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CFTC Proposes Amendments to Swap Dealer *De Minimis* Exception

CFTC Proposes Rule to Amend the *De Minimis* Exception to the Definition of “Swap Dealer” and Requests Comments Regarding Further Potential Changes

SUMMARY

On June 4, 2018, the Commodity Futures Trading Commission (the “CFTC” or the “Commission”) voted 2-1, along party lines, to propose a rule (the “Proposed Rule”) amending the definition of “swap dealer” under the Commodity Exchange Act (the “CEA”), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).

Among other things, the Proposed Rule would (1) set the threshold of the *de minimis* exception from swap dealer registration at \$8 billion of gross notional amount in swap dealing activity entered into over the preceding twelve months; (2) exclude certain activity from the threshold calculation including (a) a broader category of swaps entered into with a customer by an insured depository institution (“IDI”) in connection with originating a loan; (b) swaps entered into to hedge financial or physical positions; and (c) swaps resulting from multilateral portfolio compression exercises; and (3) allow the Commission to determine the methodology for calculating the aggregate gross notional amount for swaps, and, in turn, delegate that authority to the Director of the Division of Swap Dealer and Intermediary Oversight. The Proposed Rule also seeks comments on three potential additional changes to the *de minimis* exemption: (i) adding minimum counterparty and transaction count thresholds; (ii) exempting exchange-traded and/or cleared swaps from the *de minimis* calculation; and (iii) exempting non-deliverable forward transactions from the *de minimis* calculation. Comments on the Proposed Rule are due on or before August 13, 2018.

BACKGROUND

Section 1a(49) of the CEA broadly defines a “swap dealer” as any person that: holds itself out as a dealer in swaps, makes a market in swaps, regularly enters into swaps with counterparties in the ordinary course of business for its own account¹ or engages in any activity causing the person to be commonly known in the trade as a dealer or market-maker in swaps. In general, a person satisfying any of those prongs is deemed to be engaged in “swap dealing activity.”

In final rules approved by the CFTC and the Securities and Exchange Commission (the “SEC,” and together with the CFTC, the “Commissions”), on April 20, 2012, the Commissions set the *de minimis* threshold at \$3 billion aggregate gross notional value of swap dealing in the preceding twelve months, which represented at the time approximately 0.001 percent of the aggregate gross notional amount of swaps in the U.S. swaps market. However, the Commissions set an initial phase-in threshold of \$8 billion in order to permit market participants time to become familiar with the requirements and provide the CFTC with more time to study the market.² CFTC Staff have since issued two reports analyzing available swap data regarding the \$3 billion threshold. The Commission also has twice extended the phase-in period for the \$3 billion *de minimis* threshold, and the current period is set to expire on December 31, 2019,³ such that, absent further formal agency action, the *de minimis* threshold would become \$3 billion at that time.

SETTING THE *DE MINIMIS* THRESHOLD AT \$8 BILLION

The Proposed Rule would set the *de minimis* threshold at an aggregate gross notional amount of \$8 billion, thereby maintaining the current level and eliminating the automatic reduction to \$3 billion. The Commission noted that the current \$8 billion threshold already subjects the vast majority of transactions to swap dealer regulation, and that allowing the \$8 billion threshold to decrease to \$3 billion could result in decreased liquidity in certain markets. According to the CFTC, greater than 99 percent of interest rate swaps, credit default swaps, FX swaps and equity swaps involve at least one counterparty that is registered as a swap dealer.⁴ The CFTC noted that reducing the *de minimis* threshold to \$3 billion would therefore only result in a minimal increase in regulatory coverage, but would come at significant cost to the additional persons required to register as swap dealers. In a statement, Chairman J. Christopher Giancarlo noted that the likely impact of allowing the *de minimis* threshold to decrease to \$3 billion would be to “cause non-financial companies to curtail or terminate risk-hedging activities with their customers, limiting risk-management options for end-users and ultimately consolidating marketplace risk in only a few large, Wall Street swap dealers.”⁵ In addition, the Proposed Rule notes that a \$3 billion threshold could result in reduced availability of swap counterparties and ability of end-users to manage risk, as well as reduced liquidity, wider spreads and increased volatility. The Commission also found that although a higher *de minimis* threshold would result in a small decrease in the aggregate gross notional amount of swaps and transactions subject to swap dealer regulation, it would result in a decreased number of

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parties transacting with registered swap dealers. Finally, the Commission stated that maintaining the status quo \$8 billion *de minimis* threshold would enhance certainty by providing long-term regulatory stability.

ADDITIONAL EXCEPTIONS TO THE *DE MINIMIS* CALCULATION

The Proposed Rule would also exempt three types of swaps from consideration when calculating the *de minimis* threshold, thereby effectively raising the *de minimis* threshold: (1) a broader category of swaps entered into by IDIs with customers in connection with a loan; (2) swaps entered into to hedge a financial or physical position; and (3) swaps resulting from multilateral portfolio compression exercises.

A. SWAPS ENTERED INTO BY INSURED DEPOSITORY INSTITUTIONS IN CONNECTION WITH A LOAN

The Proposed Rule would except from the *de minimis* calculation any swaps entered into by IDIs with customers in connection with a loan. The Proposed Rule is not an amendment to the IDI exclusion in paragraph (5) of the swap dealer definition,⁶ which was jointly adopted by the CFTC and SEC and allows an IDI to exclude certain loan-related swaps with customers for purposes of determining whether it is a swap dealer. Rather, the Proposed Rule adds an exception to the *de minimis* calculation for loan-related swaps with customers by IDIs that meet a less restrictive set of requirements than the paragraph (5) IDI exclusion. The Proposed Rule states that the Commission believes that the addition to the *de minimis* exception would further the policy goal of the *de minimis* exception by allowing some IDIs to enter into swaps with customers without having to register as swap dealers with the CFTC. The exception is subject to various requirements: (1) the IDI must enter into the swap no earlier than 90 days before execution of the relevant loan agreement or no earlier than 90 days before transfer of the principal to the customer; (2) the rate, asset, liability, or other notional item must be tied to the financial terms of the loan or be required as a condition of the loan; (3) the duration of the swap must not extend beyond termination of the loan; (4) the IDI must be the source of at least 10 percent of the principal amount of the loan or the source of a principal amount greater than the notional amount of the swaps; (5) the aggregate gross notional amount must not exceed the outstanding principal on the loan; (6) the swap must be reported as required by the CEA if it is not accepted for clearing; (7) the transaction must not be a sham; (8) the loan must not be a synthetic loan, including a credit default swap or total return swap. Although swaps meeting the requirements of the paragraph (5) IDI exception would meet the requirements of the IDI *de minimis* exception in the Proposed Rule, the Proposed Rule's exception is broader, including (i) an extension of the time period within which the swaps must be entered into; (ii) an expansion of the types of swaps that are eligible; (iii) a reduced syndication percentage requirement; and (iv) an elimination of the notional cap.

B. SWAPS ENTERED INTO TO HEDGE FINANCIAL OR PHYSICAL POSITIONS

The Proposed Rule would exempt swaps entered into in order to hedge financial or physical positions from the *de minimis* calculation. The definition of swap dealer currently provides that, subject to certain

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restrictions, swaps entered into for the purpose of hedging physical positions are not considered in determining whether an entity is a swap dealer,⁷ but there is no similar specific exclusion for swaps entered into for purposes of hedging financial positions. The Proposed Rule would provide that, so long as certain conditions are satisfied, swaps entered into to hedge financial or physical risks do not count toward the *de minimis* threshold. To qualify, a person must enter into the swap transaction to mitigate one or more specific risks to which it is subject, including, but not limited to, market risk, commodity price risk, rate risk, basis risk, credit risk, volatility risk, correlation risk and foreign exchange risk. Further, the person must not be the price maker of the swap, receive a bid/ask spread or commission for the transaction or receive any other compensation for entering into the transaction. Swaps to hedge physical risks are subject to certain additional qualifications, including: the swap must be economically appropriate to the reduction of risks that may arise in the conduct and management of an enterprise engaged in the type of business in which the person is engaged; the swap must be entered in accordance with sound business practice; and the swap must not be structured to evade designation as a swap dealer.

C. SWAPS RESULTING FROM MULTILATERAL PORTFOLIO COMPRESSION EXERCISES

The Proposed Rule would also exempt swaps resulting from multilateral portfolio compression exercises. This exception is consistent with a 2012 CFTC no-action letter, in which the CFTC Staff stated that it would not recommend enforcement against any person for failure to include in its *de minimis* calculation swaps entered into as replacement swaps as part of a multilateral portfolio compression exercise, as defined in paragraph 23.500(h) of the Commission's regulations.⁸ Multilateral portfolio compression allows parties to "net down" the size and number of swaps between them, generally through a process of entering into new equal and opposite swaps to replace existing swaps instead of terminating them. The Commission states that such exercises advance the policy goals of swap dealer regulation by reducing counterparty credit risk, lowering the aggregate gross notional amount of outstanding swaps, and reducing operational risk by reducing the number of total outstanding swaps.

COMMISSION DELEGATES AUTHORITY TO DETERMINE THE METHODOLOGY TO CALCULATE THE NOTIONAL AMOUNT OF SWAPS

In order to provide clarity regarding the methodology used in the calculation of aggregate gross notional amounts on a timely basis, the Proposed Rule provides a mechanism for the Commission, on its own or upon written request, to approve or establish methodologies for calculating aggregate gross notional amounts for any group, category or class of swaps and simultaneously proposes to delegate that authority to the Director of the Division of Swap Dealer and Intermediary Oversight (the "DSIO"). In effect, the Proposed Rule would give the DSIO Director authority to determine the methodology used in calculating the aggregate gross notional amount. The Commission would continue to reserve the right to exercise the delegated authority itself at any time, as is the case with existing delegations to staff. The Proposed Rule would also provide that any methodology the DSIO Director develops must be economically reasonable, analytically supported and made available to the public. The Commission notes

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that the determination mechanism is in response to requests from market participants for clarity regarding aggregate gross notional amounts for certain swaps and believes that this approach will be more timely and provide more certainty than no-action letters or engaging in separate rulemakings further noting that, as with other staff interpretive letters, once the CFTC or the DSIO Director makes a methodology determination, all persons may rely on the determination.

REQUEST FOR COMMENTS REGARDING ADDITIONAL POTENTIAL AMENDMENTS TO THE *DE MINIMIS* EXCEPTION

In addition to changes noted above, the Proposed Rule also requests comments on three additional potential changes to the *de minimis* exception: (1) adding minimum counterparty and transaction count thresholds; (2) exempting exchange-traded and/or cleared swaps from the *de minimis* calculation; and (3) exempting non-deliverable forward transactions from the *de minimis* calculation.

A. MINIMUM COUNTERPARTY AND TRANSACTION COUNT THRESHOLD

The Proposed Rule notes that the CFTC is reconsidering whether aggregate gross notional amount is, by itself, the proper measure of whether an entity's swap activity is *de minimis*. In particular, the Commission is seeking comment on whether the CFTC should add two additional *de minimis* exceptions: (1) a proposed minimum counterparty threshold; and (2) a proposed minimum transaction threshold. The aim of the additional *de minimis* thresholds, according to the Commission, would be to eliminate "false positives" that might arise from relying solely on the aggregate gross notional amount threshold. Because certain asset classes may generally result in swaps with higher notional amounts than others, providing additional ways in which an entity could qualify for the *de minimis* exception could provide for more consistent treatment across asset classes. In particular, the Commission is seeking comment on proposed thresholds of 10 counterparties and 500 transactions. The Commission also further seeks comment on whether there should be an aggregate gross notional amount "backstop," such that once an entity's exchange-traded notional value has surpassed a certain threshold, it would be required to register. According to the Commission, these alternative measures would ensure that, even with the addition of the transaction and counterparty thresholds, entities that engage in significant swap activity would be still be required to register with the CFTC.

The Commission noted that while it "remains open to the possibility of relying on a different approach in the future . . . at this time, the Commission continues to believe that the *de minimis* exception should include an [aggregate gross notional amount] threshold component."⁹ The Commission's list of potential viable alternative metrics includes thresholds based on entity-netted notional amounts, initial margin, open positions, material swaps exposure, net current credit exposure, gross negative or positive fair value, potential future exposure, value-at-risk or expected shortfall.¹⁰

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B. EXCEPTION FOR EXCHANGE-TRADED AND CLEARED SWAPS

The Commission seeks comments on whether to exclude from the calculation swaps that are executed on an exchange or designated contract market and/or cleared by a DCO from the *de minimis* calculation. The Proposed Rule states that such swaps raise fewer systemic risk concerns because entities must post margin and risk management is handled centrally by the designated clearing organization. The Proposed Rule further notes that exempting such swaps may encourage clearing, a central policy goal of Dodd-Frank. Alternatively, the Commission is considering applying a haircut to the notional amount of exchange-traded and/or cleared swaps, such that only a certain percentage of such swaps would count toward the *de minimis* threshold.

C. EXCEPTION FOR NON-DELIVERABLE FORWARD TRANSACTIONS

The Commission is seeking comment as to whether non-deliverable forwards (“NDFs”), which are foreign exchange swaps under which one or more of the referenced currencies is not actually delivered, should be excluded from the *de minimis* calculation. Pursuant to authority granted in Section 1a(47) of the CEA, the Secretary of the Treasury determined that foreign exchange swaps and foreign exchange forwards are exempted from the definition of “swap,”¹¹ but took the position that Treasury lacked the statutory authority to exempt NDFs from the swap definition. The Proposed Rule notes that market participants generally treat NDFs and foreign exchange forwards as equivalents and, therefore, the Commission is considering exempting NDFs from the *de minimis* calculation.

COMMISSIONER ROSTIN BEHNAM’S DISSENT

Commissioner Rostin Behnam, currently the lone Democratic CFTC Commissioner, dissented from the Commission’s Proposed Rule. Commissioner Behnam’s core objection to the Proposed Rule was that “the Commission is moving far beyond the task before it—setting the aggregate gross notional amount threshold for the *de minimis* exception—to redefine swap dealing activity absent meaningful collaboration with the Securities and Exchange Commission.”¹² In addition, Commissioner Behnam expressed concern that the Commission will have to act on an unusually quick timeline: as noted above, because the phase-in period is set to end on December 31, 2019 and the *de minimis* calculation requires a twelve-month look-back period, entities will have to begin tracking their swap activities beginning on January 1, 2019, absent further Commission action. Commissioner Behnam add that “[s]ix months is an ambitious time for even a simple rule.”

Commissioner Behnam also objected to the Proposed Rule’s delegation of authority to the DSIO Director to determine the methodology for calculating aggregate gross notional amounts. Commissioner Behnam noted that this “could subsume the entire *de minimis* threshold by giving the Director of the DSIO broad authority to determine what swaps count toward the threshold—and perhaps more importantly, what swaps do not.”¹³

ENDNOTES

- ¹ The CFTC has interpreted this category to refer only to transactions entered into for the purpose of accommodating a counterparty's interest or that are structured to address a counterparty's needs, not transactions entered into solely for proprietary purposes. See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Participant" and "Eligible Contract Participant," 75 Fed. Reg. 80174, 80177 (December 21, 2010) available at: <http://www.gpo.gov/fdsys/pkg/FR-2010-12-21/pdf/2010-31130.pdf>.
- ² Please see our memorandum to clients entitled "CFTC and SEC Issue Final Swap-Related Rules Under Title VII of Dodd-Frank" dated June 8, 2012, available at [https://www.sullcrom.com/siteFiles/Publications/SC Publication CFTC and SEC Issue Final Swap Related Rules.pdf](https://www.sullcrom.com/siteFiles/Publications/SC%20Publication%20CFTC%20and%20SEC%20Issue%20Final%20Swap%20Related%20Rules.pdf).
- In addition, certain swaps are not required to be included in a person's *de minimis* calculation, subject to a number of conditions, including, for example: swaps related to loans made by IDIs, certain swaps between affiliates, swaps between cooperatives and their members, swaps hedging physical positions, swaps by certain floor traders, certain cross-border swaps executed outside the U.S., FX swaps and FX forwards that are settled by actual exchanges of currencies, commodity trade options and swaps resulting from portfolio compression. Additionally, certain inter-governmental international financial institutions and government-related entities are exempted from the definition of "swap dealer."
- ³ See Order Establishing De Minimis Threshold Phase-In Termination Date, 81 FR 71605 (Oct. 18, 2016); Order Establishing a New De Minimis Threshold Phase-In Termination Date, 82 FR 50309 (Oct. 31, 2017).
- ⁴ Proposed Rule, at page 28.
- ⁵ Opening Statement of Chairman J. Christopher Giancarlo, Open Commission Meeting, June 4, 2018.
- ⁶ 17 CFR 1.3, Swap dealer, ¶ (5).
- ⁷ 17 CFR 1.3, Swap dealer, ¶ (6)(iii).
- ⁸ CFTC Staff Letter No. 12-62, No-Action Relief: Request that Certain Swaps Not Be Considered in Calculating Aggregate Gross Notional Amount for Purposes of the Swap Dealer De Minimis Exception for Persons Engaging in Multilateral Portfolio Compression Activities (Dec. 21, 2012), available at <https://www.cftc.gov/sites/default/files/idc/groups/public/@lrllettergeneral/documents/letter/12-62.pdf>.
- ⁹ Proposed Rule, at Page 20.
- ¹⁰ Earlier this year CFTC Chief Economist Dr. Bruce Tuckman released a paper discussing the use of "entity netted notional" amounts to gauge the swaps market, taking into account the practice of entering into reverse and equal swaps to remove trades between counterparties. See Introducing ENNs: A Measure of the Size of Interest Rate Swap Markets (Jan. 2018), available at http://www.cftc.gov/idc/groups/public/@economicanalysis/documents/file/oc_e_enns0118.pdf. Chairman Giancarlo, commenting on the paper, stated that "[w]hile that may be worth academic consideration, it was not my intention in directing Dr. Tuckman's research to come up with a specific alternative to the CFTC's current swap dealer *de minimis* calculation methodology." See Remarks of Chairman J. Christopher Giancarlo before Derivcon 2018, New York City, NY (Feb. 1, 2018), available at <https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo35>.
- ¹¹ See Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 77 FR 69694, 69704-05 (Nov. 20, 2012).
- ¹² Statement of Dissent of Commissioner Rostin Behnam, Open Commission Meeting, June 4, 2018.
- ¹³ *Id.*

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