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Client Alert

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CFTC Issues Foundational Definitions for New OTC Derivatives Regulation

On August 13, 2012, the U.S. Commodity Futures Trading Commission ("CFTC" or "Commission") issued a joint final rulemaking in conjunction with the U.S. Securities and Exchange Commission ("SEC") further defining the term "Swap" as required under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was enacted in July 2010 in response to the 2008 financial crisis. Title VII of the Act established a new framework for the regulation of the over-the-counter ("OTC") derivatives markets. The Act requires the CFTC and SEC to establish a number of new regulations to implement the requirements of the Act, including further definitions of what constitutes a "Swap," as well as defining two new classes of market participants: Swap Dealers and Major Swap Participants. Together, these foundational definitions determine which market participants may be subject to more than 50-plus new CFTC regulations.

Definition of Swap

The definition of what constitutes a "Swap" under the Dodd-Frank Act is key to determining whether a market participant meets the definition of a Swap Dealer or Major Swap Participant, and to how the new regulatory framework and obligations should be applied. As discussed below, the level of swap activity that a market participant engages in determines how it will be treated under the new regulatory framework. The statutory definition of "Swap" is lengthy, but generally includes any agreement, contract, or transaction that is a put, call, cap, floor, collar, or similar option for the purchase or sale (or based on the value of) one or more interest rates, currencies, commodities, securities, debt instruments, indices, quantitative measures, or other kind of financial/economic interests or property. The definition does not include any contract of sale of a commodity for future delivery, authorized leverage contracts, security futures products, or any sale of a nonfinancial commodity or security for deferred shipment or delivery (so long as the transaction is intended to be physically settled).

Under the CFTC's final rule further defining the term "Swap," the Commission includes several important clarifications regarding the treatment of certain agreements, contracts and transactions. For example, products traditionally treated as insurance products generally will not be considered "Swaps;" however, financial guaranty insurance and other guarantees for any "Swap" will themselves be considered a part of the "Swap" and subject to applicable regulations.

The Commission's definition also will apply the historical regulatory exclusion for forward contracts for future delivery ("Forward Contract Exclusion") to exempt forward contracts in nonfinancial commodities that are intended to be physically settled from the definition of "Swap," and will interpret the Forward Contract Exclusion for swaps consistent with its historical interpretations regarding the exclusion for futures contracts. Further, the Commission is retaining the historical "Brent Interpretation" that permits book-outs developed in connection with the Forward Contract Exclusion, and is expanding the scope of the interpretation (which previously applied only to oil) to all nonfinancial commodities. As a result of the widening of the Brent Interpretation, the Commission is withdrawing its 1995 "Energy Exemption," which had previously extended the scope of the interpretation to energy commodities other than oil.

In the Final Rule, the CFTC interprets the term "nonfinancial commodity," with respect to the Forward Contract Exclusion from the swap definition, as a commodity that can be physically delivered and that is an exempt commodity or an agricultural commodity. Additionally, the Commission provides an interpretation that an intangible commodity, one that can be physically delivered, also qualifies as a "nonfinancial commodity" if ownership of the commodity can be conveyed in some manner and the commodity can be consumed. This interpretation permits the inclusion of environmental commodities such as emissions allowances, carbon offsets or credits, and renewable energy certificates under the Forward Contract Exclusion, provided they meet the criteria of a "nonfinancial commodity."

The CFTC declined to address the status of transactions in Regional Transmission Organizations and Independent System Operators ("RTO/ISO"), including financial transmission rights and ancillary services. The Commission states that it will consider public interest waivers for Federal Energy Regulatory Commission-regulated instruments as directed by Congress under § 722 of the Dodd-Frank Act, rather than through the Final Rule.

Finally, in order to prevent evasion of the swap definition, the Commission determined that any transaction that is willfully structured to evade the provisions of the Dodd-Frank Act governing the regulations of swaps will itself be deemed a swap. Any such transaction willfully structured to evade swap regulation (and thus considered a swap) will also be included in the determination of whether a person is deemed to be Swap Dealer or Major Swap Participant. However, these anti-evasion provisions will not apply to any agreement, contract or transaction structured as a security.

Options

The CFTC reaffirmed that commodity options are "Swaps" in its final definition, but did not provide any additional guidance or interpretation regarding commodity options, which it previously addressed by adopting a modified trade option exemption under a separate rulemaking.[1] Regarding forward contracts for nonfinancial commodities with embedded options, the Commission will rely upon its existing 1985 interpretation by its Office of General Counsel. Under that interpretation, a forward contract with an embedded option will be considered an excluded nonfinancial commodity forward contract if the embedded option(s):

1. May be used to adjust the forward contract price, but does not undermine the overall nature of the contract as a forward contract;
2. Does not target the delivery term, so that the predominant feature of the contract is actual delivery; **and**
3. Cannot be severed and marketed separately from the overall forward contract in which it is embedded.

Swap Dealers and Major Swap Participants

The Dodd-Frank Act created two new classes of market participants ("Swap Dealer" and "Major Swap Participant") and required the CFTC to issue a further definition of each term. These new classes are intended to capture market participants that engage in a high level of trading activity and pose a greater risk to the stability of the market and the U.S. financial system as a whole. As such, the determination of a person's status as a Swap Dealer or Major Swap Participant is based on the type and level of trading activity in which they engage. The CFTC, again together with the SEC, issued its final rule defining these two terms on May 23, 2012.

[1] *See Final Rule and Interim Final Rule on Commodity Options*, 77 Fed. Reg. 25,320 (Apr. 27, 2012) ("Commodity Options Rule").

The definition of “Swap Dealer” lists four ways to determine whether a person is engaging in “dealing activity.” In general, a person is a Swap Dealer if they: (i) hold themselves out as a dealer in swaps; (ii) make a market in swaps; (iii) regularly enter into swaps in the ordinary course of their business; or (iv) engage in any activity that causes the person to be commonly known as a dealer or market maker. To clarify, a person need satisfy only one of these four criteria to be designated as a Swap Dealer. However, a person may enter into swaps for their own account without being designated as a Swap Dealer. Further, the definition includes an exception from designation if a person engages in dealing activity below a *de minimis* quantity threshold of $8 billion in swaps activity initially (to be revised downward to approximately $3 billion within five years).

The Major Swap Participant definition is intended to capture market participants with a substantial position in swaps that do not otherwise meet the criteria of a Swap Dealer. Specifically, a Major Swap Participant is any person who: (i) maintains a substantial position in swaps; (ii) whose outstanding swaps create substantial counterparty exposure that could have adverse effects on U.S. financial stability; or (iii) is a financial entity that is highly leveraged and maintains a substantial position in swaps. A “substantial position” is defined as swap positions that are large enough to pose a significant risk to the U.S. financial system. In order to quantify the risks posed by a potential default, the definition implements a series of tests, or calculations, that are designed to reflect the credit risks of a person’s swap positions. Accordingly, the “substantial position” tests include both current exposure and potential future exposure, but do not include positions held for hedging or mitigating commercial risk. In order for a person to be deemed as having a “substantial position,” they must hold a daily average current uncollateralized exposure of at least $1 billion, or a daily average current uncollateralized exposure plus potential future exposure of $2 billion.

Compliance with Additional Regulations

The issuance of the “Swap” definition, preceded by the definitions of “Swap Dealer” and “Major Swap Participant,” provides the keystone for the overarching regulatory framework established by Title VII. Prior to the issuance of these definitions, the Commission finalized a number of rules governing swaps markets, including mandatory clearing and trade execution, reporting and recordkeeping obligations, internal and external business conduct standards, position limits, protections and prohibitions against market manipulation, and whistleblower protections and incentives. Should a market participant be designated as a Swap Dealer or Major Swap Participant, they will be subject to even more stringent regulation and stricter oversight.

The “Swap” definition becomes effective on October 12, 2012. Additionally, many of the previously finalized regulations mentioned above already require compliance, or will require compliance by October 12, 2012, as well. As the rules require market participants to make their own determinations as to whether their swaps activity meets the criteria of a Swap Dealer or Major Swap Participant (and register accordingly with the Commission), market participants should examine these key definitions, as well as all other applicable regulations, to determine what impacts these new rules may have on their business.

Hunton & Williams LLP attorneys are available to provide more information about the Dodd-Frank Act and the regulation of the OTC derivatives market. If you would like to receive more information, please contact **Mark W. Menezes** (202.419.2122), **Joseph B. Buonanno** (704.378.4750), or **Matthew C. Thomas** (202.955.1585).[2]

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