

CLIENT ALERT

# Comment Period Begins for CFTC Proposal to Retain and Expand the *De Minimis* Exception from Swap Dealer Registration

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On June 12, 2018, the Federal Register published the CFTC's proposed amendments to existing rules that address which entities must register as a "swap dealer."<sup>1</sup> In particular, the proposal modifies an exception to the swap dealer registration requirement for entities that engage in a "*de minimis*" level of swap dealing activity by proposing to:

- Convert the aggregate \$8 billion gross notional amount phase-in threshold into a permanent threshold, and thus, remove the automatic drop to \$3 billion;
- Exempt certain swap activity from the \$8 billion notional amount calculation, including swaps: (1) intended to hedge financial or physical positions, (2) relating to certain loans, and (3) resulting from multilateral portfolio compression exercises; and
- Delegate to the CFTC's Division of Swap Dealer and Intermediary Oversight the authority to establish a methodology to calculate the gross notional amount of swaps that count toward the \$8 billion threshold.

Comments on the proposal are due no later than August 13, 2018.

<sup>1</sup> De Minimis Exception to the Swap Dealer Definition, 83 Fed. Reg. 27444 (June 12, 2018).

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The Dodd–Frank Act directed the Commodity Futures Trading Commission (“CFTC”) and the Securities and Exchange Commission (“SEC”) to jointly issue a rule defining the term “swap dealer,” including a *de minimis* exception. As finalized, the *de minimis* exception currently provides that a person shall not be deemed to be a swap dealer unless its dealing activity measured over the prior 12 months is in excess of an aggregate gross notional amount threshold of \$3 billion (subject to a phase-in period ending December 31, 2017, during which time the gross notional amount threshold would be \$8 billion). Pursuant to CFTC Rule 1.3, the CFTC directed CFTC staff to issue a report analyzing the *de minimis* exception, and further provided that after giving consideration to the report and public comment, the CFTC may establish a termination date for the phase-in threshold or propose a rule modifying the threshold.

The phase-in termination date was extended twice, first in October 2016, and again in October 2017.<sup>2</sup> Without further action by the CFTC, the phase-in period will terminate on December 31, 2019. As explained in the Orders, the CFTC provided both of these one-year extensions in order to allow additional time to analyze swap data and consider further action.

Given the 12-month lookback for calculating an entity’s notional amount of swap dealing against the threshold, firms may need to start tracking their activity on January 1, 2019, unless a final rule or additional relief issues prior to the end of this year.

### Proposed Amendments

#### The *De Minimis* Threshold

The proposed rule would set the aggregate gross notional amount threshold for the *de minimis* exception at \$8 billion of swap dealing activity over the prior 12 months. The proposed rule would prevent the threshold amount from dropping to \$3 billion, which under the current phase-in schedule, would occur on January 1, 2019.<sup>3</sup>

Setting the *de minimis* exception threshold at \$8 billion ideally would focus the CFTC’s registration requirements on swap dealers whose activity is large enough to warrant oversight. Meanwhile, it would allow small, commercial companies, agricultural cooperatives, and community banks to engage in some dealing activity without being required to register, thereby reducing the market’s reliance on larger financial institution swap dealers.

If the threshold were to be reduced to \$3 billion, the CFTC noted that many of the smaller dealers may reduce or cease their activity to avoid registration and its related costs. These smaller dealers often are housed in small community banks,

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<sup>2</sup> Order Establishing De Minimis Threshold Phase-In Termination Date, 81 Fed. Reg. 71605 (Oct. 18, 2016); Order Establishing a New De Minimis Threshold Phase-In Termination Date, 82 Fed. Reg. 50309 (Oct. 31, 2017) (“Orders”).

<sup>3</sup> Order Establishing a New De Minimis Threshold Phase-In Termination Date, 82 Fed. Reg. 50309 (Oct. 31, 2017).

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local energy utilities or commodity trading houses, which may not be able to compete economically with registered swap dealers in light of the costs of registration and ongoing compliance. In fact, the CFTC noted that the costs associated with registering as a swap dealer may exceed the revenue derived from dealing swaps for many smaller entities.<sup>4</sup>

The CFTC pointed out that lowering the *de minimis* threshold may have a greater negative impact in markets for physical commodity swaps as compared to other asset classes. In particular, the CFTC noted that a lower *de minimis* threshold could cause participants in the physical commodity swaps markets “to curtail or terminate risk-hedging activities with their customers, limiting risk management options for end-users.”<sup>5</sup> Importantly, the CFTC acknowledged that entities engaged in only limited physical commodity swap dealing activity pose less systemic risk and have a “unique role in the market in that their primary business is generally non-financial in nature and the swap dealing activity is ancillary to their primary role in the market.”<sup>6</sup> Moreover, end users of physical commodity swaps often do not have trading relationships with larger financial entity swap dealers, further underscoring the impact of any rule that might lead to a further reduction in the number of small physical commodity dealers.

The CFTC seeks comments on, among other things, whether the threshold amount should be higher than \$8 billion, and it included an analysis of potential impacts at thresholds of \$20 billion, \$50 billion, and \$100 billion.

### Exceptions from the \$8 Billion Calculation

At present, the definition of swap dealer in CFTC Rule 1.3 identifies specific activities that do not constitute swap dealing in subparagraph (6). Although the proposal attempts to expand the scope of activities that do not require registration as a swap dealer, the proposal does not supplement the list of activities excluded from swap dealing in subparagraph (6). Instead, the proposal expands the *de minimis* exception in subparagraph (4) of the definition of swap dealer to identify activities that do not count toward the *de minimis* threshold. Below is a summary of the CFTC’s new exceptions to the *de minimis* threshold.

**Swaps used to hedge physical or financial positions.** Consistent with past staff informal guidance, the Commission seeks to clarify that swaps entered into for purposes of hedging financial positions are not required to be counted toward the *de minimis* threshold. The proposal addresses the issue by providing that swaps used to hedge physical or financial positions are not subject to the *de minimis* threshold. However, the proposal imposes certain conditions in order for swaps to qualify—namely, the **primary** purpose must be to reduce or otherwise mitigate one or more specific risks, including market risk, commodity price risk, rate risk, etc. Additional conditions may limit the practical utility of this

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<sup>4</sup> 83 Fed. Reg. at 27454. The Commission also noted that a \$3 billion threshold would impose significant burdens on small dealers while only increasing regulatory coverage of the marketplace by less than one percent. According to economic research cited by Commissioner Quintenz, the estimated present value of the cost of swap dealer registration compliance is \$390 million per firm. 83 Fed. Reg. at 27480.

<sup>5</sup> 83 Fed. Reg. at 27480.

<sup>6</sup> 83 Fed. Reg. at 27457.

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exception; namely, the person entering into the hedging swap must **not** (1) be the price-maker of the hedging swap; (2) receive or collect a bid/ask spread, fee or commission for entering into the hedging swap; or (3) receive other compensation separate from the contractual terms of the hedging swap in exchange for entering into the hedging swap. Interestingly, the swap dealer definition in CFTC Rule 1.3 already excludes hedging of physical positions in subparagraph (6), so the proposed exception from the *de minimis* threshold under subparagraph (4) would supplement, but not replace, the existing exclusion. Market participants should comment on these proposed limitations.

**Insured Depository Institution (“IDI”) swaps in connection with certain loans.** At present, the swap dealer definition in CFTC Rule 1.3 excludes, pursuant to subparagraph (6), IDIs that enter into swaps with their customers in connection with originating a loan, provided that the IDI meets specific criteria. The proposal notes that the criteria to fall within the exclusion in subparagraph (6) are unnecessarily restrictive. However, rather than amend the criteria in subparagraph (6), the proposal adds a new exception to the *de minimis* threshold in subparagraph (4). For example, under the new exception in subparagraph (4), an IDI could write a swap with a customer 181 days after entering into a loan without it counting toward the \$8 billion threshold (as opposed to the limitation in subparagraph (6) that the swap must be entered into between 90 and 180 days of a loan).

**Multilateral compression exercises.** The proposed rule would codify no-action relief excluding swaps resulting from multilateral portfolio compression exercises from the *de minimis* threshold.<sup>7</sup>

### The Calculation Methodology

The proposed rule would authorize the CFTC to establish the methodology used for calculating notional amount for purposes of determining whether a company is eligible for the *de minimis* exception. In the release accompanying the rule, the CFTC noted that the process for submitting requests regarding the methodology would be consistent with the process described in Section 140.99 of the CFTC’s regulations.

The CFTC has proposed to delegate this authority to the Director of the Division of Swap Dealer and Intermediary Oversight (“DSIO”). The CFTC noted that DSIO previously has issued interpretive responses to frequently asked questions regarding calculating notional amounts and routinely issues no-action letters on a variety of issues.<sup>8</sup> The proposal only requires that any determination made by DSIO be economically reasonable and analytically supported.

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<sup>7</sup> See 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/idc/groups/public/@llettergeneral/documents/letter/12-62.pdf>.

<sup>8</sup> See Frequently Asked Questions (FAQ) – [DSIO] Responds to FAQs About Swap Entities (Oct. 12, 2012), available at [https://www.cftc.gov/idc/groups/public/@newsroom/documents/file/swapentities\\_faq\\_final.pdf](https://www.cftc.gov/idc/groups/public/@newsroom/documents/file/swapentities_faq_final.pdf).

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Moreover, it must be made publicly available and posted on the CFTC's website. However, the CFTC retains the right to exercise this delegated authority itself at any time.

### Additional Comments Sought by the Commission

In addition to the proposed rule amendments, the CFTC also requested comments on adding a minimum dealing counterparty count and a minimum dealing transaction count threshold, a position publicly supported by Commissioner Brian D. Quintenz. Under this approach, an entity that exceeded the *de minimis* threshold **also** would have to exceed certain counterparty counts and dealing transaction counts before it would have to register as a swap dealer. As explained in the release accompanying the proposal, these additional measures could help to account for differences in transaction sizes across asset classes and the fact that volumes may fluctuate over time.

The CFTC's decision to formulate these additional measures as further safeguards from *de minimis* registration is a departure from its original proposal in 2010, which would have imposed these measures as alternative thresholds that, if exceeded, would each independently designate an entity as a "swap dealer."

The CFTC also requested comments on excepting exchange-traded and/or cleared swaps, as well as non-deliverable forwards from the *de minimis* calculation. The CFTC explained that exchange-traded and cleared swaps pose less systemic risk than other swaps, largely due to the presence of the clearinghouse, standardization procedures, and margin posting requirements.

### Behnam's Dissent

Commissioner Rostin Behnam dissented from the proposal, arguing that it is an inappropriate attempt by the Commission to redefine swap dealing without collaborating with the SEC. Commissioner Behnam also expressed additional concerns about whether the lack of coordination with the SEC would lead to further uncertainties for market participants and further delay a final rule.

### Conclusion

The Commission has less than six months to either finalize the rule or issue another order extending the *de minimis* phase-in date. If the rule is not finalized by January 1, 2019, market participants will have to start tracking their swap dealing activity to determine whether they will have to register as swap dealers when the phase-in period ends on December 31, 2019. Given that federal regulatory agencies often require more than a year to finalize a rule, providing market participants with greater and timely certainty about their registration status will be a tall order for the Commission.

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If you have any questions regarding this client alert, please contact the following attorneys or the attorney with whom you regularly work.

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