US Derivatives Regulation: The Eligible Contract Participant (ECP) Requirement for OTC Derivatives and Implications for Secured Lending

USA (National/Federal) Related Content

A Practice Note explaining how the CFTC interprets the status of guarantors and pledgors under swap arrangements after implementation of the Dodd-Frank rule that requires all swap guarantors to be eligible contract participants (ECPs) under the Commodity Exchange Act (CEA). This Note discusses the potential consequences of that interpretation for secured bank financings and the related credit support features, and suggests certain steps that may be taken to address these potential consequences.

Lenders in secured bank financings frequently require or allow borrowers to hedge against interest rate, commodity, and/or currency risks by entering into swap agreements or other derivative products with lender-affiliated and non-lender-affiliated dealer counterparties. To facilitate borrowers and their subsidiaries entering into such swaps, secured loan agreements often allow financial institution counterparties providing the swaps to share in the collateral provided by the borrower and its guarantor and pledgor subsidiaries and affiliates, including any parties that have pledged assets as security for the loan (often collectively referred to in loan documents as "Loan Parties," and, generically, in this Note, "loan parties") to lenders under the loan documentation, and also to benefit from guarantees given for the bank financing.

Section 723(a)(2) of the **Dodd-Frank Act** amended Section 2(e) of the **Commodity Exchange Act** (CEA) to provide that "it shall be unlawful for any person other than an eligible contract participant (emphasis added) 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 [the CEA]" (7 U.S.C. § 2(e)).

No-Action Letter 12-17 Requires Swap Guarantors and Pledgors to Be Eligible Contract Participants

On October 12, 2012, the Office of the General Counsel (OGC) of the **CFTC** issued No-Action Letter 12-17, clarifying that under the CEA, as amended by Dodd-Frank, swap guarantors and pledgors of assets used to secure swap obligations are subject to the same requirements as direct swap participants. As a result, each such guarantor of – and pledgor of assets to secure – any swap must be an **eligible contract participant** (ECP), or it may not provide credit support for a swap (see Legal Update, No-Action Guidance on SD, MSP and CPO Rules Under Dodd-Frank Issued by CFTC). Further, under the CEA, either:

- Each party to a swap must meet the requirements of the ECP definition; or
- The swap must be conducted on, and under the rules of, a registered **designated contract market** (DCM). Swaps conducted on a DCM are subject to a host of protective rules and regulations making it less necessary, from the perspective of swap regulators, for the parties to have high net worth.

The swaps typically contemplated in secured bank financings are **over-the-counter** (OTC) arrangements provided by a lender or a lender's affiliate to the borrower and are not provided through a DCM.

While swap obligations are typically documented separately under an **ISDA® Master Agreement** and related documents, rather than in the loan documents (even if the swap is related to the borrower's loan obligations), these swap obligations are often covered by the guaranty and collateral provisions of the loan agreement, or wrapped into the related security documents. This guaranty or asset pledge is typically provided to the lender or

syndicate by the borrower and its subsidiaries (and sometimes certain other parties). If the obligations secured by the guaranties and asset pledges include swap obligations, each such subsidiary (and any other loan party) that is included in the loan documents as a guarantor of or pledgor of assets used to secure these obligations will be required to be an ECP when the swap is entered into for the swap guaranty or asset pledge to be enforceable.

Most large corporate borrowers involved in secured bank financings easily meet the definition of an ECP by reaching the threshold of having total assets in excess of $10,000,000 (see Requirements for ECP Status). However, a borrower's obligations under its loan documents are often guaranteed by, or secured by assets of, its subsidiaries or affiliates, regardless of their total assets or net worth. Many guarantors or pledgors of assets in connection with the loan may meet the definition of an ECP, but others may not.

Requirements for ECP Status

The ECP definition provides several alternatives for meeting the test, but the alternative most likely to be relevant for loan parties in secured lending transactions is as follows:

> "(v) a corporation, partnership, proprietorship, organization, trust, or other entity — (I) that has total assets exceeding $10,000,000; (II) the obligations of which under an agreement, contract, or transaction are guaranteed or otherwise supported by a letter of credit or keepwell, support, or other agreement by an entity described in subclause (I), …; or (III) that: (aa) has a net worth exceeding $1,000,000; and (bb) enters into an agreement, contract, or transaction in connection with the conduct of the entity's business or to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by the entity in the conduct of the entity's business[.]" (7 U.S.C. § 1a(18)(A)(v)).

For loan parties that do not otherwise qualify as an ECP, one solution may be for another loan party that otherwise qualifies as an ECP to provide a "keepwell" or other similar credit support for non-ECP guarantors and/or pledgors of assets, under clause (v)(II) of the ECP definition. This would be the simplest approach, in many cases, for addressing the issues raised by No-Action Letter 12-17 while maintaining the typical credit support structure for swaps that are included in loan guaranties.

Consequences of Failure to Meet CFTC Requirements for Non-ECP Loan Parties

The consequences of noncompliance with the requirements discussed in No-Action Letter 12-17 are as follows:

- Illegality and unenforceability of the guaranty or asset pledge by the non-ECP guarantor or pledgor, as applicable, of the swap obligations. The **LSTA** in its February 15, 2013 LSTA Market Advisory expressed concern that the unenforceability of a swap guarantee in loan documentation under these circumstances could taint the enforceability of the loan guarantees, generally, under the loan documents. It should be pointed out that No-Action Letter 12-17 states that its pronouncements should not be interpreted to invalidate any credit support provided by non-ECP loan parties with respect to loan obligations and that this concern is not necessarily the view of the authors.
- Potential CFTC enforcement action against the offending swap dealer (7 U.S.C. §§ 9(1), 6b-1).

No-Action Letter 12-17 does not offer guidance regarding the consequences of noncompliance in certain situations. For example, certain loan documents provide that it is a default under the loan documents if any of the obligations, often including swap-related obligations, of the loan parties are determined to be invalid.

No-Action Letter 12-17 is also silent regarding whether non-swap-related guarantees or asset pledges made by non-ECP loan parties (for example, those supporting loans rather than swaps but included in the loan documents) could be affected by the illegality and unenforceability of a swap guarantee or asset pledge. Although No-Action Letter 12-17 does make clear that these rules do not limit the ability of a non-ECP to guarantee a loan (No-Action Letter 12-17, fn. 17).

Steps to Consider

Large secured bank financings can no longer be structured to wrap the swap provider's credit support into that of the loan obligations without additional considerations, including:

- Conducting due diligence to determine whether there are any guarantors or pledgors in a secured bank financing that would not qualify as ECPs.
- Requiring each guarantor or pledgor of a security interest in a secured bank financing in which swap obligations are included in the loan obligations to make a representation that it is an ECP, which representation would be deemed to be made at any time a swap is entered into. The test of whether a loan party is an ECP is made at the time a swap agreement is entered into and is not an ongoing maintenance test.

- Contractually excluding non-ECPs as guarantors and pledgors with respect to swap obligations or carving out obligations under the borrower's (or any other loan party's) swaps from the basket of guaranteed or secured obligations under the loan documents (see Suggested Carve-Out Language).
- Including a severability provision in loan guaranty and security provisions or agreements specifying that non-ECP status does not affect a loan party's non-swap guaranty obligations, the validity of the security documents themselves, or any non-swap-related security interest granted thereunder, or the obligations of other ECP guarantors or pledgors under the security documents.
- Including in the credit documents "keepwell" support from loan parties that qualify as ECPs (as contemplated by sub-section (II) of Section 1a(18)(A)(v) of the CEA (7 U.S.C. § 1a(18)(A)(v))), which would require other loan parties to the bank financing transaction that qualify as ECPs to provide support to non-ECP compliant loan parties with respect to their credit support for the loan obligations, to the extent these include swap obligations. The following is an optional keepwell provision and related defined term provided by the LSTA in its February 2013 advisory as suggested language for insertion into a guaranty agreement or provision:

  > "Each Qualified ECP Guarantor hereby jointly and severally absolutely, unconditionally and irrevocably undertakes to provide such funds or other support as may be needed from time to time by each other [Loan Party] to honor all of its obligations under this Guaranty in respect of Swap Obligations (provided, however, that each Qualified ECP Guarantor shall only be liable under this Section [___] for the maximum amount of such liability that can be hereby incurred without rendering its obligations under this Section [___], or otherwise under this Guaranty, as it relates to such other [Loan Party], voidable under applicable law relating to fraudulent conveyance or fraudulent transfer, and not for any greater amount). The obligations of each Qualified ECP Guarantor under this Section shall remain in full force and effect until a [Discharge of Guaranteed Obligations]. Each Qualified ECP Guarantor intends that this Section [___] constitute, and this Section [___] shall be deemed to constitute, a "keepwell, support, or other agreement" for the benefit of each other [Loan Party] for all purposes of Section 1a(18)(A)(v)(II) of the Commodity Exchange Act."
  >
  > "Qualified ECP Guarantor" means, in respect of any Swap Obligation, each [Loan Party] that has total assets exceeding $10,000,000 at the time such Swap Obligation is incurred or such other person as constitutes an ECP under the Commodity Exchange Act or any regulations promulgated thereunder and can cause another person to qualify as an "eligible contract participant" at such time by entering into a keepwell under Section 1a(18)(A)(v)(II) of the Commodity Exchange Act.

ISDA has also released template keepwell provisions designed to address this issue in a similar manner, which may be incorporated into documentation by reference (see Legal Update, ISDA Publishes ECP Swap Guarantor Provisions).

For outstanding credit arrangements that do not comply with the guidance offered in No-Action Letter 12-17, simply entering into a separate keepwell arrangement between an ECP loan party for the benefit of all non-ECP loan parties may serve to achieve compliance with No-Action Letter 12-17.

Suggested Carve-Out Language

To avoid the risk that a loan guaranty is rendered unenforceable as a result of these rules, market participants may find it useful to carve out obligations under the borrower's (or any other party's) swaps from the basket of guaranteed obligations under the loan documents. Toward this end, the LSTA, on February 15, 2013, released a market advisory recommending that the defined term or terms used in the guaranty or security agreement to identify the obligations guaranteed or secured (typically terms like "Obligations" or "Guaranteed Obligations" and "Secured Obligations") specifically exclude all Excluded Swap Obligations. The LSTA included in the advisory the following suggested language that can be used in loan guaranty and security agreements that also provide credit support for swap obligations to address this issue:

> "Commodity Exchange Act" means the Commodity Exchange Act (7 U.S.C. §§ 1 to 27f), as amended from time to time, and any successor statute.
>
> "Excluded Swap Obligation" means, with respect to any Guarantor, any Swap Obligation if, and to the extent that, all or a portion of the Guarantee of such Guarantor of, or the grant by such Guarantor of a security interest to secure, such Swap Obligation (or any Guarantee thereof) is or becomes illegal under the Commodity Exchange Act or any rule, regulation or order of the Commodity Futures Trading Commission (or the application or official interpretation of any thereof) by virtue of such Guarantor's failure for any reason to constitute an "eligible contract participant" as defined in the Commodity Exchange Act and the regulations thereunder at the time the Guarantee of such

Guarantor or the grant of such security interest becomes effective with respect to such Swap Obligation. If a Swap Obligation arises under a master agreement governing more than one swap, such exclusion shall apply only to the portion of such Swap Obligation that is attributable to swaps for which such Guarantee or security interest is or becomes illegal.

"Swap Obligation" means, with respect to any Guarantor, any obligation to pay or perform under any agreement, contract or transaction that constitutes a "swap" within the meaning of Section 1a(47) of the Commodity Exchange Act.

The LSTA also advises that parties should ensure that waterfall and other provisions governing the distribution of collateral proceeds are clear that "the proceeds of guarantees and collateral are allocated only among holders of the loan obligations and such other obligations as are supported by such guarantees and collateral" to make clear that swap providers are not permitted to share in the proceeds of collateral or guarantees provided by non-ECPs.

ISDA has also released template guaranty-exclusion provisions designed to address this issue in a similar manner, which may be incorporated into documentation by reference (see Legal Update, ISDA Publishes ECP Swap Guarantor Provisions).

Opinion Language

Note that the use of the LSTA approach should eliminate the need for legal practitioners to make adjustments to their security interest enforceability opinions in order to accommodate this development. However, if parties want to carve out non-ECP swap guarantors from their enforceability opinions out of an abundance of caution or where the above language is not used, see Standard Document, Legal Opinion for Secured Loans: Drafting Note, Eligible Contract Participant and the related optional opinion language.

Final Notes

The CFTC may give further attention to how its pronouncements in No-Action Letter 12-17 could affect secured bank financings and may provide additional guidance on the issue. In the meantime, it would be prudent to consider and discuss with legal counsel how to address non-ECP guarantees of and asset pledges securing loan obligations that may include swap obligations. It may also be advisable to discuss with counsel how these considerations may be addressed in loan documentation for transactions that are currently "on the shelf" and those being entered into going forward.

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