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Office of General Counsel

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Office of General Counsel

Staff Interpretations and No-Action Relief Regarding ECP Status: Swap Guarantee Arrangements; Jointly and Severally Liable Counterparties; Amounts Invested on a Discretionary Basis; and “Anticipatory ECPs”

Section 723(a)(2) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”)¹ amended section 2(e) of the Commodity Exchange Act (“CEA”)² to provide that “it shall be unlawful for any person, other than an [ECP], 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.”³ On May 23, 2012, the Commodity Futures Trading Commission (“CFTC” or “Commission”) published jointly with the Securities and Exchange Commission (“SEC,” and together with the CFTC, “Commissions”) final rules further defining, inter alia, the term “eligible contract participant” (“ECP”) and providing interpretations regarding ECP definitional issues.⁴

In response to various requests for further clarifications and relief with respect to the application of section 2(e) in various circumstances,⁵ the Office of General Counsel (“OGC”) is providing the following interpretations, as further explained in this letter:⁶ (I.A) swap guarantors

¹ Public Law 111–203, 124 Stat. 1376 (2010).

² 7 U.S.C. § 1 et seq.

³ 7 U.S.C. § 2(e).

⁴ Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant,” 77 FR 30596 (May 23, 2012) (“Entities Adopting Release”).

⁵ Most of these were received in response to the Commissions’ proposed rules further defining the term “eligible contract participant” (Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant,” 75 FR 81074 (Dec. 21, 2010)) and are available at <http://comments.cftc.gov/PublicComments/CommentList.aspx?id=933>.

⁶ This letter is intended to be consistent with the Commission’s prior “guidance on how it intends to exercise its enforcement discretion with respect to certain unintentional violations of section 2(e)” as set forth in the

generally must be ECPs; (I.B.) a non-ECP generally may not be jointly and severally liable for swap obligations; and (I.C.) cash proceeds from a loan may be included within the calculation of total assets. In addition, OGC is providing no-action relief, subject to the conditions specified herein, with respect to the application of CEA sections 2(e) and 13(a) to: (II.A) certain ECP guarantee arrangements; (II.B) “anticipatory ECPs”; and (II.C) certain determinations regarding “amounts invested on a discretionary basis” under CEA section 1a(18)(A)(xi).⁷ Nothing in this letter is applicable to swaps that are security-based swaps or mixed swaps.

I. Interpretations

In further defining the term “swap” jointly with the SEC, the Commissions interpreted the term swap (other than a “security-based swap” or “mixed swap”) “to include a guarantee of such swap, to the extent that a counterparty to a swap position would have recourse to the guarantor in connection with the swap.”⁸ In light of the Commissions’ interpretation that the term “swap” includes a guarantee of a swap, OGC is issuing the following interpretations regarding the application of CEA section 2(e) to guaranteed swaps. Additionally, OGC is interpreting whether cash proceeds from a loan can be included within the calculation of total assets for purposes of CEA section 1a(18)(A)(v)(I).

A. Swap Guarantors Generally Must be ECPs

In response to the Commissions’ proposed further definition of the term “eligible contract participant,”⁹ commenters stated that non-ECPs should be able to guarantee the swap obligations of ECPs.¹⁰ Another commenter concurred by suggesting that banks may not make certain loans

Commission’s Second Amendment to July 14, 2011 Order for Swap Regulation, 77 FR 41260 (July 13, 2012) (“Second Effective Date Extension Order”).

⁷ CEA section 13(a) is codified at 7 U.S.C. § 13c(a). Because the no-action relief set forth herein is limited to ECP status for purposes of CEA section 2(e), it is not applicable to commodity pools seeking to qualify as ECPs under the proviso in CEA section 1a(18)(A)(iv)(II), 7 U.S.C. § 1a(18)(A)(iv)(II), or related Commission regulations or to persons seeking to qualify as ECPs for purposes of CEA sections 2(c)(2)(B)-(E) or related Commission regulations. The Commission’s regulations are set forth in Chapter I of Title 17 of the Code of Federal Regulations.

⁸ Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 FR 48208, 48226 (Aug. 13, 2012) (“Products Adopting Release”).

⁹ 75 FR 80174 (December 21, 2010) (“Entities Proposing Release”).

¹⁰ See, e.g., Letter from Branch Banking and Trust Company, East West Bank, Fifth Third Bank, The Private Bank and Trust Company, Regions Bank, SunTrust Bank, U.S. Bank National Association and Wells Fargo Bank, N.A. dated May 11, 2011 (“Midmarket Banks Letter”) at 3-4, n.5 (stating that “banks routinely lend to partnerships on the strength of the assets of the partnership combined with guaranties of the general partners, and, therefore, the guaranties would extend to the partnership’s swap obligations incurred to hedge the loan. If a partnership qualifies as an ECP, then the bank will want legal certainty that the guaranty is still valid for its swap obligations even if the guarantor is not an ECP.”).

or offer hedging swaps if non-ECPs cannot be guarantors.¹¹ In light of the interpretation that the term swap includes a guarantee of a swap, OGC interprets CEA section 2(e) as requiring that each guarantor of a swap must be an ECP unless: (1) the guaranteed swap¹² is entered into on, or subject to the rules of, a DCM;¹³ (2) a Commission Order issued pursuant to CEA section 4(c)¹⁴ provides such guarantor relief from compliance with section 2(e) (“4(c) Relief”); or (3) the guaranteed swap is a trade option and the terms of CFTC regulation 32.3 (the “Trade Option Exemption” are satisfied).¹⁵ Guarantors of swaps assume and bear the risk of the swaps that they guarantee. Given that “the intent behind the ECP requirement [in section 2(e)] . . . is to limit the availability of [non-DCM-listed] . . . 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[]” not subject to the regulatory protections applicable to swaps listed on DCMs,¹⁶ it would undermine CEA section 2(e) (other than in limited

¹¹ See generally letter from Wells Fargo Bank, N.A. dated Aug. 15, 2011 (“Wells Fargo Letter”).

¹² This interpretation is limited to guarantees of swaps and does not address any other credit support arrangements or other issues raised by commenters in response to the Entities Proposing Release, unless expressly addressed herein. Thus, for example, a non-ECP may provide collateral to support a third party’s swap obligations. The Commission or its staff, acting alone or jointly with the SEC or its staff, may address such issues in the future.

¹³ CFTC regulation 38.601 requires that all transactions executed on or through a DCM must be cleared through a CFTC-registered DCO. See Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management, 77 FR 21278 (Apr. 9, 2012) (adopting, among other regulations, regulation 38.601). Consequently, in practice, there may be few guarantees of swaps executed on or through a DCM, because beneficiaries of swap guarantees would face the DCO rather than the swap counterparty once the swap was accepted for clearing. See Clearing Requirement Determination Under Section 2(h) of the CEA, 77 FR 47169 at 47183, 47203 (Aug. 7, 2012) (stating the Commission’s belief that clearing credit default swaps and interest rate swaps, respectively, would mitigate counterparty credit risk). In any case, nothing in the CEA or the Dodd-Frank Act prohibits such guarantees.

¹⁴ 7 U.S.C. § 6(c).

¹⁵ OGC interprets the language in CFTC regulation 32.3(a) stating that “any person . . . may . . . conduct activity related to [] any commodity option” to include guaranteeing trade options if the terms of the Trade Option Exemption are satisfied with respect to the trade option.

¹⁶ Entities Adopting Release at 30721. See also 146 CONG. REC. E1878 (daily ed. Oct. 23, 2000) (statement of Rep. Markey) (in noting that he believed the dollar limits were too low, referring to ECPs as “the sophisticated institutions that will be allowed to play in the swaps market with little or no regulation”); Hearing Before the H. Comm. on Banking and Fin. Servs. Concerning H.R. 4541, The Commodity Futures Modernization Act of 2000, 106th Cong. 12 (2000) (testimony of Annette L. Nazareth, Director, Division of Market Regulation, U.S. Securities and Exchange Commission) (noting that the lines drawn in the ECP definition “reflect the sophistication of market participants who will use the exclusion”); id. at 112 (testimony of Dennis Oakley, Managing Director, Global Credit Capital Management Department, The Chase Manhattan Bank) (testifying that the ECP definition was “adequate to capture the range of sophisticated participants in the OTC derivatives market for whom the protections of the CEA are not necessary or appropriate”); Department of the Treasury, Financial Regulatory Reform—A New Foundation 46-47 (2009) (“OTC derivatives markets, including [credit default swap] markets, should be subject to comprehensive regulation that addresses relevant public policy objectives [including] ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties.”) (cited by the Commission in the Entities Adopting Release at 30724, n.1454).

circumstances, such as when undertaken pursuant to 4(c) Relief or when the Trade Option Exemption applies), were that section to be interpreted to permit persons who are not ECPs to guarantee swaps not entered into on, or subject to the rules of, a DCM when counterparties to those same swaps must be ECPs.¹⁷

OGC notes that guarantors who do not currently meet the ECP requirements can request to be treated or defined as ECPs.¹⁸

B. Non-ECPs Generally Cannot be Jointly and Severally Liable for Swap Obligations

Another group of commenters stated that, when ECPs and non-ECPs are jointly and severally liable for their loan obligations, “they may want to hedge their . . . exposure to the loan . . . by entering into an interest rate swap” and that “[b]ecause the borrowers are jointly and severally liable under the loan . . . they likely will seek to enter into the related swap on the same basis.”¹⁹ CEA section 2(e) clearly makes it unlawful for a non-ECP to be a jointly and severally liable swap counterparty because such conduct would constitute entering into a swap, which the CEA prohibits a non-ECP from doing other than on or subject to the rules of a designated contract market. However, to the extent a jointly and severally liable non-ECP swap counterparty, a guarantor of the swap obligations of such counterparty or a swap counterparty to such jointly and severally liable swap counterparty satisfies the conditions of the no-action relief

¹⁷ See id. Also, non-ECPs can manage interest rate risk without using swaps. See e.g., Products Adopting Release at 48247 (where the Commissions stated that “[t]he types of commercial agreements, contracts, or transactions that involve customary business arrangements . . . and will not be considered swaps . . . under this interpretation include: . . . fixed or variable rate commercial loans . . . with embedded interest rate . . . caps . . .”, provided that such embedded caps are included only to address the loan’s interest rate risk “and do not include additional provisions that would provide exposure to enhanced or inverse performance, or other risks unrelated to the interest rate risk being addressed[]”). Additionally, nothing in this letter would limit the ability of a non-ECP to guarantee a loan.

¹⁸ See CFTC regulations 13.2 (petition for issuance, amendment, or repeal of a rule) and 140.99 (requests for exemptive, no-action and interpretative letters).

¹⁹ Midmarket Banks Letter at 3. These commenters also:

urge[d] the Commissions to . . . clarify, in circumstances where there is a ‘joint and several counterparty’ (i.e., a counterparty to a swap or security-based swap that is composed of multiple obligors that are jointly and severally liable under the swap or security-based swap), that, provided at least one of the obligors is an ECP as defined in Section 1a of the CEA, each obligor will be deemed to be an ECP if the transaction is entered into to manage risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by a business with which such obligor is affiliated or in which such obligor has an economic or financial interest.

Id.

provided below in section II.A. (as applicable), such person(s) each can rely on the no-action relief.²⁰

C. Cash Proceeds from a Loan Count Towards Total Assets

One commenter also voiced uncertainty as to whether the proceeds of a purchase money loan count as total assets for purposes of qualifying as an ECP under the \$10 million threshold for total assets under CEA section 1a(18)(A)(v)(I) prior to the borrower using the funds to purchase the asset for which the borrower needed the loan.²¹ Specifically, Wells Fargo suggested that “[s]ince [under] purchase money loans where borrowers will be acquiring the assets with the loan proceeds, borrowers may be unable to qualify as ECPs until after the loan closes and title to the property has passed.”²² However, while assets purchased or a project constructed with loan proceeds count towards the \$10 million in total assets threshold of CEA section 1a(18)(A)(v)(I), so too do the cash proceeds of the loan, upon receipt by the borrower. Therefore, a borrower will qualify as an ECP under CEA section 1a(18)(A)(v)(I) upon receipt of more than \$10 million in loan proceeds, and it is not the case that such borrower will not be an ECP under CEA section 1a(18)(A)(v)(I) until it receives title to a property it purchases with the loan proceeds.²³

II. **No-Action Relief**

A. Swap Guarantee Arrangements

CEA section 1a(18)(A)(v)(II) confers ECP status upon any “corporation, partnership, proprietorship, organization, trust, or other entity” whose obligations are guaranteed by certain enumerated ECPs.²⁴ Several commenters requested that the list of eligible guarantors be expanded. Some commenters contended that an ECP described in CEA section 1a(18)(A)(v)(III)

²⁰ As discussed above in section I.A., 4(c) Relief or the Trade Option Exemption may also be available.

²¹ See CEA section 1a(18)(A)(v)(I); 7 U.S.C. § 1a(18)(A)(v)(I).

²² Wells Fargo Letter at 4-5.

²³ While, upon receipt of loan proceeds, the borrower will have both an asset (the cash received) and a liability (the loan repayment obligation), the CEA section 1a(18)(A)(v)(I) total asset threshold is \$10 million in “total assets,” not net assets, so the liabilities of the borrower do not factor into the \$10 million calculation. Cf. CEA section 1a(18)(A)(v)(III) (qualifying a “corporation, partnership, proprietorship, organization, trust, or other entity” as an ECP if it has a “net worth” exceeding \$1 million). Consequently, a corporation, partnership, proprietorship, organization, trust, or other entity would qualify as an ECP if it has more than \$10 million in total assets, even if it has a zero or negative net worth.

²⁴ 7 U.S.C. 1a(18)(A)(v)(II). The enumerated ECPs eligible to confer ECP status based on providing credit support for a swap includes an entity that has total assets exceeding \$10,000,000, certain financial institutions, state-regulated insurance companies, investment companies subject to regulation under the ‘40 Act, certain regulated commodity pools, certain governmental entities (including political subdivisions thereof), and any other person that the Commission determines to be eligible in light of the financial or other qualifications of the person pursuant to CEA section 1a(18)(C), 7 U.S.C. 1a(18)(C).

(a “Net Worth ECP”)²⁵ should be eligible to confer ECP status to a non-ECP through the guarantee of a swap obligation.²⁶ These commenters explained that:

[n]ot all commercial borrowers qualify as ECPs. It is common for an operating business to organize a separate limited liability company (for tax and legal reasons) to acquire productive assets such as real estate and equipment and to lease these assets to the operating company. As a result, the limited liability company becomes the borrowing entity for the loan used to acquire those assets. The limited liability company often does not maintain sufficient capital to qualify as an ECP.²⁷

Some commenters requested that individual guarantors who are ECPs be permitted to confer ECP status as well, although these commenters generally sought to include individuals who satisfy the \$1 million net worth requirement of CEA section 1a(18)(A)(v)(III), rather than the higher dollar amounts required to meet the aggregate amounts invested on a discretionary basis thresholds in CEA section 1a(18)(A)(xi).²⁸

The Commissions received a comment from three affiliated commenters in response to the Entities Proposing Release stating that “[t]he way in which American farmers commonly structure their business raise particular interpretive issues under the new ECP definition for individuals.”²⁹ These commenters also advised that farmers commonly own their farm businesses and related assets “through a series of legal entities” while serving in a personal capacity as swap counterparty and having the non-ECP entities controlled by the farmer act as guarantors.³⁰ After the publication of the Entities Adopting Release in the Federal Register, the Commission received two inquiries seeking the staff’s confirmation that a swap counterparty owned by one or more individuals could achieve ECP status under CFTC regulation 1.3(m)(7)

²⁵ CEA section 1a(18)(A)(v)(III), 7 U.S.C. § 1a(18)(A)(v)(III), defines as an ECP a “corporation, partnership, proprietorship, organization, trust, or other entity” having a net worth exceeding \$1,000,000 that enters into agreements, contracts or transactions in connection with conducting its business or to risk manage assets or liabilities owned or incurred or reasonably likely to be owned or incurred in conducting its business.

²⁶ See, e.g., Letter from B&F Capital Markets, Inc. at 3 (June 1, 2011) (“B&F Letter”).

²⁷ Letter from Fifth Third Bank and Union Bank, N.A. dated June 15, 2011, at 2.

²⁸ See B&F Letter at 3.

²⁹ Letter from Rabobank, N.A., Rabo AgriFinance, Inc., and Cooperatieve Centrale Raiffesisen-Boerenleenbank B.A. dated May 31, 2011, at 3 (“Rabo Letter”).

³⁰ See id.

by having its swaps guaranteed by the individual owners if such owners each had more than \$5 million in amounts invested on a discretionary basis.³¹

As acknowledged in the Rabo Letter, these interpretations “raise particular interpretive issues[,]” given that the farmers described in the Rabo Letter appear to be operating farming businesses, although seemingly indirectly,³² which would seem to be inconsistent with CEA section 1a(18)(A)(xi)(II).³³ Without addressing the circumstances described in the Rabo Letter or the accuracy of the views expressed in the Post-Adoption Ex Parte Bank Communications with respect to CEA section 1a(18)(A)(xi)(II) and CFTC regulation 1.3(m)(7), OGC is persuaded that there is merit in allowing certain market participants that otherwise are not ECPs to manage the floating interest rate risk of their loans using swaps other than on or subject to the rules of a DCM in the limited circumstances specified below. Additionally, to avoid precluding: (1) financially sophisticated proprietorships³⁴ from guaranteeing swaps entered into by their co-proprietors³⁵ to manage the floating interest rate risk of the proprietorship’s loans; (2) individuals

³¹ August 6, 2012 ex parte communication from Wells Fargo (interpreting: (1) CEA section 1a(18)(A)(xi)(II) as qualifying an individual as an ECP when the individual has more than \$5 million in amounts invested on a discretionary basis and more than \$1 million in net worth and guarantees a swap entered into by a limited liability company (“LLC”) of which the individual is the sole owner to address the floating interest rate risk of a loan received by the LLC; and (2) CFTC regulation 1.3(m)(7) as qualifying the LLC based on the individual owner’s net worth); June 4, 2012 ex parte communication from Paul Architzel on behalf of B&F Capital Markets, Inc. (seeking confirmation of the same approach described by Wells Fargo) (together, the “Post-Adoption Ex Parte Bank Communications”).

³² Such farmers might qualify as “indirect proprietorships,” as defined below.

³³ CEA section 1a(18)(A)(xi)(II) requires that an individual be risk managing an asset or liability owned or incurred, or reasonably likely to be owned or incurred, by the individual, not by a related business owned by the individual. Unlike the CEA section 1a(18)(A)(v) language describing Net Worth ECPs as “corporation[s], partnership[s], proprietorship[s], organization[s], trust[s], or other entit[ies]” having more than \$1 million in net worth and entering into agreements, contracts or transactions “in connection with the conduct of the entity’s business” or to risk manage its assets or liabilities, CEA section 1a(18)(A)(xi)(II) describes individuals with language regarding risk management of an individual’s assets or liabilities. This same distinction makes it difficult to concur with the interpretations advanced in the Post-Adoption Ex Parte Bank Communications that a swap guaranty provided by an individual owner of a swap counterparty, or the swap, constitutes the asset or liability owned or incurred by the individual described in CEA section 1a(18)(A)(xi)(II). Such concurrence is particularly difficult given that, unlike CEA section 1a(18)(A)(v)(II), CEA section 1a(18)(A)(xi)(II) contains no concept of indirect achievement of ECP status via a guarantee. See also Entity Definitions Adopting Release at 30658, n.725.

³⁴ A proprietorship is an individual (or, in certain limited circumstances discussed below, individuals) conducting a business without using a legal entity. Such an individual (or individuals) therefore would directly own all the assets and be directly responsible for all of the liabilities of the business.

³⁵ Commenters stated that spouses may sometimes both be proprietors (or “co-proprietors”), or guarantors, of what is otherwise a “sole proprietorship.” See, e.g., Midmarket Banks Letter at 8 (stating these commenters’ view that “by including the word ‘proprietorship’ in this element of the ECP definition, Congress intended to include within the definition an individual acting as a sole proprietor and to allow that individual (together with a spouse or other family member that may jointly own the business or its assets) to operate under this subsection of the definition of an ECP, rather than the subsection dealing with individuals.”). While many states’ laws generally contemplate that a proprietorship will have only a sole proprietor, see, e.g., the Missouri Secretary of State Web site,

with more than \$1 million in net worth or more than \$5 million in amounts invested on a discretionary basis who operate small businesses through legal entities for creditor protection, tax efficiency or other legitimate business reasons from guaranteeing swaps entered into by their small businesses to manage the floating interest rate risk of their business loans because such individuals are not technically proprietorships (such individuals, “indirect proprietorships”);³⁶ or (3) corporations, partnerships, organizations, trusts or other entities who own and operate affiliated small businesses, or through which indirect proprietorships own and operate small businesses, from guaranteeing swaps entered into by such small businesses to manage the floating interest rate risk of their business loans because such corporations, partnerships, organizations, trusts or other entities do not have \$10 million in total assets, OGC is recommending that the Commission not commence enforcement action should such persons continue to engage in such activity in compliance, in each case, with the conditions described below.³⁷

http://www.sos.mo.gov/business/sbac/startup_guide.asp (stating that, “[i]n general, a single person who is operating a business is a sole proprietor, and a group of people who are operating a business together and sharing profits are a partnership”), in some states there may be more than one proprietor in certain limited circumstances. See, e.g., California Franchise Tax Board Web site, https://www.ftb.ca.gov/businesses/bus_structures/soleprop.shtml (advising that, in general, “[a] sole proprietorship consists of only “one” individual; ownership by more than one person creates a partnership,” but also noting that “[a] husband and wife can be classified as a sole proprietorship”, although “[a] business conducted by registered domestic partners must be classified as a partnership”). Where applicable state law contemplates the possibility of more than one proprietor, proposed regulation 1.3(m)(9)(i) would permit each proprietor to guarantee the swap obligations of a co-proprietor undertaken in connection with the business of the proprietorship.

³⁶ While this letter contains references to “individuals” and incorporates \$5 million in amounts invested on a discretionary basis as an element of one of the conditions of no-action relief in section II.B., as underscored by several of the conditions to that no-action position (including, but not limited to, the active role in operating the business of the Guaranteed Swap Counterparty (other than performing solely clerical, secretarial or administrative functions) condition), as applied to natural persons, the no-action relief in section II.B. is applicable only to such persons’ business activity undertaken as proprietorships or indirect proprietorships, not to activity undertaken for personal purposes, whether personal hedging or otherwise. Such persons must rely on CEA section 1a(18)(A)(xi) and any related guidance or interpretations.

³⁷ In this regard, OGC notes that, unlike ECPs with greater than \$10 million in total assets described in CEA section 1a(18)(A)(v)(I) (each a “Total Assets ECP”), whose liabilities can exceed their assets (rendering them technically insolvent) but who CEA section 1a(18)(A)(v)(II) nevertheless permits to confer ECP status upon a third party by guaranteeing or otherwise providing credit support for the third party’s swaps, it is possible that Net Worth ECPs and indirect proprietorships may have more assets (and/or less in liabilities) than Total Assets ECPs, rendering Net Worth ECPs in some circumstances more creditworthy and a more desirable guarantor (from the perspective of the beneficiary of the guarantee). For example, a Total Assets ECP that has \$11 million in total assets but \$22 million in total liabilities would be technically insolvent. A Net Worth ECP or indirect proprietorship may only have \$4 million in total or discretionary assets, respectively, and \$1 million in total liabilities, or \$15 million in total assets and \$10 million in total liabilities. In the former case, while the Net Worth ECP or indirect proprietorship would have \$7 million less in total assets or discretionary assets, respectively, than the Total Assets ECP, its net worth would be \$14 million greater and it would be solvent. In the latter case, the Net Worth ECP or indirect proprietorship would have both \$4 million more in total or discretionary assets, respectively, than the Total Assets ECP and \$12 million less in liabilities, in addition to being solvent.

The Commission found merit in similar circumstances in granting prior relief. In 2003, the Commission issued an order pursuant to CEA section 1a(12)(C) (subsequently renumbered by the Dodd-Frank Act as CEA section 1a(18)(C))³⁸ providing that, “subject to certain conditions, Single Asset Development Borrowers (“SADB”) that have a natural person, who is an [ECP], acting as a guarantor for the SADB['] over-the-counter (“OTC”) derivatives transactions, are “eligible contract participants” as that term is defined in section 1a(12) of the Act.”³⁹

In OGC’s view, if an individual is sophisticated enough to be an ECP under the CEA, based on having \$5 million in amounts invested on a discretionary basis, to use swaps to manage risks arising from assets or liabilities owned or incurred in the individual’s personal capacity,⁴⁰ then the individual should also qualify to guarantee the floating interest rate risk management obligations of a swap counterparty that it owns and plays an active role in operating.

Accordingly, OGC will not recommend that the Commission commence an enforcement action against a guarantor (“Guarantor”) guaranteeing the swap obligations of a third party that is not an ECP (such third party, a “Guaranteed Swap Counterparty”) for violating CEA sections 2(e) or 13(a), or against a Guaranteed Swap Counterparty, for violating section 2(e) of the CEA, or against the beneficiary of the swap guarantee (“Beneficiary”) for violating CEA section 13(a), if:

1. the Guarantor is:
 - a. a corporation, partnership, proprietorship, organization, trust, or other entity that has a net worth exceeding \$1 million; or
 - b. an indirect proprietorship (as defined above) that consists of an individual or, if permitted by applicable state law,⁴¹ individuals, with:
 - i. a net worth (in the aggregate across all indirect co-proprietors, where applicable state law permits proprietorships comprised of more than one individual) exceeding \$1 million; or
 - ii. amounts invested on a discretionary basis, the aggregate of which is in excess of \$5 million (in the aggregate across all

³⁸ See Dodd-Frank Act section 721(a)(1).

³⁹ In the Matter of Washington Mutual Inc. and Its Various Subsidiaries Request for Relief, 68 FR 13903 (Mar. 21, 2003) (the “WAMU Order”).

⁴⁰ See CEA section 1a(18)(A)(xi)(II), 7 U.S.C. § 1a(18)(A)(xi)(II).

⁴¹ Applicable state law means the law of each state in which a proprietorship operates.

indirect co-proprietors, where applicable state law permits proprietorships comprised of more than one individual); and

2. all of the following conditions applicable to a particular Guarantor and/or Guaranteed Swap Counterparty, respectively, are satisfied:
 - a. the Guaranteed Swap Counterparty enters into the swaps solely to manage the floating interest rate risk associated with a loan received, or reasonably likely to be received,⁴² by the Guaranteed Swap Counterparty in the conduct of its business;⁴³
 - b. in the case of all Guarantors other than a proprietorship Guarantor, the Guarantor is an owner of the Guaranteed Swap Counterparty and plays an active role in operating the business of such Guaranteed Swap Counterparty (other than performing solely clerical, secretarial or administrative functions);⁴⁴
 - c. in the case of a proprietorship Guarantor, if applicable state law contemplates proprietorships with more than one proprietor, the Guarantor and the Guaranteed Swap Counterparty are co-proprietors;⁴⁵
 - d. the Guarantor computes its net worth or amounts invested on a discretionary basis in accordance with generally accepted accounting principles (“GAAP”), consistently applied (provided that the value of real property can be determined using fair market value (“FMV”));⁴⁶

⁴² In this context, OGC will view a loan as “reasonably likely to be received” if the borrower has received a bona fide loan commitment or bona fide loan agreement, as defined below in Section II.B., from a lender.

⁴³ Commenters generally sought relief from the ECP requirement for borrowers using swaps to hedge the interest rate risk of floating rate loans, not to use swaps more broadly in their businesses. OGC is limiting this letter accordingly.

⁴⁴ The active substantive role requirement is intended to distinguish indirect proprietors and other business owners from those owners who are merely passive investors in a business, who may be less likely to have the financial sophistication to understand the terms of a swap as such terms relate to the business and who themselves, in the case of individual owners, would be required to qualify as ECPs under CEA section 1a(18)(A)(xi) in order to enter into non-DCM-listed swaps.

⁴⁵ OGC is not including an ownership or active management condition with respect to co-proprietors because, unlike entities, which can own and be owned by other entities, an individual cannot own and operate another individual.

⁴⁶ OGC is requiring that GAAP be used because of its broad applicability and conservative approach and because principle-based standards familiar to market participants will be most effective in preventing

- e. the Guaranteed Swap Counterparty enters into the guaranteed swaps only as a principal;⁴⁷ and
- f. the Beneficiary verifies that the Guarantor and Guaranteed Swap Counterparty satisfy the conditions of this no action position.⁴⁸

B. “Anticipatory ECPs”

CEA section 1a(18)(A)(v)(I) provides that a corporation, partnership, proprietorship, organization, trust, or other entity with total assets exceeding \$10 million is an ECP.⁴⁹ Wells Fargo expressed a concern that common loans, including purchase money and construction loans, could not be hedged using swaps because the borrower would not qualify as an ECP under CEA section 1a(18)(A)(v)(I).⁵⁰ With respect to construction loans, Wells Fargo noted that “the loan is funded incrementally as construction progresses and progress payments are made,” and, as such, while “[t]he completed project may be an asset that exceeds \$10 million, [] until the project is completed, these borrowers may be unable to qualify as ECPs under the asset test.”⁵¹ Wells Fargo also noted that borrowers may seek to enter into forward-starting swaps prior to closing on their purchase money, construction or other loans to lock in a favorable fixed interest rate on the fixed leg of the interest rate swap they enter to hedge or mitigate the floating interest rate risk of their loans.⁵² In OGC’s view, if a lender has provided a borrower a bona fide

unqualified persons from claiming to be ECPs. OGC also notes that staff has informally advised interested parties over the years that GAAP is the appropriate measure of net worth and total assets in the context of the ECP definition. Nevertheless, OGC is permitting reliance on good faith determinations of FMV because depreciation mandated by accounting standards is not indicative of a person’s sophistication, and FMV is a better indication of a person’s ability to satisfy its obligations than a value decreased by depreciation required for accounting purposes. Given the potential for intentionally inflating FMV determinations, OGC emphasizes that the FMV must be determined in good faith. Absent evidence to the contrary, OGC would view independent third party valuations (such as from tax appraisals or independent appraisers) as good faith FMV determinations.

⁴⁷ Cf. WAMU Order at 13905 (condition 5 of which required, in relevant part, that the SADBs whose swaps were guaranteed acted as principals).

⁴⁸ Cf. id. (condition 2 of which required WAMU, the counterparty to the SADBs, to verify the ECP status of the SADBs’ natural person guarantors). In this regard, OGC believes that SDs and MSPs should follow CFTC regulation 23.430, seeking to verify compliance with the terms of this no-action letter rather than ECP status, and other Beneficiaries should employ commercially reasonable efforts to verify compliance with the terms of this no-action letter (which should be guided by the principles discussed in 23.430 and the related adopting release; see Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties; 77 FR 9734 (Feb. 17, 2012)).

⁴⁹ 7 U.S.C. § 1a(18)(A)(v)(I).

⁵⁰ See generally Wells Fargo Letter at 4-5.

⁵¹ Id.

⁵² Sept. 24, 2012 ex parte communication with Barry Taylor-Brill of Wells Fargo and Diana Preston of the American Bankers Association (“ABA”).

commitment to fund a loan amount greater than \$10 million or such other amount necessary for the borrower to have in excess of \$10 million in total assets,⁵³ such an “anticipatory ECP” should be permitted to enter into a non-DCM-listed swap prior to loan closing so that the borrower can lock in a favorable fixed interest rate on the fixed leg of the interest rate swap it wishes to use to manage the floating interest rate risk of the loan.⁵⁴

Consequently, OGC will not recommend that the Commission commence an enforcement action against a (1) Guaranteed Swap Counterparty or other non-ECP swap counterparty for violating CEA section 2(e), (2) Guaranteed Swap Counterparty’s Guarantor for violating CEA sections 2(e) or 13(a), or (3) a Beneficiary or other swap counterparty to a non-ECP swap counterparty for violating CEA section 13(a), in connection with a swap entered into other than on or subject to the rules of a DCM prior to the borrower receiving the proceeds of a related loan in an amount sufficient for the Guaranteed Swap Counterparty or other non-ECP swap counterparty to achieve ECP status under CEA section 1a(18)(A)(v)(I), if:

1. the swap for which ECP status is necessary is intended to manage the Guaranteed Swap Counterparty’s or other non-ECP swap counterparty’s floating interest rate risk on the loan;
2. in the case of a swap entered into by a Guaranteed Swap Counterparty or other non-ECP swap counterparty to manage its floating interest rate risk on a loan that would, if disbursed, cause the Guaranteed Swap Counterparty or other non-ECP swap counterparty to qualify as an ECP under CEA section 1a(18)(A)(v)(I) but that has not yet closed, the Guaranteed Swap Counterparty or other non-ECP swap counterparty has received a bona fide loan commitment for such loan;
3. in the case of a construction loan or other loan disbursed in stages, the lender intends at the time of making the loan, or the related loan commitment to fund the entirety of the loan, subject only to the satisfaction of commercially reasonable closing conditions and/or the failure to occur, after loan disbursements have commenced, of any events set forth in the loan or swap documentation that would excuse the lender’s obligation to continue funding the loan (such as, for example, the borrower’s failure to make a payment), provided that such events are not designed to permit the lender to fail to fund the loan while leaving the swap in place; and

⁵³ If the borrower already has some assets, then the loan could be for \$10 million or less, so long as the proceeds of the loan would provide the borrower with in excess of \$10 million in total assets.

⁵⁴ Compare CFTC regulation 1.3(ggg)(5)(i)(A) (providing that the insured depository institution (“IDI”) exclusion from the SD definition applies to loans entered into between IDIs and their customers as long as 90 days before executing a loan agreement) and Entities Adopting Release at 30621 (summarizing comments that the insured depository institution exclusion from the SD definition “should apply to swaps entered into in anticipation of a loan . . .”). The discussion herein of loan commitments applies equally to bona fide loan agreements which have been executed but where the loan has not yet been funded.

4. the loan is funded in an amount causing the Guaranteed Swap Counterparty or other non-ECP swap counterparty to qualify as an ECP under CEA section 1a(18)(A)(v)(I), unless it is not funded in such amount as a result of a failure to satisfy a commercially reasonable condition to closing the loan set forth in the bona fide loan commitment or an event set forth in the loan or swap documentation that would excuse the lender's obligation to continue funding the loan (such as, for example, the borrower's failure to make a payment).

OGC will treat a loan commitment as bona fide if the following conditions are satisfied:

1. the commitment is in writing;
2. the loan closing is subject only to the satisfaction of commercially reasonable conditions to closing;⁵⁵ and
3. the loan commitment is entered into solely for business purposes unrelated to qualifying as an ECP.

This guidance should be applied in a manner to prevent evasion. Failures to fund loans may be scrutinized to ensure that such failures are for legitimate business reasons, as discussed above, rather than part of a scheme to establish ECP status in order to enter into a swap with a non-ECP without actually having to fund a loan in an amount sufficient for a Guaranteed Swap Counterparty or other non-ECP swap counterparty to qualify as an ECP under CEA section 1a(18)(A)(v)(I).⁵⁶

C. Amounts Invested on a Discretionary Basis

The Dodd-Frank Act redesignated CEA section 1a(12) as section 1a(18)⁵⁷ and replaced "total assets in an amount" with "assets invested on a discretionary basis, the aggregate of which is in excess of".⁵⁸ The Commission received a number of comments in response to the Entities

⁵⁵ Without limitation, a condition that the Guaranteed Swap Counterparty (or other non-ECP swap counterparty) and/or the Guarantor provide the Beneficiary (or other swap counterparty to a non-ECP swap counterparty) documentation of the source(s) of its/their income for the prior two tax years is an example of a commercially reasonable closing condition.

⁵⁶ In this regard, if the lender terminates the loan, OGC would expect the related swap to be terminated, either automatically or contemporaneously. While OGC recognizes that industry standard swap master agreements grant the non-defaulting party some discretion in determining when to terminate a swap upon the occurrence of an event of default or other trigger, depending on the facts and circumstances, leaving a hedging swap in place for longer than the loan it was hedging could raise questions as to whether the loan was arranged to qualify the borrower as an ECP so that it could enter into a swap rather than for unrelated business purposes.

⁵⁷ See Dodd-Frank Act § 721(a)(1).

⁵⁸ See Dodd-Frank Act § 721(a)(9)(A)(ii).

Proposing Release on the implications of that change.⁵⁹ More recently, the American Bankers Association requested an interim final rule, an interpretive letter or other guidance as to the meaning of the new language, stating that absent such guidance, “banks and their customers who are individuals will be unable to determine whether their swaps are legally enforceable” and lending may be “on less advantageous terms that may leave borrowers with few or no options for the long-term, fixed rate, or flexible loans they need to run their businesses.”⁶⁰

OGC observes that the QP definition in the ’40 Act includes language that is very similar to the new language in CEA section 1a(18)(A)(xi), providing that “any person . . . who in the aggregate owns and invests on a discretionary basis,” not less than \$25,000,000 in investments” is a QP.⁶¹ The QP definition also includes “any natural person . . . who owns not less than \$5,000,000 in investments,” as defined by the SEC.⁶² The SEC has defined the term “investments” in detail in ’40 Act Rule 2a51-1 for purposes of Section 2a(51) of the ’40 Act.⁶³ The SEC’s rule defining “investments” addresses, for purposes of Section 2a(51) of the ’40 Act, a number of the same questions raised by commenters in the context of the new “amounts invested on a discretionary basis” language in CEA section 1a(18)(A)(xi), including whether a person’s cash⁶⁴ or interests in small businesses⁶⁵ count and how to treat investments held jointly with a person’s spouse.⁶⁶ The purpose of the QP definition is to delineate a category of investors not needing the full protections of the ’40 Act,⁶⁷ a purpose similar to that of the ECP definition: to delineate a category of counterparties who do not need the full protections of the CEA.⁶⁸

⁵⁹ See, e.g., Midmarket Banks Letter at 4 (indicating that “among the items that we believe should qualify for this purpose are cash or currency deposits in an account at a “financial institution” as defined in the CEA.”); Wells Fargo Letter at 7 (advising that “it is also important to banks and their customers that the Commissions provide guidance with respect to spouses with a joint investment account.”).

⁶⁰ Letter from American Bankers Association dated August 24, 2012 at 3.

⁶¹ ’40 Act section 2(a)(51)(A)(iv), 7 U.S.C. § 80a-2(a)(51)(A)(iv).

⁶² ’40 Act section 2a(51)(A)(i), 7 U.S.C. § 80a-2(a)(51)(A)(i).

⁶³ See 17 CFR § 270.2a51-1.

⁶⁴ See 17 CFR § 270.2a51-1(b)(7) (including cash and cash equivalents held for investment purposes and listing two categories of examples); 17 CFR § 270.2a51-1(c) (defining “investment purposes”).

⁶⁵ See 17 CFR § 270.2a51-1(b)(1) (excluding, with certain exceptions, securities of an issuer that controls, is controlled by, or is under common control with, the prospective QP).

⁶⁶ See 17 CFR § 270.2a51-1(g)(2) (describing the treatment of joint spousal investments).

⁶⁷ See 61 FR 68100, 68102 (December 26, 1996) (noting that Congress intended qualified purchases to encompass those “investors with a high degree of financial sophistication who are in a position to appreciate the risks associated with investment pools that do not have the protections afforded by the Investment Company Act”).

⁶⁸ While swaps will be more highly regulated with the onset of the Dodd-Frank regulatory regime, the ECP definition still serves a protective purpose in that ECPs can enter into swaps other than on or subject to the

Given the similar goals of the QP and ECP definitions, OGC will not recommend that the Commission commence an enforcement action against a Guaranteed Swap Counterparty or other non-ECP swap counterparty for violating CEA section 2(e), against a Guarantor for violating CEA section 2(e) or 13(a) or against a Beneficiary or other swap counterparty to a non-ECP swap counterparty for violating CEA section 13(a), if such persons rely on the standards set forth in '40 Act Rule 2a51-1 (as part of its § 23.402 policies and procedures and § 23.430 counterparty eligibility verification efforts, in the case of a swap dealer or major swap participant) to determine whether a Guaranteed Swap Counterparty or other non-ECP swap counterparty or a Guarantor is an ECP based on having the requisite amounts invested on a discretionary basis for purposes of CEA section 1a(18)(A)(xi).⁶⁹

III. Effective Date and Transitional No-Action Relief

The interpretations and no-action positions contained in sections I.B., I.C., II.A, II.B. and II.C. above commence on the date of this letter.

However, during the period commencing October 12, 2012 and ending March 31, 2013, OGC will not recommend that the Commission commence an enforcement action against (1) a non-ECP guarantor of a swap for violating CEA section 2(e) or (2) a beneficiary of a swap guaranteed by a non-ECP, provided that the beneficiary's swap counterparty is an ECP or satisfies the terms of a no-action position set forth herein, for violating CEA section 2(e) or 13(a) with respect to a swap guarantee.

Further, during the period commencing October 12, 2012 and ending December 31, 2012, OGC also will not recommend that the Commission commence an enforcement action against any person for violating CEA section 2(e) or 13(a) with respect to a swap with a party that is not an ECP, provided such party was an ECP as defined in CEA section 1a(12) prior to enactment of the Dodd-Frank Act, or prior to October 12, 2012 was eligible to enter into an agreement, contract, or transaction in reliance upon the Second Effective Date Extension Order in accordance with and subject to the terms and conditions of such Order, and provided, with respect to this CEA section 13(a) no-action position, that a swap counterparty to a non-ECP is in

rules of highly regulated DCMs, which are self-regulatory organizations with their own sets of rules. OGC notes that the Dodd-Frank Act was enacted, among other reasons, to protect counterparties to swap transactions by limiting those counterparties trading swaps not on a DCM to only those market participants with the requisite sophistication and financial assets to sufficiently assess and bear the risk of the swap transactions. See Entities Adopting Release, 77 FR at 30721.

⁶⁹ The Commission notes that commenters recommended a similar approach to interpreting the swap dealer definition in CEA section 1a(49)(A)(iii) and (C), suggesting that the Commissions interpret those provisions consistently with the SEC's dealer-trader line of authority. See, e.g., Coalition for Derivatives End-Users letter dated Feb. 22, 2010 (noting that the SEC proposed to apply its existing dealer-trader distinction and that the CFTC should as well and opining that the swap dealer definition was "modeled in part on the definition of "dealer" under the . . . Securities and Exchange Act" and that such modeling "evidenc[ed] Congress's intent that the CFTC and SEC rely on the established securities law to inform their interpretation of 'swap dealer' . . .").

good faith: preparing to come into compliance with CFTC regulation 23.430, if applicable; or otherwise seeking to determine whether its swap counterparty is an ECP.⁷⁰

IV. General Matters

The no-action and interpretive positions taken herein represent only the position of OGC and do not bind the Commission, other Commission staff, or any other Federal agency. Nothing in this letter shall limit the applicability of any CEA provision or CFTC regulation, except as provided herein. As with all no-action letters, OGC retains the authority to condition further, modify, suspend, terminate, or otherwise restrict the terms of the no-action relief provided herein, in its discretion.

If you have any questions regarding the content of this staff no-action letter, please contact David Aron, an OGC attorney, at daron@cftc.gov or (202) 418-6621, or Graham McCall, an attorney in the Division of Market Oversight, at gmccall@cftc.gov or (202) 418-6150.

Sincerely,

Dan M. Berkovitz
General Counsel

⁷⁰ See the Second Effective Date Extension Order at 41263-41264.