Spring 2011

Weil

Finance Digest

Auditor Independence in Public Offerings

By Alexander D. Lynch and Kevin Yung

In This Issue

Any company undertaking an IPO or a high yield offering that will result in a subsequent registered exchange offer should ensure they have engaged auditors that are independent. The confirmation of auditor independence should be done early in the offering process. The following is a brief discussion of some of the issues related to the auditor independence requirement.

Independence and Affiliates

After the adoption of Sarbanes-Oxley, it is a fundamental requirement that a company that is filing a registration statement or is already public provide financial statements that have been audited by an independent registered public accounting firm. Rule 2-01 ("Rule 2-01") of Regulation S-X under the Securities Act of 1933, as amended, and Rule 3520 ("Rule 3520"), *Auditor Independence*, of the Public Company Accounting Oversight Board ("PCAOB") require that a company's registered public accounting firm must be considered independent from their audit clients throughout the audit and professional engagement period. For these purposes, an audit client is not only the issuer and its subsidiaries, but also any affiliates of the issuer, including entities under common control. For an issuer that is a private equity portfolio company, this means that the auditor must be independent not only for the issuer, but also the private equity investor and for every other portfolio company that is an affiliate of the private equity investor.

Non-Audit Services Impact Independence

Rule 2-01 specifies certain types of non-audit services an accounting firm may provide to a client or its affiliate that could render the accounting firm not independent. Examples of such services include:

- Contingent fee arrangements;
- Bookkeeping or other services related to the accounting records or financial statements of the audit client;
- Human resource functions;
- Financial information systems design and implementation;
- Management functions; and
- Legal services.

Many companies, particularly those domiciled in Europe or Asia, use accounting firms to provide these types of services. Accordingly, if the issuer is a portfolio company of a large global private equity fund, then it is important to confirm that its auditor has not provided any of these services to any of the fund's other portfolio companies.

Auditor Confirmation of Independence

An auditor is required to confirm its independence to a company's audit committee at the time of the initial engagement and periodically throughout the engagement period. As part of that process, the public accounting firm should confirm that they have not provided any prohibited services to the issuer, the private equity sponsor or any of the other affiliates in the private equity investor's portfolio. A public accounting firm should self-report any independence issues to the audit committee as well as the Securities and Exchange Commission (the "SEC").

Auditor Independence Diligence

Given the importance of auditor independence in the offering context, it is important to determine that there are no independence issues early in the offering process. Accordingly, issuers, investment bankers and counsel should consider the following steps as part of the offering process:

Don't ignore independence issues. If you become aware of any potential auditor independence issues, raise them immediately with the audit committee, SEC counsel and the auditors. Even minor issues can lead to the determination that an auditor is not independent and result in an issuer having to retain a new audit firm prior to filing a registration statement.

Review the auditor's process for reviewing independence. Ensure that the auditor has a robust independence review process that includes confirming that the auditor has examined its independence at the issuer, the private equity sponsor and the portfolio company levels. Inquire as to the procedures that the auditor undertakes in establishing its independence and determine whether they seem adequately designed to identify independence issuers for the issuer and its affiliates.

As IPO and leverage buyout activity increases, it is important that auditor independence is firmly established early in any process.

Establish that all affiliates have been identified. If the issuer is a portfolio company, ensure that the private equity sponsor has identified all of its affiliates and provided the list to the auditor. In addition, ask the sponsor if the auditor has provided any non-audit services to any of its portfolio companies.

Review auditor's correspondence to the audit committee and the SEC. A registered public accounting firm is required to confirm its independence and provide the audit committee with a letter pursuant to PCAOB Rule 3526 confirming its independence. Review those letters and any related correspondence or disclosure and actively pursue any independence issues identified by the auditors in those letters.

Ensure that the audit committee has determined that the auditors are independent. The audit committee is obligated to make its own independence determination. Accordingly, review any audit committee discussions and determinations regarding independence issues and discuss their independence review process.

Confirm whether the SEC has reviewed any identified independence issues. In the event an independence issue has been identified, confirm that the audit firm has reported the issue to the SEC and that the SEC has determined that there is no independence issue or that it will not object to the continued role of the auditor. Make sure that any required SEC review occurs early in the process so that the SEC review does not delay a filing or so that there is time to retain a new auditor if required.

Don't assume that the SEC will overlook the issue. The SEC takes auditor independence issues seriously and has limited authority to make exceptions to the independence requirements. You should not assume that a relatively minor issue will not lead to a determination that the auditor is not independent. In certain circumstances, the SEC has not objected to the existence of independence issues, such as in the case of a newly acquired affiliate for which the existing auditor has provided prohibited services or for the inadvertent provision of a limited amount of prohibited services for a subsidiary or affiliate of a large conglomerate. However, in most of these instances, the auditor has audited the issuer's financial statements for some time and the issuer is already public. The

SEC typically will not overlook the existence of independence issues in an IPO context when there are other public accounting firms that do not have independence issues available to provide audit services to the company or if the audit firm is new to the issuer.

Conclusion

As IPO and leverage buyout activity increases, it is important that auditor independence is firmly established early in any process that will involve a private company or a newly acquired company filing a registrations statement with the SEC. Auditor independence can be complex in the private equity portfolio context. Issuers and underwriters should confirm that the auditor is independent with respect to the issuer, the private equity investor and the other companies in the private equity portfolio. In addition, counsel should review the auditors process for determining whether the auditor has provided any prohibited services to the issuer, the private equity fund or any other portfolio companies. Lastly, counsel should review all correspondence relating to auditor independence with the issuer, the audit committee and the SEC and should confirm that the auditor has not reported any independence issues to the SEC or that the SEC will not object to the continued involvement of the auditor.

Intercreditor Case Law Update

By Elaine Stangland and Daniel Ferguson

"Belt and Suspenders" as the Best Way to Assure Enforceability of Waiver of Junior Creditors' Rights

When drafting intercreditor agreement provisions that waive junior lenders' rights, the best strategy to ensure that the waivers are enforced is to combine a general waiver by the junior creditor of its enforcement and bankruptcy rights, to the extent inconsistent with the provisions of the intercreditor agreement, with explicit waivers of the rights most commonly asserted by a junior creditor in a defaulted credit. While other factors may influence courts' enforcement of waiver provisions (such as obstructive behavior by creditors), attention to the basics of good draftsmanship is essential.

In *Ion Media*,[1] a second lien lender faced with broad "stay-silent" provisions did not have standing to object to a debtor-in-possession ("DIP") loan facility or to a senior lender supported plan and disclosure statement. In this case, FCC licenses were part of the original collateral package, and the ability of a creditor to hold a valid and perfected lien in this type of asset is subject to well-known limitations. The intercreditor agreement specified that each party's priority vis-à-vis the collateral would not be affected or impaired on account of any nonperfection of any lien "purportedly" securing such collateral. It also included a clause forbidding second lien lenders from taking any action inconsistent with the intercreditor agreement including challenging the validity, priority, or enforceability of liens granted to the first lien lenders. In addition, while the second lien lenders retained their rights as unsecured creditors, they expressly agreed not to object to any reorganization plan or disclosure statement consistent with the rights of the first lien lenders under the loan documents.

The out-of-the-money second lien lenders (a) contested the inclusion of the FCC licenses in the original collateral and the DIP collateral package and (b) objected to confirmation of the first lien supported plan of reorganization. The bankruptcy court found they did not have standing as a result of the explicit "stay-silent" provisions described above. The court concluded that the intercreditor agreement covered the FCC licenses under the "purportedly" language quoted above and prohibited second lien lenders from arguing they were not included in the original collateral package or improperly secured the DIP. The court also ruled that the intercreditor agreement prohibited the second lien lenders from objecting to the reorganization plan, which, the court ruled, satisfied the requirements of § 1129(b). The court further suggested that the second lien lenders were engaging in "obstructive behavior" in violation of the intercreditor agreement and that the increase in the administrative expenses of the case might be a measure of damages for their breach.

Similarly, the court in *Erickson Retirement Communities*[2] ruled that the second lien lenders "either lack standing and/or contractually waived the right to seek an examiner" in a bankruptcy case due to broad waiver provisions in the intercreditor agreement.

In *Erickson*, the second lien lenders agreed not to "exercise any rights or remedies or take any action or proceeding to collect or enforce" the second lien obligations, and waived "for the benefit of the Agent and the Lenders ... any principles or provisions of law, statutory or otherwise, which are or might be in conflict with the [intercreditor agreement's] terms." The court noted that the motion for an examiner brought by the second lien lenders did not allege fraud, misconduct or the like, was designed to slow down proceedings and was tantamount to both a pursuit of a remedy and the commencement of an action aimed ultimately at collection of the obligations in violation of the intercreditor agreement.

Relying on broad waivers does not always work, however. In *Boston Generating*,[3] a second lien lender had standing to object to bidding procedures and a subsequent § 363 sale supported by first lien creditors. The intercreditor agreement provided that subject to certain exceptions, including the retention of any rights available to unsecured creditors not inconsistent with the intercreditor agreement and the right to vote on a plan of reorganization, the "*sole right* of the Second Lien [lenders] is to hold a lien on the Collateral... to the extent granted [in the collateral documents]." The court noted that since no provision of the intercreditor agreement reflected an express or intentional waiver of its right to object to the sale as would be required under New York law, and because the second lien lender retained all the rights of an unsecured lender not inconsistent with the intercreditor agreement, the second lien lender had not waived its right to object. In contrast, the court noted, section 6.2 of the ABA Model Intercreditor Agreement contains an express waiver of the right to object to a sale pursuant to § 363 of the Bankruptcy Code.

However well drafted, there are limits to the enforceability of intercreditor agreements, especially in bankruptcy.

However, the *Boston Generating* court noted that additional factors entered into its analysis of whether the second lien lenders had standing to object. First, the § 363 sale of substantially all of the debtors' assets would have effectively deprived the second lien lenders of the meaningful opportunity to vote on a plan of reorganization, which was specifically granted to them under the intercreditor agreement. Second, the second lien lenders were on the "cusp" of recovery and were not engaging in the kind of "obstructive" behavior found in *Ion Media* and *Erickson*. Finally, the court noted that the result likely would have been different had the first lien lenders not, for reasons that remain unclear, stipulated that the § 363 sale was not an "exercise of remedies," which were exclusively reserved to first lien lenders under the intercreditor agreement.

Ambiguous or Inconsistent Drafting Is Rolling the Dice

Three recent intercreditor cases involving real estate financing are further examples of the risks attendant to ambiguous and/or inconsistent drafting.

In two state court cases, *Bank of America v. PSW NYC*,[4] and *First Choice Bank v. Riverview Muir Doran*,[5] unclear drafting gave rise to unintended interpretations of the intercreditor agreement with unfortunate results for junior lenders. In *PSW*, the court required the junior lenders to cure all outstanding defaults under the senior loans – including payment of $3.6 billion in accelerated debt resulting from a default – before foreclosing on their separate collateral. Both courts found the language to be "unambiguous" and did not consider either the economics of the deal or the industry's general understanding of the provisions of the intercreditor agreements. However, in *FCCD Limited v. State Street Bank*,[6] the Southern District of New York took a different approach and considered expert opinions on trade usage of the particular provisions in question. That court concluded that in light of the purpose of the provisions and the agreement as a whole, the only plausible reading of that agreement was the one consistent with industry understanding.

Limits of Intercreditor Enforceability

However well drafted, there are limits to the enforceability of intercreditor agreements, especially in bankruptcy. First, while waivers by second lien lenders are generally enforceable, both the *Boston Generating* and *Ion Media* courts expressed doubt about the enforceability of waivers by junior lenders of their right to vote on a restructuring plan under § 1126(a) of the Bankruptcy Code.[7]

Another exception to enforceability of intercreditor agreements in bankruptcy was revealed in *TCI 2 Holdings*,[8] where the court ruled that under the "cramdown" provisions of § 1129(b)(1), a bankruptcy court may confirm a plan over the objections of creditors and in violation of an intercreditor agreement which would otherwise be enforceable in bankruptcy under § 510(a).

In *TCI 2*, the bankruptcy court approved a plan supported by the debtor and second lien lenders which appears to have been in clear violation of both the "keep silent" and payment priority provisions of the intercreditor agreement. The court did not decide whether the intercreditor agreement was breached, but noted that "even if such a violation occurred, it would not impede the confirmation of [the plan] as proposed" due to the introductory phrase of § 1129(b)(1) which overrides § 510(a) and eliminates the enforcement of subordination agreements in cases in which a class rejects the plan of reorganization. Unlike in *Ion Media* where the court enforced the intercreditor in order to confirm a plan over the objections of what the court called an obstructive creditor, the *TCI 2* court refused to enforce the intercreditor agreement in order to reach the same result. The first lien lenders in *TCI 2* then sued in New York for breach of the intercreditor agreement, but the New York court transferred the claim to the bankruptcy court since adjudication could have a "conceivable effect" on the bankrupt estate.[9] Following a settlement between the parties, both the appeal of the confirmation of the plan and the breach of contract suit have been dismissed.

Conclusion

As these cases demonstrate, courts are willing to enforce intercreditor agreements to some extent but the outcome will depend on the facts of each case, especially since the law in this area gives courts leeway to achieve a desired result. Drafters should consider these cases as examples of the need for general and explicit waivers of rights by junior lenders, for clear drafting that reflects the deal struck by the parties, and as a reminder of the limitations on the enforceability of intercreditor agreements in bankruptcy.

1 *In re Ion Media Networks Inc.*, 419 B.R. 585 (Bankr. S.D.N.Y. 2009).

2 *In re Erickson Retirement Communities LLC*, 425 B.R. 309 (Bankr. N.D. Tex 2010).

3 *In re Boston Generating, LLC*, 440 B.R. 302 (Bankr. S.D.N.Y. 2010).

4 *Bank of America, N.A. v. PSW NYC LLC*, No. 651293/10, 29 Misc.3d 1216(A), 2010 NY Slip Op 51848(U) (N.Y. Sup. Ct. Sept. 16, 2010).

5 *First Choice Bank v. Riverview Muir Doran, LLC*, No. A09-1337, 2010 WL 2161778 (Minn. Ct. App. June 1, 2010).

6 *FCCD Limited v. State Street Bank & Trust Co*., No. 10 Civ. 1632 (S.D.N.Y. Feb. 15, 2011).

7 *But see In re Avondale Gateway Center Entitlement, LLC*, Nos. CV10-1772-PHX-DGC 02-09-BK-12153-CGC (D. Ariz. Apr. 12, 2011) (holding a subrogation clause effectively transferred a junior lender's reorganization plan voting rights to the senior lender).

8 *In re TCI 2 Holdings, LLC*, 428 B.R. 117 (Bankr. D. N.J. 2010).

9 *Beal Bank S.S.B. v. U.S. Bank N.A.*, 2010 WL 2541165 (S.D.N.Y. 2010).

Proposed Amendments to Article 9 of the Uniform Commercial Code

By Roshelle Nagar and Suhan Shim

The current version of Article 9 of the Uniform Commercial Code ("UCC"), which governs the perfection and priority of a secured party's security interests over the personal property of a debtor, has been enacted in all fifty states, the District of Columbia and the U.S. Virgin Islands and generally took effect on July 1, 2001.[1] In an effort to address certain ambiguities and problems that arose with respect to the revised statutes, the Uniform Law Commissioners ("ULC") and The American Law Institute ("ALI") formed a committee to recommend certain amendments to the text of the statutes and revisions to the official comments to Article 9. Although many of the proposed changes are technical clarifications, some of these changes affect the manner in which UCC searches and filings are conducted. This article focuses primarily on how the proposed amendments deal with the thorny issue of the proper approach to determining the correct legal name of a debtor in a UCC financing statement when the debtor is an individual. In addition, it examines the effect of a change in the governing law of a debtor under the new amendments and the proposed changes to the use of correction statements.

Filing a UCC-1 Financing Statement Against Individual Debtors

§9-502(a)(1) provides that a financing statement must provide the name of the debtor. If the debtor is an individual person, § 9-503(a)(4)(A) requires that the financing statement provide the individual debtor's name. Since financing statements are indexed under the last name of a debtor that is an individual, the filing office is required to reject a financing statement unless the debtor's last name can be identified (e.g., it must be clear whether the debtor's name is Elton John or John Elton). Ultimately, as long as the financing statement can be discovered by a search under the debtor's correct name using the filing office's standard search logic, the financing statement would not be considered seriously misleading under § 9-506.

Unfortunately, choosing the right name is not as easy as it sounds, and Article 9 provides no clear guidance regarding what constitutes the debtor's "correct name" under § 9-506. Problems arise if an individual uses multiple names on different documents and in different scenarios. If the "correct name" is construed narrowly, a financing statement might be considered seriously misleading under § 9-506 if the secured party chooses the wrong variation of the debtor's name, resulting in the loss of the secured party perfected security interest in its collateral. On the flip side, parties searching the UCC filing records would have to search multiple iterations of a "debtor's correct name" if the "correct name" is construed broadly. As an example, there are the obvious ambiguities with commonly abbreviated names, such as Susan as Sue or Eugene as Gene. Some individuals are more commonly known by their nicknames, like Alicia Augello Cook, a.k.a. "Alicia Keys." Others may change their legal names after marriage or divorce. Another example is Madonna, born Madonna Louise Ciccone. Despite her fame, most people probably assume that Madonna is merely a nickname and have no idea that "Madonna" is her full legal name. This proves to be a risky proposition for all parties, because if the wrong name is used, a secured party risks losing its perfected status and a searcher that fails to discover a properly filed financing statement might unwittingly take a lien on assets that were already subject to a prior perfected lien.

The committee appointed by the ULC and ALI has opted to resolve this conundrum by providing two alternative approaches that shift the risk allocation between filers and searchers. These alternatives are codified in the proposed revisions to § 9-503(a) and are explained in the draft official comments. The legislative notes make it clear that the states should adopt one of these alternatives.

Alternative A specifies that the correct name to be used is the name that appears on the debtor's unexpired driver's license or other specified document issued by the state of the debtor's principal residence. If an individual debtor does not have either type of documentation, Alternative A indicates that a financing statement must provide the "individual name" of the debtor or the surname and first personal name of the debtor. The official comments to the new amendments make clear that the name on the financing statement must be the same as the name indicated on the license. This is true even if the name on the driver's license contains an error. For example, a secured party would file a financing statement using the name "Allen S. Cohen" if that were the name indicated on the individual's driver's license, even if the correct name were "Allan Stewart Cohen." Under this alternative, the searcher can rely on the official state issued document and will generally be able to search quickly and efficiently. Although this approach is very simple, it allocates a certain degree of risk to the secured party trying to perfect its security interests because in order to maintain its perfection it must constantly monitor the debtor to ensure that the license or official document does not expire or that the debtor is not issued a new license under a different name.

Alternative B takes the opposite approach; relying on the name that appears on the debtor's unexpired driver license or other specified document issued by the state as a safe harbor. A secured party can file a financing statement that specifies the "individual name" of the debtor or first personal name and surname. In addition, as a safe harbor, it can also file a financing statement with the individual's name indicated on the individual debtor's unexpired driver license or other specified document issued by the state. As the individual's name on the official state document is sufficient for purposes of perfection, the secured party has more assurance that its security interest will be properly perfected. The searcher, however, will have no way of knowing whether a filing has been made only under the name on the state issued document and will need to conduct a broader search of potential alternative names to uncover any filings that may have been filed against the debtor's "individual name" or its surname and first personal name.

This proves to be a risky proposition for all parties, because if the wrong name is used, a secured party risks losing its perfected status.

As of the writing of this article, most states which have introduced the new amendments have adopted Alternative A. In addition, Alternative A has received strong support from the banking industry. This is because of the certainty that Alternative A provides compared to Alternative B and the efforts of the committee to address the concerns with Alternative A during the drafting process. For example, (i) if the debtor doesn't have a current driver's license, the default rules control, and it is sufficient to use the debtor's surname and first personal name, (ii) if the debtor holds two licenses, the more recent one controls and (iii) if the license expires, or the debtor gets a new license with a different name, normal rules governing change in a debtor's name come into play and the secured party gets a four month grace period to re-file the financing statement.

Even though Alternative A isn't a perfect solution, it provides more certainty to secured lenders that their liens against the debtor's assets are properly perfected.

The Effect of a Change of Governing Law.

The committee also proposed significant changes to the effect of a change of governing law under § 9-316. Article 9 provides that when a debtor changes its location or merges into a new debtor with a different location, the law of the new jurisdiction governs perfection. The secured party remains perfected (for a grace period four months or one year, depending on the circumstances) but only with respect to the assets in which it was perfected before the debtor changed its location. This creates an issue for a secured party who may not be immediately aware of the change and wants to ensure that its security interest in the debtor's after acquired collateral remains continuously perfected.

The proposed amendments would add a new § 9-316(h), which provides that a secured party is also perfected in the newly acquired assets to which its security interest would have attached if there had been no change in governing law, for the applicable grace period. For example, for the applicable grace period, a secured party with perfected security interest in the collateral of the debtor in jurisdiction X would have a perfected security interest in additional collateral acquired by the debtor, even if the new collateral was acquired after the debtor relocated to its new jurisdiction Y.

The newly proposed § 9-316(i) is similar, except that it applies to a new debtor that is bound as debtor by a security agreement entered into by the original debtor due to a merger or other transaction. A common example is that of the original debtor incorporated in jurisdiction X merging into a new debtor incorporated in jurisdiction Y. In this case, the amendments make clear that for the applicable grace period, a secured party with a perfected security interest in the collateral of the original debtor would automatically gain perfection over the relevant type of personal property of the new debtor. The secured party would be required to make the necessary filings against the new debtor within the grace period under the UCC of the new jurisdiction Y in order to maintain its continuous perfected security interest in the collateral.

Additional Amendments

In addition to the issues covered by this article, the new amendments cover a broad range of issues, including clarifications regarding how to "authenticate" documents in the digital age. The new amendments also make conforming changes to the form of UCC financing statement forms and clarify the proper use and effect of "information statements" (formerly labeled "correction statements") that are filed in the UCC records in connection with inaccurate or wrongfully filed records.

There has been considerable confusion in the secured lending community over the use of "correction statements" and who is authorized to file them. Although they were originally created to allay concerns that unauthorized filings might be made against debtors (due to the elimination of the signature requirement on all financing statements), both debtors and secured parties have been using correction statements for far broader purposes. In addition, while the term "correction" made it seem as if the filings could alter the filing records, the sole role of the correction statement has always been to provide searchers with information that might help to clarify any inaccuracies or ambiguities. Under the proposed amendments, the form would be renamed "information statement" to further clarify that it has no legal effect and that its sole purpose is to provide public notice that the filing record is disputed. Secured parties would also be authorized to use an information statement in connection with a filing made by an unauthorized person but could not use it to correct an error in the secured party's own financing statement.

Conclusion

In drafting the proposed amendments to Article 9 of the UCC, the ULC and ALI endeavored to introduce revisions that would balance (i) the benefits of predictability as to priority and perfection, (ii) the likely costs that would be imposed on secured parties filing financing statements and searchers searching the UCC records, (iii) the costs of transitioning to the new rules and (iv) the likely legislative outcome if a particular approach were to be adopted. The proposed statutory changes were finalized in the fall of 2010. The new amendments have now been introduced by some state legislatures, and have already been enacted by North Dakota. The goal is to have the amendments adopted by the states with a uniform effective date of July 1, 2013.

1 All citations to Article 9 refer to the current version of Article 9 unless otherwise indicated.

CFTC and SEC Propose Joint Rule re Further Definition of "Swap Dealer" and "Major Swap Participant"

By Hyun K. Kim

The Commodity Futures Trading Commission (the "CFTC") and the Securities Exchange Commission (the "SEC," and together with the CFTC, the "Commissions") held public meetings on December 1, 2010 and December 3, 2010, respectively, to consider, among other things, the much-anticipated further definition of "swap dealer," "major swap participant," "security-based swap dealer," and "major security-based swap participant" under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). The proposed rule was passed by the CFTC in a 3-2 vote and was adopted by the SEC unanimously and was published in the Federal Register for comment on December 21, 2010. The comment period for the rule expired on February 22, 2011.

Definition of "Swap Dealer" and "Security-Based Swap Dealer"

In discussing this definition, the Commissions noted certain distinguishing features of swap dealers and security-based swap dealers. For example, swap dealers and security-based swap dealers:

- tend to accommodate demand for swaps and security-based swaps from other parties;
- are generally available to enter into swaps or security-based swaps to facilitate other parties' interest in entering into those instruments;
- tend to enter into swaps or security-based swaps on their own standard terms or on terms they arrange in response to other parties' interest, rather than requesting that other parties propose the terms of those instruments;
- tend to be able to arrange customized terms for swaps or security-based swaps upon request or to create new types of swaps or security-based swaps on their own; and
- tend to enter into swaps or security-based swaps with more counterparties than do non-dealers.

The Commissions also discussed examples of specific dealing activities in connection with the definition of "swap dealer" and "security-based swap dealer." If a person:

- contacts potential counterparties to solicit interest in swaps or security-based swaps;
- develops new types of swaps or security-based swaps and informs potential counterparties of the availability of such swaps or security-based swaps and a willingness to enter into such swaps or security-based swaps with the potential counterparties;
- has membership in a swap association in a category reserved for dealers;
- provides marketing materials (such as a web site) that describe the types of swaps or security-based swaps that such person is willing to enter into with other parties; or
- generally expresses a willingness to offer or provide a range of financial products that would include swaps or security-based swaps,

then such activities may indicate that the person holds himself out as, and is commonly known in the trade as, a swap dealer or security-based swap dealer.

The definition of "swap dealer" does not include a person who enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of regular business.

De Minimis Exemption

Dodd-Frank requires that the Commissions exempt a person who engages in a de minimis quantity of swap or security-based swap dealing from designation as a "swap dealer" or "security-based swap dealer." The Commissions are not required to fix a specific level of swap activity for this exemption, but instead are required to promulgate regulations to establish factors for determining whether certain swap activities may be considered de minimis.

To take advantage of the de minimis exemption, a person must meet all of the following conditions:

- The aggregate effective notional amount,[1] measured on a gross basis,[2] of swaps or security-based swaps that the person entered into over the immediately preceding 12 months in connection with its dealing activities[3] does not exceed $100 million. In addition, the aggregate effective notional amount of swaps or security-based swaps that the person entered into over the immediately preceding 12 months, in which the person's counterparty is a "special entity,"[4] does not exceed $25 million.

- The person has not entered into swaps or security-based swaps as a dealer with more than 15 counterparties, other than swap dealers or security-based swap dealers, over the course of the immediately preceding 12 months. In determining the number of counterparties, all counterparties that are members of a single group of persons under common control[5] shall be considered a single counterparty.
- The person has not entered into more than 20[6] swaps or security-based swaps as a dealer during the immediately preceding 12 months.

Statutory Exclusion for Swaps in Connection with Originating a Loan

The definition of "swap dealer" (but *not* the definition of "security-based swap dealer") does not include an insured depository institution to the extent that it offers to enter into a swap with a customer in connection with originating a loan with that customer. In order to prevent evasion of the rules applicable to "swap dealer," this exclusion does not apply where:

- the purpose of the swap is not linked to the financial terms of the loan;[7]
- the insured depository institution enters into a "sham" loan; or
- the purported "loan" is actually a synthetic loan including, without limitation, a loan credit default swap or loan total return swap.

Recognizing the complexity in originating commercial loans, the CFTC believes that this exclusion should be applicable to all insured depository institutions that provide funds to a borrower. If a loan syndicate provides a loan to a borrower, all insured depository institutions that are part of that syndicate could claim this exclusion with respect to swaps entered into with the borrower that are linked to the financial terms of the loan. The CFTC also proposes that this exclusion apply to an insured depository institution that participates in such loan by means of a transfer or otherwise[8] if such insured depository institution enters into a swap with a borrower or is an insured depository institution that is a source of funds for the refinancing of a loan (whether directly or through a syndicate, participation or otherwise) if such insured depository institution enters into a swap with the refinancing borrower.

This exclusion is available to *insured depository institutions only*. Therefore, if an insured depository institution transfers its participation in a loan to a non-insured depository institution, for example, that transferee, which is not an insured depository institution, would not be able to claim this exclusion. Similarly, if a non-insured depository institution is part of a loan syndicate with insured depository institutions, the former would not be able to take advantage of this exclusion.

Limited Designation as Swap Dealer or Security-Based Swap Dealer

In general, the Commissions propose that a person meeting the definition of "swap dealer" or "security-based swap dealer" would be a dealer for all categories of swaps or security-based swaps[9] in which the person engages and therefore be subject to all regulatory requirements applicable to dealers for all swaps or security-based swaps into which the person enters. The Commissions may, however, provide a person an opportunity to seek a limited designation based on facts and circumstances of its particular activities. The Commissions anticipate that a swap dealer could seek a limited designation at the same time as, or at a later time subsequent to, the person's initial registration as a swap dealer.

Affiliate Issues

The word "person" in the definitions of "swap dealer" and "security-based swap dealer" should be interpreted to mean a particular legal person. An affiliated group of legal persons under common control could include more than one dealer as any legal person within such a group that engages in swap or security-based swap dealing activities would be a swap dealer or security-based swap dealer, as applicable. Swaps and security-based swaps between persons within an affiliated group may not have the distinguishing characteristics indicative of dealing activities (such as holding oneself out as a dealer or being commonly known as a dealer in the trade) that are typically found in those between unaffiliated persons. To the extent that a person uses transactions with an affiliated person under common control to avoid meeting the definition of "swap dealer" or "security-based swap dealer," the Commissions will have the authority to prohibit practices aimed at evading the requirements applicable to swap dealers and security-based swap dealers.

Definition of "Major Swap Participant" and "Major Security-Based Swap Participant"

Unlike the definitions of "swap dealer" and "security-based swap dealer" that focus on a person's activities and the amount of those activities in the context of the de minimis exception, the definitions of "major swap participant" ("MSP") and "major security-based swap participant" ("MSSP") focus on the market impacts and risks associated with a person's swap and security-based swap positions. Because of the potential risk that MSPs and MSSPs pose to the U.S. financial system generally, MSPs and MSSPs are subject to comprehensive regulatory requirements just as swap dealers and security-based swap dealers.

Three Alternative Tests

An MSP/MSSP means a person who satisfies *any* of the following three tests:

- a person who maintains a "substantial position" in any of the major categories of swaps or security-based swaps, *excluding* positions held for hedging or mitigating commercial risk and positions maintained by employee benefit plans primarily for hedging or mitigating risks directly associated with the operation of the plans;
- a person whose outstanding swap or security-based swap positions create "substantial counterparty exposure" that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or
- a "highly leveraged" non-bank "financial entity" that maintains a substantial position in swaps or security-based swaps in any of the major categories of swaps or security-based swaps.

The definition of MSP, but *not* the definition of MSSP, has an exception for any "entity whose primary business is financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90% or more of which arise from financing that facilitates the purchase or lease of products, 90% or more of which are manufactured by the parent company or another subsidiary of the parent company."

Major Categories of Swaps and Security-Based Swaps

The Commissions designated "major categories" of swaps and security-based swaps and these categories will apply only for purposes of the definitions of MSPs and MSSPs under Dodd-Frank.

For purposes of the MSP definition, there are four major categories of swaps:

- ***rate swaps*** – swaps primarily based on one or more reference rates including, but not limited to, any swap of payments determined by fixed and floating interest rates, currency exchange rates, inflation rates or other monetary rates, any foreign exchange swap as defined in the Commodity Exchange Act, as amended (the "CEA"), and any foreign exchange option;
- ***credit swaps*** – swaps primarily based on instruments of indebtedness including, but not limited to, any swap primarily based on one or more broad-based indices related to debt instruments and any swap that is an index credit default swap or total return swap on one or more indices of debt instruments;
- ***equity swaps*** – swaps primarily based on equity securities including, but not limited to, any swap primarily based on one or more broad-based indices of equity securities and any total return swap on one or more equity indices; and
- ***other commodity swaps*** – swaps not included in any of the first three categories, generally including any swap for which the primary underlying item is a physical commodity or the price or any other aspect of a physical commodity.

These four categories are intended to cover all swaps. Each swap, therefore, would belong to the category that most closely describes the primary item underlying the swap. If a swap has more than one underlying item of different types, the swap would go into the category that describes the underlying item that would likely have the most significant effect on its economic return.

For purposes of the MSSP definition, there are two major categories of security-based swaps:

- ***security-based credit derivatives*** – any security-based swap based, in whole or in part, on one or more instruments of indebtedness (including loans), or a credit event relating to one or more issuers or securities, including, but not limited to, any security-based swap that is a credit default swap, total return swap on one or more debt instruments, debt swap, debt index swap, or credit spread; and
- ***other security-based swaps*** not included in the first category.

Alternative Test 1 – Substantial Position

For purposes of this first alternative test to determine whether a person is an MSP or MSSP, the Commissions propose two tests to define "substantial position." If a person's position in any of the enumerated major categories of swaps or security-based swaps, excluding hedges for commercial risk and certain employee benefit plan positions, meets either of the tests, then the person would be viewed as having a substantial position and therefore as being an MSP or MSSP, as applicable.

Current Uncollateralized Exposure Test

A person's current uncollateralized exposure would be calculated by aggregating the person's current uncollateralized mark-to-market exposure within a particular category of swaps or security-based swaps, subtracting the aggregate value of any collateral that the person posted, and applying any applicable master netting agreements between the person and a single counterparty. If the person is permitted to maintain an uncollateralized "threshold" amount under the swap or security-based swap agreement, that amount would be considered current uncollateralized exposure for purposes of this test. Further, if the swap or security-based swap agreement provides for a minimum transfer amount exceeding $1 million, the entirety of that amount would be considered current uncollateralized exposure.

For purposes of the MSP and MSSP definitions, the Commissions propose the current uncollateralized exposure threshold at a daily average of $1 billion in the applicable major category of swaps and security-based swaps, except that the threshold for the rate swap category would be a daily average of $3 billion. These daily averages would be measured at the close of each business day, beginning on the first business day of each calendar quarter and continuing through the last business day of that quarter.

Current Uncollateralized Exposure Plus *Potential Future Exposure Test*

Under this test, a person's potential future exposure is calculated by multiplying the total notional principal amount[10] of the person's swap or security-based swap positions by specified risk factor percentages (see Table on next page), with adjustments for certain types of positions that pose relatively lower potential risks[11] and the risk mitigation effects of master netting agreements, central clearing and daily mark-to-market margining. Specified risk factor percentages apply to positions that are *not* cleared by a registered clearing agency or subject to mark-to-market margining. The potential future exposure attributed to positions that are subject to daily mark-to-market margining or clearing by a registered clearing agency or derivatives clearing organization would be adjusted downward to 20% of the product of the total notional principal amount and the applicable specified risk factor percentage.

For purposes of the MSP and MSSP definitions, the Commissions propose the current uncollateralized exposure plus potential future exposure threshold at a daily average of $2 billion in the applicable major category of swaps and security-based swaps, except that the threshold for the rate swap category would be a daily average of $6 billion.

Hedging or Mitigating Commercial Risk

Both "substantial position" tests in the first alternative test exclude positions held for "hedging or mitigating commercial risk." The Commissions state that the determinative factor in deciding whether a position is held for purposes of hedging or mitigating commercial risk would be whether the underlying activity to which the position relates is commercial in nature, as opposed to being in the nature of speculation, trading or investing[12] or being held to hedge or mitigate the risk of another swap or security-based swap position, unless that other position itself is held for purposes of hedging or mitigating commercial risk. The Commissions believe that the determination of whether a position hedges or mitigates a person's commercial risk should be made based on the facts and circumstances at the time the swap or security-based swap is entered into and the person's overall hedging and risk mitigation strategies.

Under the proposed rule, the Commissions define "hedging or mitigating commercial risk" broadly to include any swap or security-based swap position that:

- is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where the risks arise in the ordinary course of a person's business from, among other things, the potential change in the value of assets, liabilities, or services relating to the person or any fluctuation in interest, currency, or foreign exchange rate exposures arising from the person's assets or liabilities;
- qualifies as bona fide hedging for purposes of an exemption from position limits under the CEA; or
- qualifies for hedging treatment under Financial Accounting Standards Board Statement No. 133.

With respect to security-based swaps, the person holding a position for purposes of hedging or mitigating commercial risk needs to satisfy the following additional conditions to exclude that position from the substantial position test:

- the person identifies and documents the risks that are being reduced by the security-based swap position;
- the person establishes and documents a method of assessing the effectiveness of the security-based swap as a hedge; and
- the person regularly assesses the effectiveness of the security-based swap as a hedge.

Alternative Test 2 – Substantial Counterparty Exposure

The second alternative test of the MSP and MSSP definitions addresses persons whose outstanding swap or security-based swap positions create "substantial counterparty exposure" that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets. Unlike the first alternative test, this test does not focus on the amount of positions in any one major category of swaps or security-based swaps, but rather looks at a person's positions across all four major swap categories or both major security-based swap categories. Further, this test does not expressly exclude hedging positions or ERISA plan positions from the analysis.

The thresholds for the "substantial counterparty exposure" test are:

- with respect to swap positions, a current uncollateralized exposure of $5 billion or a combined current uncollateralized exposure and

Specified Risk Factor Percentages for Various Swaps and Security-Based Swaps

Residual Maturity	Interest Rate	Foreign Exchange Rate and Gold	Precious Metals (except for gold)	Other Commodities	Credit	Equity
1 year or less	0%	1%	7%	10%	10%	6%
1-5 years	0.5%	5%	7%	12%	10%	8%
over 5 years	1.5%	7.5%	8%	15%	10%	10%

potential future exposure of $8 billion; and

- with respect to security-based swap positions, a current uncollateralized exposure of $2 billion or a combined current uncollateralized exposure and potential future exposure of $4 billion.

The current uncollateralized exposure and the potential future exposure of a person under this second alternative test are calculated in the same way as the substantial position of a person under the first alternative test.

Alternative Test 3 – Highly Leveraged Financial Entity

Under the third alternative test, a "highly leveraged" non-bank "financial entity" with a substantial position in swaps or security-based swaps for any of the major categories would be designated as an MSP or MSSP. This test does not exclude hedging positions from the analysis. It is not known what thresholds will apply to this test.

The definition of "financial entity" in this context will be the same as the "financial entity" definition provided in the end-user exemption from mandatory clearing.

For the definition of "highly leveraged," the Commissions propose to apply a ratio of total liabilities to equity, measured at the close of business on the last business day of the applicable fiscal quarter, of 8 to 1 or 15 to 1. Upon publication of the proposed rule, the Commissions solicited comments as to whether this ratio should be set at 8 to 1 or 15 to 1.

To promote consistent application of this leverage test, persons that file[13] Form 10-Qs and Form 10-Ks with the SEC would determine their total liabilities and equity based on the financial statements included with such filings. All other persons would calculate the value of their total liabilities and equity in accordance with the U.S. generally accepted accounting principles consistently applied.

Limited Designation as MSP/MSSP

Similar to the swap dealer and security-based swap dealer designation, if a person is designated as an MSP or MSSP, that person shall be deemed to be an MSP or MSSP, as applicable, for *each* swap or security-based swap that it enters into, *regardless of the category* of the swap or security-based swap, or the person's activities in connection therewith. A person designated as an MSP, however, may make an application to the CFTC to limit its MSP designation to specified categories of swaps or specified activities of the person in connection therewith at the same time as, or at a later time subsequent to, the person's initial registration as an MSP. Similarly, the SEC may limit a person's designation as an MSSP to specified categories of security-based swaps or specified activities of the person in connection therewith.

Timing Requirements

If a person meets the definition of an MSP and/or MSSP, the person will be required to register with the CFTC and/or the SEC and comply with the requirements applicable to MSPs or MSSPs. Recognizing that the person will need time to prepare its application for registration and to come into compliance with the applicable requirements, the Commissions stated that the person would not be deemed to be an MSP or MSSP until the earlier of (i) the date on which it submits a complete application for registration and (ii) two months after the end of the fiscal quarter during which it met the criteria for an MSP or MSSP.

Reevaluation Period

If an unregistered entity meets one or more of the applicable MSP or MSSP criteria in a fiscal quarter but does not exceed any of the applicable daily average thresholds by more than 20% in that quarter, that entity will not be immediately subject to the timing requirements described above. The entity would become subject to those requirements at the end of the next fiscal quarter if the entity exceeded any of the applicable daily average thresholds in that next quarter. The Commissions believe that the reevaluation period would help entities avoid being subject to the MSP or MSSP requirements when they meet the MSP or MSSP criteria for only a short time due to unusual swaps activity.

Termination of Status

Once an entity registers as an MSP or MSSP, it would maintain the MSP/MSSP status until such time that it does not exceed any of the applicable thresholds for four consecutive fiscal quarters after the date on which it became registered.

Application of MSP/MSSP Definitions to Managed Accounts

The MSP and MSSP definitions are intended to apply to entities that actually maintain substantial positions or that create substantial counterparty exposure. Therefore, in the case of an asset manager or investment adviser that manages various accounts, the positions of those individual accounts under the asset manager or investment adviser's advisement should not be aggregated for purposes of determining whether the asset manager or investment adviser itself is an MSP or MSSP. Asset managers and investment advisers are separate legal entities from the accounts that they manage. Furthermore, they do not maintain capital to support the trades of their clients. It is the clients that are counterparties to the swaps or security-based swaps and that actually maintain the positions. In the event that entities may try to evade the MSP or MSSP definitions by allocating their swaps or security-based swaps among different accounts and thereby attempt to treat such accounts as the entities that have entered into swaps or security-based swaps, the Commissions have the authority to adopt anti-evasion rules to address such situation. In addition, the Commissions noted that all of the managed positions of which a person is the beneficial owner would be aggregated and combined with such beneficial owner's other positions for purposes of determining whether such beneficial owner is an MSP or MSSP.

Application of MSP/MSSP Definitions to Positions of Affiliated Entities

The Commissions believe that the MSP/MSSP tests should aggregate positions of affiliated entities, because, absent such aggregation, entities could seek to evade the MSP/MSSP status by allocating their positions among their various affiliates. If a parent is the majority owner of a subsidiary, the Commissions propose that the subsidiary's positions should be aggregated at the parent for purposes of determining whether the parent is an MSP or MSSP. The Commissions believe that attributing those positions of the affiliate to the parent is consistent with the concepts of "substantial position" and "substantial counterparty exposure," considering that the parent would effectively be the beneficiary of those positions.

1 To the extent that the stated notional amount of a swap or security-based swap is leveraged or enhanced by the structure of the swap or security-based swap, the effective notional amount rather than the stated notional amount should be the basis of this calculation.

2 The purpose here is to measure the person's overall amount of dealing activity and therefore the market risk offsets associated with combining long and short positions, collateral held by or provided by the person, or other risk mitigating factors are not taken into account in measuring the aggregate effective notional amount.

3 This aggregate effective notional amount limit does not apply to swap or security-based swap activity that does not constitute dealing activity. Therefore, swap or security-based swap activity for purposes of hedging or mitigating a commercial risk of the person's business unrelated to a dealing business is not subject to this limit.

4 The term "special entity" encompasses: Federal agencies; states, state agencies and political subdivisions (including cities, counties and municipalities); "employee benefit plans" as defined under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"); "governmental plans" as defined under ERISA; and endowments.

5 The members of an affiliated group that reports information and prepares its financial statements on a consolidated basis would generally count as one counterparty.

6 An amendment of an existing swap or security-based swap in which the counterparty remained the same and the underlying item remained substantially the same as the original item would not count as a new swap or new security-based swap. To the extent that an amendment changes the underlying item in such a way that modifies the economic risk reflected by the swap or security-based swap,

The Financial Regulatory Reform Working Group will continue to monitor any developments with this proposal and provide timely coverage at Weil's Financial Regulatory Reform Center.

If you are interested in discussing the proposal, please contact any of these Working Group members:

Eric Peterman	(eric.peterman@weil.com)	+ 1 212 310 8373
Robert Chiperfield	(robert.chiperfield@weil.com)	+ 1 212 310 8701
Ariel Kronman	(ariel.kronman@weil.com)	+ 1 212 310 6741
Hyun K. Kim	(hyun.kim@weil.com)	+ 1 212 310 8057

however, it would be counted as a new swap or new security-based swap.

7 The financial terms of a loan include, without limitation, its duration, interest rate, currency in which it is made and its principal amount.

8 The CFTC believes that an insured depository institution that participates in a loan through any means involving a payment to a lender to take the place of that lender, including an "English style" participation, could claim this exclusion.

9 The Commissions preliminarily believe that there are four major categories of swaps and two major categories of security-based swaps (discussed below).

10 If the stated notional amount of a swap or security-based swap position is leveraged or enhanced by the particular structure, the potential future exposure calculation would be based on the position's effective notional amount.

11 For example, the potential future exposure calculation would exclude swap or security-based swap positions that constitute the purchase of an option with respect to which the person has no additional payment obligations, and other positions with respect to which the person has prepaid or otherwise satisfied all of its payment obligations. The potential future exposure associated with a credit default swap position by which a person buys credit protection would be capped at the net present value of the unpaid premiums.

12 According to the Commissions, positions held for short term resale or to obtain arbitrage profits would be considered positions that are held for speculation or trading purposes, and positions held primarily to obtain an appreciation in value of the swap position itself, without regard to using the swap to hedge an underlying risk, would be considered positions held for investing purposes.

13 These persons would include those that submit reports voluntarily to the SEC, as well as those that are required to file periodic reports with the SEC.

Finance Digest is published by the Capital Markets, Banking & Finance, and Structured Finance and Derivatives Groups of Weil, Gotshal & Manges LLP, 767 Fifth Avenue, New York, NY 10153, +1 212 310 8000. http://www.weil.com.

If you would like more information about the contents of this issue, or about Weil's finance practices, please speak to your regular contact at Weil or to the members of the Editorial Board.