

CFTC Proposes Definitions for "Swap Dealer" and "Major Swap Participant"

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On December 1, the Commodity Futures Trading Commission (CFTC) voted out a proposed rulemaking to set final definitions for the key Dodd-Frank terms "Swap Dealer" and "Major Swap Participant," among others. The text of the Notice of Proposed Rulemaking (NOPR) was made available by the Commission on December 8. Entities captured by the Swap Dealer and Major Swap Participant definitions will face costly clearing and margin requirements, as well as reporting and business conduct requirements, even if they are energy companies hedging commercial risk through their trading in swaps. As proposed, the Swap Dealer definition in particular is ambiguous, subjective and appears broad enough to encompass some energy company 'end users' who actively trade swaps for the fundamental purpose of hedging commercial or commodity price risk.

While Dodd-Frank provided general definitions of Swap Dealer and Major Swap Participant, the CFTC and the Securities Exchange Commission were jointly tasked by the statute with creating more specific regulatory definitions.

Swap Dealer

Under Dodd-Frank, a Swap Dealer: (1) holds itself out as a dealer in swaps, (2) makes a market in swaps, (3) regularly enters into swaps with counterparties as an ordinary course of business for its own account, or (4) engages in activity such that it is commonly known in the trade as a dealer or market maker in swaps. The proposed rule would codify this definition in a regulation, and the Commission will use the following criteria to interpret the regulation to determine whether an entity is a Swap Dealer.

The criteria are that the entity:

- Tends to accommodate demand for swaps from other parties;
- Is generally available to enter into swaps to facilitate other parties' interest in entering into swaps;

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- Tends not to request that other parties propose the terms of swaps, but tends to enter into swaps on their own standard terms; and
 - Tends to be able to arrange customized terms for swaps upon request, or to create new types of swaps at their own initiative.

To further explain the criteria, the NOPR also sets forth a set of factors to be utilized to indicate that an entity is holding itself out as a dealer or is commonly known in the trade as a dealer. Such factors include:

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

In addition, the proposed definition of Swap Dealer would expressly exclude any person that enters into swaps for such person's own account, but not as a "part of regular business." The NOPR states that persons who enter into swaps as part of a "regular business" are those whose function is to accommodate demand for swaps from other parties and enter into swaps in response to interest expressed by other parties. It also states that persons who do not function to accommodate demand for swaps from other parties do not enter into swaps as a part of "regular business" and should not be captured by the definition of Swap Dealer.

These criteria are general and subjective in nature and the Commission has offered relatively little guidance as to how they might be utilized to identify Swap Dealers. Commissioners O'Malia and Sommers opposed the proposed rule as being overly broad and potentially improperly implicating end users of commodity swaps as Swap Dealers. Commissioner O'Malia asked CFTC staff members if there was a safe harbor end users (such as energy producers or commodity purchasers who hedge commodity risk with swaps) could rely on to avoid a Swap Dealer designation. Staff responded that there was not, but suggested that the intent of the definition is not to capture such swap counterparties.

The proposed rule does provide more clarity in relation to the initial discussion of the rule at the December 1 meeting, but still it shows significant subjectivity. For example, the NOPR text indicates that the intention of the proposed Swap Dealer definition is to focus on "persons whose function is to serve as the points of connection in [the swaps] markets." In addition, while still subjective, the "regular business" exception could be a basis for end users to show that they are not Swap Dealers.

The Commission also admits to lacking a clear understanding of physical energy markets. The NOPR text states that swaps markets related to physical commodities including oil and gas, as well as in relation to electricity generation and transmission, are highly complex and varied. Accordingly, the NOPR has specifically solicited comments regarding these markets to understand whether any

different or additional factors ought to be employed in considering how to apply the Swap Dealer definition to energy market participants.

The NOPR also proposes a *de minimis* exception for entities that would otherwise be Swap Dealers. The exemption appears quite limited. An entity would qualify for this exemption if:

- The aggregate effective notional amount, measured on a gross basis, of the swaps that the person enters into over the prior 12 months in connection with swap dealing activities must not exceed \$100 million;
- The aggregate effective notional amount of such swaps with "special entities" (as defined in CEA Section 4s (h)(2)(C) to include certain governmental and other entities) over the prior 12 months must not exceed \$25 million;
- The person must not enter into swaps as a dealer with more than 15 counterparties, other than security based swap dealers, over the prior 12 months; and
- The person must not enter into more than 20 swaps as a dealer over the prior 12 months.

Major Swap Participant

According to Chairman Gensler, the proposed definition of Major Swap Participant is intended to capture a small set of swap counterparties whose large positions pose a systemic risk to the financial system, but who are not captured by the definition of Swap Dealer. This proposed definition would exclude entities with substantial positions in swaps held for hedging or mitigating commercial risk.

Any one of the following is an Major Swap Participant according to Dodd-Frank:

- A person that maintains a "substantial position" in any of the major swap categories (rate, credit, equity or commodity), *excluding positions held for hedging or mitigating commercial risk* and positions maintained by certain employee benefit plans for hedging or mitigating risks in the operation of the plan;
- A person 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
- Any financial entity that is highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking agency and that maintains a substantial position in any of the major swap categories.

The NOPR proposes defining some of the operative terms in these criteria. For the phrase "*positions held for hedging or mitigating commercial risk*," the Commission will propose the following criteria, which if satisfied would mean that such swap positions would not be counted to render an entity a Major Swap Participant:

- Swaps that qualify as bona fide hedges under existing Commodity Exchange Act regulations;
- Swaps that qualify for hedging treatment under a certain financial accounting standard (Financial Accounting Standards Board Statement No. 133); or

- A swap position that is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where the risks arise in the ordinary course of business from:

-- a potential change in the value of (i) assets that a person owns, produces, manufactures, processes, or merchandises, (ii) liabilities that a person incurs, or (iii) services that a person provides or purchases;

-- a potential change in value related to any of the foregoing arising from foreign exchange rate movements; or

-- a fluctuation in interest, currency, or foreign exchange rate exposures arising from a person's assets or liabilities.

This proposed definition appears better developed than the Swap Dealer criteria, and as drafted it seems likely that end users of swaps utilized to hedge commercial risk could classify such positions as those "held to hedge or mitigate commercial risk" under the above criteria.

Since the categorization of a person as a Swap Dealer or Major Swap Participant has a material impact on such person's regulatory responsibilities and its very business, energy companies are well advised to heed the CFTC's request and comment on the NOPR. Comments will be due 60 days after publication in the Federal Register. Further, it appears from the definition that the universe of Major Swap Participants will be relatively small.

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