



# Commodity Futures Trading Commission

## Office of Public Affairs

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### Q & A – Further Defining “Swap Dealer,” “Major Swap Participant” and “Eligible Contract Participant.”

#### **What is the goal of the proposed rulemaking?**

The notice of proposed rulemaking proposes definitions of the terms “swap dealer” and “major swap participant.” These terms were added to the Commodity Exchange Act (CEA) by Section 721 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Section 712(d)(1) of the Dodd-Frank Act requires the Commission and the SEC, in consultation with the Federal Reserve Board, to jointly further define those terms. In addition, the proposed rulemaking, as authorized by Section 712(d)(1), includes minor changes to the term “eligible contract participant” which is currently defined in Section 1a of the CEA.

#### **What are some of the principles that the Commission proposes to apply in determining if a person is a swap dealer?**

The Commission preliminarily believes that swap dealers may be identified by the functional role they fulfill in the swap markets. Swap dealers tend to accommodate demand and to be available to enter into swaps to facilitate other parties’ interest in swaps. The Commission also believes that persons that fulfill the function of swap dealers exist in most parts of the swap markets.

#### **What are some of the activities the Commission would consider as indicators that a person holds itself out as, or is commonly known in the trade as, a swap dealer?**

The Commission believes that indicators that a person is holding itself out as a swap dealer or is commonly known in the trade as a swap dealer include:

- contacting potential counterparties to solicit interest in swaps,
- developing new types of swaps and informing potential counterparties of their availability,
- 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 one is willing to enter into with other parties, and
- generally expressing a willingness to offer or provide a range of financial products that would include swaps.

#### **How would a person be designated as a swap dealer?**

The proposed rule provides that a person that meets the definition must register as a swap dealer. The Commission believes the proposed rule will allow each market participant to assess its activities to determine whether it functions as a swap dealer. The proposed rule also permits persons to make an application to be designated as a swap dealer with respect to only specified categories of swaps or activities without being considered a swap dealer for other categories of swaps or activities.

### **Are there other issues in the definition of swap dealer that the public should consider?**

Yes. The Commission also considered how swaps between persons under common control should be treated for purposes of the swap dealer definition, how the swap dealer definition should be applied to parties that aggregate the swap positions of other parties, and how the definition should be applied in the physical commodity markets and to the generation or transmission of electricity. Each of these issues is discussed more fully in the notice of proposed rulemaking and the Commission is interested in hearing the comments of the public on these topics.

### **The proposed rules defining “major swap participant” (MSP) include rules on the calculation of “substantial position.” How do the proposed rules on substantial position account for the effect of central clearing?**

The method of calculating substantial position proposed by the Commission would account for the risk-mitigating effects of central clearing. First, the method deducts from current exposure the value of any collateral posted with respect to a swap position. Since centrally cleared swaps are typically subject to full mark-to-market margining, the swaps would generally be eliminated from the calculation of current exposure. Also, in the calculation of potential future exposure, centrally cleared swaps are subject to a substantial discount in value.

### **How do the proposed rules on substantial position account for potential short-term variations in the value of a person’s swap positions?**

The proposed calculations in the substantial position test would be applied as the mean of the amounts measured at the close of each business day in a calendar quarter. This method takes into account concerns that swap positions should not be evaluated based on a single point in time because short-term market fluctuations may not fairly reflect risks. The Commission expects that use of a daily average approach should also help preclude the possibility that a person may use short-term transactions to distort the measure of substantial position.

### **Why do the proposed rules on substantial position include an element to account for potential future exposure?**

The Commission believes that rules which focus solely on current uncollateralized exposure could be overly narrow by failing to identify risky entities until after they begin to pose risk. Because exposure can change quickly over short periods of time, swaps may already pose significant risk even before uncollateralized mark-to-market exposure increases up to the applicable threshold. However, the Commission recognizes that any test of potential future exposure reflects only an estimate of that type of risk, and would be only as effective as the factors used by the test. Therefore, the Commission is interested in receiving comments from the public on alternative tests that could be used to consistently and predictably measure potential future exposure for all participants in the swap markets.

### **Did the Commission consider other tests for determining if a person has a substantial position in swaps for purposes of the MSP definition?**

Yes. The Commission considered several other types of tests that, but does not believe their advantages justify their disadvantages. For example, a test based on the number of a person’s counterparties could identify highly interconnected entities, but a large number of counterparties also means that the losses from that person’s default may be more easily absorbed by the market. A threshold based on a person’s financial strength would not address risks that arise before the person defaults, such as price movements caused when an MSP faces a large margin call. A threshold based on the financial strength of a person’s counterparties could encourage concentration of swaps within a few counterparties. For these reasons, and others described in the notice of proposed rulemaking, the Commission proposes to use objective calculations of current and potential future exposure to determine substantial position.

**Is the proposed definition of “hedging or mitigating commercial risk” limited to positions that qualify for hedge accounting treatment or bona fide hedging treatment?**

No. Although the proposed definition includes swaps that are recognized as hedges for accounting purposes or as bona fide hedging under Commission rules, the swaps included within the proposed exclusion for hedging or mitigating commercial risk are not limited to those categories. Rather, the proposal covers swaps hedging or mitigating any of a person’s business risks, regardless of their status under accounting guidelines or the bona fide hedging rule.

**How would a person be designated as an MSP?**

Similarly to the proposed rule for swap dealers, the proposed rule provides that a person that meets the definition must register as an MSP, requiring each market participant whose swap activities may exceed any of the thresholds to assess its activities. The proposed rule also permits persons to apply to be designated as an MSP with respect to only specified categories of swaps or activities.

**Are there other issues in the definition of MSP that the public should consider?**

Yes. The Commission considered the application of the MSP definition to ERISA plans, sovereign wealth funds, legacy portfolios of swaps in “run off” mode, registered investment companies, and end users subject to various restrictions on their use of swaps. The notice of proposed rulemaking goes into detail on these points, and now that the public can review and consider the proposed rules in their entirety, the Commission would like to receive the public’s comments on these issues.