ALERT MEMORANDUM

CFTC Adopts Permanent $8 Billion Swap Dealer *De Minimis* Threshold

November 27, 2018

On November 5, 2018, the Commodity Futures Trading Commission (the "**CFTC**") adopted an amendment (the "**Amendment**") to the *de minimis* exception to the definition of "swap dealer" under the Commodity Exchange Act (the "**CEA**") and the CFTC's regulations thereunder (the "***De Minimis* Exception**").[1]

The *De Minimis* Exception previously provided that, during a phase-in period, a person will not be deemed to be a swap dealer unless, over the prior 12 months, its swaps entered into in connection with swap dealing (together with those of its affiliates not registered as swap dealers) exceed either (a) $8 billion aggregate gross national amount ("**AGNA**") with all types of counterparties or (b) $25 million AGNA with counterparties that are Special Entities. The phase-in period was originally scheduled to end on December 31, 2017, but the CFTC extended it twice, with the latest extension lasting until December 31, 2019. At the end of the phase-in period, the $8 billion AGNA threshold was scheduled to decrease to $3 billion.

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On June 5, 2018, the CFTC released a notice of proposed rulemaking (the "**Proposal**") proposing to: (a) permanently fix the AGNA threshold at $8 billion; (b) delegate authority to CFTC staff to approve or establish methodologies for calculating notional amounts; and (c) adopt new exclusions from the *de minimis* calculation for (1) swaps between an insured depository institution (an "**IDI**") and its customer in connection with loan origination ("**Loan-Related Swaps**"), (2) swaps entered into to hedge physical or financial positions ("**Hedging Swaps**") and (3) swaps resulting from multilateral compression exercises. The Proposal also sought comment on adding new criteria regarding a minimum number of transactions or counterparties to the *De Minimis* Exception in addition to AGNA, excluding exchange-traded and/or cleared swaps from the *de minimis* calculation, and excluding non-deliverable foreign exchange forwards ("**NDFs**") from the *de minimis* calculation.[2]

[1] 83 Fed. Reg. 56666 (Nov. 13, 2018).

[2] Our Alert Memorandum regarding the Proposal can be found at https://www.clearygottlieb.com/-/media/files/alert-memos-2018/cftc-proposes-amendments-to-the-swap-dealer-de-minimis-exception.pdf.

The Amendment permanently fixes the AGNA threshold at $8 billion, but it does not adopt any of the other changes set forth in the Proposal. Despite strong support for these changes during the comment period, adopting them at this time would have been challenging for the CFTC for a few reasons. First, the CFTC was under pressure to finalize the Amendment before the beginning of 2019, when the scheduled decrease of the AGNA threshold to $3 billion otherwise would have become relevant due to the 12-month rolling application of the threshold. In addition, two of the CFTC's Commissioners expressed concerns regarding moving forward with the changes outside of a joint rulemaking with the Securities and Exchange Commission ("**SEC**"), taking the view that the changes amounted to modifications of the "swap dealer" definition, which must be made jointly by the CFTC and the SEC, as opposed to modifications of the *De Minimis* Exception, which do not.[3] Nonetheless, the CFTC might take up these changes in the future.

This Memorandum provides an overview of the Amendment and possible further changes to the "swap dealer" definition and the *De Minimis* Exception.

Background

Section 712(d) of the Dodd-Frank Act requires the CFTC and the SEC, in consultation with the Federal Reserve Board, to further define the term "swap dealer" and certain other terms relevant to Title VII of the Dodd-Frank Act. Pursuant to this requirement, the CFTC and SEC issued a joint rulemaking (the "**SD Adopting Release**") in May 2012.[4]

In accordance with CEA Section 1a(49)(D), which provides that the CFTC shall "exempt from designation as a swap dealer an entity that engages in a *de minimis* quantity of swap dealing", the SD Adopting Release and related agency guidance have stated that a person would not be considered a swap dealer unless its swaps connected with swap dealing activity (together with those of its affiliates not registered as swap dealers) exceed an AGNA threshold of $3 billion measured on a rolling 12-month basis, subject to a phase-in period during which the AGNA threshold is set at $8 billion.

In addition to this *De Minimis* Exception, the SD Adopting Release provided that certain swaps would not be considered in determining whether a person is a swap dealer. These included swaps executed by IDIs in connection with originating loans to customers. This exception was an implementation of CEA Section 1a(49)(A), which states that "in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer." The SD Adopting Release also included a safe harbor for certain swaps entered into for the purpose of hedging physical positions.

Considering the limited data available in 2012 regarding swap dealing activity, the SD Adopting Release required the CFTC staff to publish reports related to the "swap dealer" definition and the *De Minimis* Exception within 30 months of its publication. The CFTC staff issued a preliminary report concerning the *De Minimis* Exception in November 2015 and a final report reflecting additional data and market feedback in August 2016 (collectively the "**Staff Reports**").[5]

Although the phase-in period for the *De Minimis* Exception was originally scheduled to terminate on December 31, 2017, following the issuance of the Staff Reports, the CFTC twice extended the termination date, currently set to expire December 31, 2019, in order to allow further consideration of the appropriate threshold for the *De Minimis* Exception.[6]

[3] *See, e.g.*, Statement of Commissioner Dan M. Berkovitz Regarding the De Minimis Exception to the Swap Dealer Definition; Final Rule, available at http://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement110518.

[4] Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 Fed. Reg. 30596 (May 23, 2012).

[5] Swap Dealer De Minimis Exception Preliminary Report (Nov. 18, 2015), available at http://www.cftc.gov/idc/groups/public/@swaps/documents/file/dfreport_sddeminis_1115.pdf; Swap Dealer De Minimis Exception Final Staff Report (Aug. 15, 2016), available at http://www.cftc.gov/idc/groups/public/@swaps/documents/file/dfreport_sddeminis081516.pdf.

[6] *See* Order Establishing De Minimis Threshold Phase-In Termination Date, 81 Fed. Reg. 71605 (Oct. 18, 2016);

On June 5, 2018, the CFTC issued the Proposal, which as noted above would have (a) fixed the AGNA threshold at $8 billion, (b) delegated authority to the Director of the Division of Swap Dealer and Intermediary Oversight ("**DSIO**") or his or her designee to approve or establish methodologies for calculating notional amounts and (c) adopted exclusions from the *de minimis* calculation for Loan-Related Swaps, Hedging Swaps, and swaps resulting from multilateral compression exercises. Despite promulgating the "swap dealer" definition jointly with the SEC in 2012, the Proposal was issued solely by the CFTC on the basis that CEA Section 1a(49)(D) states that the "Commission" shall create a *De Minimis* Exception.[7]

Fixing the AGNA Threshold at $8 Billion

The Amendment amends the *De Minimis* Exception by permanently fixing the AGNA threshold at $8 billion over the immediately preceding 12 months. The Amendment also deletes paragraph (4)(ii) of the *De Minimis* Exception, which details the phase-in procedure, and a parenthetical clause in paragraph (4)(i)(A), referring to the period of time after the adoption of a rule further defining "swap," since both provisions are no longer relevant.

In coming to this decision, the CFTC analyzed the AGNA of swaps activity for swaps other than non-financial commodity swaps. To conduct this analysis, the CFTC filtered out certain types of market participants (such as commercial end users) that are unlikely to be swap dealers, as well as market participants that traded with less than 10 unique counterparties. These filters were designed to help distinguish swap dealing from other types of transactions, recognizing that the CFTC does not require market participants to report which of their swaps are connected to swap dealing.

The CFTC used this data to determine how the swap market would be affected by changes to the AGNA threshold. CFTC staff studied how much swaps activity (by AGNA and number of transactions) was subject to swap dealer regulation because at least one party to the swap was a registered swap dealer. Staff also studied how many swap counterparties transacted with at least one swap dealer. Staff then analyzed how these amounts would change at different AGNA thresholds.

The results of this analysis mirrored the results of the Staff Reports in suggesting that decreasing the AGNA threshold to $3 billion would have resulted in only a very modest increase in regulatory coverage. The analysis also indicated that somewhat larger decreases in regulatory coverage would result from increasing the AGNA threshold.

In light of this analysis, the CFTC stated that decreasing the AGNA threshold to $3 billion would not seriously advance its policy objectives for the *De Minimis* Exception, as it would not subject materially more swap transactions to swap dealer regulation. A reduction in the AGNA threshold could, on the other hand, lead some market participants to curtail or stop swap dealing in order to avoid having to register as swap dealers, with the effect of lowering market liquidity. The CFTC also ruled against increasing the AGNA threshold because of the likelihood that fewer counterparties would enjoy the protections of swap dealer regulation.

Order Establishing a New De Minimis Threshold Phase-In Termination Date, 82 Fed. Reg. 50309 (Oct. 31, 2017).

[7] *See* 77 Fed. Reg. at 30634 n.464 ("We do not interpret the joint rulemaking provisions of section 712(d) of the Dodd-Frank Act to require joint rulemaking here, because such an interpretation would read the term 'Commission' out of CEA section 1a(49)(D) (and [Securities] Exchange Act section 3(a)(71)(D)), which themselves were added by the Dodd-Frank Act.").

One of the key reasons why the CFTC did not change the AGNA threshold was that market participants have already established systems and processes with the current threshold in mind. Any change to the threshold would thus result in new costs and potential disruptions to long-term plans based on the current threshold. The CFTC cited this consideration both in support for the existing numerical threshold of $8 billion and for maintaining the existing AGNA calculation mechanics (*e.g.*, using notional amounts instead of risk-based metrics and using a rolling 12-month calculation instead of month-end calculations). The CFTC did, however, indicate that it might consider changes in the future, and Chairman Giancarlo indicated in particular that he will ask staff to study alternative, risk-based metrics, especially for cleared swaps.

Proposed Rule Amendments Not Adopted

Loan-Related Swaps

The "swap dealer" definition currently contains an exception for certain Loan-Related Swaps. The Proposal contained a parallel, but broader exclusion from the *de minimis* calculation for Loan-Related Swaps. This proposed exclusion would have lessened restrictions on when an IDI could enter into a Loan-Related Swap in relation to when it originated a loan, loosened the extent to which the swap must be related to the loan, eliminated the need for an IDI to fund a specified percentage of a syndicated loan, eliminated a notional cap on the amount of Loan-Related Swaps a customer could enter into in connection with a loan (subject to limitations in certain syndicated loan contexts), and expanded the types of swaps that could qualify as Loan-Related Swaps.

The CFTC received several comments regarding the proposed exclusion, including some expressing concerns that the proposed exclusion would retain a requirement that the termination date of a Loan-Related Swap cannot extend beyond termination of the related loan.

So that it would have more time to consider the issues raised by commenters, the CFTC did not adopt the proposed exclusion for Loan-Related Swaps. Chairman Giancarlo stated, however, that staff have informed him that "they would consider no-action relief for IDIs pending formal Commission action should they receive a meritorious request."

Hedging Swaps

The CFTC proposed a provision that would exclude certain Hedging Swaps from the *de minimis* calculation. For a Hedging Swap to be excluded from the calculation, the swap's primary purpose must be to mitigate some risk that the counterparty is subject to. The counterparty making the swap could not be the price maker, or receive a bid/ask spread, fee, or other commission for entering into the swap.

Although most commenters supported the Hedging Swap exclusion, many of them also expressed concerns regarding the ambiguity of some of the proposed conditions to the exclusion. Others expressed concern that the exclusion might cover hedges of swap dealing positions.

The CFTC declined to adopt the provision because of uncertainty about which financial and physical hedges should be excluded from the *de minimis* calculation. The CFTC also emphasized that existing guidance from the SD Adopting Release and CFTC staff[8] regarding the treatment of Hedging Swaps under the "swap dealer" definition remains in effect and "market participants should continue to evaluate such swaps without consideration" of the proposed exclusion.

Multilateral Portfolio Compression Exercises

The CFTC proposed a provision that would exclude swaps that resulted from multilateral portfolio compression exercises from the *de mimimis* calculation if they were not entered into by the counterparty for

[8] *See* "Frequently Asked Questions (FAQ) – DSIO Responses to FAQs About Swap Entities" (Oct. 12, 2012).

the purposes of evading designation as a swap dealer. This exclusion would have effectively codified existing no-action relief.[9]

Although many commenters supported this exclusion as well, several of them expressed concerns that it was too narrow because it did not cover other risk-reducing swaps, such as those resulting from bilateral compression exercises. On the contrary, some commenters thought that the definition of portfolio compression was overbroad.

The CFTC declined to adopt the proposed exclusion because it believes that many issues raised by commenters require further consideration.

Methodology for Calculating Notional Amounts

The CFTC proposed a provision that would allow the Director of DSIO or his or her designee to determine the methodology used to calculate AGNA for any type of swaps.

The CFTC declined to adopt this provision because of concerns over the CFTC staff solely determining the notional amount, especially in the absence of a public comment period.

Other Matters Raised by the Proposal

The CFTC also declined to make changes in connection with the other matters raised by the Proposal, including adding new criteria regarding a minimum number of transactions or counterparties to the De Minimis Exception in addition to AGNA, excluding exchange-traded and/or cleared swaps from the *de minimis* calculation, and excluding NDFs from the *de minimis* calculation.

The CFTC also declined to consider modifications to the $25 million AGNA threshold for swaps with Special Entities or the cross-border application of the *De Minimis* Exception.[10]

Although the CFTC did not take up these other matters, there appears to be strong support from Chairman Giancarlo and Commissioner Quintenz to reexamining the use of a notional amount threshold in lieu of a more risk-sensitive metric. In this regard, Chairman Giancarlo has asked the CFTC staff to consider the feasibility of: (1) removing cleared swaps from the *de minimis* calculation; (2) haircutting cleared swaps included in the *de minimis* calculation; (3) adopting a new, bifurcated *de minimis* calculation that uses initial margin amounts for cleared swaps and entity-netted notional amounts for uncleared swaps;[11] and (4) applying other risk-based approaches that the staff may recommend.

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[9] *See* CFTC Letter 12-62 (Dec. 21, 2012).

[10] On October 1, 2018, Chairman Giancarlo released a white paper that addresses the cross-border application of the *De Minimis* Exception, among other topics. Our Alert memorandum regarding this white paper can be found at https://www.clearygottlieb.com/-/media/files/alert-memos-2018/cftc-chairman-proposes-crossborder-swaps-regulation-version.pdf.

[11] Entity-netted notional amounts are a new metric developed by the CFTC staff. *See* Richard Haynes, John Roberts, Rajiv Sharma, and Bruce Tuckman, "Introducing ENNs: A Measure of the Size of Interest Rate Swap Markets" (Jan. 2018).