News Bulletin

October 18, 2012

The CFTC's No-Action Letter Relating to Eligible Contract Participants and Swap Guarantee Arrangements

In a no-action letter issued on October 12, 2012 (the "No-Action Letter")[1], the Office of the General Counsel ("OGC") of the Commodity Futures Trading Commission (the "CFTC") clarified a number of matters relating to the parties and guarantors that will qualify for treatment as "Eligible Contract Participants" under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). Dodd-Frank both amended the definition of "Eligible Contract Participant" (hereinafter, "ECP")[2] contained in the CEA and made it unlawful for a party that is not an ECP to enter into a swap except on, or subject to the rules of, a designated contract market (a "DCM").[3] The No-Action Letter, one of more than a dozen interpretive letters that the CFTC issued last week, should significantly aid market participants in understanding which counterparties and which guarantee arrangements are permissible under Dodd-Frank.

In the No-Action Letter, as set out in greater detail in Part I below, the OGC gives interpretive guidance that:

- a non-ECP generally may not be jointly and severally liable for obligations under a swap;
- a guarantor of obligations under a swap must generally be an ECP; and
- cash proceeds from a loan may count as assets for purposes of determining whether an entity's "total assets" meet the $10 million threshold for such entity to constitute an ECP under CEA § 1a(18)(A)(v)(I).

In addition, as detailed in Part II below, the OGC provides no-action relief with respect to:

- certain ECP guarantee arrangements relating to small businesses;
- so-called "anticipatory ECPs," entities anticipating the receipt of loan proceeds that will enable them to qualify as ECPs; and

[1] CFTC Letter No. 12-17, No-Action and Interpretation, October 12, 2012, 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'."
[2] The definition of ECP, too long to include in its entirety here, is contained in § 1a(18) of the Commodity Exchange Act ("CEA"), 7 *U.S.C.* 1, et seq. In addition, the CFTC has published rules further defining the term. See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 Fed. Reg. 30596 (May 23, 2012).
[3] Dodd-Frank at § 723(a)(2).

- the nature of the "amounts invested on a discretionary basis" that an individual must have in order to qualify as an ECP under CEA § 1a(18)(A)(xi).

Finally, the No-Action Letter grants temporary relief relating to certain situations in which a counterparty or a guarantor fails to qualify as an ECP, as set out in Part III below.

I. Interpretations

A. Joint and Several Liability of Non-ECPs Under Swaps

As explained in the No-Action Letter, unless some basis for no-action relief applies, each counterparty to a swap, even if liable on a joint and several basis with other parties that are ECPs, must itself be an ECP.[4] This may make it unlawful for parties that are jointly liable under a loan to enter into a related swap on the same basis. The OGC's rationale for this view is straightforward: a non-ECP becoming liable under a swap on a joint and several basis "would constitute entering into a swap," which is forbidden under the CEA unless the swap is on, or subject to the rules of, a DCM.[5]

B. Non-ECP Guarantors

Similarly, noting that the CFTC had earlier defined "swap" to include a guarantee of a swap, in the No-Action Letter the OGC states that, subject to narrow exceptions, and unless some basis for no-action relief applies, each guarantor of obligations under a swap that is not executed on or pursuant to the rules of a DCM must be an ECP, even if the counterparty directly liable, whose obligations are being guaranteed (the "Guaranteed Swap Counterparty"), is itself an ECP. To find otherwise, the OGC states, would undermine the goal of limiting the non-DCM swap market to sophisticated entities that are able to assess and bear that market's risks.[6]

C. Loan Proceeds Forming Part of a Counterparty's "Total Assets"

The No-Action Letter clarifies that, when a counterparty receives a loan in order to purchase an asset, the proceeds of that loan may be counted as part of its "total assets" for purposes of CEA § 1a(18)(A)(v)(I), under which a corporation, partnership, proprietorship, organization, trust, or other entity with "total assets" exceeding $10 million constitutes an ECP. This determination is intended to allay concern that borrowers in purchase money loans might not be able to qualify as ECPs prior to the passing of title of the property being purchased. "[W]hile 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."[7]

II. No-Action Relief

In addition to interpretive guidance, the No-Action Letter provides no-action relief in relation to (i) certain guarantees of obligations under swaps, (ii) loan proceeds and "anticipatory ECPs" and (iii) the determination of individuals' "assets invested on a discretionary basis" for purposes of CEA § 1a(18)(A)(xi).

[4] See No-Action Letter at 4-5.
[5] No-Action Letter at 4.
[6] No-Action Letter at 3.
[7] No-Action Letter at 5.

A. Swap Guarantees

Under the CEA, certain types of entities that are ECPs may confer ECP status upon a party that is not otherwise an ECP by guaranteeing such non-ECP's obligations. Among the types of parties that can confer ECP status by means of providing a guarantee are entities with total assets exceeding $10 million, certain financial institutions, insurance companies, investment companies, commodity pools and governmental entities, and any other person that the CFTC determines to be eligible.[8]

Responding to comments that the CFTC should expand the types of guarantors that may confer ECP status on a non-ECP, the OGC in the No-Action Letter recommends, subject to the limitations set out below, that the CFTC not commence enforcement action with respect to certain additional types of guarantors. This no-action determination is intended to provide relief to small businesses by permitting:

- co-proprietors to guarantee each other's swap obligations;
- high net worth individuals operating small businesses through legal entities (not technically constituting proprietorships) for legitimate business reasons (such individuals, "Indirect Proprietorships") to guarantee their businesses' swap obligations; and
- corporations or other entities that own or operate small businesses, or through which Indirect Proprietorships own and operate small businesses, to guarantee such small businesses' swap obligations.[9]

Specifically, the No-Action Letter states that the OGC will not recommend enforcement action against a guarantor, Guaranteed Swap Counterparty or beneficiary of a guarantee if the following conditions are met:

- the guarantor is:
  - a corporation, partnership, proprietorship, organization, trust, or other entity with a net worth exceeding $1 million; or
  - an Indirect Proprietorship consisting of an individual or (where permitted by applicable state law) individuals with
    - a net worth in the aggregate across all indirect co-proprietors exceeding $1 million; or
    - amounts invested on a discretionary basis, the aggregate of which is in excess of $5 million across all indirect co-proprietors; and
- all of the following conditions applicable to a particular guarantor or Guaranteed Swap Counterparty are satisfied:
  - 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, by the Guaranteed Swap Counterparty in the conduct of its business;

[8] CEA at § 1a(18)(A)(v)(II).
[9] See No-Action Letter at 7-8.

- 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 its business (other than solely clerical or administrative functions);

- 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;

- the guarantor computes its net worth or amounts invested on a discretionary basis in accordance with generally accepted accounting principles, consistently applied (provided that the value of real property may be determined using fair market value);

- the Guaranteed Swap Counterparty enters into the guaranteed swaps only as a principal; and

- the beneficiary of the guarantee verifies that the guarantor and Guaranteed Swap Counterparty satisfy the conditions of this no-action position.[10]

B. Loan Proceeds and "Anticipatory ECPs"

The OGC also provides a no-action determination applicable to corporations, partnerships, proprietorships, trusts or other entities seeking to qualify as ECPs under CEA § 1a(18)(A)(v)(I), under which such entities qualify for ECP status if they have more than $10 million in "total assets."

The No-Action Letter states that if a lender has committed to fund a loan in an amount that, when counted as an asset, would permit the borrower to claim in excess of $10 million in total assets, the "anticipatory ECP" borrower should be permitted to enter into a swap to hedge its loan obligations prior to the closing of the loan.[11] Accordingly, the OGC states that it will not recommend enforcement action against any of the anticipatory ECP, its guarantor, if any, or its swap counterparty, if the following conditions are met:

- the swap for which ECP status is necessary is intended to manage the non-ECP swap counterparty's floating interest rate risk on the loan;

- if the loan would, if disbursed, cause the non-ECP swap counterparty to qualify as an ECP under CEA § 1a(18)(A)(v)(I) but the loan has not yet closed, the non-ECP swap counterparty has received a bona fide loan commitment for such loan;

- 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 (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

- the loan is actually funded in an amount causing the non-ECP swap counterparty to qualify as an ECP under CEA § 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

[10] No-Action Letter at 9-11.
[11] No-Action Letter at 11-12.

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).[12]

The No-Action Letter warns that a failure to fund a loan may be scrutinized to assure that there is a legitimate business reason for the failure and no attempt to evade the ECP requirement. [13]

C. Amounts Invested on a Discretionary Basis

The third no-action determination contained in the No-Action Letter relates to the term "assets invested on a discretionary basis" contained in CEA § 1a(18)(A)(xi). Under that provision, an individual qualifies as an ECP if the individual has aggregate "amounts invested on a discretionary basis" in excess of (i) $10 million or (ii) $5 million and the individual "enters into the agreement, contract, or transaction in order to manage the risk associated with an asset owned or liability incurred, or reasonably likely to be owned or incurred, by the individual."[14]

The No-Action Letter notes the similarity of this language of the CEA to the language contained in Section 2(a)(51)(A)(iv) of the Investment Company Act of 1940 defining the term "qualified purchaser." [15] Based on this similarity, and the perceived similarity in the purposes of the two provisions, the OGC states that it will not recommend enforcement action against any of a non-ECP counterparty, its guarantor, if any, or its swap counterparty, if "such persons rely on the standards set forth in '40 Act Rule 2a51-1" in determining whether a party has sufficient "amounts invested on a discretionary basis" to constitute an ECP under § 1a(18)(A)(xi) of the CEA.[16]

III. Transitional No-Action Relief

In addition to the no-action relief noted above, the No-Action Letter provides for additional relief on a temporary, transitional basis.

First, the No-Action Letter states that, until March 31, 2013, the OGC will not recommend enforcement action with respect to situations in which a non-ECP guarantees obligations under a swap, assuming the Guaranteed Swap Counterparty either is an ECP or otherwise satisfies the terms for a no-action determination under the No-Action Letter.

Second, the No-Action Letter states that, until December 31, 2012, the OGC will not recommend enforcement action against any person for the failure of a swap counterparty to qualify as an ECP, provided that (i) the relevant party did qualify as an ECP prior to enactment of Dodd-Frank or, prior to October 12, 2012, was eligible to enter into an agreement, contract, or transaction in reliance upon a certain previous CFTC order[17] and (ii) a swap counterparty to a non-ECP "is in good faith," preparing to come into compliance with applicable CFTC regulations or otherwise seeking to determine whether its counterparty is an ECP. [18]

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[12] No-Action Letter at 12-13.
[13] No-Action Letter at 13.
[14] CEA at § 1a(18)(A)(xi).
[15] 7 U.S.C. § 80a-2(a)(51)(A)(iv).
[16] No-Action Letter at 15.
[17] See No-Action Letter at 15 and note 6; Second Amendment to July 14, 2011 Order for Swap Regulation, 77 Fed. Reg. 41260 (July 13, 2012).
[18] No-Action Letter at 15-16.

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Author

James E. Schwartz
New York
(212) 336-4327
jschwartz@mofo.com

Contacts

Larry Abrams
New York
(212) 336-4113
labrams@mofo.com

Chrys A. Carey
New York
(202) 887-8770
ccarey@mofo.com

David H. Kaufman
New York
(212) 468-8237
dkaufman@mofo.com

Anna T. Pinedo
New York
(212) 468-8179
apinedo@mofo.com

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