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D O D D - F R A N K

In this issue:

CLIENT ALERT: CFTC ISSUES FINAL RULE DEFINING SWAP DEALER AND RELATED ENTITIES

On April 27, the CFTC and SEC (jointly, “Commissions”) issued a final rule providing further definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant.”¹ We write to report on the key provisions of these entity definitions as they relate to your business and transactions. The CFTC applies the terms Swap Dealer and Major Swap Participant to entities that engage in certain types of swap transactions at sufficiently high volume. Anyone who qualifies as either of these designations will be subject to substantial regulatory requirements above and beyond those applicable to other participants in swap transactions, including registration, margin, capital, business conduct, and other requirements. Nevertheless, most small- and medium-sized utilities are unlikely to be categorized as Swap Dealers or Major Swap Participants under the new rules. However, the rules will still be of some concern because some of your counterparties will be. Because security-based swaps are less relevant to small- and medium-sized utilities, we omit discussion of those definitions here.

An issue of more relevance to small- and medium-sized utilities is that any entity wishing to engage in bilateral swap transactions outside a registered exchange must qualify as an Eligible Contract Participant. Those who engage in bilateral contract transactions that may be swaps should pay close attention to whether they qualify as Eligible Contract Participants.

Swap Dealer Definition

The final rule provides for a multi-factor analysis to determine whether an entity is a Swap Dealer. However, in response to comments, the Commissions made a number of modifications from the proposed rule. In particular, the Commission has proposed provisions stating that swaps entered into

¹ Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant,” 77 Fed. Reg. 30,596 (May 23, 2012), available at <http://www.gpo.gov/fdsys/pkg/FR-2012-05-23/pdf/2012-10562.pdf>.

for hedging physical positions, as defined in the rule,² are excluded from the transactions counted to determine who qualifies as a Swap Dealer.

The bottom line remains that small- and medium-sized utilities are not likely to fall within the definition of Swap Dealer. There is a substantial *de minimis* threshold – \$3 billion in annual transactions,³ – and in addition, as discussed above, the Commissions’ interim final rule provides that the determination of whether a person is a Swap Dealer will not consider swaps entered into for the purpose of hedging physical positions.⁴ However, the CFTC is seeking comments on this interim final rule, so it may change.

As a result of Dodd-Frank’s elimination of the categorical exception for energy transactions, it is quite possible that some large utility or marketer counterparties will qualify as Swap Dealers. Some counterparties will not be able to avail themselves of the high \$3 billion *de minimis* threshold because swaps with special entities such as municipal utilities are subject to a much smaller \$25 million threshold. This lower threshold may discourage some counterparties from entering into swaps with municipal utilities and other special entities.⁵ Others may qualify based on the nature of their own transactions.

Eligible Contract Participant Definition

Only a person who is an Eligible Contract Participant may enter into a swap that is not on a designated contract market (i.e. a board of trade or exchange), and you have an obligation to know the status of your counterparties. This means that your counterparties in bilateral transactions will

² See 17 C.F.R. § 1.3(ggg)(6)(iii); see also 77 Fed. Reg. at 30,611.

³ There is a much lower \$25 million threshold for transactions with special entities. This threshold may create significant difficulties and is discussed further below. “Special entity” means: (i) a Federal agency; (ii) a state, state agency, city, county, municipality, or other political subdivision of a state.” 77 Fed. Reg. at 30,630 n.424.

⁴ The interim final rule provides a multi-prong list of elements that all must be satisfied in order for a swap to qualify for the exclusion. A swap qualifies 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) [a]ssets that the person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising; (2) [l]iabilities that the person owns or anticipates incurring; or (3) [s]ervices that the person provides, purchases, or anticipates providing or purchasing; (B) [t]he 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) [t]he swap is economically appropriate to the reduction of the person’s risks in the conduct and management of a commercial enterprise; (D) [t]he swap is entered into in accordance with sound commercial practices; and (E) [t]he person does not enter into the swap in connection with activity structured to evade designation as a swap dealer.” See 17 C.F.R. § 1.3(ggg)(6)(iii). Note that this exclusion draws upon but is not identical to the language in the CFTC’s definition of *bona fide* hedging.

⁵ On July 12, a group of entities representing federal, state and municipal utilities filed a petition at the CFTC requesting a limited exception for transactions with Special Entities who are in the utility business and using the swaps to hedge the risks of their utility businesses. If approved, such transactions would not count against the \$25 million limit for counterparties of special entities.

request that you demonstrate that you are an Eligible Contract Participant before they will enter a swap transaction with you.⁶

The Dodd-Frank Act provides that a municipal government entity will be an Eligible Contract Participant if it is acting for its own account and can satisfy one of three statutory tests. Because almost all municipal utilities should be able to satisfy the first of these tests, it is the only one we discuss here. Under that test, your utility must “have a demonstrable ability, directly or through separate contractual agreement, to make or take delivery of the underlying commodity,” or incur risks, in addition to price risk, related to the commodity.⁷

For “other entities” such as cooperatives, the Dodd-Frank Act provides that you will be an Eligible Contract Participant if you are acting for your own account and can satisfy one of the following three tests:⁸

1. You have “total assets exceeding \$10,000,000”;
2. Your obligations under the agreement are guaranteed by another qualifying Eligible Contract Participant; or
3. You have a “net worth exceeding \$1,000,000” and the swap is entered into in connection with your business or to manage the risk associated with an asset or liability reasonably likely to be owned or incurred in the conduct of your business.

Although the Commissions declined to create a *per se* rule of Eligible Contract Participant status for certain categories of entities, the CFTC “currently is considering a draft petition for relief” for transactions between FPA section 201(f) entities.⁹

Major Swap Participant Definition

Under the final rule it is still unlikely that small- and medium-sized electric utilities would qualify as Major Swap Participants.

While the actual rule as implemented is quite complicated, the basic idea is that a Major Swap Participant is an entity that “maintains a substantial position in swaps for any of the major swap categories”¹⁰ or “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.”¹¹ To

⁶ Indeed, some of you may have already made representations to this effect.

⁷ 7 U.S.C. § 1a(17)(A)(i), *cross-referenced by* 7 U.S.C. § 1a(18)(A)(vii).

⁸ See 7 U.S.C. § 1a(18)(A)(v). The actual statutory test has been paraphrased and simplified.

⁹ 77 Fed. Reg. at 30,657.

¹⁰ *Id.* at 30,714. Commodity swaps such as those for energy products would all fall into the same category.

¹¹ *Id.*

simplify substantially, for commodity swaps, a “substantial position” means \$1 billion or more in uncollateralized outward exposure, and “substantial counterparty exposure” means uncollateralized exposure of \$5 billion or more.¹² However, swaps held for the purpose of hedging or mitigating commercial risk are excluded from calculating whether an entity has a “substantial position” in swaps, and the final rule clarifies that this exclusion is available to non-profit or governmental entities, if the underlying activity to which the swap relates is commercial in nature.

Because calculating the required exposures described above may be quite burdensome, the final rule also includes a “safe harbor” under which an entity will not be deemed to be a Major Swap Participant. There are a few different ways to demonstrate that you qualify for the safe harbor, but the simplest requires you to demonstrate that the express terms of your agreements relating to swaps with your counterparties at no time would permit you to maintain a total uncollateralized exposure of more than \$100 million to all such counterparties and the maximum notional amount of your swap positions in commodity swaps does not exceed \$2 billion.

The CFTC has stated that it does not expect that a small entity 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 threshold.¹³

If you are engaged in transactions that may be considered swaps, the information contained here should not be relied upon to the exclusion of specific and detailed legal advice. If you have any questions about these or other CFTC actions that may affect your utility, please contact the Spiegel attorney with whom you regularly work, or a member of our CFTC compliance team listed below.

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¹² *Id.* at 30,715. There are separate higher thresholds which must include an evaluation of “potential future exposure.”

¹³ *Id.* at 30,701.