given that persons with the business model of seeking to profit by providing liquidity in general may reasonably be expected to engage in transactions with persons who are not themselves recognized as dealers.

In estimating that 50 or fewer entities ultimately may have to register as dealers, we are seeking to take a conservative approach that recognizes both the limitations on the conclusions that may be drawn from available data and the potential for changes in the security-based swap market. We recognize that the criteria applied in the CDS Data Analysis are imperfect in that they do not directly apply the dealer-trader distinction, and that some alternative criteria may prove to be superior predictors of actual dealing activity. We also recognize that the estimate may overstate the number of possible registered dealers insofar as not all of the activity of persons identified as potential dealers based on the CDS Data Analysis necessarily reflects dealing activity, meaning that in practice a greater number of entities may be able to take advantage of the *de minimis* exception, and fewer entities would have to register as dealers, than estimates implied by that analysis may suggest. This estimate of 50 potential dealers further seeks to reflect the potential for growth in the size of the security-based swap market, as well as growth in the number of registered dealers as a result of competition promoted by the policies contemplated by the Dodd-Frank Act, and the possibility that some business groups that are identified as a single entity for purposes of this data ultimately may register multiple legal entities as security-based swap dealers.

[1458] The proposal estimated approximately 50 entities would be required to register as security-based swap dealers, based on discussions with industry. *See* Proposing Release, 75 FR at 80209, n.188. Commenters did not contradict this estimate. To the extent that the actual number of registrants differs from this estimate, it is reasonable to assume that the actual number will be lower than the

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Alternative approaches to identifying dealer activity, including those suggested by commenters, may have led to a lower or higher number of potential dealers out of the over 1,000 total participants in the security-based swap market. For example, commenters variously suggested, among other approaches, that the dealer definition should be interpreted to be coextensive with the concept of market making activity, that dealer status should be limited to persons available to take either side of the market at any time, or that dealer status should be limited to transactions arising from a ''customer'' relationship.[1459] Following those alternative approaches potentially would reduce the ultimate number of persons required to register as dealers.

In adopting the final rules and providing interpretive guidance that adapts our traditional dealer-trader analysis for the security-based swap market, we have sought to capture those entities whose security-based swap activity is warranted due to the nature of their interactions with counterparties, or is warranted to promote market stability and transparency. In this respect, we have sought to limit the costs imposed by regulation under Title VII to those entities whose regulation would serve the transparency, customer protection, and market stability purposes of the statute while not imposing those costs on entities whose regulation may not produce sufficient benefit in terms of those purposes. The core dealer analysis that we have adopted here focuses on activity that characterizes dealers, as the statutory text requires, and does so while drawing on a well-established approach used in an analogous securities dealer context by a wide range of financial intermediaries.[1460]

B. De Minimis Exception to the Dealer Definition

Exchange Act rule 3a71–2 implements the *de minimis* exception to the dealer definition. This rule will directly affect the scope of the dealer definition by excepting certain entities that otherwise would be encompassed by the dealer definition but whose security-based swap dealing activities fall below a specified notional threshold. As above, we believe that the application of the final rule implementing the *de minimis* exception, in combination with application of the dealer-trader distinction, reasonably may be expected to result in 50 or fewer entities ultimately registering with the SEC as security-based swap dealers.[1461]

As discussed above, the final rule implementing the *de minimis* exception reflects our attempt to focus the application of dealer regulation onto those entities for which that regulation would be appropriate, taking into account the comparative costs and benefits of dealer regulation, and the high degree of concentration of dealing activity in the security-based swap market.[1462] The final rule particularly provides that a dealer may take advantage of the exception if the notional amount of its dealing activity involving security-based swaps that are credit default swaps over the trailing 12 months is no more than $3 billion. For other types of swaps, a dealer may take advantage of the exception if the notional amount of its dealing activity is no more than $150 million. The threshold for dealing activity with counterparties that are ''special entities,'' regardless of the type of security-based swap, is $25 million. The final rule also eliminates proposed tests based on the number of an entity's dealing counterparties and on the number of its dealing security-based swaps. This approach also mitigates concerns raised by some commenters about the exception being overly narrow.[1463]

We have concluded that a $3 billion threshold for security-based swaps that are credit default swaps would appropriately apply dealer regulatory requirements to entities that comprise the vast majority of domestic dealing activities in these products, while not imposing the fixed costs of dealer regulation upon those entities responsible for only a small portion of total dealing activity, and avoiding the threat of leaving an excessive amount of dealing activity outside the ambit of dealer regulation.[1464] We believe that this approach strikes a balance that appropriately maximizes the benefits of dealer regulation while avoiding the application of the fixed costs of dealer regulation onto those entities for which dealer regulation may not significantly contribute to those benefits and avoiding the threat of allowing an excessive volume of unregulated dealing activity.[1465]

Similar considerations influenced our determination that a $3 billion *de minimis* threshold would be inappropriate for persons engaged in dealing activity involving other types of security-based swaps, given the comparatively smaller size of that market.[1466] We instead have set the threshold at a level that reflects the relative volume in the security-based swap market of security-based swaps that are not credit default swaps.[1467]

The final rule implementing the *de minimis* exception also sets forth a lower notional threshold for dealing activities involving ''special entities,'' consistent with the special protections that Title VII affords those entities. While we recognize that this lower threshold may deter certain entities that are not registered as dealers from

estimate in the proposal because the *de minimis* level established by the final rules for credit default swaps that are security-based swaps—as described above, by far the overwhelming majority of the security-based swap market—is higher than the level that was proposed (*i.e.,* $3 billion vs. $100 million).

[1459] *See* part II.A.2, *supra.*

[1460] *See* part II.A.5, *supra* (discussing the application of the dealer-trader distinction to the security-based swap market).

[1461] *See* note 1457, *supra.*

[1462] *See* parts II.D, *supra.* Regardless of the criterion used for identifying entities engaged in dealing activity, analysis of 2011 transaction data for single-name credit default swaps indicates that possible dealers with $3 billion or more in trailing notional activity account for over 98 percent of all the trailing notional activity by such entities. *See* CDS Data Analysis at 8–17.

[1463] *See* part II.D.2, *supra.* Conversely, some commenters suggested lower thresholds than those provided in the final rule, an approach that reasonably would be expected to lead more entities to have to register as security-based swap dealers. We did not adopt these lower thresholds because we determined that, given our understanding of the current structure of the market, it was unnecessary to do so to achieve the purposes of Title VII. Under any of the metrics used in the CDS Data Analysis (with the exception of the metrics relying on the posting of margin, which are, for reasons provided in the analysis, particularly unreliable), for example, retaining the proposed *de minimis* threshold of $100 million would have captured at most an additional 0.75 percent of transaction activity engaged in by entities captured by the respective analysis. *See* CDS Data Analysis at 8–17.

In adopting this rule we also considered alternative approaches and thresholds suggested by some commenters that potentially may lead fewer entities to have to register as security-based swap dealers. For example, while some commenters supported the use of an exposure-based threshold rather than a notional threshold, we declined to adopt this approach because the use of an exposure threshold could permit a virtually unlimited amount of dealing activity within the *de minimis* exception so long as exposures are collateralized (or offset, as generally occurs with dealing activity), a result inconsistent with the purposes of Title VII.

[1464] As noted above, a sufficiently high *de minimis* threshold could allow a significant amount of unregulated security-based swap dealing activity to develop among entities whose dealing activity does not exceed the *de minimis* threshold. *See* part II.D.5.b, *supra.*

[1465] As noted above, an extended compliance period will be available to entities that engage in $8 billion or less in annual notional dealing activity in security-based swaps that are credit default swaps (or $400 million in dealing activity in other types of security-based swaps), to help facilitate the orderly implementation of Title VII and to afford the SEC additional time to study the security-based swap market as it evolves in the new regulatory framework. *See* part II.D.5.c.ii, *supra.*

[1466] *See* part II.D.5.d, *supra.*

[1467] *See id.* (discussing rationale for use of $150 million threshold and $400 million phase-in level in connection with those types of security-based swaps).

entering into security-based swap transactions with special entities, and hence may have the effect of reducing the availability of security-based swaps to those entities or increasing their costs,[1468] we believe that this lower threshold is appropriate to avoid undermining those separate Title VII protections.[1469]

The final rule implementing the *de minimis* exception further provides that security-based swap activities of affiliates under common control with an entity should be considered when determining whether the entity can avail itself of the *de minimis* exception. That is intended to avoid evasion of the dealer registration requirement; thus, while a contrary approach might be expected to reduce the number of registered dealers, such an approach would not be consistent with the purposes of Title VII.[1470]

C. ''Substantial Position'' and ''Substantial Counterparty Exposure'' Definitions

Exchange Act rules 3a67–3 and 3a67–5 define ''substantial position'' and ''substantial counterparty exposure,'' which constitute key terms within the major participant definition. The rules defining these thresholds—including the use of current exposure and potential future exposure tests, the specific features of those tests, and the thresholds associated with those tests[1471]—can be expected to directly influence the overall number of persons who may fall with the major participant definition.

These tests seek to capture persons whose security-based swap positions pose sufficient risk to counterparties and the markets generally that regulation as a major participant is warranted.[1472] Based on available data regarding the single-name credit default swap market—which we believe will comprise the majority of security-based swaps—we estimate that the number of major security-based swap participants likely will be fewer than five and, in actuality, may be zero. As discussed above, an entity that posts daily variation margin in connection with those positions generally would need to have security-based swap positions approaching $100 billion to reach the levels of potential future exposure required to meet the substantial position threshold, even before accounting for the impact of netting, while an entity that clears its security-based swaps generally would need to have positions approaching $200 billion.[1473] The available data shows that as of December 2011 a single entity had aggregate gross notional positions (*i.e.,* aggregate buy and sell notional positions) in single-name credit default swaps exceeding $100 billion, and three others had aggregate gross notional positions between $50 and $100 billion.[1474] However, as discussed above, the purchase of credit protection is weighed less heavily than the sale of credit protection for purposes of the analysis,[1475] meaning that an entity's positions reflecting single-name credit protection sold to its counterparties may be expected to be more of a key determinant of the entity's potential future exposure level under the rules we are adopting. The data shows that no entities have more than $100 billion in positions arising from selling single-name credit protection and that only two have between $50 and $100 billion in positions arising from such transactions.[1476]

While a ''substantial position'' or ''substantial counterparty exposure'' also can be established by a sufficiently high amount of current uncollateralized exposure, the available data does not provide information about individual entities' uncollateralized exposure in connection with security-based swap positions. We note, however, our understanding that certain of the financial entities that may have large security-based swap positions, such as hedge funds, tend to collateralize their security-based swap exposures as a matter of course, which would reduce the potential impact of this aspect of the test.

As noted above, commenters suggested both higher and lower thresholds, as well as different discounts or risk multipliers for certain positions.[1477] If the final rules defining ''substantial position'' and ''substantial counterparty exposure'' incorporated higher major participant thresholds, potentially fewer entities may be major participants. Conversely, lower thresholds may have led to a higher number of major participants, with the upper bound being represented by the over 1,000 non-dealer entities that participate in the security-based swap market.[1478]

By potentially capturing more or fewer major participants, such alternatives would have correspondingly increased or decreased the programmatic costs and benefits associated with Title VII regulation of major participants. As discussed above, however, the tests incorporated into the final rules, and the thresholds associated with those tests, are in our view tailored to capture only those entities that pose the risks that major participant regulation in Title VII seeks to address; in other words, these thresholds and related calculations

[1468] We expect any such effect will likely be minimal. An analysis of 2011 transaction data regarding single-name credit default swap transactions involving special entities shows that 16 counterparties account for all transactions with special entities. Although all but one of these entities engaged in more than $25 million in transactions with such entities in 2011, all of these entities engaged in total single-name credit default swap activity well in excess of the $3 billion *de minimis* threshold that applies to dealers generally. *See* CDS Data Analysis, Table 9 and note 8. Consequently, it is possible that all 16 entities would have been required to register as dealers under the standard *de minimis* threshold of $3 billion, regardless of the lower *de minimis* threshold for special entities.

[1469] *See* note 179, *supra* (discussing business conduct requirements applicable to dealing activities involving special entities).

[1470] *See* note 437, *supra* (discussing use of common control standard in this anti-evasion context, rather than the majority ownership standard used in connection with the inter-affiliate exclusions from the dealer and major participant definitions).

[1471] As detailed above in part IV.B.3, an entity will generally be required to register as a major security-based swap participant if its current security-based swap exposure exceeds $1 billion in a single major category of security-based swaps or to a single counterparty or if its current security-based swap exposure plus its potential future exposure exceeds $2 billion in a single major category of security-based swaps or to a single counterparty. The current exposure test looks to an entity's current uncollateralized exposure posed by its security-based swap positions in a given category; the potential future exposure test looks to the effective notional exposure represented by an entity's security-based swap positions, with certain adjustments for cleared or margined positions and netting.

[1472] *See* parts IV.C.3 and IV.E.3, *supra.*

[1473] *See* note 914, *supra.* Although it is possible that a notional position of $20 billion could cause an entity to be a major participant in the absence of central clearing or mark-to-market margining (and assuming that there is no risk reduction associated with netting or with certain positions that pose lower credit risk), we expect that those entities (such as hedge funds) that may be expected to have large positions would, as a matter of course, post mark-to-market margin in connection with positions that are not cleared. *See* Proposing Release, 75 FR 80207–08 n.181 (stating our understanding that banks, securities firms, and hedge funds typically collateralize most or all of their mark-to-market exposure to U.S. banks as a matter of practice). Accordingly, we believe that $100 billion provides a reasonable focus for the analysis.

[1474] *See* CDS Data Analysis at table 10.

[1475] *See* part IV.B.3.c.iii, *supra.*

[1476] *See id.* Although this data describes aggregate notional positions only for single-name credit default swaps and does not include analysis of positions in other types of security-based swaps, as noted above, credit default swaps appear to account for approximately 95 percent of the security-based swap market. That fact reduces the likelihood that positions involving security-based swaps that are not credit-related would cause a person to be a major security-based swap participant, or lead any entity to find it necessary to perform the major participant analysis in connection with those instruments.

[1477] *See* part IV.B.2, *supra.*

[1478] *See* CDS Analysis at tables 10 through 12.

incorporate the risk criteria embedded in the major participant definition.[1479] For example, we have declined to exclude centrally cleared positions from the potential future exposure test, instead permitting entities to discount those positions for purposes of the analysis, because central clearing cannot reasonably be expected to fully eliminate all counterparty risk that may affect the broader markets. Based on this fact, we conclude that it would be inappropriate, given the purposes of Title VII, to exclude an entity from the major participant definition simply because all of its security-based swap positions arise from cleared transactions.[1480] Similar considerations informed our approach to other aspects of the substantial position and substantial counterparty position tests, as discussed more fully above.[1481]

ii. Rules That May Be Expected To Have a Lesser Effect on Programmatic Costs and Benefits

Several of the final rules may be expected to have relatively smaller effects on the scope of the major participant and dealer definitions because they are likely to affect relatively fewer entities. By extension, they will also have a smaller effect on the programmatic costs and benefits arising from these definitions.

A. Limited Purpose Dealer and Major Participant Designations

Exchange Act rules 3a67–1 and 3a71–1 retain the presumption that a person that is encompassed within the major participant or dealer definitions will be deemed to be a dealer or major participant with respect to all of its security-based swap activities or positions, unless the SEC exercises its authority to limit the person's designation as a dealer to specified categories of swaps or security-based swaps, or to specified activities. This presumption may affect programmatic costs in at least two ways.

First, by not providing for registration as a limited purpose major participant or dealer as a matter of course, the final rules may be expected to increase the costs associated with the registration of those entities that seek designation as dealers or major participants or dealers. Aside from the costs of registration described in the SEC's proposal related to the registration of dealers and major participants,[1482] we expect that entities seeking to register as a limited purpose major participant or dealer would incur some additional marginal costs associated with making applications for limited designation.[1483]

In addition, the presumption against limited purpose designation may be expected to reduce the number of limited purpose major participants and dealers below the number that would otherwise register as limited purpose entities absent the presumption. In concept, broader availability of limited purpose registration of major participants or dealers may be expected to reduce the programmatic costs associated with regulation under Title VII, without necessarily reducing certain programmatic benefits if appropriately crafted. In particular, any programmatic effects of an appropriately scoped limited designation likely would affect only the transaction-level requirements applicable to dealers and major participants (*e.g.,* certain business conduct standards and requirements related to trading records, documentation and confirmations), potentially reducing costs and benefits that would otherwise arise from such requirements with respect to transactions that occur outside the limited designation. At the same time, certain of the entity-level regulatory requirements applicable to dealers and major participants as a whole (such as requirements related to capital) would continue to apply in the context of limited designation, ensuring that a limited purpose designation would not undermine the counterparty protection and systemic risk concerns of Title VII.

Notwithstanding these effects, we believe that the presumption against limited purpose designations is appropriate. This conclusion reflects the statutory language, the difficulty of separating a dealer's activities from its non-dealing activities (or a major participant's security-based swap positions taken under its limited purpose designation from other of its security-based swap positions) for compliance purposes, and the challenges of applying dealer or major participant regulatory requirements to only a portion of the entity's security-based swap business. Instead, we will consider limited purpose applications on an individual basis through analysis of the unique circumstances of each applicant.[1484]

We note that the available data does not indicate how many, or which, entities may have business models that conceivably could make limited purposed designations appropriate (*e.g.,* large positions in one major category of security-based swaps accompanied by minor positions in the other).[1485]

B. Inter-Affiliate Exclusions From Dealer and Major Participant Definitions

Exchange Act rules 3a67–3 and 3a71–1 respectively exclude inter-affiliate security-based swaps from the calculation of substantial position and substantial counterparty position thresholds under the major participant

[1479] *See* part IV.B.3, *supra* (discussing the decisions made regarding the substantial position definition and the reasoning behind the adopted approach). For example, we have concluded that the proposed thresholds are set prudently in a manner that takes into account the financial system's ability to absorb losses of a particular size, the need for major participant regulation not to encompass entities only after they pose significant risks to the market, and the need to account for the possibility that multiple market participants may fail close in time. In addition, as discussed above, we believe that this threshold is tailored to address the types of events associated with the failure of AIG FP. *See* part IV.B.3.d, *supra.*

[1480] Central clearing helps to mitigate counterparty credit risk by improving risk management and, among other things, mutualizing the risk of counterparty failure. If multiple members of a central counterparty fail beyond the level to which such risk is managed, however, the central counterparty would also be at risk of failure. *Cf.* Basel Committee on Banking Supervision, Consultative Document, ''Capitalisation of bank exposures to central counterparties,'' Nov. 25, 2011 (available at: *http://www.bis.org/publ/bcbs206.pdf*) (proposing that the capital charge for trade exposures to a qualifying central counterparty should carry a low risk weight, reflecting the relatively low risk of default of the qualifying central counterparty).

[1481] *See* part IV.B.3, *supra.*

[1482] *See* ''Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants,'' Exchange Act Rel. No. 34–65543 (''Registration Proposing Release''), 76 FR 65784, 65814–65818 (describing various costs associated with registration, including $11,800 per entity to complete and file form SBSE and between approximately $94,000 and $610,000 per entity to certify to the capabilities of the entity seeking registration).

[1483] These costs may include the costs of identifying how the entity would be able, as a limited designation entity, to comply with the various entity-level requirements of Title VII.

[1484] We will consider applications for limited purpose designation in the context of the registration requirements for major participants and dealers. In that context, we could consider applications on a case-by-case basis, pursuant to requests by specific major participants or dealers. This could help to ensure that any person that is designated as a limited purpose major participant or dealer is able to comply with the regulatory requirements applicable to major participants or dealers. Accordingly, we intend to further consider issues regarding limited designations, including associated costs, in a release relating to the specific registration requirements (for example, the form used for registration) for major participants and dealers. Furthermore, as noted above, the SEC is directing the staff to prepare a report on all aspects of the dealer and major participant definitions. Upon completion of this report, the SEC may further assess whether changes to the presumption against limited designation are warranted in light of the then-current state of the security-based swap market and the types of business in which security-based swap dealers are engaged.

[1485] The study that will be conducted in connection with the dealer and major participant definitions may also provide relevant information regarding limited designations of dealers and major participants.

definition, and from the *de minimis* calculation under the dealer definition. The inter-affiliate exclusion from the major participant and dealer definitions has the potential to affect the scope of these definitions for those entities that engage in inter-affiliate transactions by leading some entities not to meet the major participant or dealer *de minimis* thresholds when they otherwise would have met those thresholds (or by allowing certain centralized hedging facilities to look only at their market-facing activities in conducting the dealer-trader analysis). The exclusion or inclusion of certain inter-affiliate transactions thus may have some impact on the programmatic costs and benefits associated with dealer and major participant regulation.

We are adopting a majority-ownership standard for determining whether transactions between affiliates can be excluded from these threshold calculations because such transactions between entities whose economic interests are aligned to a degree represented by majority ownership do not appear to pose the kinds of counterparty and market risks that Title VII addresses.[1486] Some commenters suggested lower levels of control (such as common control) that may be expected to lead to fewer entities being registered as dealers or major participants, with associated impacts on programmatic costs and benefits. In our view, however, such alternative standards would not be consistent with the scope of the interactions to which dealer regulation is intended to apply, or with an alignment of economic interests consistent with an exclusion from the major participant definitions.

We also note that the data upon which the staff assessment of credit default swap transactions and positions is based excludes certain inter-affiliate credit default swap transactions. As a result, estimates of market concentration and the distribution of dealing activity or credit default swap positions derived from this data should reflect to some extent the effect of the inter-affiliate exclusions we are adopting in this rule.

C. Commercial Risk Hedging Exclusion

Exchange Act rule 3a67–4 defines ''hedging or mitigating commercial risk'' as that term is used in the major participant definition. The scope of this definition has the potential to determine whether certain market participants will be major participants by virtue of the first statutory major participant test, and will therefore affect the scope of the programmatic costs and benefits associated with major participant regulation. In application, this effect may be limited in light of the fact that we estimate that, as discussed above, only five or fewer entities—perhaps as few as zero—may have to register as major security-based swap participants.

The final rule adopts an ''economically appropriate'' standard for determining whether a security-based swap position hedges or mitigates commercial risk, and sets forth exclusions for security-based swap positions that have a speculative or trading purpose. As we discuss above, we carefully considered the alternative approaches suggested by some commenters, including the suggestion that the definition should encompass positions that hedge speculative or trading positions and the suggestion that the definition should incorporate a ''congruence'' standard. We concluded, however, that these approaches are inconsistent with the focus of the statutory text, which is on ''commercial risk.'' [1487] We also concluded that broadening the exclusion as some commenters suggested could largely exclude security-based swap positions from the first major participant test. This would produce a result that we believe to be contrary to the purposes of that part of the statutory definition, which envisions that entities might be required to register as major participants by virtue of their security-based swap positions.

D. ''Financial Entity'' Definition

Exchange Act rule 3a67–6 defines ''financial entity'' for purposes of the third test of the major participant definition, which applies to certain highly leveraged non-bank financial entities and does not prevent them from excluding commercial risk hedging positions when conducting the substantial position analysis (in contrast to the first test within the major participant definition, which permits exclusion of those hedging positions).

Although the scope of the financial entity definition has the potential to affect the number of persons who are captured by the third test of the statutory major participant definition (and thus, by extension, the programmatic costs and benefits associated with major participant regulation), we believe that as a practical matter such an effect would be minimal. This is based on our view that persons that have security-based swap positions large enough and risky enough to potentially lead to major participant status to be financial in nature and thus would likely fall within any reasonable interpretation of the term ''financial entity,'' [1488] thus making such entities potentially subject to the third major participant test (to the extent that such entities are subject to bank capital requirements).

E. ''Highly Leveraged'' Definition

Exchange Act rule 3a67–7 defines ''highly leveraged'' for purposes of the third prong of the major participant definition, which applies to certain non-banks as described above. In adopting the final rule, we have considered alternative approaches suggested by commenters. For example, a number of commenters favored the use of a 15 to 1 leverage ratio, which may be expected to reduce the number of persons who are deemed to be ''highly leveraged'' and thus subject to the third test. Conversely, some commenters favored a ratio that is lower than the one found in the final rule, which may be expected to increase the number of entities deemed to be highly leveraged.[1489]

The final rule defines ''highly leveraged'' as a leverage ratio of 12 to 1 or higher. In our view, this ratio reasonably sets forth objective criteria for identifying entities that pose a heightened risk of being unable to meet their obligations through their use of leverage. This 12 to 1 ratio reflects a number of factors, including the use of a 12 to 1 ratio in connection with certain broker-dealer capital rules, as well as reasons to distinguish the use of a 15 to 1 ratio in Title I of the Dodd-Frank Act.[1490]

As with the financial entity definition in rule 3a67–6, as a practical matter we do not believe that expanding or narrowing the leverage ratio within any reasonable definition of ''highly leveraged'' for purposes of the third major participant test will have a significant impact on the programmatic costs and benefits of major participant regulation. In part, this is because we believe that in many circumstances the

[1486] *See* parts II.C.2.b and IV.G.2, *supra* (discussing nature of inter-affiliate security-based swap transactions).

[1487] *See* parts IV.C.5.a and IV.C.5.b, *supra* (discussing rationale for excluding hedges of speculative and trading positions from the definition).

[1488] *See* Federal Reserve Bank of New York staff reports, ''An Analysis of CDS Transactions: Implications for Public Reporting'' (2011) at table 3 (''NY Fed analysis'') (available at *http://www.newyorkfed.org/research/staff_reports/sr517.pdf*) (discussing credit default swap trade frequency by market type, and indicating that most activity is done by entities of a financial nature).

[1489] *See* part IV.F.2.b, *supra.*

[1490] *See* part IV.F.3.b, *supra* (discussing the rationale for using a 12 to 1 ratio for purposes of defining the term ''highly leveraged'' in the context of the major participant definitions).

sales of credit protection cannot reasonably be interpreted to constitute the hedging of commercial risk,[1491] meaning that such positions in any event may be expected to be considered as part of the analysis of the first major participant test. The programmatic impact of this definition further is mitigated by the fact that we believe that there will be relatively few entities whose security-based swap positions would cause them to be major participants.

F. ''Major'' Categories of Security-Based Swaps

Exchange Act rule 3a67–2 defines ''major'' categories of security-based swaps, a term that plays a role in the two statutory major participant tests that turn upon the presence of a substantial position in a ''major'' category of security-based swaps. The final rule retains the proposal's division of those instruments into debt-based and other categories. As discussed above, these major categories are broadly consistent with market usage and statistics, and we believe that it is reasonable for entities undertaking this analysis to use these categories in calculating whether they have a substantial position.[1492]

In theory, it is possible that the categorization of security-based swaps for these purposes could result in a particular entity exceeding the applicable thresholds in a major category, causing it to be a major security-based swap participant and triggering the Title VII registration and regulatory requirements.[1493] The relationship between the major security-based swap categories as we have defined them in this rule and the programmatic costs and benefits associated with major participant regulation will depend largely on how the security-based swap positions of entities with security-based swap exposures approaching these thresholds are distributed between these categories.

The available data suggests that the debt-based major category (*i.e.,* credit default swaps) accounts for the vast majority of security-based swap positions.[1494] Absent an approach that breaks single-name credit default swaps in to multiple ''major'' categories—which itself would not appear to be justified based on current information—this suggests that this categorization as a practical matter will not have a significant effect on the programmatic costs and benefits of major participant regulation.[1495]

G. Registration Period

Exchange Act rules 3a67–8 and 3a71–2 establish periods for registration as a dealer and major participant, as well as periods for revaluating or terminating one's status as a registered entity. As such, these provisions may affect the length of time that particular entities may be deemed to be major participants or dealers, and hence subject to the requirements applicable to those entities. However, any effect of delaying or accelerating dealer or major participant status on the programmatic costs and benefits associated with major participant or dealer status likely will be negligible compared to the overall programmatic costs and benefits associated with major participant or dealer regulation.

H. Calculation Safe Harbor

Exchange Act rule 3a67–9 establishes a calculation safe harbor for the major participant threshold tests. We do not believe that this safe harbor changes the scope of the major participant definition, as it should not exclude from the major participant definition any entity that would otherwise fall within the definition if that entity performed the substantial position calculations.[1496] Accordingly, we do not believe that the safe harbor would have a material effect on the programmatic costs and benefits associated with major participant regulation.

I. Interpretation Related to Guarantees

In adopting these final rules, we also have finalized an interpretation regarding when a person will have security-based swap positions attributed to it by virtue of having guaranteed the positions of another party. In general, we have clarified that an entity's security-based swap positions need not be attributed to its parent unless the counterparty has recourse to the parent. We also clarified that, even in the presence of a guarantee, positions of certain regulated entities—including swap dealers, security-based swap dealers, major participants, broker-dealers, FCMs and certain entities subject to U.S. bank capital requirements—will not be attributed to the guarantor.[1497]

We recognize that attributing security-based swap positions to the entity guaranteeing another entity's security-based swap transactions may increase the number of major participants. At the same time, excluding certain regulated entities from the attribution requirement even in the presence of a guarantee may help prevent a guarantor, such as a holding company, from being deemed to be a major participant when the risks associated with those positions already are subject to regulation.

We do not currently possess data relating to the existence of guarantees of the security-based swap positions of other parties and thus cannot reasonably estimate the number of additional entities that may be brought within the ambit of major participant regulation by virtue of this interpretation. However, we note that, to the extent that guarantees of another entity's security-based swap positions creates the level of exposure—and corresponding risk to the market and to counterparties—that warrants regulation under Title VII, it would appear inconsistent with the purposes of the statute not to subject that entity to major participant regulation.

J. Other Interpretations

Finally, in this release we also have provided a number of additional interpretations and discussions in connection with the dealer and major participant definitions. These include, among others: the rejection of requests for entity-specific exclusions from the dealer and major participant definitions;[1498] interpretations regarding the application of the ERISA exclusion from the first major

[1491] *See* note 1019, *supra.*

[1492] *See* part IV.A.3 (discussing rationale for final ''major'' categories).

[1493] In other words, the dividing line that the rule sets between the major category of debt-based security-based swaps and the major category for other security-based swaps (or other dividing lines based on different or additional major categories) could determine whether an entity's security-based swap positions exceed or fall below the major participant thresholds for a particular major category, and hence whether the entity will be deemed to be a major participant.

[1494] *See* note 476, *supra.*

[1495] For example, an alternative approach might divide narrow-based index CDS and single-name CDS into separate major categories. We believe, however, that single-name CDS account for the large majority of debt-based security-based swaps, *see id.,* suggesting that most entities' status as major participants would turn on their single-name CDS exposures under any reasonable approach to defining major categories and that the subtraction of narrow-based index CDS exposures in the calculation of substantial exposure would, given their relatively small market volume, have little effect on whether most entities meet the substantial exposure threshold. Thus, we believe that the decision to classify all debt-based security-based swaps in a single category will likely have minimal effect, if any, on any entity's status as a major participant, as compared to dividing debt-based security-based swaps into two categories.

[1496] *See* part IV.M.2, *supra.*

[1497] *See* part IV.H.3, *supra.*

[1498] *See* parts II.A.6 and IV.J, *supra* (stating that such exclusions from the dealer definition would have no basis in the statutory text and would be inconsistent with the activity focus of the dealer definition, and not providing entity exclusions from the major participant definition because entities that meet the thresholds of the rules may pose high risk to the U.S. financial system regardless of how they are organized).

participant test,[1499] and interpretations regarding the application of the major participant analysis to managed accounts.[1500] In theory, each of these interpretations potentially has a programmatic impact.[1501] For the reasons discussed above, we believe that these interpretations reflect reasonable choices.

3. Analysis of Assessment Costs

Certain persons engaged in security-based swap activity are likely to incur costs in connection with evaluating whether they fall within the dealer or major participant definitions.[1502] As detailed below, we have considered these assessment costs in adopting definitional rules and interpretations that seek to capture entities whose security-based swap activity or whose security-based swap positions warrant regulation under Title VII as dealers or major participants, while excluding entities whose activity or positions do not warrant such regulation.

a. Assessment Costs Associated With the ''Security-Based Swap Dealer'' Definition

i. Core Dealer Analysis and *De Minimis* Exception

A. Overview

Exchange Act rule 3a71–1 in part restates the statutory definition of ''security-based swap dealer'' to consolidate the definition and related interpretations for market participants' ease of reference. In conjunction with these final rules the SEC has set forth interpretations to provide additional guidance to implement the statutory approach of capturing persons that engage in certain security-based swap activities while excluding persons that do not engage in those activities as part of a ''regular business.'' [1503] We believe that this guidance—including its reliance on the distinction between dealing activity and non-dealing activity such as hedging or trading—will allow a number of market participants to readily conclude that their security-based swap activities will not cause them to be security-based swap dealers. In adopting this approach, we have considered alternative views, expressed by some commenters, that would have had the effect of narrowing the statutory definition's scope.[1504]

Exchange Act rule 3a71–2 specifies when a person that otherwise would be a security-based swap dealer can take advantage of the *de minimis* exception. In adopting the rule's tests and thresholds—including the use of a $3 billion notional threshold in connection with dealing activity involving credit default swaps that are security-based swaps, a $150 million notional threshold in connection with other types of security-based swaps, higher phase-in levels in connection with those thresholds, and a separate $25 million threshold in connection with dealing activity involving ''special entities''—we have considered a range of alternative approaches and thresholds suggested by commenters.[1505]

In application, the assessment costs associated with the core dealer test and *de minimis* exception are linked.

B. Assessment Costs Associated With the Final Rules and Interpretations

We recognize that certain participants in the security-based swap market may incur costs in connection with the facts-and-circumstances analysis of whether they are security-based swap dealers as defined in the statute and in the final rules, particularly with regard to the application of the dealer-trader distinction and the *de minimis* exception.

As noted above, analysis of market data indicates that the overwhelming number of participants in the single-name credit default swap market in 2011 had total activities (dealing or non-dealing) of significantly less than $3 billion notional amount over the prior 12 months.[1506] In general—aside from potential dealing activity involving other types of security-based swaps and dealing activity involving ''special entities''—such persons likely would not be deemed to be security-based swap dealers regardless of whether their current level of security-based swap activities constitutes dealing (apart from those entities that increase their dealing activity following the implementation of Title VII).

On the other hand, some market participants whose security-based swap activities exceed, or are not materially below, the $3 billion *de minimis* threshold may be expected to incur costs in connection with the dealer analysis. Those entities reasonably may conclude that they need to incur costs to analyze their security-based swap activities to determine whether those activities are non-dealing in nature (*e.g.,* hedging or trading), or whether those activities instead are dealing in nature (*e.g.,* part of a business purpose of providing liquidity in connection with security-based swaps), consistent with the statute and the rules and guidance provided in this release.[1507]

There are over 1,000 entities (U.S. and non-U.S.) that from time to time may engage in single-name credit default swap transactions.[1508] Of this number,

[1499] *See* part IV.D, *supra* (interpreting the provision to exclude security-based swap positions entered into for the primary purpose of hedging or mitigating risks associated with operation of the plan, consistent with the statutory language that does not limit the hedging exclusion for ERISA plans to commercial risk; also clarifying that such positions may be eligible for exclusion even if they are held by a non-plan entity that holds plan assets).

[1500] *See* part IV.I, *supra* (clarifying that the position will be attributed to the client account rather than to the investment advisers or asset managers and that a beneficial owner should be required to treat the positions of such an account as its own only if the security-based swap counterparty has recourse to the beneficial owner).

[1501] For example, attributing security-based swap positions to investment advisors would have increased the likelihood of advisers being deemed to be major participants. Our interpretations do not take that approach, however, as we believe that it would be inconsistent with the focus of the statutory definition.

[1502] These costs are distinguishable from the costs associated with registration as a dealer or major participant (which for purposes of this analysis we treat programmatic costs) and the other programmatic costs discussed above.

[1503] *See* part II.A.5, *supra.*

[1504] These include suggestions that: the dealer definition should be interpreted to be coextensive with the concept of market making activity; the dealer definition requires that a person be available to take either side of the market at any time; the dealer definition should not extend to persons solely engaged in security-based swap activity on swap execution facilities; the dealer definition should exclude persons whose security-based swap dealing activity is relatively small compared to its other activities; and dealing activity requires the presence of a ''customer'' relationship. *See id.* (discussing interpretive approach to ''security-based swap dealer'' definition). Conversely, a few commenters suggested rejection of the dealer-trader distinction, and implied that the dealer definition should be applied more broadly. *See id.*

These also include suggestions that the dealer analysis incorporate particular *per se* exclusions. Although we recognize that such approaches may be simpler for market participants to implement, we nonetheless do not believe that such *per se* exclusions would be consistent with the statutory definition, which identifies dealers based on their security-based swap activities. *See* part II.A.6, *supra* (discussing reasons not to include *per se* exclusions from the dealer definitions).

[1505] *See* parts II.D.3 and II.D.5, *supra.*

[1506] Of 1,084 entities with single-name credit default swap transaction activity over the 12 months ending in December 2011, 961 entities, or 88.7 percent, engaged in less than $3 billion notional in such activity. These 961 entities were responsible for approximately 3.2 percent of the notional value of all single-name credit default swap transactions during that period. *See* CDS Data Analysis, table 1.

[1507] The use of the $8 billion phase-in level in connection with these activities may also be expected to temporarily mitigate such costs.

[1508] *See* CDS Data Analysis, table 1. The Federal Reserve Bank of New York has published data that is consistent with this analysis. *See* NY Fed analysis at 10 (noting that for a three month period spanning from May through July of 2010, there were 933 unique market participants in the credit default swap market).

As noted above, *see* note 148, *supra,* in relying on the available data we are not indicating our views as to the application of Title VII to non-U.S.

Continued

however, only 123 entities engaged in more than $3 billion in single-name credit default swap transactions over the previous 12 months. For purposes of analyzing the assessment costs of this rule, we have assumed that all of these entities would perform the dealer analysis.[1509] We also recognize that some entities whose activities fall below the *de minimis* threshold may opt to engage in this analysis out of an abundance of caution or to meet internal compliance requirements, and for purposes of this analysis have assumed that the 43 entities whose activity during the trailing 12 month period fell between $2 and $3 billion also would engage in the dealer analysis, leading to a total of 166.[1510]

This estimate of 166 entities, although derived from data about total (dealing and non-dealing) transactions,[1511] illustrates a potential upper bound for the total costs arising from security-based swap dealer determinations, to the extent that all market participants whose security-based swap activity approaches or exceeds the $3 billion *de minimis* threshold identify a need to retain outside counsel to analyze their status under the security-based swap dealer definition. In that context, this estimate suggests that the costs of analysis may approach $4.2 million.[1512]

In accounting for the *de minimis* exception in estimating these costs, we note our expectation that market participants generally would be aware of the notional amount of their activity involving security-based swaps as a matter of good business practice. Consequently, we would not expect market participants to incur costs in determining the availability of the *de minimis* exception significantly in excess of the costs associated with the general dealer determination.[1513]

We recognize that additional market participants may be expected to incur these types of assessment costs to the extent that they engage in activity involving other types of security-based swaps in an amount close to, or in excess of, $150 million annually. Because the market for these other types of security-based swaps appears to be highly concentrated (like the single-name credit default swap market) and to involve many of the same entities,[1514] we expect the number of entities that will incur assessment costs solely by virtue of this lower threshold also to be small.

In addition, we recognize that some market participants potentially may incur these types of assessment costs to the extent they engage in security-based swap activities in an amount close to, or in excess of, $25 million annually.[1515]

For the reasons discussed above we believe that the approach we are adopting in the final rules is necessary and appropriate given the goals of Title VII and the statute's express requirement that we implement a *de minimis* exception to the dealer definition.

ii. Additional Issues Related to the Dealer Analysis

A. Limited Designation of Dealers

Exchange Act rule 3a71–1(c) implements the portion of the ''security-based swap dealer'' definition that provides for limited purpose registration of dealers. The rule provides for a presumption that a person that acts as a security-based swap dealer is a dealer with regard to all of its security-based swaps or security-based swap activities, unless the SEC limits its designation. While we recognize that permitting persons to more broadly take advantage of limited dealer designations potentially would lower the cumulative costs that individual dealers otherwise would incur to determine whether to

persons. Issues regarding the extraterritorial application of Title VII instead will be addressed in a separate release.

[1509] *See* CDS Data Analysis, table 1. This approach potentially overstates the number of entities that would need to engage in the analysis. Of entities with more than $3 billion in activity over the trailing 12 month period, some number can be expected to determine, given the nature of their business, that they are (or are not) dealers under the definition without having to engage in this analysis. For example, the NY Fed analysis discussed above found that so-called G14 dealers were responsible for roughly 78 percent of CDS transactions as buyer and 85 percent of CDS transactions as sellers, and that so-called ''other dealers'' were responsible for approximately an additional seven percent of CDS transactions as sellers and six percent as buyers. *See* NY Fed analysis at 9, table 3. Many of these entities would likely determine that performing this analysis was unnecessary.

[1510] For the reasons stated above, we also believe that this number potentially overstates the number of entities with less than $3 billion in activity over the trailing 12 month period that would be likely to engage in this analysis. Because it appears that all entities engaged in security-based swap transactions with special entities engaged in more than $8 billion in security-based swap transactions in 2011, *see* CDS Data Analysis at 21 n.8, we do not expect that the *de minimis* threshold for dealing activity involving special entities to cause market participants to incur costs independent of those associated with the general *de minimis* threshold.

[1511] The CDS Data Analysis uses criteria that screen for likely characteristics of entities engaged in dealing activity. *See* CDS Data Analysis at 2. However, the available data does not permit identification of which of these entities' transactions arise from dealing activity and which arise from non-dealing activity (such as proprietary trading or hedging). It is therefore likely that the notional amounts provided in each table of the data analysis include both dealing and non-dealing activity. For purposes of the economic analysis of our rules further defining ''security-based swap dealer,'' we have assumed that the entire notional amount for each entity appearing in Tables 2–9 represents dealing activity. Although this potentially results in an overestimate of dealing activity for these entities—and thus in an overestimate of the costs associated with conducting the dealer analysis—we believe that this represents a conservative approach to evaluating the assessment costs of these rules.

[1512] This total is based on the assumption that 166 market participants would seek outside legal counsel to determine their status under the security-based swap dealer definition, with such analysis costing an average of $25,000 per entity.

The average cost incurred by such entities in connection with outside counsel is based on staff experience in undertaking legal analysis of status under federal securities laws, and assumes that the legal analysis for a complex entity on average may cost $30,000, and that the legal analysis for a less complex entity on average may cost $20,000. The use of inside counsel in lieu of outside counsel would reduce this upper bound.

We recognize that the complexity of market participants may vary greatly, and that we do not have insight into market participants such that we could reasonably determine how many entities may be considered more or less complex for these purposes. Thus, based on our understanding of the market we believe that an average of the costs associated with more complex and less complex entities equaling $25,000 would reasonably approximate the average costs for entities across the credit default swap market, assuming that all such participants perceive a need to retain outside counsel for purposes of the analysis.

[1513] We note that different cost estimates have been used for purposes of the ''swap dealer'' definition under the CEA. We do not believe that the estimate of the number of persons who would have to engage in a dealer analysis under the CEA would be germane to the analysis of the costs associated with the Exchange Act's ''security-based swap dealer'' definition, given the wide range of markets that are exclusive to the ''swap'' definition. We also do not believe that the basis that underpins the CFTC's estimate of the cost of performing the dealer analysis under the definition of swap as set forth in the CEA would be relevant to the Exchange Act definition. In part, this is because we believe that the entities whose security-based swap activities may cause them to be dealers likely would have businesses that are financial in nature. We thus expect that those entities would be particularly sensitive to the link between the business purpose of their activities and the dealer definition. In many cases those entities also should be familiar with the use of the dealer-trader distinction in connection with their activities involving other types of securities.

We also note that different cost estimates have been used for purposes of the *de minimis* exception under the CEA. We expect, however, that entities whose security-based swap activities may cause them to be dealers likely would have businesses that are financial in nature. We thus expect that those entities would: (a) be well placed to distinguish their security-based swap dealing activities from their non-dealing activities under the dealer-trader distinction; and (b) would be familiar with the notional amount of their security-based swap activities over the prior year.

[1514] *See, e.g.,* OCC Quarterly Report at tables 1 and 10 (listing notional credit and equity derivatives for largest U.S. banks and trust companies). *See also* note 429, *supra.*

[1515] We believe that any such costs would be modest, in light of data indicating that persons who are counterparties to special entities in the single-name credit default swap market may otherwise have to register as dealers notwithstanding the lower threshold connected with special entities. *See* note 1510, *supra.*

seek a limited designation,[1516] after careful consideration of commenter concerns we have determined that it is appropriate to adopt a presumption against limited designation.[1517]

Certain persons who satisfy the dealer definition may incur costs in determining whether to seek a limited designation. We believe that such costs would affect no more than the 166 entities that potentially may be expected to engage in the dealer analysis,[1518] and expect these costs to be included in the estimated costs of seeking outside legal counsel described above.

B. Exclusion of Inter-Affiliate Security-Based Swaps

Exchange Act rule 3a71–1 also provides that security-based swaps between majority-owned affiliates will be excluded for purposes of the dealer analysis. After consideration of commenter views, we are adopting this standard, rather than potential alternatives such as a common control test, because we believe that it is appropriate, in light of the goals of Title VII, that the dealer definition not capture entities by virtue of security-based swap transactions with affiliated entities that have a sufficient alignment of economic interests to avoid raising systemic risk, customer protection, and other concerns that dealer regulation is intended to address.[1519] Moreover, we note that a majority-ownership test should, given its objective nature, impose fewer assessment costs on market participants than a more subjective common control test.

Some market entities may need to incur costs in connection with determining whether particular security-based swap positions may be excluded from the dealer analysis by virtue of the inter-affiliate exclusion. Such costs potentially could be incurred by any of the approximately 166 entities that we believe may engage in the dealer analysis. The costs specifically associated with that assessment may vary depending on factors including the extent to which those entities engage in inter-affiliate security-based swaps, but we expect these costs to be included in the estimated costs of seeking outside legal counsel described above.

C. Timing Issues Connected to the De Minimis Exception

In response to commenter concerns, Exchange Act rule 3a71–2 specifies that an entity that no longer may rely on the *de minimis* exception, because its dealing activity has exceeded the exception's thresholds, has two months to submit a completed application to register as a dealer.[1520] The final rule also specifies that a person who has been registered as a dealer for at least 12 months may withdraw from registration while continuing to engage in a limited amount of dealing activity under the exception.

In adopting these rules we have carefully considered alternatives that would lead to slower entry and faster exit from dealer status, and we recognize that providing particular entities with additional time to register as a dealer may have the potential to reduce the costs associated with the registration process.[1521] We believe, however, that a two-month period for registration should provide entities with sufficient time to register without incurring additional expenses—both for large firms with security-based swap businesses well above the $3 billion threshold, and for mid-sized firms that fluctuate near the $3 billion threshold amount. We also conclude that this approach will appropriately help to avoid applying dealer requirements to entities that no longer meet the dealer criteria, and will avoid the prospect of persons moving in and out of dealer status overly frequently.

b. Assessment Costs Associated With the ''Major Security-Based Swap Participant'' Definition

i. ''Substantial Position'' and ''Substantial Counterparty Exposure'' Definitions

A. Overview of ''Substantial Position'' and ''Substantial Counterparty Exposure'' Definitions

Exchange Act rule 3a67–3 defines the term ''substantial position'' for purposes of the first and third tests of the statutory major participant definition (which address whether a person has a ''substantial position'' in a major category of security-based swaps). The final rule sets forth two tests for identifying the presence of a substantial position—one test based on a $1 billion daily average measure of uncollateralized mark-to-market exposure, and one based on a $2 billion daily average measure of combined uncollateralized mark-to-market exposure and potential future exposure. Both of those daily measures would be calculated and averaged over a calendar quarter. In developing the ''substantial position'' tests and their associated thresholds, we have sought to capture those entities whose security-based swap positions have the potential to pose significant risks to financial markets, while not capturing other entities for which major participant regulation and its associated costs would be unwarranted.[1522]

Exchange Act rule 3a67–5 defines ''substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets,'' a phrase that comprises part of the second test of the ''major security-based swap participant'' definition. The analysis set forth in this rule parallels the ''substantial position'' analysis, but: (i) Contains higher thresholds; (ii) examines an entity's security-based swap positions as a whole (rather than focusing on a particular ''major'' category); and (iii) would not exclude certain hedging positions.[1523]

In adopting these definitions, we carefully considered alternative

[1516] A default presumption in favor of the availability of limited designations may be expected to reduce the costs associated with an entity determining whether it qualifies for such relief, such as the costs of hiring outside legal counsel to undertake this analysis to determine that they could take advantage a limited designation relief.

[1517] In this regard we note the relative lack of data about the types of security-based swap positions held by particular entities that will fall within the dealer definition. Our decision takes into account the difficulty of separating a dealer's activities from its non-dealing activities for compliance purposes, and the challenges of applying dealer requirements to only a portion of the entity's security-based swap activities. In reaching our decision, we have especially been influenced by the statutory definition's discretionary language in connection with the potential for limited designations, and by the need for persons subject to limited designations to be able to comply with the statutory and regulatory requirements applicable to major participants. *See* part II.E.3, *supra* (discussing limited designation principles applicable to dealers).

We note that the discussion of limited designation of ''swap dealers'' under the CEA generally seeks to quantify the costs associated with applications for limited designations. However, we believe that the costs of applying for a limited designation are dependent upon the application process for this type of registration category. As noted previously, the SEC expects to address the limited designation application process for security-based swap dealers in separate rulemakings. *See id.* As such, we believe that the costs associated with security-based swap dealer limited designation applications under the Exchange Act are more appropriately addressed in the context of those separate rulemakings.

[1518] As discussed above, *see* note 1457, *supra,* we have estimated that 50 or fewer entities ultimately may have to register as security-based swap dealers.

[1519] *See* part II.C.2, *supra.*

[1520] *See* part II.D.6, *supra* (discussing rational for final rule addressing registration period for entities that exceed the *de minimis* threshold).

[1521] For example, a shorter period for registration might be expected to cause some entities to incur over-time costs arising from the need to complete the registration process within a short time frame, whereas a longer time period could have enabled such an entity to avoid those costs.

[1522] *See* part IV.B.3, *supra* (discussing basis for the substantial position analysis we are adopting).

[1523] *See* part IV.E.3, *supra* (discussing basis for the substantial counterparty exposure analysis we are adopting).

approaches suggested by commenters, including suggestions that the thresholds should be raised or lowered, and that certain positions should be excluded from the potential future exposure test, or that the test should discount certain positions differently.[1524] We have retained the tests largely as proposed, however, as we believe that the tests appropriately address the risk criteria embedded in the major participant definition.[1525] We also believe that the tests minimize the assessment costs to these entities in a manner consistent with the statutory definition. For example, the decision to base the potential future exposure analysis on tests used by bank regulators for purposes of setting prudential capital reflects our view that it would be appropriate to implement the analysis by building upon an existing regulatory approach that is less subjective—and thus less costly—for market participants to utilize (as compared to, for example, a VaR approach [1526]) and would lead to reproducible results, rather than seeking to develop a brand new approach.[1527]

B. Assessment Costs Associated With the Final Rules Defining ''Substantial Position'' and ''Substantial Counterparty Exposure''

Certain market participants may be expected to incur costs in connection with the determination of whether they have a ''substantial position'' in security-based swaps or pose ''substantial counterparty exposure'' in connection with security-based swaps.

Based on a review of notional positions maintained in 2011 by entities with single-name credit default swap positions, we estimate that approximately 12 entities have security-based swap positions of such an amount that, as a matter of prudence, they may reasonably find it necessary to engage in the requisite calculations, particularly given the additional availability of the calculation safe harbor.[1528] In our view, the data indicates that other than approximately 12 entities, the non-dealer market participants in the security-based swap market use these products in such limited amounts that they reasonably would conclude that they do not need to undertake the calculations used to determine whether they have a ''substantial position.'' [1529]

Although some commenters noted concerns about the complexity of the major participant calculation,[1530] commenters did not appear to directly question the Proposing Release's per-entity cost estimates.[1531] After further

[1524] *See* parts IV.B.2 and IV.E.2, *supra.*

[1525] *See* part IV.B.3, *supra* (discussing the decisions made regarding the substantial position definition and the reasoning behind the adopted approach). For example, we have concluded that the proposed thresholds are set prudently in a manner that takes into account the financial system's ability to absorb losses of a particular size, the need for major participant regulation not to encompass entities only after they pose significant risks to the market, and the need to account for the possibility that multiple market participants may fail close in time. In addition, as discussed above, we believe that this threshold is tailored to address the types of events associated with the failure of AIG FP. *See* part IV.B.3.d, *supra.*

As discussed above, for an entity with no current uncollateralized exposure—and before accounting for netting—it would take a $100 billion notional portfolio of marked-to-market security-based swaps that reflect written protection on credit to meet the $2 billion potential future exposure threshold for security-based credit derivatives, and it would take a $200 billion notional portfolio of cleared positions to meet that threshold. Even in the absence of clearing or daily mark-to-market margining, it would take a minimum $20 billion notional portfolio of written protection on credit (reflecting the 0.10 multiplier in the risk adjustment tables) to meet the $2 billion potential future exposure threshold. Accounting for netting (which can reduce potential future exposure measures by up to 60 percent) could materially increase that required amount. *See* note 914, *supra.*

[1526] For example, because value-at-risk measures typically account only for market risk and not for other types of risk, an approach based on such measures would likely require separate calculations for these other risks, as well as calculations to account for possible losses in the event of a severe market downturn; such an approach would also require the selection of appropriate parameters for the test. *See* Concept Release: Net Capital, Exchange Act Rel. No. 39456, at 13–19 (comparing value-at-risk and haircut approaches to net capital calculations).

[1527] *See* part IV.B.3.c, *supra.*

[1528] In the Proposing Release, we stated that based on our understanding of the market, we concluded that only 10 entities had security-based swap positions of a size to necessitate performing the calculations to determine whether they meet those thresholds. *See* Proposing Release, 75 FR at 80207–08. Some commenters challenged the assumption that only approximately 10 entities would engage in the requisite calculations. Those commenters took the view that certain entities with smaller security-based swap positions would perceive a need to conduct the relevant calculations on a daily basis even if they are not reasonably likely to be major participants, and, to address that concern, requested a safe harbor from having to perform the major participant calculations. *See* letters from SIFMA AMG I and Vanguard.

[1529] As discussed above, an entity that margins its positions daily generally would need to have security-based swap positions approaching $100 billion notional to meet the substantial position threshold, assuming no current uncollateralized exposure, while an entity that clears those positions generally would need positions approaching $200 billion notional to meet the threshold. *See* note 914, *supra.* We believe that it is reasonable to assume that most entities that will have security-based swap positions large enough to potentially cause them to be major participants in practice will post variation margin in connection with those positions that they do not clear, making $100 billion the relevant measure. The available data shows that as of December 2011 a single entity had aggregate gross notional positions from bought and sold credit protection exceeding $100 billion, four had aggregate gross notional single-name credit default swap positions exceeding $50 billion, and 12 had aggregate gross notional single-name credit default swap positions exceeding $25 billion. *See* CDS Data Analysis at table 10. Making allowances for certain entities that may determine, due to internal policies or other reasons, that they need to conduct this analysis and cannot rely on the calculation safe harbor we also are adopting, we believe that it is reasonable to assume that entities with aggregate gross notional single-name credit default swap positions exceeding $25 billion may identify a need to perform the major participant analysis. (In the Proposing Release, we stated that based on our understanding of the market, we thought that fewer than ten entities had security-based swap positions of a size to necessitate performing the calculations to determine whether they meet those thresholds. *See* Proposing Release, 75 FR at 80207–08.)

We believe, moreover, that the estimate that 12 entities will perceive a need to perform this analysis in practice may overstate the number of entities that reasonably will find it necessary to perform the major participant analysis, given that only four entities had $25 billion or more of aggregate gross notional single-name credit default swap positions arising from the selling of credit protection. *See id.* As discussed above, moreover, we believe that fewer than five entities ultimately may be required to register as major security-based swap participants. *See* part VIII.A.2.d.i.*C, supra.*

Finally, we note that this estimate may also overstate the size of positions held by individual legal entities, thus further overstating the number of legal entities that have security-based swap positions of such a size as to potentially trigger major participant status. This is because the data in the analysis at times aggregates multiple affiliated accounts—which may reflect the legal entities that are counterparties to the security-based swap—at the parent level. While such aggregation is appropriate for these purposes given that parents may be deemed to be major participants by virtue of security-based swap positions that they guarantee, the aggregation in fact may tend to overstate the extent to which a legal entity bears credit risk in connection with security-based swaps.

To the extent that an entity's security-based swap transactions are not cleared or associated with the posting of variation margin, security-based swap positions of $20 billion may lead to sufficient potential future exposure to cause the entity to be a major participant. As we have noted, we believe that few if any entities with significant security-based swap positions will have a significant number of such transactions. Even then, the data indicates that only a total of 32 entities have notional credit default swap positions in excess of $10 billion. *See* CDS Data Analysis at table 10 (showing that 32 entities have aggregate gross single-name credit default swap positions of $10 billion or greater).

[1530] *E.g.,* letter from WGCEF II (addressing technical complexity of the proposed major participant calculations).

[1531] Based on industry discussions, in the Proposing Release we estimated that those 10 entities would incur one-time programming costs of approximately $13,444 per entity, or $134,440 in total, and that these entities would incur annual ongoing costs of $7,260 per entity, or $72,600 in total. *See* Proposing Release, 75 FR at 80207–08, nn.183–86 and accompanying text (providing a summary of the methodology used to estimate these costs). The hourly cost figures in the Proposing Release for the positions of Compliance Attorney, Compliance Manager, Programmer Analyst, and Senior Internal Auditor were based on data from SIFMA's Management & Professional Earnings in the Securities Industry 2009. For purposes of the cost estimates in this release, we have updated these figures with more recent data as follows: the figure for a Compliance Attorney is $322/hour, the figure for a Compliance Manager is $279/hour, the figure for a Programmer Analyst is $196/hour, and the figure for a Senior Internal Auditor is $198/

consideration, however, we are modifying that estimate, in that we believe that the annual per-entity costs associated with the assessment will amount to $15,268, and the annual one-time per-entity costs associated with the assessment will amount to approximately $13,692.[1532] The total industry-wide assessment costs associated with the major participant definition, given our expectation that 12 entities will need to engage in this analysis, is $183,216 for annual costs and $164,304 for annual one-time costs.[1533]

We believe that these estimates also address the assessment costs under the ''substantial counterparty exposure'' test. Because credit default swaps may be expected to constitute the bulk of the likely security-based swap market, it is possible that participants in the market may be more likely to have a ''substantial position'' in debt-related security-based swaps than they would be to meet this second test. Nonetheless, we conservatively estimate that the same approximately 12 entities would engage in the ''substantial counterparty exposure'' calculation as would undertake the ''substantial position'' calculation.[1534] Given the link between this rule and the ''substantial position'' calculations, however, we do not anticipate that the ''substantial counterparty exposure'' test would create incremental costs additional to those associated with the definition of ''substantial position.''[1535] We thus believe that the estimate of assessment costs in connection with the ''substantial position'' analysis (consisting of one-time programming costs of approximately $13,692 per entity, and annual costs of $15,268 per entity) also adequately addresses the costs of assessment under this statutory test.[1536]

At the same time, upon further consideration we believe these rules also may impose certain interpretive costs, including those related to obtaining legal counsel, on market participants. Given the size and complexity of the entities that may find it necessary to analyze their status under the major participant definition, we believe that it is reasonable to conclude that at least some entities with security-based swap positions that approach the major participant thresholds are likely to seek legal counsel for interpretation of various aspects of the rules pertaining to the major participant definition. The costs associated with obtaining such legal services would vary depending on the relevant facts and circumstances, including the size and complexity of the person's security-based swap positions, and the extent to which these interpretations may be germane to whether the entity ultimately is deemed to be a major participant. We believe, however, that $30,000 represents a reasonable estimate of the upper end of the range of the costs of obtaining the services of outside counsel in undertaking the legal analysis of the entity's status as a major participant.[1537]

hour, each from SIFMA's Management & Professional Earnings in the Securities Industry 2011, modified by SEC staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead. We have also updated the Proposing Release's $450/hour figure for a Chief Financial Officer, which was based on data from 2010. Using the consumer price index to make an inflation adjustment to this figure, we have multiplied the 2010 estimate by 1.03 and arrived at a figure of $464/hour for a Chief Financial Officer in 2011. Incorporating these new cost figures, the updated one-time programming costs based upon our assumptions regarding the number of hours required in the proposing release would be $13,692 per entity, or $136,920 in total, and the annual ongoing costs would be $7,428 per entity, or $74,280 in total.

[1532] This revision in part is based on the addition of an ongoing cost of a Programmer Analyst who we estimate would spend an additional 40 hours annually on software maintenance attributable to the modifications made to an automated system to undertake these tests. We further estimate that the hourly wage of a Programmer Analyst would be approximately $196. The $196/hour figure for a Programmer Analyst is from SIFMA's Management & Professional Earnings in the Securities Industry 2011, modified by SEC staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead. Based on these assumptions, we estimate these additional costs as $7,840 per year per entity and $94,080 per year for all entities as follows: (Programmer Analyst at $196 per hour for 40 hours) × (12 entities) = $94,080.

[1533] These adjustments do not materially change the estimated costs associated with performing these calculations.

To the extent that additional entities perceive a need to perform the major participant calculations provided by the rules, notwithstanding a relatively low position in security-based swaps, these costs would differ. For example, if we assume that 32 entities will perceive the need to conduct the major participant analysis, *see* note 1529, *supra,* initial legal costs will total approximately $960,000 (based on the per-entity cost estimate of $30,000); one-time industry-wide costs would total approximately $440,000 (based on the per-entity cost estimate of $13,692); and annual industry-wide costs would total approximately $490,000 (based on the per-entity cost estimate of $15,268 addressed below).

At the extreme, available data indicates that 1,188 participants have single-name credit default swap positions in the security-based swap market (excluding ISDA-recognized dealers and ICE Trust). *See* CDS Data Analysis at table 10, To the extent that none of these 1,188 entities avail themselves of the calculation safe harbor we are adopting, and that all of them engage in the full major participant analysis, then there potentially will be initial legal costs of approximately $35.6 million (based on the per-entity cost estimate of $30,000), one-time industry-wide costs of approximately $16.3 million (based on the per-entity cost estimate of $13,692), and annual industry-wide costs of approximately $18.1 million (based on the per-entity cost estimate of $15,268 addressed below).

In practice, however, we think that the estimates for 12 entities more fairly assesses the relevant costs for the reasons discussed above. *See* note 1529, *supra.* In our view, a large number of participants in the market have notional security-based swap positions low enough to permit them to conclude that they do not have to engage in the relevant calculations. *See id.*

[1534] *See* part VIII.A.3.b.i.*A, supra.* These costs would differ if additional entities perceive a need to perform the major participant calculations provided by the rules, notwithstanding a relatively low position in security-based swaps. Commenters have taken the view that more than 10 entities may identify a need to perform the requisite calculations. As already noted, based on the analysis of 2011 transaction data, we have revised this estimate upward to 12 entities, though we believe that the actual number is likely to be smaller. In any event, these concerns should be addressed by the calculation safe harbor that we are adopting as part of these final rules.

[1535] *See* Proposing Release, 75 FR at 80209.

[1536] We note that higher cost estimates have been used for purposes of the ''major swap participant'' definition under the CEA. We expect, however, that the entities that may have security-based swap positions of a size that could lead them to be major participants likely would have businesses that are financial in nature (rather than being non-financial entities that use security-based swaps as part of their commercial activities). As such, we would expect those entities to generally be cognizant of, or in a good position to obtain information about: their uncollateralized exposure with counterparties (to the extent that those financial entities have any material amount of uncollateralized exposure); the total notional amount of their security-based swap positions; the notional amount of those positions that are subject to central clearing or daily mark-to-market margining; and the extent to which those positions are in-the-money or out-of-the-money (for purposes of calculating the netting discount to the potential future exposure calculation). We also expect that security-based swaps will be used less frequently for hedging purposes than swaps. *See, e.g.,* Bernadette A. Minton, René Stulz & Rohan Williamson, ''How Much Do Banks Use Credit Derivatives to Hedge Loans?,'' 35 J. Fin. Serv. Res. 1 (2008) (noting that the ''net notional amount of credit derivatives used for hedging of loans in 2005 represents less than 2% of the total notional amount of credit derivatives held by banks''). Accordingly, there is reason to believe that the costs of calculation associated with the ''major security-based swap participant'' assessment will be lower than the costs associated with the ''major swap participant'' assessment.

[1537] The average cost incurred by such entities in connection with outside counsel is based on staff experience in undertaking legal analysis of status under federal securities laws. The staff believes that costs associated with obtaining outside legal counsel relating to such determinations range from $20,000 to $30,000 depending on the complexity of the entity. We believe that an entity that maintains security-based swap exposures of the size that would necessitate undergoing this analysis will generally be large, complex financial organizations. We also recognize that, while the major participant test may be more objective and quantitative than the dealer test (and therefore require a less involved legal analysis), the test is novel (unlike the core dealer test, which draws on the dealer-trader distinction familiar to many market participants) and, as such, may cause entities to incur additional costs in interpreting and applying the test. Together, these factors lead us to estimate that entities undertaking this analysis will incur legal costs at the upper end of our estimated range. The use of inside counsel in lieu of outside counsel would reduce this upper bound.

Continued

Based on the conclusion that no more than 12 entities have security-based swap positions that they would face enough of a possibility of being a major participant that they would need to engage in such analysis,[1538] we estimate that the total legal costs associated with evaluating the various elements of this definition may approach $360,000.[1539]

ii. Calculation Safe Harbor

We also are adopting Exchange Act rule 3a67–9, which provides a safe harbor from the definition of ''major security-based swap participant'' for market participants whose security-based swap positions fall below certain thresholds. This safe harbor responds to concerns raised by commenters that—based on internal compliance policies and procedures, out of an abundance of caution, or for other reasons—certain entities may feel compelled to perform the full major participant calculations even if their security-based swap positions did not rise to a level near the thresholds in the ''substantial position'' or ''substantial counterparty exposure'' definitions.[1540]

The safe harbor makes use of three alternative tests. The first of these is based on the maximum possible uncollateralized exposure under the applicable credit support arrangements, and on the notional amount of a participant's security-based swap positions. The two other alternatives entail monthly calculations, with the second alternative using calculations based on the maximum possible uncollateralized exposure under the applicable credit support arrangements and monthly adaptations of the substantial position and substantial counterparty exposure calculations, and the third alternative using calculations based on uncollateralized exposure and a modified version of the potential future exposure calculation.

Although the provisions of the safe harbor we are adopting do not mirror the safe harbors suggested by commenters,[1541] the inclusion of this safe harbor should help address commenter concerns regarding entities with small positions that would nonetheless feel compelled (due to their own internal compliance programs, or otherwise) to undertake the major participant calculations. While recognizing that more liberal standards for this safe harbor[1542] could further mitigate costs of assessing major participant status, the safe harbor may be expected to help some entities avoid the costs associated with assessing if they are major participants.

It is not clear how many firms may ultimately seek to rely on the calculation safe harbor.[1543] Participants in the security-based swap market vary greatly in the size of their positions, and may be expected to vary greatly in the complexity of their operations, and in the requirements of their internal compliance and risk management policies. As a result, it is possible that some firms with relatively small positions may choose to undertake the safe harbor analysis while significantly larger firms may determine that such analysis is unnecessary.

The first of the three alternatives within the safe harbor would be based on the maximum possible uncollateralized exposure under the applicable credit support arrangements, and on the notional amount of a participant's security-based swap positions. We believe that as a matter of good business practice large participants in the security-based swap market already would be aware of that information, making the test relatively simple to implement. We also note that available data indicates that 1,073 of the 1,188 entities with single-name credit default swap positions (other than ISDA-recognized dealers and ICE Trust), have notional positions less than $2 billion, potentially making the first test of the safe harbor available to them.[1544]

The other alternatives within the safe harbor would also entail monthly calculations, with such calculations for the second alternative based on the maximum possible uncollateralized exposure under the applicable credit support arrangements and monthly adaptations of the substantial position and substantial counterparty exposure calculations, while the monthly calculation for the third alternative is based on uncollateralized exposure and a modified version of the potential future exposure calculation. Both of these would entail additional analysis beyond current industry practices, causing entities to incur higher costs than the first alternative, but no more than would be required to complete the full major participant test.[1545]

The legal costs associated with the major participant analysis may include, among other things, legal advice with respect to whether an affiliate with which the entity enters into security-based swap transactions qualifies as an ''affiliate'' under rule 3a67–3, whether particular transactions fall within the definition of security-based swap, whether certain types of security-based swap transactions fall within the debt-based security-based swap or other security-based swap category, whether the entity falls within the definition of ''financial entity,'' and whether certain types of security-based swap transactions qualify for the hedging exclusion under the substantial exposure tests. We recognize that the complexity of the analysis required for any of these issues may vary considerably across entities, depending on each entity's individual business model.

The major participant test is based on daily average exposures over the course of the previous quarter, and, as discussed further below, some number of entities may decide to establish a system that will monitor their exposure on an ongoing basis. To the extent that the entity does so, we expect that any initial legal analysis should permit the entity to make determinations about these calculations on an ongoing basis. As such, we assume that any additional costs associated with outside counsel with respect to ongoing monitoring of positions would be negligible.

[1538] *See* note 1529, *supra.*

[1539] If 32 entities were to perform this analysis, as discussed above, the market-wide legal costs associated with the analysis would total $960,000.

[1540] In particular, some commenters challenged the assumption in the Proposing Release that only approximately 10 entities had security-based swap positions large enough to lead them to engage in the major participant calculations. Those commenters took the view that certain entities with smaller security-based swap positions would perceive a need to conduct the relevant calculations on a daily basis even if they are not reasonably likely to be major participants, and, to address that concern, requested a safe harbor from having to perform the major participant calculations. *See* letters from SIFMA AMG I and Vanguard.

[1541] *See* part IV.M, *supra* (discussing rationale for safe harbor).

[1542] *See* part IV.M.2, *supra* (discussing rationale for final rule implementing safe harbor).

[1543] As noted previously in part VIII.A.3.b.i.*B, supra,* we expect that approximately 12 entities may have security-based swap positions in an amount such that it may be reasonably necessary for them to undertake the major participant calculations. To the extent, however, that entities with smaller positions nonetheless identify a reason to perform a major participant analysis, the safe harbor would permit those entities to conclude that they are not major participants without the need to engage in the full set of calculations otherwise anticipated by the rules.

[1544] *See* CDS Data Analysis at table 10.

[1545] We expect that the outer bounds of the assessment costs associated with this safe harbor will be no higher than the one-time costs associated with conducting the major participant analysis, given that, to the extent that an entity determines that performing the safe harbor analysis is more expensive, it would likely choose to perform the less-costly major participant analysis. As such, the upper bound of costs associated with the safe harbor is not likely to exceed our estimates of the costs associated with the full major participant analysis, and should in fact be considerably lower.

We estimate that one-time costs associated with establishing a system to identify and monitor security-based swap positions, as may be necessary to perform the monthly assessments anticipated by two of the three alternative tests that comprise the safe harbor, would be similar to the one-time costs associated with the major participant analysis, and that, therefore, up to 1,188 entities may incur one-time industry-wide costs of approximately $16.3 million. *See* note 1533 and accompanying text, *supra.* The annual costs associated with monthly assessment would be expected to be less than the costs of daily assessment, and $9.1 million—approximately half of the estimated $18.1 million estimated annual costs if all 1,188 entities found it necessary to perform the daily assessment required by the substantial position test (*see id.*)—may be a reasonable estimate of that amount, given the relative simplicity of the test and the less frequent assessments that it requires. In practice, however, we believe that the costs associated with this safe harbor will be less because we expect that far fewer entities would perceive a need to rely on these aspects of the safe harbor, particular given that, as

iii. Additional Issues Related to the Major Participant Analysis

A. ''Major'' Categories of Security-Based Swaps

Exchange Act rule 3a67–2 sets forth two ''major'' categories of security-based swaps for purposes of the first and third tests of the major participant definitions—one consisting of debt-based security-based swaps and the other consisting of other security-based swaps (including equity swaps). These categories are consistent with our understanding of the ways in which those products are used, as well as market statistics and current market infrastructures,[1546] and we believe it is appropriate that those market categories be reflected in the major participant definition.

The consistency of the rule with current market practices should help mitigate any assessment costs incurred by market participants. Moreover, we do not expect that market participants will be required to incur costs to determine the major category with respect to a large majority of their security-based swap positions, given that the vast majority of security-based swaps likely fall within the debt-based security-based swap major category. Also, in adopting the final rules we also have provided additional guidance related to the categorization of certain types of instruments in response to commenter concerns. Nonetheless, given the fact-specific nature of any such assessment, we recognize that some entities may seek the opinion of legal counsel as to how specific security-based swap transactions should be categorized for purposes of this rule (such as legal costs associated with having counsel analyze a particular security-based swap to determine its status under these rules, to the extent that certain types of security-based swaps with complex, novel or bespoke structures are not readily categorized within one of the two identified major categories). We expect that these costs would be included in the estimated costs of seeking outside legal counsel in connection with the major participant analysis, as described above.[1547]

B. Definition of ''Hedging or Mitigating Commercial Risk''

Exchange Act rule 3a67–4 defines the term ''hedging or mitigating commercial risk'' for purposes of the exclusion from the first major participant test. Among other aspects, this rule makes use of an ''economically appropriate'' standard, and sets forth exclusions for security-based swap positions that have a speculative or trading purpose.

As discussed above, we carefully consider alternative approaches suggested by some commenters, including the suggestion that the definition should encompass positions that hedge speculative or trading positions and the suggestion that the definition should incorporate a ''congruence'' standard.[1548] We concluded, however, that these approaches are inconsistent with the focus of the statutory text, which is on ''commercial risk,'' and in adopting this definition we have sought to set forth criteria that reasonably distinguish hedging positions from other positions. We believe that the approach we are adopting, which seeks to exclude positions that hedge commercial risk without also excluding other types of positions, is necessary and appropriate in light of the statute.[1549]

Some market participants may be expected to incur costs in connection with determining whether certain security-based swap positions fall within this hedging exclusion.[1550] Any such costs of analyzing the status of particular security-based swaps as a hedge of commercial risk would reflect the unique character of individual positions and the business purpose associated with the position. Such costs may be particularly relevant for security-based swaps of a more complex nature, or for security-based swaps that introduce some degree of basis risk in connection with the hedge. Because of the facts-and-circumstances nature of this analysis,[1551] we believe that some entities may seek the opinion of legal counsel as to whether certain transactions qualify for the commercial hedging exclusion at the time they conduct their initial analysis, and these costs would likely be encompassed within the estimated costs of legal services related to the major participant definition.[1552]

C. Definitions of ''Financial Entity'' and ''Highly Leveraged''

Exchange Act rule 3a67–6 defines the term ''financial entity'' for purposes of the third major participant test. This definition is largely consistent with the statutory ''financial entity'' definition used in Title VII's exception from mandatory clearing for commercial end-users.[1553] However, in response to commenter concerns, the final rules exclude centralized hedging facilities from the ''financial entity'' definition (in a way that itself is consistent with that Title VII hedging exception).[1554]

noted above, approximately 1,073 entities have aggregate gross notional single-name credit default swap positions under $2 billion. *See* note 1544 and accompanying discussion, *supra.*

We note that our analysis of the safe harbor in connection with the ''major security-based swap participant'' definition differs from that of the CFTC with regard to the ''major swap participant'' safe harbor. This, in part, reflects the differences between the markets for swaps and security-based swaps. We also note our expectation that many of the entities that may opt to avail themselves of the safe harbor likely would have businesses that are financial in nature (rather than being non-financial entities that use security-based swaps as part of their commercial activities). As such, we would expect those entities to generally be cognizant of, or in a good position to obtain information about: Their maximum potential uncollateralized exposure with security-based swap counterparties; the total notional amount of their security-based swap positions; the notional amount of those positions that are subject to central clearing or daily mark-to-market margining; and the extent to which those positions are in-the-money or out-of-the-money (for purposes of calculating the netting discount to the potential future exposure calculation). Other non-financial entities seeking to take advantage of the safe harbor may minimize their costs by utilizing whichever safe harbor option may be expected to most closely align with the security-based swap information that readily is available to such entities.

[1546] In particular, the major categories of security-based swaps adopted in these final rules are consistent with how bank derivatives data is presented by the Office of the Comptroller of the Currency, as well as with categories used by derivatives market infrastructure such as The Depository Trust & Clearing Corporation. *See* part IV.A.3, *supra.*

[1547] Entities may also incur programming and other costs related to recording the classification of their security-based swap transactions in systems designed to monitor current exposure and potential future exposure, but we expect these costs to be one component of entities' overall system costs relating to its substantial position calculations, which we discuss in further detail above. *See* part VIII.A.3.b.i.*B, supra.*

[1548] *See* parts IV.C.5.a and IV.C.5.b, *supra* (discussing rationale for excluding positions hedging speculative and trading positions from the definition).

[1549] *See* parts IV.C.3 and IV.C.5, *supra.*

[1550] We have incorporated provisions into the final rule designed to provide guidance to market participants as to which types of security-based swap positions could be expected to fall within this exclusion. This release also provides further guidance as to the scope of the exclusion.

[1551] The transaction-related costs of making a hedging determination would apply only to entities with security-based swap positions that are near to or exceed the substantial position threshold prior to taking advantage of the hedging exclusion. This may be expected to mitigate costs associated with making this determination.

[1552] Separately, the proposed rule defining this term would have included certain documentation and assessment conditions that commenters stated could lead to significant costs. Commenters expressed concerns regarding the application of these conditions and the associated costs. As discussed previously in this release, we have determined not to include these conditions in the final rule. *See* part IV.C.5.d, *supra.*

[1553] *See* Exchange Act section 3C(g).

[1554] In addition, we considered, but do not incorporate, some commenters' suggestion that ''financial entity'' be defined more narrowly, such as by excluding employee benefit plans. *See* part IV.F.3.a, *supra,* (discussing rationale for final rule defining ''financial entity'').

Although particular market participants may incur costs in connection with determining whether they fall within the ''financial entity'' definition, we believe that such costs would be minimal in light of the objective nature of the definition, and its consistency with the use of the term elsewhere in Title VII. We also recognize that entities may seek the opinion of legal counsel as to whether the entity falls within the scope of this ''financial entity'' definition, but believe that these costs would likely be encompassed within the estimated costs of legal services related to the major participant definition.

Exchange Act rule 3a67–7 defines the term ''highly leveraged,'' also for purposes of the third statutory major participant test. After considering commenters' views, the final rule defines that term based on a 12 to 1 leverage ratio, as discussed in greater detail above. In adopting this leverage ratio, we also modify the proposed method of calculating leverage in certain respects,[1555] but conclude that it would not be appropriate to provide special methodologies for insurers to measure leverage.[1556] It is possible that certain market participants will incur costs in connection with determining whether they are ''highly leveraged'' for purposes of the major participant definitions. In part, we believe that those costs are mitigated by the fact that the final rules identify ''highly leveraged'' entities based on a ratio of liabilities to equity, which we expect are simpler for entities to implement than alternative methods for measuring leverage, such as risk-adjusted methods.

We recognize that the unavailability of an alternative method of calculation for insurers may have the effect of increasing certain insurers' cost of calculating leverage for purposes of determining whether they fall within the major participant definition, to the extent that insurers have security-based swap positions that are close enough to the relevant thresholds that they have to perform the required calculations.[1557] We believe, however, that a uniform approach to defining ''highly leveraged'' is appropriate here given that the large insurance firms that are most likely to meet the major participant definition would be expected already to use GAAP in preparing their financial statements. This should mitigate any additional costs arising from the absence of an alternative calculation method for insurers.

D. Limited Designations of Major Participants

Exchange Act rule 3a67–1 in part implements the portion of the ''major security-based swap participant'' definition that provides for limited purpose registration of major participants. The rule sets forth a presumption that a person that acts as a major security-based swap participant in general will be deemed to be a major participant with regard to all of its security-based swaps, unless the SEC limits its designation.

In adopting this rule we have considered the alternative, suggested by some commenters, of permitting persons to more broadly take advantage of limited major participant designations.[1558] Our decision to use this presumption takes into account the difficulty of separating a major participant's positions taken under its limited purpose designation from other of its positions for purposes of compliance, and the challenges of applying major participant regulatory requirements to only a portion of the entity's security-based swap activities. The presumption further reflects the statutory definition's discretionary language in connection with the potential for limited designations, and the need for persons subject to limited designations to be able to comply with the statutory and regulatory requirements applicable to major participants.[1559]

Certain persons who satisfy the major participant definition may incur costs in determining whether to seek a limited designation. Consistent with the discussion above, in general we believe that such costs would affect no more than 12 entities.[1560] These costs could, however, vary significantly depending on the structure or other characteristics of an entity's business.

E. Exclusion of Inter-Affiliate Security-Based Swaps

Exchange Act rule 3a67–3 provides that security-based swap transactions between majority-owned affiliates will be excluded for purposes of the substantial position test.[1561] We have concluded that majority ownership represents an alignment of interests appropriate to justify an inter-affiliate exclusion.[1562] Moreover, we note that a majority-ownership test should, given its objective nature, impose fewer assessment costs on market participants than a more subjective common control test.

Some market entities may incur costs in connection with determining whether

[1555] *See* part IV.F.3.b, *supra* (addressing leverage ratio calculation for certain employee benefit plans).

[1556] *See* note 1107, *supra* (providing special rules related to the calculation of leverage for certain employee benefit plans).

[1557] We note that many large insurers of the type that maintain security-based swap positions in an amount that would require them to perform the major participant calculations may be publicly traded companies, in which case they would already calculate their financial statements according to GAAP for purposes of public disclosure, and thus would not incur additional costs due to our decision not provide special methodologies for insurers to calculate their leverage. We also expect that the concerns of many smaller insurers that are not publicly traded and thus may not use GAAP will be addressed by our inclusion of the safe harbor for major participant calculations.

In addition, publicly available information regarding insurer use of derivatives suggests that the potential costs to insurers arising from the definition of ''major security-based swap participant'' may be negligible. As of the end of 2010, U.S. insurers as a whole had enter into roughly $33.5 billion in notional amount of credit default swaps (not distinguishing between credit default swaps that fall within the ''security-based swap'' definition and those that are ''swaps''). *See* National Association of Insurance Commissioners, ''Insights into the Insurance Industry's Derivatives Exposure'' (available at *http://www.naic.org/capital_markets_archive/110610.htm*) (stating that life insurers had entered into roughly $27.1 billion of that amount, and that property and casualty insurers had entered into roughly $6.4 billion of that amount). Even if those positions were concentrated within single entity, they would not necessarily lead that entity to exceed the thresholds that could cause it to be a major participant, *see* note 914, *supra,* suggesting that, given the likely distribution of these positions across a significant number of insurers, few or no insurers may have exposures that approach the thresholds.

[1558] Such an approach may be expected to lower the cumulative costs that major participants would incur in determining whether to seek a limited designation. For example, a default presumption in favor of the availability of limited designations may be expected to reduce the costs that certain entities would incur to determine that they could take advantage of limited designation relief, and thus reduce the costs associated with an entity determining whether it qualifies for such relief, such as the costs of hiring outside legal counsel to undertake this analysis to determine that they could take advantage a limited designation relief. A default presumption in favor of limited designations also would be expected to reduce costs in connection with the registration process for entities seeking limited designation status, as discussed above. *See* part VIII.A.2.d.ii.*A, supra.*

[1559] *See* part IV.N.3, *supra* (discussing limited designation principles applicable to major participants). We note that the discussion of limited designation of ''swap dealers'' under the CEA generally seeks to quantify the costs associated with applications for limited designations. However, we believe that the costs of applying for a limited designation are dependent upon the application process for this type of registration category. As noted previously, the SEC expects to address the limited designation application process for major security-based swap participants in separate rulemakings. *See id.* As such, we believe that the costs associated with major security-based swap participant limited designation applications under the Exchange Act are more appropriately addressed in the context of that separate rulemaking.

[1560] *See* note 1529, *supra.*

[1561] This exclusion also applies to the ''substantial counterparty exposure'' analysis.

[1562] *See* part IV.G.2, *supra* (discussing rationale for the approach we are adopting, and considering alternative approaches).

particular security-based swap positions may be excluded from the major participant analysis by virtue of the inter-affiliate exclusion. It is possible that such costs could be incurred by any of the approximately 12 entities that we believe reasonably may have to engage in the major participant calculations.[1563] We believe that any costs arising out of such an analysis would be encompassed within the $30,000 estimated for legal services related to the major participant definition as a whole.

F. Timing Requirements, Reevaluation Period and Termination of Status

Exchange Act rule 3a67–8 specifies the time at which an entity that satisfies the major participant tests would be deemed to be a ''major security-based swap participant,'' and also addresses the time at which an entity's status as a major security-based swap participant would be terminated. In adopting this rule we have considered alternatives that would lead to slower entry and faster exit from major participant status, and we believe that the approach that we are adopting provides a reasonable amount of time for registration based on the proposed registration process, will appropriately help to avoid applying major participant requirements to entities that meet the major participant criteria for only a short time due to unusual activity, and will avoid the prospect of persons moving in and out of major participant status overly frequently.[1564]

Persons falling within the major participant definitions will incur costs in connection with the registration process,[1565] and it is possible that alternative timing approaches could allow such persons to register at a more deliberate pace, potentially reducing the associated costs.[1566] Such cost differences may affect the up-to-twelve entities that we believe reasonably may have to engage in the major participant calculations. Moreover, altering the timing requirements may not significantly decrease costs associated with registration because in all cases we would expect the same preparatory actions to be taken, and we believe that the final rules provide sufficient time for entities to perform the activities necessary for compliance.[1567]

4. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act requires the SEC, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action would promote efficiency, competition, and capital formation.[1568] In addition, section 23(a)(2) of the Exchange Act [1569] requires the SEC, when adopting rules under the Exchange Act, to consider the impact such rules would have on competition. Section 23(a)(2) of the Exchange Act also prohibits the SEC from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

We are adopting these rules and interpretive guidance pursuant to authority under section 712(d) of the Dodd-Frank Act, which requires the Commissions to further define several terms, including ''security-based swap dealer'' and ''major security-based swap participant.'' [1570] In the Proposing Release, we stated that we preliminarily believed that the proposed Exchange Act rules would not result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, that they would not significantly affect capital formation, and that they would improve efficiency. We requested comment on each of these issues, and certain commenters raised concerns that overbroad definitions would lead to undue competitive impacts.[1571]

In adopting these final rules, we recognize that the most significant impact of the dealer and major participant definitions will derive from those definitions' role in implementing Title VII, particularly given the significant impacts that Title VII will have on the security-based swap market. Many of these impacts may be expected to be positive, because Title VII imposes, among other measures, requirements that may be expected to promote safety and soundness, transparency, and competition within the security-based swap market. We recognize, however, that regulation also can pose costs that have negative impacts on the markets.

In adopting these definitional rules and interpretations, moreover, we have sought to fairly reflect the statutory definitions and their underlying intent. Given the link between these definitional rules and interpretations and the Title VII framework, the scope of the definitions will affect the ultimate regulatory benefits and costs that will accompany the full implementation of Title VII. Definitions that capture more entities will tend to promote the Title VII benefits, but will also risk increasing the accompanying costs. Definitions that capture fewer entities may be expected to lead to the converse result.

a. Competitive Impacts

As noted above, the SEC is required to consider the effect of these rules and interpretations on competition. The SEC also is prohibited from adopting any rule that would impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. Because these definitional rules and interpretations will help determine which entities within the market are subject to the Title VII requirements that govern dealers and major participants, they may also affect competition within the security-based swap market.

In enacting Title VII, Congress set forth a regulatory framework for OTC derivatives; security-based swaps represent one segment of the overall OTC derivatives market. Within the security-based swap market, dealers compete for business from counterparties, while non-dealers that participate in the market use security-based swaps for purposes that can

[1563] The data underlying this assessment already excludes certain inter-affiliate credit default swaps.

[1564] *See* part IV.L.3, *supra* (discussing rationale for the final rules addressing timing, reevaluation and termination).

[1565] Registration Proposing Release, 76 FR at 65814–65818.

[1566] For example, it is possible that an entity may perceive the steps associated with the registration process as requiring it to take additional steps to complete the registration process within the time frame we are adopting, whereas a longer time period could have enabled such an entity to avoid those costs.

[1567] Specific costs associated with the registration process will be addressed by the SEC in final rules related to the registration of major security-based swap participants that have not yet been adopted. However, we expect any additional costs arising from the timing provisions of this rule to be insignificant.

[1568] 15 U.S.C. 78c(f).

[1569] 15 U.S.C. 78w(a)(2).

[1570] The SEC is also acting pursuant to its rulemaking authority provided by Exchange Act sections 3 and 23(a).

[1571] *See, e.g.,* letters from Representatives Bachus and Lucas (''Casting an overly-broad net in defining these terms could force some smaller participants to leave the marketplace as a result of increased costs, or eliminate certain types of contracts used for hedging.''), SIFMA—Regional Dealers (stating that the proposed *de minimis* exception ''is unnecessarily narrow, will discourage smaller dealers from competing in the market and will limit the availability of efficient and cost-effective intermediation services to small- and medium-sized organizations'') and Midsize Banks (stating that a reduction in small dealers due to an overly narrow *de minimis* exception would ''curtail economic development going forward and would leave end-users less options for hedging risks with community and smaller regional dealers'').

include speculation and hedging. To date, security-based swaps primarily have traded in the over-the-counter market, and have not been subject to comprehensive regulation in the U.S. We understand that entities engaged in dealing activity within this market facilitate the vast majority of security-based swap transactions.[1572] Dealing activity within the market also is highly concentrated.[1573] This concentration in large part appears to reflect the fact that larger entities possess competitive advantages in engaging in over-the-counter security-based swap dealing activities, particularly with regard to having sufficient financial resources to provide potential counterparties with adequate assurances of financial performance.[1574] As such, it is reasonable to conclude that there are high barriers to entry in connection with security-based swap dealing activity.[1575]

At the same time, commenters have noted that some entities engage in smaller volumes of security-based swap dealing activity. Some small and mid-size banks, for example, routinely provide such services involving relatively small notional amounts to their customers.[1576] Although these relatively smaller dealers in general may not compete directly with the largest dealers (because they service a different segment of the market), they may be expected to play a role in helping certain types of customers (such as customers with a relatively smaller need for security-based swaps) enter into security-based swaps, thus promoting the availability of these products.

Fundamentally, in considering the competitive impacts associated with Title VII regulation of dealers and major participants—and hence the competitive impacts associated with the dealer and major participant definitions—we recognize that one consequence of the current concentrated market structure [1577] is the potential for risk spillovers and systemic risk, which can occur when the financial sector as a whole (or certain key segments) becomes undercapitalized. Risk spillovers emerge when losses and financial distress at one firm lead to losses and financial distress for the financial sector as a whole, either through direct counterparty relationships or the deterioration of asset values. As financial distress spreads, the aggregate financial system may become undercapitalized, hindering its ability to provide financial intermediation services. If firms do not internalize this aggregate cost, the financial system may end up holding more risk than its aggregate capital can manage.

In enacting Title VII, Congress set forth a framework that will impose new costs and regulatory burdens, including capital, margin, and registration requirements, on persons who act as security-based swap dealers, and on persons whose security-based swap positions are large enough to cause them to be major security-based swap participants. While the substantive rules associated with capital, margin, and registration requirements have yet to be finalized, we have sought to set the dealer and major participant definitions in such a way as to impose the substantive rules on those entities most likely to contribute to an aggregate capital shortfall without imposing unnecessary burdens on those who do not pose similar risks to the market.[1578] It is reasonable to expect that it is the largest security-based swap entities that are more likely to contribute to an aggregate capital shortfall than smaller participants, as more risk is likely to be concentrated within these entities.[1579]

As discussed above, persons who fall within the statutory definitions of security-based swap dealer and major security-based swap participant will incur a range of one-time costs and ongoing costs by virtue of that status.[1580] Also, as discussed above, market participants may incur costs in connection with determining whether their security-based swap activities or positions will cause them to be dealers or major participants.[1581] To the extent the costs associated with these statutorily mandated requirements are relatively fixed or large enough, they may negatively affect competition within the market. This may, for example, lead smaller dealers or entities for whom dealing is not a core business to exit the market, which could cause smaller customers to have less access to the market or to incur higher costs in accessing the market. Such costs might also deter the entry of new firms into the market. If sufficiently high, these costs of compliance may increase concentration among dealers. We also recognize that some market participants may be expected to incur costs in connection with determining their status as a dealer or major participant, but such costs can be expected to be significantly less than the costs associated with the various rules applicable to dealers or major participants.

Conversely, certain aspects of Title VII may enhance competition in the market. For example, the business conduct and other requirements of Title VII may enhance the availability of information to market participants. Measures designed to equalize access to information through disclosure requirements should promote participation, which may intensify price competition among dealers, and thus

[1572] Data from the credit default swap trade information warehouse operated by DTCC indicates that as of the week ending October 7, 2011, single-name credit default swaps involving two counterparties that are not dealers (as identified by DTCC) constitutes roughly 0.2 percent of the notional amount of all open positions involving single-name credit default swaps (amounting to $24.6 billion gross notional out of a total of $15.2 trillion gross notional). Conversely, single-name credit default swaps involving two dealers (as identified by DTCC) constitute roughly 74.2 percent of the total notional amount (amounting to $11.3 trillion gross notional out of the $15.2 trillion total). *See http://www.dtcc.com/products/derivserv/data/index.php* (as of October 7, 2011). We have no reason to believe that the market for other types of security-based swaps exhibits different amounts of concentration with regard to dealer activity.

[1573] As discussed above in the context of the *de minimis* exception to the security-based swap dealer definition, analysis of available data shows that, under any metric used to screen for dealers in our CDS Data Analysis, over 90 percent of activity in single-name credit default swaps among entities identified as dealers is attributable to the fourteen or fifteen largest of those entities. We have no reason to believe that the concentration of dealing activity involving other types of security-based swaps significantly differs from the concentration of dealers in the single-name credit default swap market.

[1574] *See* Pirrong, note 487, *supra,* at 17–18 (noting that counterparties seek to reduce risk of default by engaging in credit derivative transactions with well capitalized firms).

[1575] *See id.,* at 18–19 (noting lack of success among new entrants into derivatives dealing market due to perception that AAA rating for subsidiary is less desirable than a slightly lower rating for a larger entity, and suggesting that there are ''economies of scale in bearing default risk'' that may induce ''substantial concentration in dealer activities'').

[1576] *See* letter from FSR I.

[1577] *See, e.g.,* notes 478 and 485, *supra,* and accompanying text.

[1578] We expect that implementation of Title VII will provide both the SEC and market participants with more information about the business of dealers and major participants, the characteristics of positions they and other market participants hold, the structure of the market, and how each of these have changed under the Title VII framework. For that reason the SEC has directed the staff to report to the Commission on all aspects of the dealer and major participant definitions. *See* part V, *supra.*

[1579] *See* Acharya, Pedersen, Philippon, and Richardson, Measuring Systemic Risk (May 2010) (available at *http://vlab.stern.nyu.edu/public/static/SR-v3.pdf*) (working paper that derives an empirical measure of a financial entity's expected contribution to an aggregate capital shortfall that scales with the size of the institution, and that shows using historical data that their measure predicted the risks that emerged during the recent financial crisis).

[1580] As discussed above, for example, security-based swap dealers and major security-based swap participants will have to meet minimum capital and margin requirements, maintain specified business and transaction records and adhere to certain standards of business conduct, along with other obligations. *See, e.g.,* notes 178 to 180, *supra.*

[1581] *See* part VIII.A.3, *supra.*

may increase participation in the security-based swap market. Other aspects of Title VII, such as rules promoting access of dealers to central clearing facilities, also may be expected to enhance competition in the market.

i. Security-Based Swap Dealer Definition

Persons who are deemed to be dealers may be expected to incur costs in connection with the substantive rules applicable to dealers, and to incur comparatively smaller costs in connection with determining whether they fall within the dealer definition. We cannot rule out the possibility that the prospects of these aggregate costs might deter new entrants from engaging in security-based swap activity that potentially could lead them to be dealers.[1582] We also cannot rule out the possibility that the imposition of those costs could lead some persons who currently engage in dealing activity involving security-based swaps to lessen or cease that activity. Those effects—if they were to occur—would be expected to reduce competition in the market. Conversely, the application of the Title VII requirements applicable to dealers, such as, for example, the business conduct requirements related to disclosures to counterparties, may be expected to enhance the availability of information to market participants. The resulting reduction in information asymmetries may be expected to promote participation, and therefore competition, in the market. Accordingly, the scope of the rules and interpretations defining security-based swap dealer, including the scope of the *de minimis* exception to the dealer definition, can be expected to affect competition in the market in a variety of ways.[1583]

As discussed above, in rule 3a71–1 we have codified the statutory definition of security-based swap dealer and provided guidance to interpret the contours of this definition in the context of the dealer-trader distinction. After considering commenters' views, we believe that this guidance interprets the statute to give effect to the four dealer tests and the ''regular business'' exclusion in a way that reflects the features of the security-based swap market. This use of the dealer-trader distinction—which parallels the analysis that securities market participants currently use in the context of the Exchange Act's ''dealer'' definition—also should help reduce the potential competitive effects associated with the costs that market participants incur to analyze their possible status as a dealer by imposing fewer costs than a more novel approach.[1584]

Moreover, as discussed above, in rule 3a71–2 we have adopted a *de minimis* test and thresholds that will impose the costs associated with dealer regulation upon entities that engage in the bulk of dealing activity in the market, without imposing those costs upon persons who account for a small portion of dealing activity (and for which dealer regulation may be accompanied by comparatively modest benefits). We believe this will mitigate some of the potential competitive burdens associated with dealer status that could fall on entities engaged in a smaller amount of dealing activity, without leaving an undue amount of dealing activity outside of the ambit of dealer regulation. As discussed in detail above, we believe we have set the threshold in a way that appropriately considers this risk along with the benefits afforded to smaller entities by a higher threshold. Furthermore, after considering commenters' views, we believe that this approach strikes a balance that appropriately will implement the transparency, risk, and customer and counterparty protection goals of Title VII. This approach, including the general use of a $3 billion threshold, also can facilitate the initial entrance of dealers into the market, and permit persons to engage in limited dealing activity that helps smaller entities participate in the market. While we recognize that the lower threshold associated with dealing activity involving ''special entities'' has the potential to reduce competition to provide dealing services to those entities, we believe that this lower threshold is appropriate to preserve the protections that Title VII affords to those entities.

In rule 3a71–1, we also have set forth a presumption that a person that acts as a dealer in the security-based swap market will be a dealer with regard to all of its security-based swaps. We recognize that this presumption may have competitive impacts: on the one hand, by imposing regulatory costs on a wider range of activities, certain entities concentrated in discrete security-based swap segments may face higher costs than they might without the presumption; on the other hand, the presumption suggests a single, uniform baseline for competition across dealers. While these impacts may bear out in a number of ways, we believe that the presumption is appropriate in light of the statutory language and the need to help ensure that security-based swap dealers comply with all applicable legal requirements.

In rule 3a71–1, we also have provided an exclusion from dealer status in connection with security-based swaps involving majority-owned affiliated counterparties. To the extent that the scope of this exclusion may have competitive impacts—such as in connection with dealing activity involving affiliates that are not majority-owned, and that hence cannot take advantage of the exclusion—we believe that the exclusion appropriately applies the Title VII dealer requirements in a way that reflects the economic reality of swaps among affiliates, which generally does not raise the customer protection or market risk concerns addressed by Title VII.

In sum, to the extent that the application of Title VII dealer requirements to certain persons were to pose a net burden on competition in the security-based swap market, we believe those effects would be a necessary or appropriate consequence of implementing the statutory definitions consistent with the purposes of the Title VII amendments to the Exchange Act.

ii. Major Security-Based Swap Participant Definition

As we discuss above, we have estimated that entities approaching the level of exposure required to be a major participant may incur certain costs in connection with analyzing their

[1582] We do think it unlikely that the costs associated with determining an entity's status, considered on their own, would have any measurable effect on competition. As noted above, we estimate that the cost of making this determination to be $30,000 at most, and likely significantly less for most entities. *See* note 1537, *supra.* In other words, the costs would amount to, at most, 0.1 percent of the *de minimis* threshold, and it is likely that few firms would feel compelled to conduct this analysis until their dealing volume approached the *de minimis* threshold.

[1583] At the same time, it is possible that these additional costs associated with dealer regulation will be comparatively small compared to the existing barriers to entry in the market (particularly the need for resources to provide counterparties with sufficient assurance of performance). *Cf.* Pirrong, note 487, *supra,* at 18–19 (noting that firms with smaller balance sheets, relative to largest dealers, ''have largely failed to make major inroads as derivatives dealers despite concerted efforts to do so''). It thus is possible the incremental costs associated with dealer regulation may not be of the magnitude to cause persons who currently engage in security-based swap dealing activity to exit the market.

[1584] As noted above, we have declined to adopt *per se* exclusions or overly simple tests, even though they might impose fewer assessment costs on market participants conducting the dealer analysis because we do not believe that such exclusions or tests would capture the full range of entities that should be regulated as dealers under Title VII. Moreover, the nature of the tests being adopted are straightforward to implement and rely on information that already should be readily available to market participants.

status.[1585] Given the size of the exposures and notional amounts required to trigger the major participant test (*e.g.,* $1 billion in daily average current uncollateralized exposure in a major category), we do not believe that these costs of assessment would materially impact the competitive role played in the security-based swap market by persons who have positions large enough that they potentially may be major participants.

We expect that the programmatic costs associated with the rules applicable to major participants will be more significant. Presumably, a market participant will weigh the costs of complying with the rules against the benefit it expects from maintaining security-based swap positions of a magnitude that would require registration as a major participant, in deciding whether to continue to maintain such positions. We cannot rule out the possibility that the prospect of those costs could deter persons from maintaining security-based swap positions of such a magnitude, and that this may reduce competition in the market.[1586]

As discussed above, Exchange Act rules 3a67–1 through 3a67–9 and the accompanying interpretations reflect choices that we believe are reasonably designed to satisfy the risk criteria set forth in the major participant definition.[1587] In reaching these conclusions we considered commenters' views on a variety of issues, including suggested alternative approaches that would lessen the likelihood of particular entities being deemed to be major participants (*e.g.,* alternative tests, higher thresholds, a broader hedging exclusion, and a higher leverage test). We believe that the choices reflected in the final rules and interpretations are necessary or appropriate in furtherance of the purposes of the Exchange Act and reasonably reflect the criteria set forth by the statutory definition.

b. Efficiency and Capital Formation

As noted above, in adopting these final rules and interpretations we also are required to consider whether these actions would promote efficiency and capital formation.

In significant part, the effect of these rules on efficiency and capital formation are linked to the effect of these rules on competition. For example, markets that are competitive, with fair and transparent pricing and equal access to security-based swaps, may be expected to promote the efficient allocation of capital. Similarly, definitional rules that promote, or do not unduly restrict, competition can be accompanied by regulatory benefits that minimize the risk of market failure and thus promote efficiency within the market. Such competitive markets would increase the efficiency by which market participants could transact in security-based swaps for speculative, trading, hedging and other purposes.

Definitional rules and interpretations of an appropriate scope also can be expected to promote capital formation by facilitating the appropriate use of security-based swaps for hedging purposes, and thus by contributing to liquidity and reducing costs in connection with the issuance of equity and debt securities. In the context of credit default swaps based on loans, moreover, definitional rules and interpretations of an appropriate scope can be expected to promote capital formation by facilitating loans to businesses that may not otherwise be made absent such a swap. Since credit risk is correlated, lenders may find it desirable to hedge credit risks on their loan portfolios by purchasing protection through single-name or index credit default swaps. Even though there is basis risk in this type of trade, it should be particularly effective at reducing exposure to systemic credit events. More generally, security-based swaps can be expected to promote risk transfer to persons better positioned and more willing to bear certain risks (*e.g.,* the transfer of risks from hedgers to speculators).

Conversely, definitional rules that are accompanied by too many competitive burdens pose the risk of imposing excessive costs of regulation that could deter the efficient allocation of capital to security-based swaps. Such rules also may be expected to reduce the capital formation benefits that otherwise would be associated with security-based swaps. Definitional rules of an inappropriate scope further may reduce the availability of security-based swaps and thus direct market participants not to seek to address certain business needs, or to use less effective financial instruments to meet their business needs. For example, major participant thresholds that broadly capture much of the security-based swap market would discourage certain entities from participating in the market, particularly if the regulatory costs for major participants are high. This could make it difficult for hedgers to find a counterparty, which would make it more expensive to hedge risks and hinder efficient risk-sharing in the broader economy. In addition, definitional rules that pose the risk of creating a market that contains an undue amount of unregulated dealing activity—as may be the result of a *de minimis* threshold that is too high—would lead to disparate treatment of dealers and could undermine the benefits of Title VII.

The rules and interpretations that we are adopting in connection with the dealer and major participant definitions are designed to apply the statutory definitions in a way that reasonably effects the goals of Title VII. For example, the rule implementing the *de minimis* exception to the dealer definition is designed to focus the application of the dealer definition in a way that implements the benefits associated with the regulation of security-based swap dealers under Title VII, without imposing the costs associated with those regulations on those entities responsible for only a small portion of total dealing activity. In addition, the rules and interpretations in connection with the major participant definition are geared to focus major participant regulation on entities whose security-based swap positions pose a particularly high degree of credit risk to the market, without applying those regulations on persons who pose a lesser degree of risk.

In conclusion, we believe that the rules and interpretations may be expected to promote efficiency in the allocation of capital to security-based swaps, and to promote the capital formation benefits of security-based swaps, by helping to focus the costs and burdens of the regulation of dealers and major participants under Title VII upon those persons for whom the imposition of those costs are most appropriate given their overall activity and positions in the security-based swap market. The rules and interpretations similarly may be expected to apply certain Title VII requirements (*e.g.,* counterparty disclosure requirements that can be expected to reduce information asymmetries) to those entities that engage in activities or maintain positions in the security-based swap market such that their compliance with these requirements may promote the efficiency and capital allocation benefits associated with such regulation.

B. Paperwork Reduction Act Analysis

The Proposing Release addressed a potential new ''collection of information'' requirement, within the

[1585] *See* text accompanying note 1532, *supra* (estimating assessment costs as roughly $44,000 in the first year, and $15,268 in subsequent years).

[1586] The extent of such possible deterrence is mitigated by the fact that major participant status is a prospect only for those persons with very large security-based swap positions.

[1587] *See* part VIII.A.2, *supra.*

meaning of the Paperwork Reduction Act of 1995,[1588] because the proposed definition of the term ''hedging or mitigating commercial risk'' included documentation and assessment conditions.

As discussed above, final rule defining ''hedging or mitigating commercial risk'' does not contain those proposed documentation and assessment conditions. Accordingly, the Paperwork Reduction Act does not apply to these definitions.[1589]

C. Regulatory Flexibility Act Certification

The Regulatory Flexibility Act (''RFA'') [1590] requires Federal agencies, in promulgating rules, to consider the impact of those rules on small entities. Section 603(a) [1591] of the Administrative Procedure Act,[1592] as amended by the RFA, generally requires the SEC to undertake a regulatory flexibility analysis of all proposed rules, or proposed rule amendments, to determine the impact of such rulemaking on ''small entities.'' [1593] Section 605(b) of the RFA provides that this requirement shall not apply to any proposed rule or proposed rule amendment, which if adopted, would not have a significant economic impact on a substantial number of small entities.[1594]

For purposes of SEC rulemaking in connection with the RFA, a small entity includes: (i) When used with reference to an ''issuer'' or a ''person,'' other than an investment company, an ''issuer'' or ''person'' that, on the last day of its most recent fiscal year, had total assets of $5 million or less,[1595] or (ii) a broker-dealer with total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a–5(d) under the Exchange Act,[1596] or, if not required to file such statements, a broker-dealer with total capital (net worth plus subordinated liabilities) of less than $500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and is not affiliated with any person (other than a natural person) that is not a small business or small organization.[1597] Under the standards adopted by the Small Business Administration, small entities in the finance and insurance industry include the following: (i) For entities engaged in credit intermediation and related activities, entities with $175 million or less in assets; [1598] (ii) for entities engaged in non-depository credit intermediation and certain other activities, entities with $7 million or less in annual receipts; [1599] (iii) for entities engaged in financial investments and related activities, entities with $7 million or less in annual receipts; [1600] (iv) for insurance carriers and entities engaged in related activities, entities with $7 million or less in annual receipts; [1601] and (v) for funds, trusts, and other financial vehicles, entities with $7 million or less in annual receipts.[1602]

The Proposing Release stated that based on feedback from industry participants about the security-based swap markets, the SEC preliminarily believes that any entities that would qualify as security-based swap dealers and major security-based swap market participants would exceed the thresholds defining ''small entities,'' and that the SEC believes it is unlikely that the proposed rules would have a significant economic impact on any small entity. As a result, the SEC certified that the proposed rules would not have a significant economic impact on a substantial number of small entities for purposes of the RFA, and requested written comments regarding this certification.[1603]

While we received comment letters that addressed cost issues in connection with the proposed rules, we did not receive any comments that specifically addressed whether the rules defining ''security-based swap dealer'' or ''major security-based swap participant'' would have a significant economic impact on small entities.

The SEC continues to believe that the types of entities that would engage in more than a *de minimis* amount of dealing activity involving security-based swaps—which generally would be major banks—would not be ''small entities'' for purposes of the RFA. Similarly, the SEC continues to believe that the types of entities that may have security-based swap positions above the level required to be a ''major security-based swap participant'' would not be a ''small entity'' for purposes of the RFA. Accordingly, the SEC certifies that the final rules defining ''security-based swap dealer'' or ''major security-based swap participant'' would not have a significant economic impact on a substantial number of small entities for purposes of the RFA.

Statutory Basis and Text of the Amendments

List of Subjects in 17 CFR Part 1

Brokers, Commodity futures, Consumer protection, Reporting and recordkeeping requirements.

Commodity Futures Trading Commission

For the reasons stated in the preamble, the CFTC is adopting the following amendments to 17 CFR part 1.

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 revising paragraph (m) and adding paragraphs (ggg) through (mmm) to read as follows:

§ 1.3 Definitions.

* * * * *

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

(1) A major swap participant, as defined in Section 1a(33) of the Act and paragraph (hhh) of this section, is an eligible contract participant;

(2) A swap dealer, as defined in Section 1a(49) of the Act and paragraph (ggg) of this section, is an eligible contract participant;

(3) A major security-based swap participant, as defined in Section 3(a)(67) of the Securities Exchange Act

[1588] 44 U.S.C. 3501.

[1589] Consistent with the discussion above, we recognize that the substantive rules applicable to dealers and major participants may contain collections of information, and that these definitions will affect which entities are subject to those collections of information. We believe that these Paperwork Reduction Act issues are more appropriately addressed in connection with the substantive rules applicable to dealers and major participants.

[1590] 5 U.S.C. 601 *et seq.*

[1591] 5 U.S.C. 603(a).

[1592] 5 U.S.C. 551 *et seq.*

[1593] Although Section 601(b) of the RFA defines the term ''small entity,'' the statute permits the Commissions to formulate their own definitions. The SEC has adopted definitions for the term small entity for the purposes of SEC rulemaking in accordance with the RFA. Those definitions, as relevant to this proposed rulemaking, are set forth in Rule 0–10, 17 CFR 240.0–10. *See* Securities Exchange Act Release No. 18451 (Jan. 28, 1982), 47 FR 5215 (Feb. 4, 1982) (File No. AS–305).

[1594] *See* 5 U.S.C. 605(b).

[1595] *See* 17 CFR 240.0–10(a).

[1596] *See* 17 CFR 240.17a–5(d).

[1597] *See* 17 CFR 240.0–10(c).

[1598] *See* 13 CFR 121.201 (Subsector 522).

[1599] *See id.* at Subsector 522.

[1600] *See id.* at Subsector 523.

[1601] *See id.* at Subsector 524.

[1602] *See id.* at Subsector 525.

[1603] *See* Proposing Release, 75 FR at 80211.

of 1934 and § 240.3a67–1 of this title, is an eligible contract participant;

(4) A security-based swap dealer, as defined in Section 3(a)(71) of the Securities Exchange Act of 1934 and § 240.3a71–1 of this title, is an eligible contract participant;

(5)(i) A transaction-level commodity pool with one or more direct participants that is not an eligible contract participant is not itself an eligible contract participant under either Section 1a(18)(A)(iv) or Section 1a(18)(A)(v) of the Act for purposes of entering into transactions described in Sections 2(c)(2)(B)(vi) and 2(c)(2)(C)(vii) of the Act; and

(ii) In determining whether a commodity pool that is a direct participant in a transaction-level commodity pool is an eligible contract participant for purposes of paragraph (m)(5)(i) of this section, the participants in the commodity pool that is a direct participant in the transaction-level commodity pool shall not be considered unless the transaction-level commodity pool, any commodity pool holding a direct or indirect interest in such transaction-level commodity pool, or any commodity pool in which such transaction-level commodity pool holds a direct or indirect interest, has been structured to evade subtitle A of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act by permitting persons that are not eligible contract participants to participate in agreements, contracts, or transactions described in Section 2(c)(2)(B)(i) or Section 2(c)(2)(C)(i) of the Act;

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

(7)(i) For purposes of a swap (but not a security-based swap, security-based swap agreement or mixed swap) used to hedge or mitigate commercial risk, an entity may, in determining its net worth for purposes of Section 1a(18)(A)(v)(III) of the Act, include the net worth of any owner of such entity, provided that all the owners of such entity are eligible contract participants;

(ii)(A) For purposes of identifying the owners of an entity under paragraph (m)(7)(i) of this section, any person holding a direct ownership interest in such entity shall be considered to be an owner of such entity; provided, however, that any shell company shall be disregarded, and the owners of such shell company shall be considered to be the owners of any entity owned by such shell company;

(B) For purposes of paragraph (m)(7)(ii)(A) of this section, the term *shell company* means any entity that limits its holdings to direct or indirect interests in entities that are relying on this paragraph (m)(7); and

(C) In determining whether an owner of an entity is an eligible contract participant for purposes of paragraph (m)(7)(i) of this section, an individual may be considered to be a proprietorship eligible contract participant only if the individual—

(*1*) Has an active role in operating a business other than an entity;

(*2*) Directly owns all of the assets of the business;

(*3*) Directly is responsible for all of the liabilities of the business; and

(*4*) Acquires its interest in the entity seeking to qualify as an eligible contract participant under paragraph (m)(7)(i) of this section in connection with the operation of the individual's proprietorship or to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by the individual in the operation of the individual's proprietorship; and

(iii) For purposes of paragraph (m)(7)(i) of this section, a swap is used to hedge or mitigate commercial risk if the swap complies with the conditions in paragraph (kkk) of this section; and

(8) Notwithstanding Section 1a(18)(A)(iv) of the Act and paragraph (m)(5) of this section, a commodity pool that enters into an agreement, contract, or transaction described in Section 2(c)(2)(B)(i) or Section 2(c)(2)(C)(i)(I) of the Act is an eligible contract participant with respect to such agreement, contract, or transaction, regardless of whether each participant in such commodity pool is an eligible contract participant, if all of the following conditions are satisfied:

(i) The commodity pool is not formed for the purpose of evading regulation under Section 2(c)(2)(B) or Section 2(c)(2)(C) of the Act or related Commission rules, regulations or orders;

(ii) The commodity pool has total assets exceeding $10,000,000; and

(iii) The commodity pool is formed and operated by a registered commodity pool operator or by a commodity pool operator who is exempt from registration as such pursuant to § 4.13(a)(3) of this chapter.

* * * * *

(ggg) *Swap Dealer.* (1) In general. The term *swap dealer* means any person who:

(i) Holds itself out as a dealer in swaps;

(ii) Makes a market in swaps;

(iii) Regularly enters into swaps with counterparties as an ordinary course of business for its own account; or

(iv) Engages in any activity causing it to be commonly known in the trade as a dealer or market maker in swaps.

(2) *Exception.* The term *swap dealer* does not include a person that enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of regular business.

(3) *Scope of designation.* A person who is a swap dealer shall be deemed to be a swap dealer with respect to each swap it enters into, regardless of the category of the swap or the person's activities in connection with the swap. However, if a person makes an application to limit its designation as a swap dealer to specified categories of swaps or specified activities of the person in connection with swaps, the Commission shall determine whether the person's designation as a swap dealer shall be so limited. If the Commission grants such limited designation, such limited designation swap dealer shall be deemed to be a swap dealer with respect to each swap it enters into in the swap category or categories for which it is so designated, regardless of the person's activities in connection with such category or categories of swaps. A person may make such application to limit the categories of swaps or activities of the person that are subject to its swap dealer designation at the same time as, or after, the person's initial registration as a swap dealer.

(4) *De minimis exception.* (i) Except as provided in paragraph (ggg)(4)(vi) of this section, a person that is not currently registered as a swap dealer shall be deemed not to be a swap dealer as a result of its swap dealing activity involving counterparties, so long as the swap positions connected with those dealing activities into which the person—or any other entity controlling, controlled by or under common control with the person—enters over the course of the immediately preceding 12 months (or following the effective date of final rules implementing Section 1a(47) of the Act, 7 U.S.C. 1a(47), if that period is less than 12 months) have an aggregate gross notional amount of no more than $3 billion, subject to a phase in level of an aggregate gross notional amount of no more than $8 billion applied in accordance with paragraph (ggg)(4)(ii) of this section, and an aggregate gross notional amount of no more than $25 million with regard to swaps in which the counterparty is a ''special entity'' (as that term is defined in Section 4s(h)(2)(C) of the Act, 7

U.S.C. 6s(h)(2)(C), and § 23.401(c) of this chapter). For purposes of this paragraph, if the stated notional amount of a swap is leveraged or enhanced by the structure of the swap, the calculation shall be based on the effective notional amount of the swap rather than on the stated notional amount.

(ii) *Phase-in procedure and staff report.* (A) *Phase-in period.* For purposes of paragraph (ggg)(4)(i) of this section, except as provided in paragraph (ggg)(4)(vi) of this section, a person that engages in swap dealing activity that does not exceed the phase-in level set forth in paragraph (ggg)(4)(i) shall be deemed not to be a swap dealer as a result of its swap dealing activity until the ''*phase-in termination date*'' established as provided in paragraph (ggg)(4)(ii)(C) or (D) of this section. The Commission shall announce the phase-in termination date on the Commission Web site and publish such date in the **Federal Register**.

(B) *Staff report.* No later than 30 months following the date that a swap data repository first receives swap data in accordance with part 45 of this chapter, the staff of the Commission shall complete and publish for public comment a report on topics relating to the definition of the term ''swap dealer'' and the *de minimis* threshold. The report should address the following topics, as appropriate, based on the availability of data and information: the potential impact of modifying the *de minimis* threshold, and whether the *de minimis* threshold should be increased or decreased; the factors that are useful for identifying swap dealing activity, including the application of the dealer-trader distinction for that purpose, and the potential use of objective tests or safe harbors as part of the analysis; the impact of provisions in paragraphs (ggg)(5) and (6) of this section excluding certain swaps from the dealer analysis, and potential alternative approaches for such exclusions; and any other analysis of swap data and information relating to swaps that the Commission or staff deem relevant to this rule.

(C) Nine months after publication of the report required by paragraph (ggg)(4)(ii)(B) of this section, and after giving due consideration to that report and any associated public comment, the Commission may either:

(*1*) Terminate the phase-in period set forth in paragraph (ggg)(4)(ii)(A) of this section, in which case the phase-in termination date shall be established by the Commission by order published in the **Federal Register**; or

(*2*) Determine that it is necessary or appropriate in the public interest to propose through rulemaking an alternative to the $3 billion amount set forth in paragraph (ggg)(4)(i) of this section that would constitute a *de minimis* quantity of swap dealing in connection with transactions with or on behalf of customers within the meaning of section 1(a)(47)(D) of the Act, 7 U.S.C. 1(a)(47)(D), in which case the Commission shall by order published in the **Federal Register** provide notice of such determination, which order shall also establish the phase-in termination date.

(D) If the phase-in termination date has not been previously established pursuant to paragraph (ggg)(4)(ii)(C) of this section, then in any event the phase-in termination date shall occur five years after the date that a swap repository first receives swap data in accordance with part 45 of this chapter.

(iii) *Registration period for persons that can no longer take advantage of the exception.* A person that has not registered as a swap dealer by virtue of satisfying the requirements of this paragraph (ggg)(4), but that no longer can take advantage of that *de minimis* exception, will be deemed not to be a swap dealer until the earlier of the date on which it submits a complete application for registration pursuant to Section 4s(b) of the Act, 7 U.S.C. 6s(b), or two months after the end of the month in which that person becomes no longer able to take advantage of the exception.

(iv) *Applicability to registered swap dealers.* A person who currently is registered as a swap dealer may apply to withdraw that registration, while continuing to engage in swap dealing activity in reliance on this section, so long as that person has been registered as a swap dealer for at least 12 months and satisfies the conditions of paragraph (ggg)(4)(i) of this section.

(v) *Future adjustments to scope of the de minimis exception.* The Commission may by rule or regulation change the requirements of the *de minimis* exception described in paragraphs (ggg)(4)(i) through (iv) of this section.

(vi) *Voluntary registration.* Notwithstanding paragraph (ggg)(4)(i) of this section, a person that chooses to register with the Commission as a swap dealer shall be deemed to be a swap dealer.

(5) *Insured depository institution swaps in connection with originating loans to customers.* Swaps entered into by an insured depository institution with a customer in connection with originating a loan with that customer shall not be considered in determining whether the insured depository institution is a swap dealer.

(i) An insured depository institution shall be considered to have entered into a swap with a customer in connection with originating a loan, as defined in paragraphs (ggg)(5)(ii) and (iii) of this section, with that customer only if:

(A) The insured depository institution enters into the swap with the customer no earlier than 90 days before and no later than 180 days after the date of execution of the applicable loan agreement, or no earlier than 90 days before and no later than 180 days after any transfer of principal to the customer by the insured depository institution pursuant to the loan;

(B)(*1*) The rate, asset, liability or other notional item underlying such swap is, or is directly related to, a financial term of such loan, which includes, without limitation, the loan's duration, rate of interest, the currency or currencies in which it is made and its principal amount;

(*2*) Such swap is required, as a condition of the loan under the insured depository institution's loan underwriting criteria, to be in place in order to hedge price risks incidental to the borrower's business and arising from potential changes in the price of a commodity (other than an excluded commodity);

(C) The duration of the swap does not extend beyond termination of the loan;

(D) The insured depository institution is:

(*1*) The sole source of funds to the customer under the loan;

(*2*) Committed to be, under the terms of the agreements related to the loan, the source of at least 10 percent of the maximum principal amount under the loan; or

(*3*) Committed to be, under the terms of the agreements related to the loan, the source of a principal amount that is greater than or equal to the aggregate notional amount of all swaps entered into by the insured depository institution with the customer in connection with the financial terms of the loan;

(E) The aggregate notional amount of all swaps entered into by the customer in connection with the financial terms of the loan is, at any time, not more than the aggregate principal amount outstanding under the loan at that time; and

(F) If the swap is not accepted for clearing by a derivatives clearing organization, the insured depository institution reports the swap as required by section 4r of the Act, 7 U.S.C. 6r (except as otherwise provided in section 4r(a)(3)(A), 7 U.S.C. 6r(a)(3)(A), or section 4r(a)(3)(B), 7 U.S.C. 6r(a)(3)(B) of the Act).

(ii) An insured depository institution shall be considered to have originated a loan with a customer if the insured depository institution:

(A) Directly transfers the loan amount to the customer;

(B) Is a part of a syndicate of lenders that is the source of the loan amount that is transferred to the customer;

(C) Purchases or receives a participation in the loan; or

(D) Otherwise is the source of funds that are transferred to the customer pursuant to the loan or any refinancing of the loan.

(iii) The term loan shall not include:

(A) Any transaction that is a sham, whether or not intended to qualify for the exclusion from the definition of the term *swap dealer* in this rule; or

(B) Any synthetic loan, including, without limitation, a loan credit default swap or loan total return swap.

(6) *Swaps that are not considered in determining whether a person is a swap dealer.* (i) *Inter-affiliate activities.* In determining whether a person is a swap dealer, that person's swaps with majority-owned affiliates shall not be considered. For these purposes the counterparties to a swap are majority-owned affiliates if one counterparty directly or indirectly owns a majority interest in the other, or if a third party directly or indirectly owns a majority interest in both counterparties to the swap, where ''majority interest'' is the right to vote or direct the vote of a majority of a class of voting securities of an entity, the power to sell or direct the sale of a majority of a class of voting securities of an entity, or the right to receive upon dissolution or the contribution of a majority of the capital of a partnership.

(ii) *Activities of a cooperative.* (A) Any swap that is entered into by a cooperative with a member of such cooperative shall not be considered in determining whether the cooperative is a swap dealer, provided that:

(*1*) The swap is subject to policies and procedures of the cooperative requiring that the cooperative monitors and manages the risk of such swap;

(*2*) The cooperative reports the swap as required by Section 4r of the Act, 7 U.S.C. 6r (except as otherwise provided in Section 4r(a)(3)(A) of the Act, 7 U.S.C. 6r(a)(3)(A) or Section 4r(a)(3)(B) of the Act, 7 U.S.C. 6r(a)(3)(B)); and

(*3*) if the cooperative is a cooperative association of producers, the swap is primarily based on a commodity that is not an excluded commodity.

(B) For purposes of this paragraph (ggg)(6)(ii), the term *cooperative* shall mean:

(*1*) A cooperative association of producers as defined in section 1a(14) of the Act, 7 U.S.C. 1a(14), or

(*2*) A person chartered under Federal law as a cooperative and predominantly engaged in activities that are financial in nature as defined in section 4(k) of the Bank Holding Company Act of 1956, 12 U.S.C. 1843(k).

(C) For purposes of this paragraph (ggg)(6)(ii), a swap shall be deemed to be entered into by a cooperative association of producers with a member of such cooperative association of producers when the swap is between a cooperative association of producers and a person that is a member of a cooperative association of producers that is itself a member of the first cooperative association of producers.

(iii) *Swaps entered into for the purpose of hedging physical positions.* In determining whether a person is a swap dealer, a swap that the person enters into shall not be considered, if:

(A) The person enters into the swap for the purpose of offsetting or mitigating the person's price risks that arise from the potential change in the value of one or several—

(*1*) Assets that the person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising;

(*2*) Liabilities that the person owns or anticipates incurring; or

(*3*) Services that the person provides, purchases, or anticipates providing or purchasing;

(B) The swap represents a substitute for transactions made or to be made or positions taken or to be taken by the person at a later time in a physical marketing channel;

(C) The swap is economically appropriate to the reduction of the person's risks in the conduct and management of a commercial enterprise;

(D) The swap is entered into in accordance with sound commercial practices; and

(E) The person does not enter into the swap in connection with activity structured to evade designation as a swap dealer.

(iv) *Swaps entered into by floor traders.* In determining whether a person is a swap dealer, each swap that the person enters into in its capacity as a floor trader as defined by section 1a(23) of the Act or on or subject to the rules of a swap execution facility shall not be considered for the purpose of determining whether the person is a swap dealer if the person:

(A) Is registered with the Commission as a floor trader pursuant to § 3.11 of this chapter;

(B) Enters into swaps with proprietary funds for that trader's own account solely on or subject to the rules of a designated contract market or swap execution facility and submits each such swap for clearing to a derivatives clearing organization;

(C) Is not an affiliated person of a registered swap dealer;

(D) Does not directly, or through an affiliated person, negotiate the terms of swap agreements, other than price and quantity or to participate in a request for quote process subject to the rules of a designated contract market or a swap execution facility;

(E) Does not directly or through an affiliated person offer or provide swap clearing services to third parties;

(F) Does not directly or through an affiliated person enter into swaps that would qualify as hedging physical positions pursuant to paragraph (ggg)(6)(iii) of this section or hedging or mitigating commercial risk pursuant to paragraph (kkk) of this section (except for any such swap executed opposite a counterparty for which the transaction would qualify as a bona fide hedging transaction);

(G) Does not participate in any market making program offered by a designated contract market or swap execution facility; and

(H) Notwithstanding the fact such person is not registered as a swap dealer, such person complies with §§ 23.201, 23.202, 23.203, and 23.600 of this chapter with respect to each such swap as if it were a swap dealer.

(hhh) *Major Swap Participant.* (1) *In general.* The term *major swap participant* means any person:

(i) That is not a swap dealer; and

(ii)(A) That maintains a substantial position in swaps for any of the major swap categories, excluding both positions held for hedging or mitigating commercial risk, and positions maintained by any employee benefit plan (or any contract held by such a plan) as defined in paragraphs (3) and (32) of Section 3 of the Employee Retirement Income Security Act of 1974, 29 U.S.C. 1002, for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;

(B) Whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or

(C) That is a financial entity that:

(*1*) Is highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an

appropriate Federal banking agency (as defined in Section 1a(2) of the Act, 7 U.S.C. 1a(2)); and

(*2*) Maintains a substantial position in outstanding swaps in any major swap category.

(2) *Scope of designation.* A person that is a major swap participant shall be deemed to be a major swap participant with respect to each swap it enters into, regardless of the category of the swap or the person's activities in connection with the swap. However, if a person makes an application to limit its designation as a major swap participant to specified categories of swaps, the Commission shall determine whether the person's designation as a major swap participant shall be so limited. If the Commission grants such limited designation, such limited designation major swap participant shall be deemed to be a major swap participant with respect to each swap it enters into in the swap category or categories for which it is so designated, regardless of the person's activities in connection with such category or categories of swaps. A person may make such application to limit its designation at the same time as, or after, the person's initial registration as a major swap participant.

(3) *Timing requirements.* A person that is not registered as a major swap participant, but that meets the criteria in this rule to be a major swap participant as a result of its swap activities in a fiscal quarter, will not be deemed to be a major swap participant until the earlier of the date on which it submits a complete application for registration as a major swap participant pursuant to Section 4s(a)(2) of the Act, 7 U.S.C. 6s(a)(2), or two months after the end of that quarter.

(4) *Reevaluation period.* Notwithstanding paragraph (hhh)(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 be deemed a major swap participant pursuant to the timing requirements specified in paragraph (hhh)(3) of this section; but

(ii) That person will be deemed a major swap participant pursuant to the timing requirements specified in paragraph (hhh)(3) 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.

(5) *Termination of status.* A person that is deemed to be a major swap participant shall continue to be deemed a major swap participant until such time that its swap activities do not exceed any of the daily average thresholds set forth within this rule for four consecutive fiscal quarters after the date on which the person becomes registered as a major swap participant.

(6) *Calculation of status.* A person shall not be deemed to be a ''major swap participant,'' regardless of whether the criteria paragraph (hhh)(1) of this section otherwise would cause the person to be a major swap participant, provided the person meets the conditions set forth in paragraphs (hhh)(6)(i), (ii) or (iii) of this section.

(i) Caps on uncollateralized exposure and notional positions.

(A) *Maximum potential uncollateralized exposure.* The express terms of the person's agreements or arrangements relating to swaps with its counterparties at no time would permit the person to maintain a total uncollateralized exposure of more than $100 million to all such counterparties, including any exposure that may result from thresholds or minimum transfer amounts established by credit support annexes or similar arrangements; and

(B) Maximum notional amount of swap positions. The person does not maintain swap positions in a notional amount of more than $2 billion in any major category of swaps, or more than $4 billion in the aggregate across all major categories; or

(ii) Caps on uncollateralized exposure plus monthly calculation.

(A) *Maximum potential uncollateralized exposure.* The express terms of the person's agreements or arrangements relating to swaps with its counterparties at no time would permit the person to maintain a total uncollateralized exposure of more than $200 million to all such counterparties (with regard to swaps and any other instruments by which the person may have exposure to those counterparties), including any exposure that may result from thresholds or minimum transfer amounts established by credit support annexes or similar arrangements; and

(B) *Calculation of positions.* (*1*) At the end of each month, the person performs the calculations prescribed by paragraph (jjj) of this section with regard to whether the aggregate uncollateralized outward exposure plus aggregate potential outward exposure as of that day constitute a ''substantial position'' in a major category of swaps, or pose ''substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets''; these calculations shall disregard provisions of those rules that provide for the analyses to be determined based on a daily average over a calendar quarter; and

(*2*) Each such analysis produces thresholds of no more than:

(*i*) $1 billion in aggregate uncollateralized outward exposure plus aggregate potential outward exposure in any major category of swaps; if the person is subject to paragraph (jjj) of this section, by virtue of being a highly leveraged financial entity that is not subject to capital requirements established by an appropriate Federal banking agency, this analysis shall account for all of the person's swap positions in that major category (without excluding hedging positions), otherwise this analysis shall exclude the same hedging and related positions that are excluded from consideration pursuant to paragraph (jjj)(1)(i) of this section; or

(*ii*) $2 billion in aggregate uncollateralized outward exposure plus aggregate potential outward exposure (without any positions excluded from the analysis) with regard to all of the person's swap positions.

(iii) *Calculations based on certain information.* (A)(*1*) At the end of each month, the person's aggregate uncollateralized outward exposure with respect to its swap positions in each major swap category is less than $1.5 billion with respect to the rate swap category and less than $500 million with respect to each of the other major swap categories; and

(*2*) At the end of each month, the sum of the amount calculated under paragraph (hhh)(6)(iii)(A)(*1*) of this section with respect to each major swap category and the total notional principal amount of the person's swap positions in each such major swap category, adjusted by the multipliers set forth in paragraph (jjj)(3)(ii)(*1*) of this section on a position-by-position basis reflecting the type of swap, is less than $3 billion with respect to the rate swap category and less than $1 billion with respect to each of the other major swap categories; or

(B)(*1*) At the end of each month, the person's aggregate uncollateralized outward exposure with respect to its swap positions across all major swap categories is less than $500 million; and

(*2*) The sum of the amount calculated under paragraph (hhh)(6)(iii)(B)(*1*) of this section and the product of the total effective notional principal amount of the person's swap positions in all major security-based swap categories multiplied by 0.15 is less than $1 billion.

(C) For purposes of the calculations set forth in this paragraph (hhh)(6)(iii):

(*1*) The person's aggregate uncollateralized outward exposure for positions held with swap dealers shall be equal to such exposure reported on the most recent reports of such exposure received from such swap dealers; and

(*2*) The person's aggregate uncollateralized outward exposure for positions that are not reflected in any report of exposure from a swap dealer (including all swap positions it holds with persons other than swap dealers) shall be calculated in accordance with paragraph (jjj)(2) of this section.

(iv) For purposes of the calculations set forth in this paragraph (hhh)(6), the person shall use the effective notional amount of a position rather than the stated notional amount of the position if the stated notional amount is leveraged or enhanced by the structure of the position.

(v) No presumption shall arise that a person is required to perform the calculations needed to determine if it is a major swap participant, solely by reason that the person does not meet the conditions specified in paragraph (hhh)(6)(i), (ii) or (iii) of this section.

(7) *Exclusions.* A person who is registered as a derivatives clearing organization with the Commission pursuant to section 5b of the Act and regulations thereunder, shall not be deemed to be a major swap participant, regardless of whether the criteria in this paragraph (hhh) otherwise would cause the person to be a major swap participant.

(iii) *Category of swaps; major swap category.* For purposes of Section 1a(33) the Act, 7 U.S.C. 1a(33), and paragraph (hhh) of this section, 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 paragraph (iii) has the meaning set forth in Section 1a(47) of the Act, 7 U.S.C. 1a(47), and the rules thereunder.

(1) *Rate swaps.* Any swap which is primarily based on one or more reference rates, including but not limited to any swap of payments determined by fixed and floating interest rates, currency exchange rates, inflation rates or other monetary rates, any foreign exchange swap, as defined in Section 1a(25) of the Act, 7 U.S.C. 1a(25), and any foreign exchange option other than an option to deliver currency.

(2) *Credit swaps.* Any swap that is primarily based on instruments of indebtedness, including but not limited to any swap primarily based on one or more broad-based indices related to debt instruments or loans, and any swap that is an index credit default swap or total return swap on one or more indices of debt instruments.

(3) *Equity swaps.* Any swap that is primarily based on equity securities, including but not limited to any swap based on one or more broad-based indices of equity securities and any total return swap on one or more equity indices.

(4) *Other commodity swaps.* Any swap that is not included in the rate swap, credit swap or equity swap categories.

(jjj) *Substantial position.* (1) In general. For purposes of Section 1a(33) of the Act, 7 U.S.C. 1a(33), and paragraph (hhh) of this section, the term ''substantial position'' means swap positions that equal or exceed any of the following thresholds in the specified major category of swaps:

(i) For rate swaps:

(A) $3 billion in daily average aggregate uncollateralized outward exposure; or

(B) $6 billion in:

(*1*) Daily average aggregate uncollateralized outward exposure plus

(*2*) Daily average aggregate potential outward exposure.

(ii) For credit swaps:

(A) $1 billion in daily average aggregate uncollateralized outward exposure; or

(B) $2 billion in:

(*1*) Daily average aggregate uncollateralized outward exposure plus

(*2*) Daily average aggregate potential outward exposure.

(iii) For equity swaps:

(A) $1 billion in daily average aggregate uncollateralized outward exposure; or

(B) $2 billion in:

(*1*) Daily average aggregate uncollateralized outward exposure plus

(*2*) Daily average aggregate potential outward exposure.

(iv) For other commodity swaps:

(A) $1 billion in daily average aggregate uncollateralized outward exposure; or

(B) $2 billion in:

(*1*) Daily average aggregate uncollateralized outward exposure plus

(*2*) Daily average aggregate potential outward exposure.

(2) *Aggregate uncollateralized outward exposure.* (i) *In general. Aggregate uncollateralized outward exposure* in general means the sum of the current exposure, obtained by marking-to-market using industry standard practices, of each of the person's swap positions with negative value in a major swap category, less the value of the collateral the person has posted in connection with those positions.

(ii) *Calculation of aggregate uncollateralized outward exposure.* In calculating this amount the person shall, with respect to each of its swap counterparties in a given major swap category, 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 deduct from that dollar amount the aggregate value of the collateral the person has posted with respect to the swap positions. The aggregate uncollateralized outward exposure shall be the sum of those uncollateralized amounts across all of the person's swap counterparties in the applicable major category.

(iii) *Relevance of netting agreements.* (A) If the person has one or more master netting agreement in effect with a particular counterparty, the person may measure the current exposure arising from its swaps in any major category on a net basis, applying the terms of those agreements. Calculation of net current exposure may take into account offsetting positions entered into with that particular counterparty involving swaps (in any swap category) as well as security-based swaps and securities financing transactions (consisting of securities lending and borrowing, securities margin lending and repurchase and reverse repurchase agreements), and other financial instruments that are subject to netting offsets for purposes of applicable bankruptcy law, to the extent these are consistent with the offsets permitted by the master netting agreements.

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

(iv) *Allocation of uncollateralized outward exposure.* If a person calculates current exposure with a particular counterparty on a net basis, as provided by paragraph (jjj)(2)(iii) of this section, the portion of that current exposure that should be attributed to each ''major'' category of swaps for purposes of the substantial position analysis should be calculated according to the formula:

$$ES(MC)_{\square} = Enet\ total_{\square} \cdot \frac{OTM_{S(MC)}}{OTM_{S(MC)} + OTM_{S(O)} + OTM_{non-S}}$$

Where: $E_{S(MC)}$ equals the amount of aggregate current exposure attributable to the entity's swap positions in the ''major'' swap category at issue; $E_{net\ total}$ equals the entity's aggregate current exposure to the counterparty at issue, after accounting for the netting of positions and the posting of collateral; $OTM_{S(MC)}$ equals the exposure associated with the entity's out-of-the-money positions in swaps in the ''major'' category at issue, subject to those netting arrangements; and $OTM_{S(O)}$ equals the exposure associated with the entity's out-of-the-money positions in the other ''major'' categories of swaps, subject to those netting arrangements; and $OTM_{non\text{-}S}$ equals the exposure associated with the entity's out-of-the-money positions associated with instruments, other than swaps, that are subject to those netting arrangements.

(3) *Aggregate potential outward exposure.* (i) *In general.* Aggregate potential outward exposure in any major swap category means the sum of:

(A) The aggregate potential outward exposure for each of the person's swap positions in a major swap category that are not subject to daily mark-to-market margining and are not cleared by a registered or exempt clearing agency or derivatives clearing organization, as calculated in accordance with paragraph (jjj)(3)(ii) of this section; and

(B) The aggregate potential outward exposure for each of the person's swap positions in such major swap category that are either subject to daily mark-to-market margining or are cleared by a registered or exempt clearing agency or derivatives clearing organization, as calculated in accordance with paragraph (jjj)(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 or exempt clearing agency or derivatives clearing organization.* (A) *In general.* (*1*) For positions in swaps that are not subject to daily mark-to-market margining and are not cleared by a registered or exempt clearing agency or a derivatives clearing organization, potential outward exposure equals the total notional principal amount of those positions, multiplied by the following factors on a position-by-position basis reflecting the type of swap. For any swap that does not appropriately fall within any of the specified categories, the ''other commodities'' conversion factors set forth in the following Table 1 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 1—CONVERSION FACTOR MATRIX FOR SWAPS

Residual maturity	Interest rate	Foreign exchange rate and gold	Precious metals (except gold)	Other commodities
One year or less	0.00	0.01	0.07	0.10
Over one to five years	0.005	0.05	0.07	0.12
Over five years	0.015	0.075	0.08	0.15

Residual maturity	Credit	Equity
One year or less	0.10	0.06
Over one to five years	0.10	0.08
Over five years	0.10	0.10

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

(*i*) Positions that constitute the purchase of an option, if the purchaser has no additional payment obligations under the position;

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

(*iii*) Positions for which, pursuant to law or a regulatory requirement, the person has assigned an amount of cash or U.S. Treasury securities that is sufficient at all times to pay the person's maximum possible liability under the position, and the person may not use that cash or those Treasury securities for other purposes.

(*4*) *Adjustment for certain positions.* Notwithstanding paragraph (jjj)(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, or associated with a position by which a person purchases an option for which the person retains additional payment obligations under the position, is capped at the net present value of the unpaid premiums.

(B) *Adjustment for netting agreements.* Notwithstanding paragraph (jjj)(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 (jjj)(3)(ii)(A) 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:

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

Where: P_{Net} is the potential outward exposure, adjusted for bilateral netting, of the person's swaps with a particular counterparty; P_{Gross} is the potential outward exposure without adjustment for bilateral netting as calculated pursuant to paragraph (jjj)(3)(ii)(A) of this section; and *NGR* is the ratio of the current exposure arising from its swaps in the major category as calculated on a net basis according to paragraphs (jjj)(2)(iii) and (iv) of this section, divided by the current exposure arising from its swaps in the major category as calculated in the absence of those netting procedures.

(iii) *Calculation of potential outward exposure for swaps that are either subject to daily mark-to-market margining or are cleared by a registered or exempt clearing agency or derivatives clearing organization.* For positions in swaps that are subject to daily mark-to-market margining or that are cleared by a registered or exempt clearing agency or derivatives clearing organization:

(A) Potential outward exposure equals the potential exposure that would be attributed to such positions using the procedures in paragraph (jjj)(3)(ii) of this section multiplied by:

(*1*) 0.1, in the case of positions cleared by a registered or exempt clearing agency; or

(*2*) 0.2, in the case of positions that are subject to daily mark-to-market margining but that are not cleared by a registered or exempt clearing agency.

(B) Solely for purposes of calculating potential outward exposure:

(*1*) A swap shall be considered to be subject to daily mark-to-market margining if, and for so long as, the counterparties follow the daily practice of exchanging collateral to reflect changes in the current exposure arising from the swap (after taking into account any other financial positions addressed by a netting agreement between the counterparties).

(*2*) If the person is permitted by agreement to maintain a threshold for which it is not required to post collateral, the position still will be considered to be subject to daily mark-to-market margining for purposes of calculating potential outward exposure, but the total amount of that threshold (regardless of the actual exposure at any time), less any initial margin posted up to the amount of that threshold, shall be added to the person's aggregate uncollateralized outward exposure for purposes of paragraph (jjj)(1)(i)(B), (ii)(B), (iii)(B) or (iv)(B) of this section, as applicable.

(*3*) If the minimum transfer amount under the agreement is in excess of $1 million, the position still will be considered to be subject to daily mark-to-market margining for purposes of calculating potential outward exposure, but the entirety of the minimum transfer amount shall be added to the person's aggregate uncollateralized outward exposure for purposes of paragraph (jjj)(1)(i)(B), (ii)(B), (iii)(B) or (iv)(B) of this section, as applicable.

(*4*) A person may, at its discretion, calculate the potential outward exposure of positions in swaps that are subject to daily mark-to-market margining in accordance with paragraph (jjj)(3)(ii) of this section in lieu of calculating the potential outward exposure of such swap positions in accordance with this paragraph (jjj)(3)(iii).

(4) *Calculation of daily average.* Measures of daily average aggregate uncollateralized outward exposure and daily average aggregate potential outward exposure shall equal the arithmetic mean of the applicable measure of exposure at the close of each business day, beginning the first business day of each calendar quarter and continuing through the last business day of that quarter.

(5) *Inter-affiliate activities.* In calculating its aggregate uncollateralized outward exposure and its aggregate potential outward exposure, the person shall not consider its swap positions with counterparties that are majority-owned affiliates. For these purposes the counterparties to a swap are majority-owned affiliates if one counterparty directly or indirectly owns a majority interest in the other, or if a third party directly or indirectly owns a majority interest in both counterparties to the swap, where ''majority interest'' is the right to vote or direct the vote of a majority of a class of voting securities of an entity, the power to sell or direct the sale of a majority of a class of voting securities of an entity, or the right to receive upon dissolution or the contribution of a majority of the capital of a partnership.

(kkk) *Hedging or mitigating commercial risk.* For purposes of Section 1a(33) of the Act, 7 U.S.C. 1a(33) and paragraph (hhh) of this section, a swap position is held for the purpose of hedging or mitigating commercial risk when:

(1) Such position:

(i) Is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise (or of a majority-owned affiliate of the enterprise), where the risks arise from:

(A) The potential change in the value of assets that a person owns, produces, manufactures, processes, or merchandises or reasonably anticipates owning, producing, manufacturing, processing, or merchandising in the ordinary course of business of the enterprise;

(B) The potential change in the value of liabilities that a person has incurred or reasonably anticipates incurring in the ordinary course of business of the enterprise; or

(C) The potential change in the value of services that a person provides, purchases, or reasonably anticipates providing or purchasing in the ordinary course of business of the enterprise;

(D) The potential change in the value of assets, services, inputs, products, or commodities that a person owns, produces, manufactures, processes, merchandises, leases, or sells, or reasonably anticipates owning, producing, manufacturing, processing, merchandising, leasing, or selling in the ordinary course of business of the enterprise;

(E) Any potential change in value related to any of the foregoing arising from interest, currency, or foreign exchange rate movements associated with such assets, liabilities, services, inputs, products, or commodities; or

(F) Any fluctuation in interest, currency, or foreign exchange rate exposures arising from a person's current or anticipated assets or liabilities; or

(ii) Qualifies as bona fide hedging for purposes of an exemption from position limits under the Act; or

(iii) Qualifies for hedging treatment under:

(A) Financial Accounting Standards Board Accounting Standards Codification Topic 815, Derivatives and Hedging (formerly known as Statement No. 133); or

(B) Governmental Accounting Standards Board Statement 53, Accounting and Financial Reporting for Derivative Instruments; and

(2) Such position is:

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

(ii) Not held to hedge or mitigate the risk of another swap or security-based swap position, unless that other position itself is held for the purpose of hedging or mitigating commercial risk as defined by this rule or § 240.3a67–4 of this title.

(lll) *Substantial counterparty exposure.* (1) *In general.* For purposes of Section 1a(33) of the Act, 7 U.S.C. 1a(33), and paragraph (hhh) of this section, the term *substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets* means a swap position that satisfies either of the following thresholds:

(i) $5 billion in daily average aggregate uncollateralized outward exposure; or

(ii) $8 billion in:

(A) Daily average aggregate uncollateralized outward exposure plus

(B) Daily average aggregate potential outward exposure.

(2) *Calculation methodology.* For these purposes, the terms *daily average aggregate uncollateralized outward exposure* and *daily average aggregate potential outward exposure* shall be calculated the same way as is prescribed in paragraph (jjj) of this section, except that these amounts shall be calculated by reference to all of the person's swap positions, rather than by reference to a specific major swap category.

(mmm) *Financial entity; highly leveraged.* (1) For purposes of Section 1a(33) of the Act, 7 U.S.C. 1a(33), and paragraph (hhh) of this section, the term *financial entity* means:

(i) A security-based swap dealer;

(ii) A major security-based swap participant;

(iii) A commodity pool as defined in Section 1a(10) of the Act, 7 U.S.C. 1a(10);

(iv) A private fund as defined in Section 202(a) of the Investment

Advisers Act of 1940, 15 U.S.C. 80b–2(a);

(v) An employee benefit plan as defined in paragraphs (3) and (32) of Section 3 of the Employee Retirement Income Security Act of 1974, 29 U.S.C. 1002; and

(vi) A person predominantly engaged in activities that are in the business of banking or financial in nature, as defined in Section 4(k) of the Bank Holding Company Act of 1956, 12 U.S.C. 1843(k).

(2) For purposes of Section 1a(33) of the Act, 7 U.S.C. 1a(33), and paragraph (hhh) of this section, the term *highly leveraged* means the existence of a ratio of an entity's total liabilities to equity in excess of 12 to 1 as measured at the close of business on the last business day of the applicable fiscal quarter. For this purpose, liabilities and equity should each be determined in accordance with U.S. generally accepted accounting principles; provided, however, that a person that is an employee benefit plan, as defined in paragraphs (3) and (32) of Section 3 of the Employee Retirement Income Security Act of 1974, 29 U.S.C. 1002, may exclude obligations to pay benefits to plan participants from the calculation of liabilities and substitute the total value of plan assets for equity.

Securities and Exchange Commission

Pursuant to the Exchange Act, 15 U.S.C. 78a *et seq.,* and particularly, Sections 3 and 23 thereof, and Sections 712 and 761(b) of the Dodd-Frank Act, the SEC is adopting Rules 3a67–1, 3a67–2, 3a67–3, 3a67–4, 3a67–5, 3a67–6, 3a67–7, 3a71–1, and 3a71–2 under the Exchange Act.

For the reasons stated in the preamble, the SEC is amending Title 17, Chapter II, of the Code of the Federal Regulations, as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

■ 3. The authority citation for part 240 is amended by adding the following citation in numerical order:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77ggg, 77nnn, 77jjj, 77kkk, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78l, 78m, 78n, 78n–1, 78o, 78o–4, 78p, 78q, 78s, 78u–5, 78w, 78x, 78ll, 78mm, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4, 80b–11, and 7201 et seq., 18 U.S.C. 1350; 12 U.S.C. 5221(e)(3), and Pub. L. 111–203, § 939A, 124 Stat. 1376 (2010), unless otherwise noted.

* * * * *

Sections 3a67–1 through 3a67–9 and 3a71–1 and 3a71–2 are also issued under Pub. L. 111–203, §§ 712, 761(b), 124 Stat. 1841 (2010).

* * * * *

■ 4. Add an undesignated center heading and §§ 240.3a67–1 through 240.3a67–9 and §§ 240.3a71–1 and 240.3a71–2 to read as follows:

Security-Based Swap Dealer and Participant Definitions

Sec.

240.3a67–1 Definition of ''major security-based swap participant.''
240.3a67–2 Categories of security-based swaps.
240.3a67–3 Definition of ''substantial position.''
240.3a67–4 Definition of ''hedging or mitigating commercial risk.''
240.3a67–5 Definition of ''substantial counterparty exposure.''
240.3a67–6 Definition of ''financial entity.''
240.3a67–7 Definition of ''highly leveraged.''
240.3a67–8 Timing requirements, reevaluation period and termination of status.
240.3a67–9 Calculation of major participant status by certain persons.
240.3a71–1 Definition of ''security-based swap dealer.''
240.3a71–2 *De minimis* exception.
240.3a71–2A Report regarding the ''security-based swap dealer'' and ''major security-based swap participant'' definitions (Appendix A to 17 CFR 240.3a71–2).

* * * * *

§ 240.3a67–1 Definition of ''major security-based swap participant.''

(a) *General. Major security-based swap participant* means any person:

(1) That is not a security-based swap dealer; and

(2)(i) That maintains a substantial position in security-based swaps for any of the major security-based swap categories, excluding both positions held for hedging or mitigating commercial risk, and positions maintained by any employee benefit plan (or any contract held by such a plan) as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;

(ii) Whose outstanding security-based swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or

(iii) That is a financial entity that:

(A) Is highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking agency (as defined in 15 U.S.C. 78c(a)(72)); and

(B) Maintains a substantial position in outstanding security-based swaps in any major security-based swap category.

(b) *Scope of designation.* A person that is a major security-based swap participant in general shall be deemed to be a major security-based swap participant with respect to each security-based swap it enters into, regardless of the category of the security-based swap or the person's activities in connection with the security-based swap, unless the Commission limits the person's designation as a major security-based swap participant to specified categories of security-based swaps.

§ 240.3a67–2 Categories of security-based swaps.

For purposes of section 3(a)(67) of the Act, 15 U.S.C. 78c(a)(67), and the rules thereunder, the terms *major security-based swap category, category of security-based swaps* and any similar terms mean either of the following categories of security-based swaps:

(a) *Debt security-based swaps.* Any security-based swap that is based, in whole or in part, on one or more instruments of indebtedness (including loans), or on a credit event relating to one or more issuers or securities, including but not limited to any security-based swap that is a credit default swap, total return swap on one or more debt instruments, debt swap, debt index swap, or credit spread.

(b) *Other security-based swaps.* Any security-based swap not described in paragraph (a) of this section.

§ 240.3a67–3 Definition of ''substantial position.''

(a) *General.* For purposes of section 3(a)(67) of the Act, 15 U.S.C. 78c(a)(67), and § 240.3a67–1, the term *substantial position* means security-based swap positions that equal or exceed either of the following thresholds in any major category of security-based swaps:

(1) $1 billion in daily average aggregate uncollateralized outward exposure; or

(2) $2 billion in:

(i) Daily average aggregate uncollateralized outward exposure; plus

(ii) Daily average aggregate potential outward exposure.

(b) *Aggregate uncollateralized outward exposure.* (1) *General. Aggregate uncollateralized outward exposure* in general means the sum of the current exposure, obtained by marking-to-market using industry standard practices, of each of the person's security-based swap positions

with negative value in a major security-based swap category, less the value of the collateral the person has posted in connection with those positions.

(2) *Calculation of aggregate uncollateralized outward exposure.* In calculating this amount the person shall, with respect to each of its security-based swap counterparties in a given major security-based swap category:

(i) Determine the dollar value of the aggregate current exposure arising from each of its security-based swap positions with negative value (subject to the netting provisions described below) in that major category by marking-to-market using industry standard practices; and

(ii) Deduct from that dollar amount the aggregate value of the collateral the person has posted with respect to the security-based swap positions.

(iii) The aggregate uncollateralized outward exposure shall be the sum of those uncollateralized amounts across all of the person's security-based swap counterparties in the applicable major category.

(3) *Relevance of netting agreements.* (i) If a person has one or more master netting agreements with a counterparty, the person may measure the current exposure arising from its security-based swaps in any major category on a net basis, applying the terms of those agreements. Calculation of current exposure may take into account offsetting positions entered into with that particular counterparty involving security-based swaps (in any security-based swap category) as well as swaps and securities financing transactions (consisting of securities lending and borrowing, securities margin lending and repurchase and reverse repurchase agreements), and other financial instruments that are subject to netting offsets for purposes of applicable bankruptcy law, to the extent these are consistent with the offsets permitted by the master netting agreements.

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

(4) *Allocation of uncollateralized outward exposure.* If a person calculates current exposure with a particular counterparty on a net basis, as provided by paragraph (b)(3) of this section, the amount of current uncollateralized exposure attributable to each ''major'' category of security-based swaps should be calculated according to the following formula:

$$E_{SBS(MC)} = E_{net\ total} \cdot \frac{OTM_{SBS(MC)}}{OTM_{SBS(MC)} + OTM_{SBS(O)} + OTM_{non-SBS}}$$

Note to paragraph (b)(4). *Where:* $E_{SBS(MC)}$ equals the amount of aggregate current exposure attributable to the entity's security-based swap positions in the ''major'' category at issue (either security-based credit derivatives or other security-based swaps); $E_{net\ total}$ equals the entity's aggregate current exposure to the counterparty at issue, after accounting for the netting of positions and the posting of collateral; $OTM_{SBS(MC)}$ equals the current exposure associated with the entity's out-of-the-money positions in security-based swaps in the ''major'' category at issue, subject to those netting arrangements; and $OTM_{SBS(O)}$ equals the current exposure associated with the entity's out-of-the-money positions in the other ''major'' category of security-based swaps, subject to those netting arrangements; and $OTM_{non\text{-}SBS}$ equals the current exposure associated with the entity's out-of-the-money positions associated with instruments, other than security-based swaps, that are subject to those netting arrangements.

(c) *Aggregate potential outward exposure.* (1) *General. Aggregate potential outward exposure* means the sum of:

(i) The aggregate potential outward exposure for each of the person's security-based swap positions in a major security-based swap category that are neither cleared by a registered or exempt clearing agency nor subject to daily mark-to-market margining, as calculated in accordance with paragraph (c)(2) of this section; and

(ii) The aggregate potential outward exposure for each of the person's security-based swap positions in a major security-based swap category that are either cleared by a registered or exempt clearing agency or subject to daily mark-to-market margining, as calculated in accordance with paragraph (c)(3) of this section.

(2) *Calculation of potential outward exposure for security-based swaps that are not cleared by a registered or exempt clearing agency or subject to daily mark-to-market margining.* (i) *General.* (A)(*1*) For positions in security-based swaps that are not cleared by a registered or exempt clearing agency or subject to daily mark-to-market margining, potential outward exposure equals the total notional principal amount of those positions, multiplied by the following factors on a position-by-position basis reflecting the type of security-based swap. For any security-based swap that is not of the ''debt'' type, the ''equity and other'' conversion factors are to be used:

Residual maturity	Debt	Equity and other
One year or less	0.10	0.06
Over one to five years	0.10	0.08
Over five years	0.10	0.10

(*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;

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

(*3*) Positions for which, pursuant to regulatory requirement, the person has assigned an amount of cash or U.S. Treasury securities that is sufficient to pay the person's maximum possible liability under the position, and the person may not use that cash or those Treasury securities for other purposes.

(D) *Adjustment for certain positions.* Notwithstanding paragraph (c)(2)(i)(A) of this section, the potential outward exposure associated with a position by which a person buys credit protection using a credit default swap, or associated with a position by which a person purchases an option for which the person retains additional payment obligations under the position, is capped at the net present value of the unpaid premiums.

(ii) *Adjustment for netting agreements.* Notwithstanding paragraph (c)(2)(i) of this section, for positions subject to master netting agreements the

potential outward exposure associated with the person's security-based swaps with each counterparty equals a weighted average of the potential outward exposure for the person's security-based swaps with that counterparty as calculated under paragraph (c)(2)(i) of this section, and that amount reduced by the ratio of net current exposure to gross current exposure, consistent with the following equation as calculated on a counterparty-by-counterparty basis:

$$P_{Net} = 0.4 \times P_{Gross} + 0.6 \times NGR \times P_{Gross}$$

Note to paragraph (c)(2)(ii): *Where:* P_{Net} is the potential outward exposure, adjusted for bilateral netting, of the person's security-based swaps with a particular counterparty; P_{Gross} is the potential outward exposure without adjustment for bilateral netting, as calculated pursuant to paragraph (c)(2)(i) of this section; and *NGR* is the ratio of:

1. The current exposure arising from its security-based swaps in the major category as calculated on a net basis according to paragraphs (b)(3) and (4) of this section, divided by

2. The current exposure arising from its security-based swaps in the major category as calculated in the absence of those netting procedures.

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

(i) Potential outward exposure equals the potential outward exposure that would be attributed to such positions using the procedures in paragraph (c)(2) of this section, multiplied by:

(A) 0.1, in the case of positions cleared by a registered or exempt clearing agency; or

(B) 0.2, in the case of positions that are subject to daily mark-to-market margining but that are not cleared by a registered or exempt clearing agency.

(ii) Solely for purposes of calculating potential outward exposure:

(A) A security-based swap shall be considered to be subject to daily mark-to-market margining if, and for as long as, the counterparties follow the daily practice of exchanging collateral to reflect changes in the current exposure arising from the security-based swap (after taking into account any other financial positions addressed by a netting agreement between the counterparties).

(B) If the person is permitted by agreement to maintain a threshold for which it is not required to post collateral, the position still will be considered to be subject to daily mark-to-market margining for purposes of calculating potential outward exposure, but the total amount of that threshold (regardless of the actual exposure at any time) less any initial margin posted up to the amount of that threshold, shall be added to the person's aggregate uncollateralized outward exposure for purposes of paragraph (a)(2) of this section.

(C) If the minimum transfer amount under the agreement is in excess of $1 million, the position still will be considered to be subject to daily mark-to-market margining for purposes of calculating potential outward exposure, but the entirety of the minimum transfer amount shall be added to the person's aggregate uncollateralized outward exposure for purposes of paragraph (a)(2) of this section.

(D) A person may, at its discretion, calculate the potential outward exposure of positions in security-based swaps that are subject to daily mark-to-market margining in accordance with paragraph (c)(2) of this section in lieu of calculating the potential outward exposure of such positions in accordance with this paragraph (c)(3).

(d) *Calculation of daily average.* Measures of daily average aggregate uncollateralized outward exposure and daily average aggregate potential outward exposure shall equal the arithmetic mean of the applicable measure of exposure at the close of each business day, beginning the first business day of each calendar quarter and continuing through the last business day of that quarter.

(e) *Inter-affiliate activities.* In calculating its aggregate uncollateralized outward exposure and its aggregate potential outward exposure, a person shall not consider its security-based swap positions with counterparties that are majority-owned affiliates. For these purposes the parties are majority-owned affiliates if one party directly or indirectly owns a majority interest in the other, or if a third party directly or indirectly owns a majority interest in both counterparties to the security-based swap, where ''majority interest'' is the right to vote or direct the vote of a majority of a class of voting securities of an entity, the power to sell or direct the sale of a majority of a class of voting securities of an entity, or the right to receive upon dissolution or the contribution of a majority of the capital of a partnership.

§ 240.3a67–4 Definition of ''hedging or mitigating commercial risk.''

For purposes of section 3(a)(67) of the Act, 15 U.S.C. 78c(a)(67), and § 240.3a67–1, a security-based swap position shall be deemed to be held for the purpose of hedging or mitigating commercial risk when:

(a)(1) Such position is economically appropriate to the reduction of risks that are associated with the present conduct and management of a commercial enterprise (or of a majority owned affiliate of the enterprise), or are reasonably expected to arise in the future conduct and management of the commercial enterprise, where such risks arise from:

(i) The potential change in the value of assets that a person owns, produces, manufactures, processes, or merchandises or reasonably anticipates owning, producing, manufacturing, processing, or merchandising in the ordinary course of business of the enterprise (or of an affiliate under common control with the enterprise);

(ii) The potential change in the value of liabilities that a person has incurred or reasonably anticipates incurring in the ordinary course of business of the enterprise (or of an affiliate under common control with the enterprise); or

(iii) The potential change in the value of services that a person provides, purchases, or reasonably anticipates providing or purchasing in the ordinary course of business of the enterprise (or of an affiliate under common control with the enterprise);

(2) Depending on the applicable facts and circumstances, the security-based swap positions described in paragraph (a)(1) of this section may be expected to encompass, among other positions:

(i) Positions established to manage the risk posed by a customer's, supplier's or counterparty's potential default in connection with: Financing provided to a customer in connection with the sale of real property or a good, product or service; a customer's lease of real property or a good, product or service; a customer's agreement to purchase real property or a good, product or service in the future; or a supplier's commitment to provide or sell a good, product or service in the future;

(ii) Positions established to manage the default risk posed by a financial counterparty (different from the counterparty to the hedging position at issue) in connection with a separate transaction (including a position involving a credit derivative, equity swap, other security-based swap, interest rate swap, commodity swap, foreign exchange swap or other swap, option, or future that itself is for the purpose of hedging or mitigating commercial risk pursuant to this section or 17 CFR 1.3(kkk));

(iii) Positions established to manage equity or market risk associated with certain employee compensation plans, including the risk associated with market price variations in connection with stock-based compensation plans, such as deferred compensation plans and stock appreciation rights;

(iv) Positions established to manage equity market price risks connected with certain business combinations, such as a corporate merger or consolidation or similar plan or acquisition in which securities of a person are exchanged for securities of any other person (unless the sole purpose of the transaction is to change an issuer's domicile solely within the United States), or a transfer of assets of a person to another person in consideration of the issuance of securities of such other person or any of its affiliates;

(v) Positions established by a bank to manage counterparty risks in connection with loans the bank has made; and

(vi) Positions to close out or reduce any of the positions described in paragraphs (a)(2)(i) through (a)(2)(v) of this section; and

(b) Such position is:

(1) Not held for a purpose that is in the nature of speculation or trading; and

(2) Not held to hedge or mitigate the risk of another security-based swap position or swap position, unless that other position itself is held for the purpose of hedging or mitigating commercial risk as defined by this section or 17 CFR 1.3(kkk).

§ 240.3a67–5 Definition of ''substantial counterparty exposure.''

(a) *General.* For purposes of section 3(a)(67) of the Act, 15 U.S.C. 78c(a)(67), and § 240.3a67–1, the term *substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets* means a security-based swap position that satisfies either of the following thresholds:

(1) $2 billion in daily average aggregate uncollateralized outward exposure; or

(2) $4 billion in:

(i) Daily average aggregate uncollateralized outward exposure; plus

(ii) Daily average aggregate potential outward exposure.

(b) *Calculation.* For these purposes, daily average *aggregate uncollateralized outward exposure* and daily average *aggregate potential outward exposure* shall be calculated the same way as is prescribed in § 240.3a67–3, except that these amounts shall be calculated by reference to all of the person's security-based swap positions, rather than by reference to a specific major security-based swap category.

§ 240.3a67–6 Definition of ''financial entity.''

(a) *General.* For purposes of section 3(a)(67) of the Act, 15 U.S.C. 78c(a)(67), and § 240.3a67–1, the term *financial entity* means:

(1) A swap dealer;

(2) A major swap participant;

(3) A commodity pool as defined in section 1a(10) of the Commodity Exchange Act (7 U.S.C. 1a(10));

(4) A private fund as defined in section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–2(a));

(5) An employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002); and

(6) A person predominantly engaged in activities that are in the business of banking or financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843k).

(b) *Exclusion for centralized hedging facilities.* (1) *General.* Notwithstanding paragraph (a) of this section, for purposes of this section the term *financial entity* shall not encompass a person that would be a financial entity solely as a result of the person's activities that facilitate hedging and/or treasury functions on behalf of one or more majority-owned affiliates that themselves do not constitute a financial entity.

(2) *Meaning of majority-owned.* For these purposes the counterparties to a security-based swap are majority-owned affiliates if one counterparty directly or indirectly owns a majority interest in the other, or if a third party directly or indirectly owns a majority interest in both counterparties to the security-based swap, where ''majority interest'' includes, but is not limited to, the right to vote or direct the vote of a majority of a class of voting securities of an entity, the power to sell or direct the sale of a majority of a class of voting securities of an entity, or the right to receive upon dissolution or the contribution of a majority of the capital of a partnership.

§ 240.3a67–7 Definition of ''highly leveraged.''

(a) *General.* For purposes of section 3(a)(67) of the Act, 15 U.S.C. 78c(a)(67), and § 240.3a67–1, the term *highly leveraged* means the existence of a ratio of an entity's total liabilities to equity in excess of 12 to 1 as measured at the close of business on the last business day of the applicable fiscal quarter.

(b) *Measurement of liabilities and equity.* For purposes of this section, liabilities and equity generally should each be determined in accordance with U.S. generally accepted accounting principles; provided, however, that a person that is an employee benefit plan, as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002), may, for purposes of this paragraph (b):

(1) Exclude obligations to pay benefits to plan participants from the calculation of liabilities; and

(2) Substitute the total value of plan assets for equity.

§ 240.3a67–8 Timing requirements, reevaluation period, and termination of status.

(a) *Timing requirements.* A person that is not registered as a major security-based swap participant, but that meets the criteria in § 240.3a67–1 to be a major security-based swap participant as a result of its security-based swap activities in a fiscal quarter, will not be deemed to be a major security-based swap participant until the earlier of the date on which it submits a complete application for registration pursuant to section 15F of the Act (15 U.S.C. 78o–10) or two months after the end of that quarter.

(b) *Reevaluation period.* Notwithstanding paragraph (a) of this section, if a person that is not registered as a major security-based swap participant meets the criteria in § 240.3a67–1 to be a major security-based swap participant in a fiscal quarter, but does not exceed any applicable threshold by more than twenty percent in that quarter:

(1) That person will not immediately be deemed a major security-based swap participant pursuant to the timing requirements specified in paragraph (a) of this section; but

(2) That person will be deemed a major security-based swap participant pursuant to the timing requirements specified in paragraph (a) of this section at the end of the next fiscal quarter if the person exceeds any of the applicable daily average thresholds in that next fiscal quarter.

(c) *Termination of status.* A person that is deemed to be a major security-based swap participant shall continue to be deemed a major security-based swap participant until such time that its security-based swap activities do not exceed any of the daily average thresholds set forth within § 240.3a67–

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

§ 240.3a67–9 Calculation of major participant status by certain persons.

A person shall not be deemed to be a major security-based swap participant, regardless of whether the criteria in § 240.3a67–1 otherwise would cause the person to be a major security-based swap participant, provided the person meets the conditions set forth in paragraph (a) of this section.

(a) *Conditions.* (1) *Caps on uncollateralized exposure and notional positions.* (i) *Maximum potential uncollateralized exposure.* The express terms of the person's agreements or arrangements relating to security-based swaps with its counterparties at no time would permit the person to maintain a total uncollateralized exposure of more than $100 million to all such counterparties, including any exposure that may result from thresholds or minimum transfer amounts established by credit support annexes or similar arrangements; and

(ii) *Maximum notional amount of security-based swap positions.* The person does not maintain security-based swap positions in an effective notional amount of more than $2 billion in any major category of security-based swaps, or more than $4 billion in aggregate; or

(2) *Caps on uncollateralized exposure plus monthly calculation.* (i) *Maximum potential uncollateralized exposure.* The express terms of the person's agreements or arrangements relating to security-based swaps with its counterparties at no time would permit the person to maintain a total uncollateralized exposure of more than $200 million to all such counterparties (with regard to security-based swaps and any other instruments by which the person may have exposure to those counterparties), including any exposure that may result from thresholds or minimum transfer amounts established by credit support annexes or similar arrangements; and

(ii) *Calculation of positions.* (A) At the end of each month, the person performs the calculations prescribed by §§ 240.3a67–3 and 240.3a67–5 with regard to whether the aggregate uncollateralized outward exposure plus aggregate potential outward exposure as of that day constitute a substantial position in a major category of security-based swaps, or pose substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; these calculations shall disregard provisions of those rules that provide for the analyses to be determined based on a daily average over a calendar quarter; and

(B) Each such analysis produces thresholds of no more than:

(*1*) $1 billion in aggregate uncollateralized outward exposure plus aggregate potential outward exposure in any major category of security-based swaps; if the person is subject to § 240.3a67–3(a)(2)(iii), by virtue of being a highly leveraged financial entity that is not subject to capital requirements established by an appropriate Federal banking agency, this analysis shall account for all of the person's security-based swap positions in that major category (without excluding hedging positions), otherwise this analysis shall exclude the same hedging and related positions that are excluded from consideration pursuant to § 240.3a67–3(a)(2)(i); or

(*2*) $2 billion in aggregate uncollateralized outward exposure plus aggregate potential outward exposure (without any positions excluded from the analysis) with regard to all of the person's security-based swap positions.

(3) *Calculations based on certain information.* (i) At the end of each month:

(A)(*1*) The person's aggregate uncollateralized outward exposure with respect to its security-based swap positions is less than $500 million with respect to each of the major security-based swap categories; and

(*2*) The sum of the amount calculated under paragraph (a)(3)(i)(A)(*1*) of this section with respect to each major security-based swap category and the total notional principal amount of the person's security-based swap positions in each such major security-based swap category, adjusted by the multipliers set forth in § 240.3a67–3(c)(2)(i)(A) on a position-by-position basis reflecting the type of security-based swap, is less than $1 billion with respect to each of the major security-based swap categories; or

(B)(*1*) The person's aggregate uncollateralized outward exposure with respect to its security-based swap positions across all major security-based swap categories is less than $500 million; and

(*2*) The sum of the amount calculated under paragraph (a)(3)(i)(B)(*1*) of this section and the product of the total effective notional principal amount of the person's security-based swap positions in all major security-based swap categories multiplied by 0.10 is less than $1 billion.

(ii) For purposes of the calculations set forth in paragraph (a)(3)(i) of this section:

(A) The person's aggregate uncollateralized outward exposure for positions held with security-based swap dealers shall be equal to such exposure reported on the most recent reports of such exposure received from such security-based swap dealers; and

(B) The person's aggregate uncollateralized outward exposure for positions that are not reflected in any report of exposure from a security-based swap dealer (including all security-based swap positions it holds with persons other than security-based swap dealers) shall be calculated in accordance with § 240.3a67–3(b)(2).

(b) For purposes of the calculations set forth by this section, the person shall use the effective notional amount of a position rather than the stated notional amount of the position if the stated notional amount is leveraged or enhanced by the structure of the position.

(c) No presumption shall arise that a person is required to perform the calculations needed to determine if it is a major security-based swap participant, solely by reason that the person does not meet the conditions specified in paragraph (a) of this section.

§ 240.3a71–1 Definition of "security-based swap dealer."

(a) *General.* The term *security-based swap dealer* in general means any person who:

(1) Holds itself out as a dealer in security-based swaps;

(2) Makes a market in security-based swaps;

(3) Regularly enters into security-based swaps with counterparties as an ordinary course of business for its own account; or

(4) Engages in any activity causing it to be commonly known in the trade as a dealer or market maker in security-based swaps.

(b) *Exception.* The term *security-based swap dealer* does not include a person that enters into security-based swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of regular business.

(c) *Scope of designation.* A person that is a security-based swap dealer in general shall be deemed to be a security-based swap dealer with respect to each security-based swap it enters into, regardless of the type, class, or category of the security-based swap or the person's activities in connection with the security-based swap, unless the Commission limits the person's

designation as a security-based swap dealer to specified types, classes, or categories of security-based swaps or specified activities of the person in connection with security-based swaps.

(d) *Inter-affiliate activities.* (1) *General.* In determining whether a person is a security-based swap dealer, that person's security-based swaps with majority-owned affiliates shall not be considered.

(2) *Meaning of majority-owned.* For these purposes the counterparties to a security-based swap are majority-owned affiliates if one counterparty directly or indirectly owns a majority interest in the other, or if a third party directly or indirectly owns a majority interest in both counterparties to the security-based swap, where ''majority interest'' is the right to vote or direct the vote of a majority of a class of voting securities of an entity, the power to sell or direct the sale of a majority of a class of voting securities of an entity, or the right to receive upon dissolution or the contribution of a majority of the capital of a partnership.

§ 240.3a71–2 De minimis exception.

(a) *Requirements.* For purposes of section 3(a)(71) of the Act (15 U.S.C. 78c(a)(71)) and § 240.3a71–1, a person that is not currently registered as a security-based swap dealer shall be deemed not to be a security-based swap dealer, and, therefore, shall not be subject to section 15F of the Act (15 U.S.C. 78o–10) and the rules, regulations and interpretations issued thereunder, as a result of security-based swap dealing activity that meets the following conditions:

(1) *Notional thresholds.* The security-based swap positions connected with the dealing activity in which the person—or any other entity controlling, controlled by or under common control with the person—engages over the course of the immediately preceding 12 months (or following the effective date of final rules implementing section 3(a)(68) of the Act (15 U.S.C. 78c(a)(68)) if that period is less than 12 months) have:

(i) An aggregate gross notional amount of no more than $3 billion, subject to a phase-in level of an aggregate gross notional amount of no more than $8 billion applied in accordance with paragraph (a)(2)(i) of this section, with regard to credit default swaps that constitute security-based swaps;

(ii) An aggregate gross notional amount of no more than $150 million, subject to a phase-in level of an aggregate gross notional amount of no more than $400 million applied in accordance with paragraph (a)(2)(i) of this section, with regard to security-based swaps not described in paragraph (a)(1)(i) of this section; and

(iii) An aggregate gross notional amount of no more than $25 million with regard to all security-based swaps in which the counterparty is a special entity (as that term is defined in section 15F(h)(2)(C) of the Act (15 U.S.C. 78o–10(h)(2)(C)).

(2) *Phase-in procedure.* (i) *Phase-in period.* For purposes of paragraphs (a)(1)(i) and (ii) of this section, a person that engages in security-based swap dealing activity that does not exceed either of the phase-in levels set forth in paragraphs (a)(1)(i) and (ii) of this section, as applicable, shall be deemed not to be a security-based swap dealer, and, therefore, shall not be subject to Section 15F of the Act (15 U.S.C. 78o–10) and the rules, regulations and interpretations issued thereunder, as a result of its security-based swap dealing activity, until the ''phase-in termination date'' established as provided in paragraph (a)(2)(ii) of this section; provided, however, that this phase-in period shall not be available to the extent that a person engages in security-based swap dealing activity with counterparties that are natural persons, other than natural persons who qualify as eligible contract participants by virtue of section 1a(18)(A)(xi)(II) of the Commodity Exchange Act, (7 U.S.C. 1a(18)(A)(xi)(II)). The Commission shall announce the phase-in termination date on the Commission Web site and publish such date in the **Federal Register**.

(ii) *Establishment of phase-in termination date.* (A) Nine months after the publication of the staff report described in Appendix A of this section, and after giving due consideration to that report and any associated public comment, the Commission may either:

(*1*) Terminate the phase-in period set forth in paragraph (a)(2)(i) of this section, in which case the phase-in termination date shall be established by the Commission by order published in the **Federal Register**; or

(*2*) Determine that it is necessary or appropriate in the public interest to propose through rulemaking an alternative to the $3 billion and $150 million amounts set forth in paragraphs (a)(1)(i) and (ii) of this section, as applicable, that would constitute a *de minimis* quantity of security-based swap dealing in connection with transactions with or on behalf of customers within the meaning of section 3(a)(71)(D) of the Act, (15 U.S.C. 78c(a)(71)(D)), in which case the Commission shall by order published in the **Federal Register** provide notice of such determination to propose through rulemaking an alternative, which order shall also establish the phase-in termination date.

(B) If the phase-in termination date has not been previously established pursuant to paragraph (a)(2)(ii)(A) of this section, then in any event the phase-in termination date shall occur five years after the data collection initiation date defined in paragraph (a)(2)(iii) of this section.

(iii) *Data collection initiation date.* The term ''*data collection initiation date*'' shall mean the date that is the later of: the last compliance date for the registration and regulatory requirements for security-based swap dealers and major security-based swap participants under Section 15F of the Act (15 U.S.C. 78o–10); or the first date on which compliance with the trade-by-trade reporting rules for credit-related and equity-related security-based swaps to a registered security-based swap data repository is required. The Commission shall announce the data collection initiation date on the Commission Web site and publish such date in the **Federal Register**.

(3) *Use of effective notional amounts.* For purposes of paragraph (a)(1) of this section, if the stated notional amount of a security-based swap is leveraged or enhanced by the structure of the security-based swap, the calculation shall be based on the effective notional amount of the security-based swap rather than on the stated notional amount.

(b) *Registration period for persons that no longer can take advantage of the exception.* A person that has not registered as a security-based swap dealer by virtue of satisfying the requirements of paragraph (a) of this section, but that no longer can take advantage of the *de minimis* exception provided for in paragraph (a) of this section, will be deemed not to be a security-based swap dealer under section 3(a)(71) of the Act (15 U.S.C. 78c(a)(71)) and subject to the requirements of section 15F of the Act (15 U.S.C. 78o–10) and the rules, regulations and interpretations issued thereunder until the earlier of the date on which it submits a complete application for registration pursuant to section 15F(b) (15 U.S.C. 78o–10(b)) or two months after the end of the month in which that person becomes no longer able to take advantage of the exception.

(c) *Applicability to registered security-based swap dealers.* A person who currently is registered as a security-based swap dealer may apply to withdraw that registration, while continuing to engage in security-based swap dealing activity in reliance on this

section, so long as that person has been registered as a security-based swap dealer for at least 12 months and satisfies the conditions of paragraph (a) of this section.

(d) *Future adjustments to scope of the de minimis exception.* The Commission may by rule or regulation change the requirements of the *de minimis* exception described in paragraphs (a) through (c) of this section.

(e) *Voluntary registration.* Notwithstanding paragraph (a) of this section, a person that chooses to register with the Commission as a security-based swap dealer shall be deemed to be a security-based swap dealer, and, therefore, shall be subject to Section 15F of the Act (15 U.S.C 78o–10) and the rules, regulations and interpretations issued thereunder.

§ 240.3a71–2A Report regarding the ''security-based swap dealer'' and ''major security-based swap participant'' definitions (Appendix A to 17 CFR 240.3a71–2).

Appendix A to § 240.3a71–2 sets forth guidelines applicable to a report that the Commission has directed its staff to make in connection with the rules and interpretations further defining the Act's definitions of the terms ''security-based swap dealer'' (including the *de minimis* exception to that definition) and ''major security-based swap participant.'' The Commission intends to consider this report in reviewing the effect and application of these rules based on the evolution of the security-based swap market following the implementation of the registration and regulatory requirements of Section 15F of the Act (15 U.S.C. 78o–10). The report may also be informative as to potential changes to the rules further defining those terms. In producing this report, the staff shall consider security-based swap data collected by the Commission pursuant to other Title VII rules, as well as any other applicable information as the staff may determine to be appropriate for its analysis.

(a) *Report topics.* As appropriate, based on the availability of data and information, the report should address the following topics:

(1) *De minimis exception.* In connection with the *de minimis* exception to the definition of ''security-based swap dealer,'' the report generally should assess whether any of the *de minimis* thresholds set forth in paragraph (a)(1) of § 240.3a71–2 should be increased or decreased;

(2) *General security-based swap dealer analysis.* In connection with the definition of ''security-based swap dealer,'' the report generally should consider the factors that are useful for identifying security-based swap dealing activity, including the application of the dealer-trader distinction for that purpose, and the potential use of more objective tests or safe harbors as part of the analysis;

(3) *General major security-based swap participant analysis.* In connection with the definition of ''major security-based swap participant,'' the report generally should consider the tests used to identify the presence of a ''substantial position'' in a major category of security-based swaps, and the tests used to identify persons whose security-based swap positions create ''substantial counterparty exposure,'' including the potential use of alternative tests or thresholds;

(4) *Commercial risk hedging exclusion.* In connection with the definition of ''major security-based swap participant,'' the report generally should consider the definition of ''hedging or mitigating commercial risk,'' including whether that latter definition inappropriately permits certain positions to be excluded from the ''substantial position'' analysis, and whether the continued availability of the exclusion for such hedging positions should be conditioned on a person assessing and documenting the hedging effectiveness of those positions;

(5) *Highly leveraged financial entities.* In connection with the definition of ''major security-based swap participant,'' the report generally should consider the definition of ''highly leveraged,'' including whether alternative approaches should be used to identify highly leveraged financial entities;

(6) *Inter-affiliate exclusions.* In connection with the definitions of ''security-based swap dealer'' and ''major security-based swap participant,'' the report generally should consider the impact of rule provisions excluding inter-affiliate transactions from the relevant analyses, and should assess potential alternative approaches for such exclusions; and

(7) *Other topics.* Any other analysis of security-based swap data and information the Commission or the staff deem relevant to this rule.

(b) *Timing of report.* The report shall be completed no later than three years following the data collection initiation date, established pursuant to § 240.3a71–2(a)(2)(iii).

(c) *Public comment on the report.* Following completion of the report, the report shall be published in the **Federal Register** for public comment.

Dated: April 27, 2012.

By the Commodity Futures Trading Commission.

David A. Stawick,

Secretary.

Dated: April 27, 2012.

By the Securities and Exchange Commission.

Elizabeth M. Murphy,

Secretary.

Note: The following appendices will not appear in the Code of Federal Regulations:

Appendices by the Commodity Futures Trading Commission to Joint Final Rule Entitled ''Further Definition of 'Swap Dealer,' 'Security-Based Swap Dealer,' 'Major Swap Participant,' 'Major Security-Based Swap Participant' and 'Eligible Contract Participant.' ''—Commission Voting Summary and Statements of Commissioners

Appendix 1—Commodity Futures Trading Commission Voting Summary

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

Appendix 2—Statement of Chairman Gensler

I support the final rule to further define entities, which is pivotal to lowering risk that swap dealers may pose to the rest of the economy. The entities rule fulfills Congress' direction to further define the terms ''swap dealer,'' ''major swap participant'' and ''eligible contract participant'' and appropriately addresses the many comments we received. It will provide essential direction to market participants on whether they will be required to register.

Regulating banks and other firms that deal in derivatives as swap dealers is central to financial reform. Leading up to the financial crisis, it was assumed by many that swap dealers were largely regulated. The 2008 crisis revealed the inadequacy of this approach: While banks were regulated for safety and soundness, including their lending activities, there was no comprehensive regulation of their swap dealing activity. Similarly, bank affiliates dealing in swaps, and subsidiaries of insurance and investment bank holding companies dealing in swaps, were not subject to specific regulation of their swap dealing activities under U.S. law, and thus often had ineffective or no oversight.

A prime example of this fact was AIG. AIG was a holding company with a number of regulated insurance companies, but its unregulated swaps subsidiary brought down the company and helped to nearly topple the U.S. economy.

The final rule gives market participants guidance on the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) definition of swap dealer:

- First, it does so by allowing market participants to draw on useful precedents developed by the SEC in the traditional

securities market to help distinguish between dealing and trading.

• Second, it does so by providing further clarity on the Dodd-Frank Act's term ''makes a market in swaps'' by focusing on entities that routinely seek to profit by accommodating other market participants' demand for swaps.

• Third, it does so by clarifying another key term ''regular business,'' focusing on whether a person has an identifiable swap dealing business.

• Fourth, it does so by fulfilling Congress' mandate that swaps entered into by an insured depository institution in connection with originating a loan are not to be considered dealing activity.

• Fifth, it does so by providing direction on the distinction between hedging and dealing and within this provides a specific rule for swaps that hedge price risk associated with a physical commodity.

• Sixth, it does so by clarifying that a swap between an agricultural cooperative or a cooperative financial institution and its members does not constitute dealing.

• Seventh, it does so by setting a de minimis threshold for swap dealing, as directed by Congress. The threshold is $3 billion total, across all asset classes, subject to a phase in level of $8 billion. As we proposed, the final rule would define as a swap dealer any entity with more than $25 million of dealing activity with pension funds and municipals—so-called ''special entities.''

True to congressional intent, end-users other than those genuinely making markets in swaps won't be required to register as swap dealers. The swap dealer definition benefited from the many comments from end-users who use swaps to hedge their risk.

As the swap dealing market is dominated by large entities, though, I believe that the final swap dealer definition will encompass the vast majority of swap dealing activity, as Congress had intended. For those who question the level of the de minimis, we considered the threshold in the context of an overall $300 trillion notional amount U.S. swaps market. Further, the statute defines swap dealing by referencing ''making a market in swaps'' and conducting a ''regular business'' in swaps. The $3 billion threshold in the rule represents, on average, $12 million a trading day, with the phase-in of $8 billion representing, on average, $32 million notional amount per trading day. Putting this in perspective, the interest rate swap market, transacts, on average, over $500 billion notional amount per day. As further reference, the futures markets for crude oil traded this year, on average, $65 billion of notional amount per day.

During this phase-in period the Commissions will collect and analyze data to evaluate the appropriate de minimis threshold.

Another question that has been raised is whether the swap dealer definition should appropriately be activities-based or relate to how an entity is classified. The final rule is consistent with Congressional intent that we take an activities-based approach.

Though many of these large swap dealers are financial entities, Congress anticipated that some non-banks would be registered as swap dealers. Congress provided in Dodd-Frank that capital and margin for bank swap dealers would be set by the bank regulators, but for non-bank swap dealers, by the CFTC. Instructive in this regard is the list of primary dealers on the International Swaps and Derivatives Association's (ISDA) Web site, which includes a number of non-bank dealers. The Association describes as meeting that designation an entity ''that deals in derivatives as part of its business.'' Congress closed the so-called ''Enron loophole,'' which let traders evade oversight by using electronic trading platforms. But it is important to recall that Enron was also a swap dealer. Congress did not intend to create a new type of loophole in its place.

Congress drafted the swap dealer definition recognizing the fact that some entities are involved in swap dealing activities, as well as other lines of business. Section 1a(49)(C) provides that an entity is a swap dealer only if it engages in swap dealing as ''a regular business.'' But it does not say that swap dealing must be its only regular business. Further, section 1a(49)(B) specifically provides for the regulation of a single entity as a swap dealer for one part of its business and not for the other part of its business. Given the business realities reflected in the statutory language, there is no compelling reason to think that an entities-based approach would better interpret the statute or that it would, in practice, be simpler than an approach based on what a business actually does.

The rule also further defines the term ''major swap participant.'' Relying on Congress' three-prong test, this category is clearly limited to only those entities with swaps positions that pose a risk large enough to threaten the U.S. financial system.

The further definition of the term ''eligible contract participant'' provides guidance regarding who is eligible to transact swaps off of an exchange. Based upon the many comments received, we incorporated further guidance to ensure that small businesses and real estate developers can continue to have access to swaps to hedge commercial risks. The final rule also clarifies how the eligible contract participant definition applies to certain foreign exchange transactions conducted by commodity pools.

Appendix 3—Statement of Commissioner O'Malia

In General

I respectfully dissent from the Commodity Futures Trading Commission's (the ''Commission'' or ''CFTC'') approval today of the Entities Rule,[1] which is a joint final and interim final rule with the Securities and Exchange Commission (''SEC'') under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the ''Dodd-Frank Act'').[2] I have a number of concerns with each definition in the CFTC Entities Rule. However, this dissent focuses on the ''swap dealer'' definition.

Preliminarily, in its proposal,[3] the Commission ignored basic canons of statutory construction[4] in defining ''swap dealer.''[5] Specifically, the statutory definition has four clauses, lettered (A) through (D). As discussed below, the Commission defined ''swap dealer'' as encompassed only within CEA section 1a(49)(A). Thus, the Commission advanced a definition focusing on *activities,* rather than

[1] Further Definition of ''Swap Dealer,'' ''Security-Based Swap Dealer,'' ''Major Swap Participant,'' ''Major Security-Based Swap Participant,'' and ''Eligible Contract Participant;'' Final Rule, (to be codified at 17 CFR part 1), available at [_____]. As stated below, this final rule and interim final rule is joint between the Commission and the SEC. Therefore, within this dissent, (i) the term ''Entities Rule'' refers to the entire rule, (ii) the term ''CFTC Entities Rule'' refers to only the CFTC portion of such rule, and (iii) the term ''SEC Entities Rule'' refers to the SEC portion of such rule.

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010).

[3] *See* Further Definition of ''Swap Dealer,'' ''Security-Based Swap Dealer,'' ''Major Swap Participant,'' ''Major Security-Based Swap Participant,'' and ''Eligible Contract Participant;'' Proposed Rule, 75 FR 80174 (Dec. 21, 2010) (the ''Proposal'').

[4] The canons of statutory construction are ''important rules and conventions'' that the judiciary applies to determine the meaning of statutory provisions. Congressional Research Service, Report for Congress, *Statutory Interpretation: General Principles and Recent Trends,* updated August 31, 2008 (the ''CRS Report'') (Summary). In general, it behooves agencies (such as the Commission) to adhere to such canons so that its regulations, if subject to legal challenge, would be more likely to survive judicial scrutiny. In the CFTC Entities Rule, the Commission acknowledges the importance of canons of statutory construction, since it cites to certain canons in determining the application of its ''eligible contract participant'' definition. *See* Section III(B)(4) of the CFTC Entities Rule.

[5] The statutory definition of ''swap dealer'' can be found in section 1a(49) of the Commodity Exchange Act (the ''CEA''), 7 U.S.C. 1a(49). For purposes of reference, the text of CEA section 1a(49) is as follows:

''(49) SWAP DEALER.—

''(A) IN GENERAL.—The term 'swap dealer' means any person who—

''(i) holds itself out as a dealer in swaps;

''(ii) makes a market in swaps;

''(iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or

''(iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps, provided however, in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer.

''(B) INCLUSION.—A person may be designated as a swap dealer for a single type or single class or category of swap or activities and considered not to be a swap dealer for other types, classes, or categories of swaps or activities.

''(C) EXCEPTION.—The term 'swap dealer' does not include a person that enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business.

''(D) DE MINIMIS EXCEPTION.—The Commission shall exempt from designation as a swap dealer an entity that engages in a de minimis quantity of swap dealing in connection with transactions with or on behalf of its customers.

The Commission shall promulgate regulations to establish factors with respect to the making of this determination to exempt.''

the *entities* conducting these activities.[6] The Commission then minimized the other clauses of the definition. Specifically, the Commission characterized CEA section 1a(49)(C) as an ''exception'' for certain activities. The Commission also characterized CEA section 1a(49)(B) as only authorizing ''limited designation.'' [7]

I have always disagreed with the Proposal. By focusing on the activities in CEA section 1a(49)(A), the Commission essentially used the ''swap dealer'' definition to capture commercial end-users.[8] Congress clearly precluded this result. As described below, CEA section 1a(49)(C) provides a mandatory exclusion for commercial end-users.[9] Alternatively, CEA section 1a(49)(B) permits the Commission to exercise its discretion to exclude commercial end-users, so long as the Commission articulates a rational basis for such differential treatment.[10] The Commission has many reasons for exercising its discretion, including certain statutory reasons.

Today, the Commission has erected the CFTC Entities Rule on the infirm scaffold of the Proposal. To be sure, the Commission has performed astonishing contortions to afford greater certainty to commercial end-users.[11] However, the Commission could have provided equivalent or superior certainty by properly construing CEA sections 1a(49)(C) and (B), either initially or in a re-proposal. By preserving and furthering the statutory misconstructions in the Proposal, the CFTC Entities Rule may ultimately provide illusory comfort. Therefore, I cannot support the CFTC Entities Rule.

The ''Swap Dealer'' Definition: Fundamental Misconstruction

• *CEA section 1a(49)(A): Not the Entire ''Swap Dealer'' Definition*

A statute should be read as a ''harmonious whole.'' [12] This statement is a basic canon of statutory construction.[13] The Commission has failed to follow such canon in defining ''swap dealer.''

As mentioned above, in the CFTC Entities Rule (as in the Proposal), the Commission insists that CEA section 1a(49)(A) *is* the entirety of the ''swap dealer'' definition. According to the Commission, any entity engaged in any *activity* enumerated in CEA section 1a(49)(A) is a ''swap dealer'' [14] (unless otherwise ''excepted'').[15] Specifically, the Commission states: ''The Dodd-Frank Act definitions of the term 'swap dealer' * * * focus on whether a person engages in particular types of activities involving swaps * * *.'' [16] Also, the Commission states: ''The CEA * * * [definition] in general encompass persons that engage in any of the [activities in CEA section 1a(49)(A)].'' [17] Finally, the Commission characterizes the activities in CEA section 1a(49)(A) as ''dealer activities.'' [18]

• *CEA section 1a(49)(C): Mandatory Exclusion for Entities*

CEA section 1a(49) contradicts in both its language and structure the Commission's focus on the *activities* of CEA section 1a(49)(A). Specifically, CEA section 1a(49)(C), when properly construed, sets forth a mandatory exclusion that focuses on the characteristics of an *entity,* and not exclusively on its *activities.* CEA section 1a(49)(C) states: ''The term 'swap dealer' does not include a person that enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as part of a regular business.''

First, CEA section 1a(49)(C) is as central to the ''swap dealer'' definition as CEA section 1a(49)(A). CEA section 1a(49)(C) begins with ''The term 'swap dealer' does not include * * *''. In comparison, CEA section 1a(49)(A) begins with ''The term 'swap dealer' means * * *''. Therefore, according to their plain language, CEA section 1a(49)(C) and CEA section 1a(49)(A) are equal and opposite of each other. In essence, CEA section 1a(49)(C) sets forth the *exclusion* criteria for the ''swap dealer'' definition, whereas CEA section 1a(49)(A) sets forth the *inclusion* criteria.

Second, CEA section 1a(49)(C) focuses on the characteristics of entities, and not solely on their activities. CEA section 1a(49)(C) states that ''[t]he term 'swap dealer' does not include a person that enters into swaps * * * not as part of a regular business.'' In contrast, CEA section 1a(49)(A)(iii) states that the ''swap dealer'' definition encompasses any person that ''regularly enters into swaps with counterparties as an ordinary course of business for its own account.'' If the Commission is correct in presuming that CEA section 1a(49)(A) focuses on *activities,* then the phrase ''regularly enters into swaps * * * as an ordinary course of business'' must refer to an activity. However, Congress used different words in CEA section 1a(49)(C). According to a basic canon of statutory construction, when Congress uses different words, it intends different meanings. In other words, a court should strive to give effect to every word of a statute.[19]

The Commission could have easily given effect to every word of CEA section 1a(49)(C), while according the same respect to CEA section 1a(49)(A)(iii). Juxtaposing CEA section 1a(49)(C) and CEA section 1a(49)(A)(iii), the following construction emerges: a ''person'' (*i.e.,* an entity) is not a ''swap dealer'' if it enters into swaps for ''its own account'' (*i.e.,* as principal) in the ''ordinary course of business'' (*i.e.,* normally while conducting business), provided that entering into these swaps is not its ''regular business'' (*i.e.,* entering into swaps is ancillary to its core business).[20]

[6] *See* Proposed Rule; 75 FR at 80175, 80179 (stating that ''The Dodd-Frank Act defines the terms 'swap dealer' * * * in terms of whether a person engages in certain types of activities involving swaps or security-based swaps * * * Based on the plain meaning of the statutory definition, so long as a person engages in dealing activity that is not *de minimis,* as discussed below, the person is a swap dealer * * *'').

[7] The following example illustrates the difference between (i) an ''exception'' and (ii) an ''exclusion.'' Imagine a circle entitled ''swap dealer.'' ''Exceptions'' are circles within the ''swap dealer'' circle. In essence, entities within those circles are subcategories of ''swap dealer'' permitted special treatment. ''Exclusions'' are circles entirely separate from the ''swap dealer'' circle. In essence, entities within those circles are not ''swap dealers'' in the first instance. As described below, CEA section 1a(49)(C), 7 U.S.C. 1a(49)(C), provides a mandatory ''exclusion'' from the ''swap dealer'' definition for—at a minimum—non-financial entities that do not have ''a regular business'' of entering into swap transactions. To be clear, this ''exclusion'' applies to *entities,* and not solely to their *activities.* Similarly, CEA section 1a(49)(B), 7 U.S.C. 1a(49)(B), provides a discretionary ''exclusion'' from the ''swap dealer'' definition (rather than just ''limited designation,'' as the Commission contends).

[8] *See, e.g.,* Opening Statement, Sixth Series of Proposed Rulemakings under the Dodd-Frank Act, Dec. 1, 2010, available at *http://www.cftc.gov/PressRoom/SpeechesTestimony/omaliastatement120110*; and Jobs on Main Street vs. Wall Street: The Choice Should be Clear, 2011 Futures Industry Association Energy Forum, New York, Keynote Address, Sept. 14, 2011, available at *http://www.cftc.gov/PressRoom/SpeechesTestimony/opaomalia-8.*

[9] *See supra* note 5 for the exact text of CEA section 1a(49)(C), 7 U.S.C. 1a(49)(C). *See also supra* note 7 for an explanation of the difference between (i) an ''exception'' and (ii) an ''exclusion.'' The collapse of CEA section 1a(49)(C) (referencing ''a regular business'') into CEA section 1a(49)(A)(iii), 7 U.S.C. 1a(49)(A)(iii) (referencing ''an ordinary course of business''), illustrates that the Commission still considers entities within CEA section 1a(49)(C) as subcategories of ''swap dealers,'' absent Commission largesse.

[10] *Id.* for the exact text of CEA section 1a(49)(B), 7 U.S.C. 1a(49)(B).

[11] In the CFTC Entities Rule, the Commission departs from the Proposal in the following ways, among others: (i) acknowledging that there is a difference between dealing, trading, and hedging; (ii) setting forth an explicit exception for swaps that an entity enters into in its capacity as a floor trader (as defined in CEA section 1a(23), 7 U.S.C. 1a(23)); (iii) providing another explicit exception for certain hedging activities; (iv) providing an exception for swaps between majority-owned affiliates; and (iv) setting forth a phase-in period with a higher *de minimis* threshold.

[12] *See, e.g.,* the CRS Report, p. CRS–2.

[13] *Id.*

[14] As mentioned above, CEA section 1a(49)(A), 7 U.S.C. 1a(49)(A), states that the term ''swap dealer'' means ''any person who—(i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.''

[15] *See supra* note 9.

[16] Section II of the CFTC Entities Rule.

[17] *Id.*

[18] *Id.*

[19] The CRS Report, p. CRS–14 (stating that ''A basic principle of statutory construction is that courts should 'give effect, if possible to every clause and word of a statute, avoiding, if it may be, any construction which implies that the legislature was ignorant of the meaning of the language it employed.'' (quoting *Montclair* v. *Ramsdell,* 107 U.S. 147, 152 (1883)). *See also* the CRS Report, CRS–12, footnote 62 (discussing the ''modern variant'' of this canon).

[20] As mentioned below, certain financial entities may also satisfy these criteria, such as ''special entities'' (as defined in CEA section 4s(h)(2)(C), 7 U.S.C. 6s(h)(2)(C) (*e.g.,* certain employee benefit plans covered by the Employee Retirement Income Security Act of 1974 (''ERISA'')). If the Commission wanted to prevent other financial entities from abusing CEA section 1a(49)(C), 7 U.S.C. 1a(49)(C), the Commission could have preliminarily limited

Continued

If the Commission had adopted this construction, the Commission would have *per se* excluded commercial end-users. Such exclusion would have permitted these entities to freely hedge their business risks, whether financial or physical, without fear of becoming a ''swap dealer.'' Just to provide some context, commercial end-users include Caterpillar, John Deere, and ConAgra Foods. These entities have ''a regular business'' of supplying energy, food, and other tangible products to America. To these entities, swaps are ancillary tools that they can use to manage risk. These entities suffered from—rather than perpetrated—the 2008 financial crisis. Yet, these entities (either individually or through trade associations) took the time to draft and submit comment letters to the Commission—sometimes multiple letters—because they were afraid of being defined as ''swap dealers.''

If the Commission had any doubt regarding the above construction, the Commission could have referred to various letters from members of Congress. Such letters explicitly state that Congress intended to exclude commercial end-users. For example, former Chairman Christopher Dodd and Chairwoman Blanche Lincoln circulated a joint letter stating: ''Congress does not intend to regulate end-users as Major Swap Participants or Swap Dealers just because they use swaps to hedge or manage the commercial risks associated with their business.'' [21] Both senators Dodd and Lincoln were instrumental in shaping the legislation that became the Dodd-Frank Act.

Recently, Chairwoman Debbie Stabenow and Chairman Frank Lucas reiterated this point: [I]t is important for the Commission to finalize the swap dealer definition in a manner that is not overly broad, and that will not impose significant new regulations on entities that Congress did not intend to be regulated as swap dealers. The Commission's final rulemaking further defining 'swap dealing' should clearly distinguish swap activities that end-users engage in to hedge or mitigate the commercial risks associated with their businesses, including swaps entered into by end-users to hedge physical commodity price risk, from swap dealing.[22]

It is important to note that Chairwoman Stabenow and Chairman Lucas lead the Congressional committees charged with overseeing the Commission.

○ *CEA section 1a(49)(B): Discretionary Exclusion for Entities*

In the alternative (assuming that the Commission rejects the above construction), CEA section 1a(49)(B) also contradicts the Commission's focus on the activities in CEA section 1a(49)(A). Specifically, CEA section 1a(49)(B), when properly construed, sets forth a permissive exclusion focused on *entities,* with respect to either their *activities* or their *swaps.* CEA section 1a(49)(B) states: ''A person may be designated as a swap dealer for a single type or single class or category of swap or activities and considered not to be a swap dealer for other types, classes, or categories of swaps or activities.''

First, CEA section 1a(49)(B) references ''[a] person.'' CEA section 1a(38) [23] defines ''person'' as ''import[ing] the plural or singular.'' Read together, the sections indicate that CEA section 1a(49)(B) focuses on either (i) an entity or (ii) multiple entities.

Second, CEA section 1a(49)(B) states that ''[a] person'' (or ''persons'') could be ''considered not to be'' a ''swap dealer'' for ''types, classes, or categories of swaps.'' So, an *entity* could be excluded from the ''swap dealer'' definition with respect to, *e.g.,* physical commodity swaps, regardless of its *activity* with respect to such swaps. That indicates that the ''swap dealer'' definition does not solely focus on activity, as the Commission maintains. Instead, the characteristics of the entity and the underlying swaps are also relevant.

Third, CEA section 1a(49)(B) states that ''[a] person'' (or ''persons'') could be ''considered not to be'' a ''swap dealer'' for certain ''activities.'' So, even if an entity engages in ''activities'' in CEA section 1a(49)(A), that entity may nevertheless not be a ''swap dealer.'' That indicates that the ''swap dealer'' definition may not even predominantly focus on activity.

Finally, CEA section 1a(49)(B) permits the Commission to include one ''person'' (or a group of ''persons'') engaging in certain activities in the ''swap dealer'' definition, but to exclude another ''person'' (or group of ''persons'') engaging in the same activities. Of course, the Commission has to articulate a rational basis for differential treatment. As discussed below, there may be certain statutory bases for differentiation (including the reference to ''financial entity'' in the end-user exception). Nothing in CEA section 1a(49)(B) prevents the Commission from so differentiating through rulemaking (rather than individual determinations).

○ *Unnecessary Statutory Contortions*

Instead of following the canons of statutory construction and properly interpreting CEA section 1a(49)(C) and CEA section 1a(49)(B), the Commission engages in a series of contortions with seemingly opposing purposes. Upon review, these contortions appear to stem from a desire of the Commission to provide a measure of certainty to commercial end-users in the CFTC Entities Rule, without explicitly contradicting the Proposal.

Preliminarily, the Commission appears to broadly define ''swap dealer'' to capture commercial end-users. For example, both the Proposal and the CFTC Entities Rule obfuscate the application of CEA section 1a(49)(C) to *entities* (rather than solely to *activities*) by collapsing CEA section 1a(49)(C) into CEA section 1a(49)(A)(iii).[24] In

the exclusion to commercial end-users (or other entities that the Commission determines could be excluded based on a holistic reading of the Dodd-Frank Act and the CEA, including small financial institutions as delineated in CEA section 2(h)(7)(C), 7 U.S.C. 2(h)(7)(C)). Additionally, if the Commission wanted to prevent commercial end-users (or such other entities) from abusing CEA section 1a(49)(C) (by, *e.g.,* entering into non-ancillary transactions in swaps), the Commission has anti-evasion authority under section 721(c) of the Dodd-Frank Act.

The regulations that the Commission promulgates under the Dodd-Frank Act will irrevocably change the structure of the swap markets. Such changes have benefits and costs. To properly weigh the benefits and costs of its regulations under CEA section 15(a), 7 U.S.C. 19(a), it would have behooved the Commission to have discussed (i) categorically excluding certain entities from the ''swap dealer'' definition within the phase-in period, and (ii) exercising anti-evasion authority, if the Commission found it necessary based on its surveillance of the swaps market.

[21] Letter from Chairman Christopher Dodd, Committee on Banking, Housing, and Urban Affairs, United States Senate, and Chairman Blanche Lincoln, Committee on Agriculture, Nutrition, and Forestry, United States Senate, to Chairman Barney Frank, Financial Services Committee, United States House of Representatives, and Chairman Collin Peterson, Committee on Agriculture, United States House of Representatives (June 30, 2010) (the ''Dodd-Lincoln Letter'').

The Dodd-Lincoln Letter (as well as the Stabenow-Lucas Letter (as defined below)) appears to have embraced a broader conception of ''commercial risk'' than the Commission. *See infra* note 42.

[22] Letter from Chairwoman Debbie Stabenow, Committee on Agriculture, Nutrition, and Forestry, United States Senate, and Chairman Frank D. Lucas, Committee on Agriculture, United States House of Representatives to Chairman Gary Gensler, United States Commodity Futures Trading Commission (March 29, 2012) (the ''Stabenow-Lucas Letter'').

[23] 7 U.S.C. 1a(38).

[24] In Section II(A)(4)(d) of CFTC Entities Rule, the Commission states: ''We recognize, as noted by one commenter (*see* letter from ISDA I), that the 'regular business' exclusion is not limited solely to the 'ordinary course of business' test of the swap dealer definition. Our interpretations of the other three tests are, and should be read to be, consistent with the exclusion of activities that are not part of a regular business.''

Preliminarily, I would note that more than one commenter observed the collapse.

Secondarily, as noted above, CEA section 1a(49)(C), 7 U.S.C. 1a(49)(C), applies to *entities* (and not solely to *activities*). Therefore, the Commission does not (and really cannot) argue that the collapse of CEA section 1a(49)(C) into CEA section 1a(49)(A)(iii), 7 U.S.C. 1a(49)(A)(iii), has little to no impact on its construction of CEA sections 1a(49)(A)(i), (ii), and (iv), 7 U.S.C. 1a(49)(A)(i), (ii), and (iv).

Finally, although it is ambiguous in the CFTC Entities Rule (and not contemplated in the Proposal), it seems like the Commission may be indirectly relying on its reference to the dealer-trader distinction to justify its collapse of CEA section 1a(49)(C) and 1a(49)(A)(iii). Interestingly, the SEC does not state that ''regular business'' in Exchange Act section 3(a)(71)(C), 15 U.S.C. 78c(a)(71)(C)) (parallel to CEA section 1a(49)(C)), is ''synonymous'' with ''ordinary course of business'' in Exchange Act section 3(a)(71)(A)(iii), 15 U.S.C. 78c(a)(71)(A) (parallel to CEA section 1a(49)(A)(iii)). Of course, it may have been understood that the SEC would hew more closely to the dealer-trader distinction, as historically applicable to securities, and thus would focus on *activities* and not *entities. See* Section II(A)(3) of the Entities Rule. However, one wonders that of all the distinctions that the Commission makes or attempts to preserve between the swaps and securities-based swaps markets, the Commission does not acknowledge (i) the ''high degree of concentration'' of dealing in the securities-based swaps markets among the largest financial entities and (ii) the lack of similar concentration in the swaps markets (particularly with respect to markets that commercial end-users frequent, such as the physical commodity swaps markets). *Compare generally* Section II(D)(5) of the SEC Entities Rule (which repeatedly references ''high degree of concentration'') with Section II(D)(4) of the CFTC Entities Rule (which does not contain such references). *See also* Section II(A)(2)(e)(iii) of the CFTC Entities Rule (describing comments with respect to electricity swaps). The

performing such collapse, the Commission states that it ''continue[s] to believe, as stated in the [Proposal], that the phrases 'ordinary course of business' and 'a regular business' are, for purposes of the definition of 'swap dealer' essentially synonymous.'' [25] Neither the Proposal nor the CFTC Entities Rule fully supports collapsing CEA section 1a(49)(C)—one of four clauses in the statutory ''swap dealer'' definition—into CEA section 1a(49)(A)(iii)—a subparagraph of one clause. Further, neither the Proposal nor the CFTC Entities Rule fully supports interpreting two separate phrases (*i.e.,* ''ordinary course of business'' and ''regular business'') as meaning the same thing. The Commission similarly minimizes CEA section 1a(49)(B) as providing for ''limited designation'' only, rather than an alternate source of authority for the Commission to exclude certain *entities* from the ''swap dealer'' definition.[26]

However, after appearing to broadly define ''swap dealer'', the Commission then cobbles together various measures that aim—with differing levels of success—to provide a measure of certainty to commercial end-users. The most important (and successful) of these measures is a higher *de minimis* threshold. Two other important measures are: (i) referencing the dealer-trader distinction and (ii) incorporating an explicit hedging exception.

Although these measures reflect positive policy choices, they also reflect various compromises that may ultimately diminish the certainty that they seek to provide. As mentioned above, the Commission could have provided equivalent or superior certainty by properly construing CEA sections 1a(49)(C) and (B), either initially or in a re-proposal.

○ *Reference to the Dealer-Trader Distinction*

In the CFTC Entities Rule, the Commission states that it ''believe[s] that the dealer-trader distinction—which already forms a basis for identifying which persons fall within the longstanding Exchange Act definition of 'dealer'—in general provides an appropriate framework for interpreting the statutory definition of the term 'swap dealer.'' [27] In so recognizing, the Commission departs from the Proposal.[28] I have always argued that differences exist among (i) dealing, (ii) trading, and (iii) hedging. I have also recommended that the Commission provide guidance to clearly distinguish among the three categories. Such guidance would aid market participants in determining whether to register as a ''swap dealer.'' Although the CFTC Entities Rule contains (i) an interim final hedging exception [29] and (ii) a final ''floor trader'' exclusion, [30] both provisions are limited in scope. Therefore, market participants will still need clear guidance on Commission interpretation of the dealer-trader distinction, in order to determine whether their trading or hedging transactions may cause them to be deemed ''swap dealers.''

Unfortunately, the Commission has missed its opportunity in the CFTC Entities Rule. After reading the relevant portions of the rulemaking multiple times, it is still unclear to me exactly how the Commission intends to distinguish among (i) dealing, (ii) trading (outside of the limited ''floor trader'' exclusion), and (iii) hedging (outside of the specific hedging exception, which I discuss below). For example, the Commission states: ''[t]he principles embedded within the 'dealer trader distinction' are also applicable to distinguishing dealers from non-dealers such as hedgers or investors.'' [31] I agree with this statement. The Commission also cites to more support from the SEC Entities Rule—specifically the fact that ''[t]he 'dealer-trader' nomenclature has been used for decades.'' [32] I also agree with this statement. However, the Commission then states: ''These same principles, though instructive, may be inapplicable to swaps in certain circumstances or may be applied differently in the context of dealing activities involving commodity, interest rate, or other types of swaps.'' [33] I do not know whether to agree or disagree with this statement, given its ambiguity. Thus, for all of its girth, the CFTC Entities Rule fails to answer a basic question—namely, under which circumstances would an entity be deemed a dealer (rather than a trader or hedger) with respect to specific swap transactions? [34]

The Commission appears to argue that inherent differences between the swaps markets and securities markets (other than security-based swaps) justify its selective incorporation of dealer-trader elements (which elements, in themselves, apparently vary according to unknown facts and circumstances). For example, the Commission states that an entity need not engage in two-way transactions in order to fall within the ''swap dealer'' definition. One justification that the Commission advances is that ''swaps thus far are not significantly traded on exchanges or other trading systems'' and that this ''[attribute]—along with the lack of 'buying *and* selling' language in the swap dealer definition * * *— suggest that concepts of what it means to make a market need to be construed flexibly in the contexts of the swap market.'' [35] However, in the same section of the CFTC Entities Rule, the Commission states: ''many cash market securities also are not significantly traded on those systems.'' [36] Therefore, the Commission advances a justification for selective incorporation of dealer-trader elements and then contradicts its justification in the same paragraph. Thus, even if market participants wished to understand Commission reasoning to determine whether they need to register as ''swap dealers,'' they may not be able to do so.

Finally, the Commission and the SEC appear to emphasize different dealer-trader elements. For example, the Commission tends to emphasize ''accommodating demand

Commission should have accorded greater consideration to differences in market structure before dismissing a construction of CEA section 1a(49)(C) as focusing on *entities* (and as independent of CEA section 1a(49)(A)(iii)).

[25] Section II(A)(4)(d) of the CFTC Entities Rule.

[26] The Commission characterizes CEA section 1a(49)(B), 7 U.S.C. 1a(49)(B), as ''limited designation'' based on a series of misconstructions. First, as noted above, the Commission insists that CEA section 1a(49)(A), 7 U.S.C. 1a(49)(A), *is* the entirety of the ''swap dealer'' definition. Second, the Commission then interprets CEA section 1a(49)(B) to apply to the *registration* of an entity as a ''swap dealer,'' and not to the ''swap dealer'' *definition.* Third, because CEA section 1a(49)(B) applies to registration, the Commission concludes that it would be appropriate to apply an individualized, facts-and-circumstances analysis.

In actuality, CEA section 1a(49)(B) does more than provide for ''limited designation.'' First, as discussed above, CEA section 1a(49)(A) sets forth general parameters for defining ''swap dealer.'' The entirety of the ''swap dealer'' definition *is* actually CEA sections 1a(49)(A), (B), (C), and (D), 7 U.S.C. 1a(49)(A), (B), (C), and (D). Second, CEA section 1a(49)(B) is in the *definition* of ''swap dealer.'' It is not in CEA section 4s(a), 7 U.S.C. 6s(a), which pertains to *registration* of ''swap dealers.'' Therefore, the Commission should have considered the effect of CEA section 1a(49)(B) in delineating the universe of entities that need to seek registration with the Commission, and not solely the effect of CEA section 1a(49)(B) in determining the scope of registration that the Commission would afford such entities. Third, because CEA section 1a(49)(B) relates to the *definition* and not the *registration* of ''swap dealers,'' the Commission articulates no basis for an individualized, facts-and-circumstances determination.

[27] Section II(A)(4)(a) of the CFTC Entities Rule.

[28] The Commission acknowledges such departure, but attempts to mitigate its legal effect by emphasizing that (i) the dealer-trader framework overlaps with the functional approach in the Proposal, and (ii) the Commission has changed its interpretative approach to the ''swap dealer'' definition in response to comments. *See* Section II(A)(4)(a) of the CFTC Entities Rule.

[29] As described below, this exception only applies to physical commodity swaps. Therefore, commercial end-users would not be able to rely on this exception for swaps to hedge financial risks. Moreover, small financial institutions would not be able to rely on this exception (as they most likely would be hedging financial risk), even if the Commission were to permit them to use the end-user exception. Finally, even financial entities (such as ''special entities'') may engage in ''hedging'' without ''dealing.'' The CFTC Entities Rule does not provide much clarity on how such financial entities could demonstrate that they are not ''dealing'' (other than the amorphous distinction between ''purpose'' and ''consequences'').

[30] The final ''floor trader'' exclusion has many limitations. For example, an entity cannot rely on this exclusion if it participates in a market-making program offered by a designated contract market (''DCM'') or swap execution facility. One wonders what would happen if an entity participates in a DCM market-making program for futures, and then the Commission requires such futures to be converted to swaps in a forthcoming rulemaking. *See, e. g.,* Core Principles and Other Requirements for Designated Contract Markets, 75 FR 80572 (Dec. 22, 2010).

[31] Section II(A)(4)(a) of the CFTC Entities Rule.

[32] Section II(A)(5)(a) of the SEC Entities Rule.

[33] Section II(A)(3) of the Entities Rule.

[34] For example, in Section II(A)(4)(a) of the CFTC Entities Rule, the Commission sets forth a list of indicia that are either ''particularly similar to'' or ''generally consistent with * * * the dealer-trader distinction as it will be applied to determine whether a person is a security-based swap dealer.'' However, the Commission immediately undermines any comfort that such list could provide by stating ''[t]o clarify, the activities listed in the text are indicative of acting as a swap dealer. Engaging in one or more of these activities is not a prerequisite to a person being covered by the swap dealer definition.''

[35] Section II(A)(4)(a) of the CFTC Entities Rule.

[36] *Id.*

or facilitating interest in the instrument.''[37] In contrast, the SEC tends to emphasize ''a business model that seeks to profit by providing liquidity.''[38] The Commission fails to provide a rationale for its difference in focus.[39] On its face, ''accommodating demand or facilitating interest'' seems to capture more traders and hedgers than having ''a business model that seeks to profit by providing liquidity.''

○ *Interim Final Rule on Hedging*

In the CFTC Entities Rule, the Commission has included an interim final rule excepting certain hedging transactions from the ''swap dealer'' definition (*i.e.,* Regulation 1.3(ggg)(6)(iii)).[40] I agree that hedging is not dealing. However, I find the interim final rule excessively narrow. First, the interim final rule only applies to a limited set of physical commodity hedges. I am not sure why the Commission does not wish to allow commercial end-users to hedge financial risks (*e.g.,* through interest rate swaps) without fearing that they could be deemed ''swap dealers.''[41] Permitting such hedging would be consonant with Congressional intent, as expressed in the letters from members of Congress.[42] Conversely, I am not sure why the Commission wants to encourage, *e.g.,* banking entities—like Barclays—to own physical commodities and claim the hedge exception.

Second, there are four other hedging definitions that are either (i) currently effective or (ii) the subject of a Dodd-Frank Act proposal.[43] Given the call by President Obama to simplify regulation,[44] I would have expected the Commission to refrain from proposing a fifth hedging definition, unless strictly necessary. In the CFTC Entities Rule, the Commission does not cogently explain the necessity for a fifth hedging exception. For example, the Commission spends a considerable amount of effort to differentiate the interim final rule from *bona fide hedging* in Regulations 1.3(z) and 151.5(a)(1). The Commission's rationale may be distilled into one circular sentence: the Commission believes that certain *bona fide hedging* transactions may constitute swap dealing, due to reasons that the Commission declines to fully explain.[45] Additionally, the Commission spends one paragraph attempting to differentiate between the interim final rule and the ''major swap participant'' definition (which contains a *hedging or mitigating commercial risk* exception). In that paragraph, the central argument appears to be that the ''swap dealer'' definition determines the parameters of the ''major swap participant'' definition—but not also *vice versa.*[46] Preliminarily, the Commission declines to cite where exactly the Dodd-Frank Act states that the ''swap dealer'' definition is determinative. Secondarily, even assuming that the Commission is correct in characterizing the interconnection, the Commission does not clearly explain why it thinks that those transactions (i) falling outside the interim final rule but (ii) falling within *hedging or mitigating commercial risk* are more likely to constitute swap dealing.

Finally, the Commission is silent on the manner in which the interim final rule interacts with the proposed Regulation 39.6 (detailing *hedging or mitigating commercial risk* for the end-user exception). If an entity is a ''swap dealer,'' then it cannot rely on the end-user exception to clearing.[47] Therefore, if the Commission overreaches in defining ''swap dealer,'' it may narrow the end-user exception in a way not congruent with Congressional intent.[48]

Other Provisions of the Dodd-Frank Act and the CEA: Further Misconstructions

As mentioned above, the Commission fails to properly construe the various clauses of CEA section 1a(49). As detailed in this section, the Commission also fails to consider other provisions of the CEA or the Dodd-Frank Act in determining the parameters of ''swap dealer.'' The Commission appears to assume that the ''swap dealer'' definition is determinative for all such provisions, rather than also *vice versa.* The Commission does not provide much (if any) rationale for this assumption. Removing this assumption, it becomes clear that other provisions of the CEA or the Dodd-Frank Act may suggest further limitations on ''swap dealer.''[49]

• *End-User Exemption: Who can take advantage of it?*

CEA section 2(h)(7) sets forth what is commonly known as the ''end-user clearing exception.'' As mentioned above, the ''swap dealer'' definition is crucial to determining which entities could use the end-user clearing exception. That is because CEA section 2(h)(7) only applies if one counterparty to a swap is not a ''financial entity.''[50] CEA section 2(h)(7)(C) defines

[37] *See generally* Section II(A)(4) of the CFTC Entities Rule.

[38] *See generally* Section II(A)(5) of the SEC Entities Rule.

The CFTC Entities Rule does acknowledge that seeking to profit from providing liquidity is one indicia of dealing. However, the CFTC Entities Rule limits its discussion of this indicia to CEA section 1a(49)(A)(ii), 7 U.S.C. 1a(49)(A)(ii), which emphasizes market-making. The Commission appears to rely more heavily on ''accommodating demand or facilitating interest'' (without necessarily emphasizing a ''business model that seeks to profit from providing liquidity'') in its interpretation of the remainder of CEA section 1a(49)(A), 7 U.S.C. 1a(49)(A). Therefore, a dissonance still exists between the CFTC Entities Rule and the SEC Entities Rule.

[39] *See supra* note 24. The Commission could have focused on differences in market composition. Unfortunately, such focus could have raised other issues with Commission construction of CEA section 1a(49), 7 U.S.C. 1a(49).

[40] *See* Section II(A)(4)(e) of the CFTC Entities Rule.

[41] The Commission relies on its misconstruction of the statutory ''swap dealer'' definition to justify such a narrow exclusion. In Section II(A)(4)(e) of the CFTC Entities Rule, the Commission states: ''In terms of the statutory definition of the term 'swap dealer,' the *CFTC* notes as an initial matter that there is no specific provision addressing hedging activity. Thus, the statutory definition leaves the treatment of hedging swaps to the *CFTC's* discretion; it neither precludes consideration of a swap's hedging purpose, nor does it require an absolute exclusion of all swaps used for hedging.'' As noted above, whereas CEA section 1a(49) does not specifically refer to ''hedging,'' CEA section 1a(49)(C), 7 U.S.C. 1a(49)(C), (as well as CEA section 1a(49)(B), 7 U.S.C. 1a(49)(B))—as properly construed—would have excluded commercial end-users that engage in swaps for purposes of hedging. It is interesting that the SEC did not endorse these specific sentences.

[42] As mentioned above, the Commission contorts itself in the CFTC Entities Rule to provide an interim hedging exception that applies only to physical commodity risks. This approach runs contrary to the Dodd-Lincoln Letter (as well as the Stabenow-Lucas Letter). Both letters emphasize exclusions for *entities*—such as commercial end-users—so that they could freely hedge their risks—whether financial or physical.

The Dodd-Lincoln Letter begins by referencing hedging of interest rate risk. It specifically states: ''Whether swaps are used by an airline hedging its fuel costs or a global manufacturing company hedging interest rate risk, derivatives are an important tool businesses use to manage costs and market volatility. This legislation will preserve that tool.'' Moreover, the Dodd-Lincoln Letter states: ''The end user exemption may also apply to our smaller financial entities—credit unions, community banks, and farm credit institutions.'' If such institutions could be categorized as ''swap dealers,'' then they would be prohibited from relying on the end-user exception. Such institutions would likely seek to hedge financial risk.

As mentioned above, the Stabenow-Lucas Letter states: ''The Commission's final rulemaking further defining 'swap dealing' should clearly distinguish swap activities that end-users engage in to hedge or mitigate the commercial risks associated with their businesses, *including* swaps entered into by end-users to hedge physical commodity price risk, from swap dealing.'' In using the term ''including,'' the Stabenow-Lucas Letter acknowledges that end-users may use swaps to hedge or mitigate risks—such as financial risks—other than those related to physical commodities.

By focusing only physical commodity risks, therefore, the interim hedging exception fails to fully satisfy Congressional intent.

[43] *See* Regulation 1.3(z), 17 CFR 1.3(z); (ii) Regulation 151.5(a)(1) (in Position Limits in Futures and Swaps; Final Rule, 76 FR 71626, 71688 (Nov. 18, 2011) (to be codified at 17 CFR parts 1, 150, and 151)); (iii) Regulation 1.3(hhh) (as set forth in the CFTC Entities Rule); and (iv) Regulation 39.6(c) (in End-User Exception to Mandatory Clearing of Swaps; Proposed Rule, 75 FR 80747, 80757 (Dec. 23, 2010)).

[44] *See* Exec. Order No. 13563, 76 FR 3821, Jan. 21, 2011; *see also* Exec. Order No. 13579, 76 FR 41587, July 14, 2011.

[45] In Section II(A)(4)(e) of the CFTC Entities Rule, the Commission attempts to distinguish between ''purpose'' and ''effect.'' Market participants may find such an attempt to be less than clear.

[46] Section II(A)(4)(e) of the CFTC Entities Rule (stating ''* * *The definition of the term ''major swap participant,'' which applies only to persons who are not swap dealers, is premised on the prior identification, by the swap dealer definition, of persons who accommodate demand for swaps, make a market in swaps, or otherwise engage in swap dealing activity. The major swap participant definition performs the subsequent function of identifying persons that are not swap dealers, but hold swap positions that create an especially high level of risk that could significantly impact the U.S. financial system.'').

[47] *See* CEA section 2(h)(7), 7 U.S.C. 2(h)(7). *See also supra* note 43.

[48] *See supra* note 42.

[49] As mentioned above, the Commission has authority to discretionarily exclude certain *entities* pursuant to CEA section 1a(49)(B), 7 U.S.C. 1a(49)(B).

[50] CEA section 2(h)(7)(A), 7 U.S.C. 2(h)(7)(A), states: ''In General.—The requirements of paragraph (1)(A) shall not apply to a swap if 1 of the

''financial entity'' as including a ''swap dealer.'' [51] Therefore, if the Commission defines ''swap dealer'' expansively, then the Commission will limit the number and types of end-users that may use the clearing exception.

Given the importance of the interconnections between the ''swap dealer'' definition and the end-user clearing exception, I would have expected the Commission to discuss such interconnections in great detail. Surprisingly, in that portion of the CFTC Entities Rule defining ''swap dealer,'' the Commission only discusses end-user clearing in a footnote.[52]

Footnote 213 illustrates in a particularly poignant manner the Commission's failure to properly consider the interaction between the ''swap dealer'' definition and the end-user exception. In that footnote, the Commission attempts to dismiss the argument that the ''swap dealer'' definition should only apply to financial entities. The Commission states:

Similarly, the absence of any limitation in the statutory definition of the term ''swap dealer'' to financial entities, when such limitation is included elsewhere in Title VII, indicates that no such limitation applies to the swap dealer definition. CEA section 2(h)(7), 7 U.S.C. 2(h)(7), specifically limits the application of the clearing mandate, in certain circumstances, to only ''financial entities.'' That section also provides a detailed definition of the term ''financial entity.'' *See* CEA section 2(h)(7)(C), 7 U.S.C. 2(h)(7)(C). That such a limitation is included in this section, but not in the swap dealer definition, does not support the view that the statutory definition of the term ''swap dealer'' should encompass only financial entities.

In actuality, Footnote 213 raises more questions than it answers. In Footnote 213, the Commission presumes that the interaction between the ''swap dealer'' definition and the end-user exception only goes one way—namely, that the ''swap dealer'' definition fixes the scope of the end-user exception, but not also *vice versa.* The Commission provides no basis for this presumption, especially since a basic canon of statutory is that the Commission should construe a statute as a ''harmonious whole.'' From that perspective, it becomes clear that Footnote 213 raises a series of fundamental questions. Why did Congress use the term ''financial entity'' in CEA section 2(h)(7)(C)? Does use of this term imply in any way that Congress presumed that the ''swap dealer'' definition would exclude commercial entities? Why or why not? Surely, Congress need not have specified *financial entity* in CEA section 2(h)(7)(C) if it had intended to permit the Commission to vitiate the reference to *financial* by simply defining ''swap dealers'' to include *commercial entities.* If Congress intended to so permit, then Congress could have simply used the term ''entity'' in CEA section 2(h)(7)(C).

• *Employee Benefit Plans: ''Swap Dealers?''*

In Section II(A)(2)(f) of the CFTC Entities Rule, the Commission describes comments requesting categorical exclusions from the ''swap dealer'' definition. One such comment was from American Benefits Council (''ABC'') and the Committee on the Investment of Employee Benefit Assets (''CIEBA'').[53] In their comments, ABC/CIEBA requested that the Commission exclude (or interpret CEA section 1a(49) to exclude) certain employee benefit plans from the ''swap dealer'' definition. In Section II(A)(6) of the CFTC Entities Rule, the Commission denies this request, mainly on the basis of its misguided construction of CEA section 1a(49).

In so denying, the Commission fails to consider CEA section 4s(h). Specifically, CEA sections 4s(h)(2), (4), and (5) prescribe heightened business conduct standards for ''swap dealers'' interacting with ''special entities.'' In fact, the Commission recently promulgated a final rulemaking on these standards.[54] CEA section 4s(h)(2)(C) defines ''special entity'' as, among other things, ''any employee benefit plan, as defined in section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002).'' CEA section 4s(h) raises another series of fundamental questions. Did Congress presume that employee benefit plans would not constitute ''swap dealers''? [55] Why or why not? Indeed, how does the Commission reconcile its denial of the ABC/CIEBA request with its own *de minimis* requirement, which seems to recognize a *per se* difference between a ''special entity'' and a ''swap dealer''? [56]

• *Internal Business Conduct Standards: Indication of the Scope of ''Swap Dealer?''*

In addition to failing to account for external business conduct standards, the Commission fails to account for certain internal business conduct standards in defining ''swap dealer.'' For example, CEA section 4s(j)(5) requires ''swap dealers'' to have systems and procedures to mitigate conflicts of interest resulting from interactions between (i)(A) any person engaged in ''research or analysis of the price or market for any commodity or swap'' or (B) any person ''acting in a role of providing clearing activities or making determinations as to accepting clearing customers'' and (ii) certain persons involved in ''pricing, trading, or clearing activities.'' The Commission recently promulgated a final rulemaking on this requirement.[57] CEA section 4s(j)(5) raises another fundamental question. Did Congress presume that ''swap dealers'' generally engage in either ''research or analysis'' or ''providing clearing activities or making determinations'' *and* ''pricing, trading, or clearing activities''? Why or why not?

• *Volcker: How does the CFTC Entities Rule Fit?*

As I have noted previously, the ''Volcker Rule'' [58] sets forth detailed metrics to differentiate between (i) market-making and (ii) proprietary trading. To say that the CFTC Entities Rule does not replicate such detail would be an understatement. Worse, the CFTC Entities Rule does not even attempt to explain why the metrics in the Volcker Rule are inapplicable to the ''swap dealer'' definition. In fact, the Commission addresses the interaction between the Volcker Rule and the CFTC Entities Rule only in one footnote. This footnote states in relevant part:

The Commissions have proposed an approach to the Volcker Rule under which a person could seek to avoid the Volcker Rule in connection with swap activities by asserting the availability of that market making exception * * * Under this approach, such a person would likely also be required to register as a swap dealer (unless the person is excluded from the swap dealer definition, such as by the exclusion of certain swaps entered into in connection with the origination of a loan).[59]

Of course, this footnote provides no useful clarification, since the operative question is whether an entity engaging in activities that would not be ''market-making'' under the Volcker Rule could nonetheless be engaging in ''market-making'' under the CFTC Entities Rule (and, solely by virtue of such characterization, be required to register as a ''swap dealer'').

counterparties to the swap—(i) is not a financial entity; (ii) is using swaps to hedge or mitigate commercial risk; and (iii) notifies the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations associated with entering into non-cleared swaps.''

[51] Notably, CEA section 2(h)(7)(C)(i), 7 U.S.C. 2(h)(7)(C)(i), also lists commodity pools, certain private funds, certain employee benefit plans, and certain banking and financial entities separately from ''swap dealer.'' Does this separate listing imply that those entities are not ''swap dealers''? Why or why not?

[52] The Commission discusses the end-user clearing exception more fully in that portion of the CFTC Entities Rule defining ''major swap participant.''

[53] Comment from ABC/CIEBA, dated February 22, 2011, available at: *http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27944&SearchText=American%20Benefits%20Council.*

[54] Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties; Final Rule, 77 FR 9734 (Feb. 17, 2012).

[55] *See supra* note 51.

[56] *See* Section II(D) of the Entities Rule.

[57] Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants; Final Rule, 77 FR 20128 (Apr. 3, 2012).

[58] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Covered Funds; Proposed Rule, 77 FR 8332 (Feb. 14, 2012).

[59] Section II(A)(4)(c) of the CFTC Entities Rule.

Conclusion

In the CFTC Entities Rule, the Commission has made many positive policy changes. To enable these changes, however, the Commission engages in a series of statutory contortions. Moreover, the Commission ignores a number of important questions. Witnessing these statutory gymnastics, I am reminded of the Robert Frost poem, ''The Road Not Taken.'' In its eagerness to adopt the CFTC Entities Rule, the Commission opted for one road. Specifically, the Commission opted for providing more relief to market participants, without contradicting the fundamental premises of the Proposal. However, once market participants have examined the rulemaking, will the Commission have wished that it had properly construed CEA section 1a(49) instead? Given the Proposal and the final CFTC Entities Rule (and their respective differences), the Commission may well conclude that ''* * * it took the one less traveled by * * * And that has made all the difference.'' [60]

[FR Doc. 2012–10562 Filed 5–22–12; 8:45 am]

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[60] Generally, because the vast body of administrative law provides guideposts to the road more traveled.