ALERT MEMORANDUM

CFTC Adopts Loan-Related Swap Exclusion from *De Minimis* Exception

April 9, 2019

On March 25, 2019, 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 provides that 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 notional amount ("**AGNA**") with all types of counterparties or (b) $25 million AGNA with counterparties that are "special entities."[2] The Amendment excludes from the $8 billion calculation certain swaps entered into between an insured depository institution (an "**IDI**") and its customer in connection with a loan ("**Loan-Related Swaps**").

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The Amendment effectively expands the existing exclusion from the "swap dealer" definition for Loan-Related Swaps ("**IDI Exclusion**"), including by providing greater flexibility in respect of the execution date and notional amount of the Loan-Related Swap. All Loan-Related Swaps, however, remain subject to applicable CFTC swap requirements, including mandatory clearing, mandatory trading and reporting requirements. Additionally, Loan-Related Swaps that fall within the scope of the Amendment, but outside the pre-existing IDI Exclusion, will continue to count toward the $25 million "special entity" threshold.

This Memorandum provides an overview of the Amendment.

[1] 84 Fed. Reg. 12450 (April 1, 2019).

[2] "Special entities" generally include federal agencies, states and their agencies and municipalities, employee benefit plans and endowments. *See* 17 C.F.R. § 23.401(c).

Background

Section 712(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**") requires the CFTC and the Securities and Exchange Commission (the "**SEC**"), in consultation with the Federal Reserve Board, to further define certain terms relevant to Title VII of Dodd-Frank, including "swap dealer." Pursuant to this requirement, in May 2012 the CFTC and the SEC issued a joint rulemaking (the "**SD Adopting Release**").[3]

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 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 would be 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, including swaps eligible for the IDI Exclusion. 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."

On June 5, 2018, the CFTC issued a Notice of Proposed Rulemaking,[4] proposing certain changes to the *de minimis* exception, including:

(1) permanently setting the AGNA threshold at $8 billion;

(2) excluding Loan-Related Swaps from the *de minimis* calculation; and

(3) excluding certain other swaps from the *de minimis* calculation.[5]

On November 13, 2018, the CFTC issued a final rule permanently fixing the AGNA threshold at $8 billion.[6]

On March 25, 2019, the CFTC issued the Amendment, which adopted the proposed exclusion from the *de minimis* calculation for Loan-Related Swaps, with minor changes from the original proposal.[7]

Relationship to the Existing IDI Exclusion

The Amendment does not modify the existing IDI Exclusion, which excludes certain Loan-Related Swaps from the swap dealer definition. Such a change would require joint action by the SEC and the CFTC. The Amendment instead sets out a parallel, but broader, exclusion for Loan-Related Swaps from the *De Minimis* Exception. Under Dodd-Frank, the CFTC may unilaterally amend the *De Minimis* Exception.[8]

[3] 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).

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

[5] 83 Fed. Reg. 27444 (Jun. 12, 2018).

[6] 83 Fed. Reg. 56666 (Nov. 13, 2018). Our Alert Memorandum regarding the final rule is available at https://www.clearygottlieb.com/-/media/files/alert-memos-2018/cftc-adopts-permanent-8-billion-swap-dealer-de-minimis-threshold.pdf.

[7] Two Commissioners, Rostin Behnam and Dan Berkovitz, voted against the change.

[8] The statutory authority for the *De Minimis* Exception is CEA Section 1a(49)(D), which requires the "Commission" to exempt from designation as a swap dealer an entity that engages in a de minimis quantity of swap dealing. By contrast, the IDI exception to the swap dealer definition was adopted pursuant to Section 712(d)(1) of Dodd-Frank, which requires the CFTC and SEC to jointly adopt rules regarding the definition of, among other things, the term "swap dealer." In adopting the Amendment, the CFTC emphasized that to require application of joint rulemaking provisions of Section 712(d) to changes in the *de minimis* threshold adopted pursuant to CEA Section 1a(49) would require reading the term "Commission" out of CEA Section 1a(49)(D), which itself was added by Dodd-Frank. 84 Fed.

As a practical matter, however, the Amendment effectively expands the scope of the IDI Exclusion, except in respect of swaps with "special entities." In particular, under the Amendment (but not the IDI Exclusion):

- A Loan-Related Swap may be entered into at any time during the term of the loan;
- A Loan-Related Swap may be entered more than 90 days before the funding of the loan if an executed commitment or forward agreement for the applicable loan exists;[9]
- The IDI's underwriting requirements need not require the Loan-Related Swap, as long as the swap is related to a financial term of the loan[10] or is permissible under the IDI's underwriting criteria and is "commercially appropriate" to hedge risks incidental to the borrower's business (other than an excluded commodity) that may affect the borrower's ability to repay the loan (e.g., it cannot be for speculative purposes);
- The IDI is not required to fund a specified portion of the loan; and
- The aggregate notional of all swaps entered into by the customer related to the loan would not be capped by the principal amount outstanding under the loan, but an IDI that funded less than 5% of a loan would be subject to a notional amount cap equal to the principal loan amount it funded.

The attached appendix includes a table comparing the existing IDI Exclusion with the Amendment and also notes the minor departures of the Amendment from the CFTC's proposal.

In addition, swaps executed prior to the effectiveness of the Amendment do not qualify for the Amendment, notwithstanding the 12-month lookback period for the *de minimis* threshold.

Availability of Exclusion to Other Institutions

Although the Amendment covers a broader range of swaps than the IDI Exclusion, the entities eligible to use that exclusion remain limited to IDIs. In the SD Adopting Release, the CFTC and SEC responded to concerns raised by commenters regarding the competitive effect of allowing only certain types of entities to rely on the IDI Exclusion by noting that the statute's "swap dealer" definition itself only refers to swaps entered into by an IDI. Because the Amendment is to the *De Minimis* Exception, rather than the loan origination exception to the statute's "swap dealer" definition, the statute does not constrain the authority of the CFTC to make the exclusion available to non-IDIs, including non-U.S. banks. Nonetheless, the CFTC rejected industry requests to expand the exclusion on the basis that such a change was not within the scope of the proposal.

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Reg. at 12461. The SEC's Chairman has agreed with the CFTC's position. *See* Joint Statement of SEC Chairman Jay Clayton and CFTC Chairman Christopher Giancarlo on the IDI Exception to the Swap Dealer Definition; available at https://www.sec.gov/news/public-statement/joint-statement-sec-and-cftc-swap-dealer-definition.

[9] The CFTC clarified that a term sheet was insufficient to satisfy this requirement.

[10] The CFTC clarified that this includes the collateral securing the loan.

Appendix

Loan-Related Swaps Exclusion Comparison Table			
Item	**IDI Exclusion**	**Amendment**	**Notes**
Time of Execution	The swap must be entered into no more than 90 before execution (or transfer of principal) and no later than 180 days after execution (or transfer of principal)	The swap can be entered into more than 90 days before execution if an executed commitment or forward agreement for the applicable loan exists The swap can be entered into any time after the loan's execution	The CFTC clarified that a term sheet is not sufficient for the purpose of establishing an executed commitment or forward agreement
Relationship to Loan	One of the following must be met: (i) The underlier of the swap is "directly related" to a financial term of loan; or (ii) the swap is required as a condition of the loan under the IDI's underwriting criteria to hedge price risk incidental to the borrower's business	One of the following must be met: (i) The underlier of the swap is "related" to a financial term of the loan; or (ii) the swap is permissible under the IDI's loan underwriting criterial and is commercially appropriate in order to hedge risks incidental to the borrower's business (other than an excluded commodity) that may affect the borrower's ability to repay the loan	Under the proposal, clause (ii) would have stated that the swap is required as a condition of the loan, either under the IDI's underwriting criteria or as is commercially appropriate, but the final rule expanded the criterion
Duration of the swap	The term of the swap may not extend beyond termination of the loan	The term of the swap may not extend beyond termination of the loan	The CFTC clarified that the eligibility of the swap is not affected if the loan is accelerated or defaults and that, if the swap is novated or partially terminated in relation to changes in the loan, the new swap may still qualify as a Loan-Related Swap
Level of loan funding	The IDI must be the source of at least 10% of maximum principal amount of the loan or a principal amount no less than the AGNA of all swaps entered into by the IDI with the customer in connection with the loan	The IDI must be the source of at least 5% of the maximum principal amount of the loan If not, then the AGNA of all swaps entered into by the IDI with the customer cannot exceed the principal of the IDI's loan	
Maximum AGNA	The AGNA of all swaps with the customer in connection with the loan cannot be greater than the outstanding principal	No AGNA maximum, except as noted above	The CFTC Office of Chief Economist will conduct a study on this point for review in three years
Exclusions	Shams, synthetic loans	Shams, synthetic loans	The CFTC indicated that loan credit default swaps and loan total return swaps could fall within the Amendment
Special Entities	Exclusion applies to the $25 million *de minimis* threshold for swaps with special entities	Does not apply to the $25 million *de minimis* threshold for swaps with special entities	