CFTC Issues New Guidelines Concerning Eligibility of Swap Guarantors

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In secured lending transactions, lenders frequently allow, and even require, borrowers to enter into swap agreements and other financial derivatives to hedge against different business risks, including fluctuations in interest rates, currency rates, and commodity prices. Performance by the borrower under such swap agreements generally constitutes a guaranteed obligation of the borrower under the loan documentation.

Until recently, there were no regulatory limitations as to who could guarantee a swap obligation. However, with the implementation of The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), the U.S. Commodity Futures Trading Commission (the "CFTC") has promulgated regulations governing swap obligations. Namely, beginning March 31, 2013, in addition to the borrowers to a swap, any guarantor of a swap obligation must be an "eligible contract participant" ("ECP"). As discussed in more detail below, a guarantor must generally have more than $10 million in assets to qualify as an ECP. This ruling has far-reaching consequences to a lender, because non-compliance with this requirement may result in the illegality and unenforceability of the entire guaranty by the non-ECP guarantor.

1) Changes to the Commodity Exchange Act

Section 723(a)(2) of Dodd-Frank amended section 2(e) of the Commodity Exchange Act ("CEA"). The new provision states that "it shall be unlawful for any person, other than an [ECP], to enter into a swap unless the swap is entered into on, or subject to the rules of, a board of trade designated as a contract market under section 7 of this title." Therefore, a participant to a swap agreement must either (a) qualify as an ECP, or (b) enter into the swap on, or be subject to the rules of, a contract market, such as the Chicago Mercantile Exchange. Based on comments from Congress, the intent behind the ECP requirement was to limit the availability of swaps not listed on a contract market to parties with the sophistication and resources to adequately assess and tolerate the risk of such transactions.

The CFTC, along with the Securities and Exchange Commission, has interpreted the term "swap" to include the guarantee of a swap. In light of this interpretation, the Office of the General Counsel of the CFTC issued a no-action letter dated October 12, 2012 stating that each guarantor of a swap must also be an ECP, unless one of a few limited exceptions apply.

The CEA provides a variety of alternatives for qualifying as an ECP. The alternatives most relevant to secured financing transactions are: (a) a corporation or similar entity that (i) either has total assets exceeding $10 million or (ii) has a net worth of $1 million and is entering into the swap to hedge commercial risk, or (b) an individual that either (i) has amounts invested on a discretionary basis in excess of $10 million or (ii) has amounts invested on a discretionary basis in excess of $5 million and is entering into the swap to hedge commercial risk. While mid-size and large corporations involved in secured lending transactions will typically qualify as an ECP, the subsidiaries of borrowers or owners of borrowers guaranteeing the swaps may find it more difficult to meet the defined criteria.

2) Failure to Meet the CFTC's ECP Requirement for Swap Guarantors

The impact of this new requirement is significant for secured lending transactions. With limited exceptions, any guarantor who is obligated to guarantee a swap agreement entered after March 31, 2013 must qualify as an ECP. A guaranty that does not comply with the new regulation is unenforceable and illegal. It is unclear at this point as to whether non-swap related obligations under a guaranty could be affected by the unenforceability of a swap guarantee. The Office of the General Counsel of the CFTC noted that the ruling "would [not] limit the ability of a non-ECP to guarantee a loan," but the issue of whether non-swap related obligations under a guaranty could be affected remains, and the use of a severability provision to alleviate this risk is untested.

3) Practice Pointers

There are a number of steps that can be taken to avoid the risk of a loan guaranty being rendered illegal and unenforceable as a result of the new regulations. When structuring secured bank financings, counsel may consider the following when drafting loan documentation:

- Prohibiting non-ECPs from guaranteeing swap obligations;
- Insisting on representations by each guarantor that it is an ECP at the time each swap is executed;
- Requiring execution of a "keepwell" agreement that would require an ECP in the borrower's corporate family to provide support to the non-ECP guarantor in a manner that confers ECP status on the non-ECP guarantor;
- Including a severability provision which states that if an entity is not an ECP, such status would not impact or inhibit the enforceability of the guarantor's non-swap obligations under the guaranty; and
- Including a savings-clause similar to that promulgated by the LSTA as noted in its market advisory on February 15, 2013 (LSTA Market Advisory: Swap Regulations' Implications for Loan Documentation).

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