



## A Simple Framework for Determining Whether Dodd-Frank Applies to Your Energy Trade

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Reading Time : **4 min**

The CFTC's definition of "swap" generally includes financial derivatives such as contracts-for-differences that are settled against a price index or a futures contract.<sup>2</sup> Forward contracts that are intended to be physically settled, contracts for full requirements or full output that are intended to be physically settled, and leases and lease-like arrangements such as tolling agreements generally are *not* regulated as swaps.<sup>3</sup>

There are important exceptions for "end users," *bona fide* hedging, and trades in organized electric markets; however, even if an exception applies, the contract still may be subject to Dodd-Frank's data collection and reporting requirements if it meets the definition of "swap."

### 2. Is the company an Eligible Contract Participant?

If the contract is a swap and no exception applies, then it needs to be executed on an organized exchange or else each party needs to qualify as an Eligible Contract Participant ("ECP"). Only ECPs may enter into bilateral, over-the-counter swaps. ECPs include entities that have, or have a guarantor that has, \$10 million in assets.<sup>4</sup> Entities with a net worth of only \$1 million may be considered ECPs, but only with respect to swaps that are entered into for the purpose of hedging risk.<sup>5</sup>

### 3. Is the company a "Swap Dealer" or "Major Swap Participant"?

Swap Dealers and Major Swap Participants are subject to extensive regulation under Dodd-Frank so market participants will want to avoid these designations. It is unlikely that any single transaction will result in a company falling into either of these categories, although any

company that engages in a large volume of swaps needs to be aware of how these categories are defined and what exemptions could apply.

Again, the CFTC's rules are complex. The final rule defining the terms "swap dealer" and "major swap participant" runs 169 Federal Register pages.<sup>6</sup>

In general, a swap dealer is a person who: (a) holds themselves out as a dealer in swaps; (b) makes a market in swaps; (c) regularly enters into swaps in the ordinary course of business; or (d) engages in any activity causing them to be known as a swap dealer.<sup>7</sup> If a company engages in activities that could cause it to be classified as a swap dealer, it may fall under the "*de minimis* exception" which excludes a company from the "swap dealer" category if, over the immediately preceding 12-month period, its aggregate swap dealing activities do not exceed the gross "notional amount" of \$3 billion (\$8 billion during the initial phase-in period),<sup>8</sup> excluding hedges.<sup>9</sup> Entities under common control are considered one company for the purposes of this calculation.<sup>10</sup>

In general, a "major swap participant" is a person other than a swap dealer that (a) maintains a substantial position in swaps for any of the major swap categories, excluding positions for hedging or mitigating commercial risk, (b) has outstanding swaps that create substantial counterparty exposure that could have "serious adverse effects" on the financial stability of the U.S. banking system or financial system, or (c) is a highly leveraged financial entity that maintains a substantial position in any major swap category.<sup>11</sup> The intent is to identify those entities whose exposure to swaps poses market risks that, in the view of the CFTC, warrant enhanced regulatory oversight and control.

#### **4. Is the contract subject to mandatory clearing requirements?**

As of December 2013, only interest rate swaps and credit default swaps are subject to mandatory clearing,<sup>12</sup> but the CFTC has stated that other classes of swaps may become subject to mandatory clearing in the future.

#### **5. Is the contract subject to position limits?**

The CFTC has issued proposed rules regarding speculative position limits for certain products, but there are currently no position limit rules in effect.<sup>13</sup> The proposed speculative position limits would apply to financial derivatives that settle against four core energy commodity

futures contracts and economically equivalent products. The core energy commodity futures contracts are (1) New York Mercantile Exchange Light Sweet Crude Oil, (2) New York Mercantile Exchange New York Harbor ULSO, (3) New York Mercantile Exchange RBOB Gasoline Blendstock, and (4) New York Mercantile Exchange Henry Hub Natural Gas. For more information on speculative position limits, see our December 23, 2013 [blog](#), “CFTC Re-Proposes Position Limits for Certain Commodity Futures Contracts and Economically Equivalent Swaps.”

## **6. Is the contract subject to mandatory reporting and recordkeeping requirements?**

Companies are required to keep full, complete and systematic records of all swaps to which they are counterparties. Information on a swap must be retained for at least five years following termination of the swap. These records must be readily retrievable throughout the life of the swap and for two years thereafter, but can then be archived.<sup>14</sup>

All swaps must be reported to a swap data repository. If the swap was not cleared on an exchange, then one of the parties must do the reporting. If one party is a Swap Dealer, Major Swap Participant, or a financial entity, that entity will be responsible for reporting the swap. If neither party falls into those categories, the parties must determine between themselves which entity will be responsible for reporting.<sup>15</sup>

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<sup>1</sup> Further Definition of “Swap,” “Security-Based Swap” and “Security-Based Swap Agreement,” 77 Fed. Reg. 48208 (Aug. 13, 2012).

<sup>2</sup> See 7 U.S.C. § 1a(47)(A) (2012).

<sup>3</sup> See *id.* § 1a(47)(B); Further Definition of “Swap,” “Security-Based Swap” and “Security-Based Swap Agreement,” 77 Fed. Reg. 48,208, 48,227-43 (Aug. 13, 2012).

<sup>4</sup> 7 U.S.C. § 1a(18).

<sup>5</sup> *Id.*

<sup>6</sup> 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).

<sup>7</sup> 7 U.S.C. § 1a(49); 17 C.F.R. § 1.3(ggg).

<sup>8</sup> In May 2015, the CFTC staff will prepare a study of the derivative markets. Nine months after this study, the CFTC may end the phase-in period or propose new *de minimis* rules. Otherwise, the five-year phase-in period will automatically terminate in October 2017. 17 C.F.R. § 1.3(ggg)(4)(ii).

<sup>9</sup> 7 U.S.C. § 1a(49)(D); 17 C.F.R. § 1.3(ggg)(4).

<sup>10</sup> 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, 30,631 (May 23, 2012) (“Further Definition”).

<sup>11</sup> 7 U.S.C. § 1a(33); 17 C.F.R. § 1.3(hhh)(1)(ii)(C).

<sup>12</sup> Clearing Requirement Determination Under § 2(h) of the CEA, 77 Fed. Reg. 74,284 (Dec. 13, 2012).

<sup>13</sup> Position Limits for Derivatives, 78 Fed. Reg. 75680 (December 12, 2013).

<sup>14</sup> Swap Data Recordkeeping and Reporting Requirements, 77 Fed. Reg. 2136, 2141-42 (Jan. 13, 2012).

<sup>15</sup> *Id.* at 2137, 2153.

## Categories

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