Client Alert

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CFTC Proposes to Maintain Swap Dealer De Minimis Threshold at $8 Billion

By Julian Hammar

On June 4, 2018, the Commodity Futures Trading Commission ("CFTC" or "Commission") by a 2 to 1 vote proposed to amend its regulations to maintain the de minimis exception threshold from swap dealer registration at the aggregate gross notional amount ("AGNA") of $8 billion measured over the previous 12 months. Further, the CFTC is proposing to:

- Expand in several respects the insured depository institution ("IDI") exception for swaps in connection with originating loans with customers for purposes of counting towards the de minimis threshold calculation;
- Exclude financial hedges (in addition to the already existing exclusion for physical hedges) from the de minimis threshold count;
- Codify staff no-action relief that would exclude swaps conducted under multilateral portfolio execution exercises; and
- Provide that the Commission may determine the methodology to be used to calculate the notional amount for any group, category, type, or class of swaps, and delegate to the Director of the CFTC's Division of Swap Dealer and Intermediary Oversight ("DSIO") the authority to make such determinations.

In addition, the CFTC is requesting comment with respect to, among other things:

- Adding a minimum dealing counterparty count threshold and a minimum dealing transaction count threshold to the $8 billion AGNA threshold;
- Excepting exchange-traded and/or cleared swaps from consideration when calculating AGNA for purposes of the de minimis threshold; and
- Excepting swaps that are categorized as non-deliverable foreign exchange forwards ("NDFs") and other foreign exchange derivatives from consideration when calculating AGNA for purposes of the de minimis threshold.

The proposal, which has been published in the Federal Register,[1] is open for public comment until **August 13, 2018**. The proposal is available here.

BACKGROUND

Under current CFTC regulations, the de minimis exception from swap dealer registration provides that a person shall not be deemed to be a swap dealer unless its swaps connected with swap dealing activities exceed an AGNA

[1] De Minimis Exception to the Swap Dealer Definition, 83 Fed. Reg. 27,444 (June 12, 2018).

threshold of $3 billion (measured over the prior 12-month period), subject to a phase-in period during which the AGNA threshold is set at $8 billion.[2] The phase-in period was originally scheduled to terminate on December 31, 2017, and the de minimis threshold was scheduled to decrease to $3 billion at that time. However, the CFTC issued two successive orders to set new termination dates in order to provide time to reassess the de minimis level, and the phase-in period is currently scheduled to terminate on December 31, 2019.[3] Absent action by the CFTC, market participants would be required to count against the $3 billion threshold starting January 1, 2019 because of the 12-month look-back period. Pursuant to CFTC regulations, CFTC staff issued a preliminary report regarding the de minimis threshold that was put out for public comment, and issued a final staff report in August 2016, which found that at the $8 billion de minimis level, approximately 96 percent of swap transactions involved at least one registered swap dealer.

There are a number of exceptions provided for in CFTC regulations for swaps that are not considered to be swap dealing and are not counted toward the de minimis threshold that the CFTC addresses in the proposal. The Commodity Exchange Act ("CEA") provides that in no event shall an IDI 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.[4] CFTC regulations implementing this provision include a number of requirements for a swap to be considered to be in connection with originating a loan with a customer. Another exception in CFTC regulations involves hedges of physical positions, which are not considered dealing activity provided the conditions of the exception are satisfied. In addition, under no-action relief issued by CFTC staff, swaps that result from multilateral portfolio compression exercises need not be included in the swap dealer de minimis calculation.

PROPOSED RULES

De Minimis Threshold

The proposed rules would amend paragraph (4)(i)(A) of the swap dealer definition in CFTC Regulation 1.3, 17 CFR 1.3, by setting the de minimis threshold at $8 billion. The release supports keeping the threshold at $8 billion through data analysis that shows that "almost all swap transactions (as measured by AGNA or transaction account)" are subject to swap dealer regulation at that level. At a lower threshold of $3 billion, the release notes there would only be a small amount of additional AGNA and swap transactions subject to such regulation, and potentially reduced liquidity in the swap market, as compared to the $8 billion threshold.[5] While the data is not as reliable for nonfinancial commodity swaps, the release states that the lower threshold could lead to reduced liquidity for such swaps, negatively impacting end-users and commercial entities who use such swaps for hedging purposes. An additional reason the Commission supports maintaining the threshold of $8 billion is that it would provide continuity and address any uncertainty associated with the end of the phase-in period. Although the release discusses higher

[2] For swaps with "special entities," CFTC regulations provide for a separate de minimis level of $25 million; that level is not proposed to be modified under the current proposal.

[3] See Order Establishing De Minimis Threshold Phase-In Termination Date, 81 Fed. Reg. 71,605 (Oct. 18, 2016); Order Establishing a New De Minimis Threshold Phase-In Termination Date, 82 Fed. Reg. 50,309 (Oct. 31, 2017).

[4] 7 U.S.C. § 1a(49)(A).

[5] 83 Fed. Reg. at 27,450.

thresholds (e.g., $20 billion), it notes that counterparty protections derived from swap dealer registration may be reduced at such higher thresholds if adopted because the higher thresholds result in fewer counterparties facing registered swap dealers.[6]

IDI Exclusion for Swaps Entered Into in Connection with Loans to Customers

In its proposal, the Commission states its belief, based on information gained from market participants and analysis of swap data repository data, that the current IDI exclusion has unnecessarily restrictive conditions, is not clear in certain instances, and limits the ability of IDIs to provide swaps that would allow their customers to properly hedge risks associated with bank loans. The proposed rules would not amend the existing IDI exclusion contained in paragraph (5) of the swap dealer definition because that provision was jointly adopted by the CFTC and the Securities and Exchange Commission ("SEC") in accordance with Section 712(d)(1) of the Dodd-Frank Wall Street Reform and Consumer Protection Act[7] as part of the definition of what constitutes swap dealing activity. Instead, the proposed rule would amend paragraph (4) of the definition, which addresses the de minimis exception, by adding new paragraph (4)(i)(C) that sets forth specific factors that an IDI can consider when determining whether swaps entered into with customers in connection with loans to those customers must be counted towards the IDI's de minimis calculation. The release clarifies that the IDI could consider these factors and exclude qualifying swaps from its de minimis calculation, regardless of whether the swaps would qualify for the IDI swap dealing exclusion in paragraph (5).[8]

Specifically, the proposed rule would add new paragraph (4)(i)(C) to the swap dealer definition, which would except from calculation of the de minimis threshold certain loan-related swaps entered into by IDIs, which the release describes as the "IDI De Minimis Provision." The IDI De Minimis Provision would modify the requirements of the IDI exclusion by providing for:

- A lengthier timing requirement for when the swap must be entered into;
- An expansion of the types of swaps that are eligible;
- A reduced syndication percentage requirement;
- An elimination of the notional amount cap; and
- A refined explanation of the types of loans that would qualify.

With regard to the timing requirement, current CFTC regulations require that the swaps must be entered into with a customer no more than 90 days before or 180 days after the date of execution of the loan agreement (or date of transfer of principal to the customer). The proposed rule would eliminate the 180-day restriction, which the Commission believes unnecessarily limits the ability of IDIs to effectively provide hedging solutions to commercial end-user borrowers, who may wait depending upon market conditions or business needs for a period of time beyond 180 days after a loan is originated to enter into a hedging swap with the IDI. The proposal would maintain

[6] Id. at 27,454.

[7] Pub. L. No. 111-203, 124 Stat. 1376 (2010). Section 712(d)(1) requires that the CFTC and SEC, in consultation with the Board of Governors of the Federal Reserve System, jointly promulgate rules further defining, among other terms, the term "swap dealer."

[8] 83 Fed. Reg. at 27,459.

the 90-day restriction, except where an executed commitment or forward agreement to loan money exists between the IDI and the borrower prior to the 90-day limit, in which case the 90-day restriction would not apply.[9]

Concerning the expansion of the types of eligible swaps, the proposal would modify the language currently provided in the IDI exclusion in paragraph (5), which requires that the "rate, asset, liability, or other notional item underlying such swap is, or is directly related to, a financial term of such loan . . . ." or that "[s]uch swap is required, as a condition of the loan under the insured depository institution's loan underwriting criteria, to be in place in order to hedge price risks incidental to the borrower's business and arising from potential changes in the price of a commodity (other than an excluded commodity)." The proposed rule adds a new paragraph (4)(i)(C)(*2*), which states that for purposes of the IDI De Minimis Provision, a swap is "in connection with" a loan if "the rate, asset, liability or other term underlying such swaps is, or is related to, a financial term of such loan . . . ," or if "[s]uch swap is required as a condition of the loan, either under the insured depository institution's loan underwriting criteria or as is commercially appropriate, in order to hedge risks incidental to the borrower's business (other than for risks associated with an excluded commodity) that may affect the borrower's ability to repay the loan." The release explains that this language provides greater flexibility because the first provision refers to a "term" rather than a "notional term," and does not include the word "directly." The release further explains that the second provision of the proposed language allows for swaps that are not explicitly required as a condition of the IDI's underwriting criteria. Specifically, the provision would permit IDIs to enter into certain swaps with borrowers to hedge risks that may not have been evident at the time the loan was entered into or that are determined based on the unique characteristics of the borrower rather than standard bank underwriting criteria.[10]

With respect to syndicated loans, the proposed IDI De Minimis Provision would reduce the percentage requirement from 10 percent to 5 percent of the principal amount of a syndicated loan for which the IDI is responsible. The Commission states that this change will provide additional flexibility for IDIs to enter into a greater range of loan-related swaps.[11]

The proposed IDI De Minimis Provision would also not generally include the cap under the existing IDI exclusion, which requires that the AGNA of swaps entered into in connection with a loan not exceed the principal amount outstanding. The cap would be lifted under the proposed IDI De Minimis Provision for IDIs responsible for at least five percent of the loan principal. The release notes that it is not uncommon for an IDI originated loan to have related swaps that hedge multiple categories of exposure, including interest rate, foreign exchange, and/or commodity risk in connection with a loan, that may exceed the principal amount outstanding. The restriction in the IDI exclusion might restrict the ability of IDIs to provide loan-related swaps to their borrowing customers to more effectively allow their customers to hedge loan-related risks. The restriction would remain, however, for IDIs that contribute less than five percent of the loan.[12]

[9] See id. at 27,460.

[10] See id. at 27,460-61.

[11] See id. at 27,461.

[12] See id.

In addition, the release states that the existing IDI exclusion does not cover types of credit financings that are similar to loans, citing as examples credit enhanced bonds, letters of credit, leases, and revolving credit facilities, but instead generally references existing common law definitions for the term "loan." To prevent evasion in connection with the existing IDI exclusion, the CFTC stated that the term "loan" shall not include "any synthetic loan, including, without limitation, a loan credit default swap or loan total return swap," or sham loans. The proposed IDI De Minimis Provision would not apply to any transaction that is a sham and would not apply to "any synthetic loan," but does not include the provision specifically listing a loan credit default swap ("loan CDS") or loan total return swap ("loan TRS") in the current IDI exclusion. In that regard, the release notes that certain loan CDS and loan TRS may be valid loan structures; however, to the extent they, or any another financial instrument, would be considered a synthetic lending arrangement, swaps entered into in connection therewith would not qualify under the IDI De Minimis Provision. The Commission also clarifies in the release that the definition of the term "loan" in its Part 75 regulations (the CFTC's version of the Volcker Rule), which defines a loan as "any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative," would also apply for purposes of the IDI De Minimis Provision.[13]

The release notes that the remaining requirements of the IDI De Minimis Provision are substantively identical to the current IDI exclusion.[14]

Swaps Entered Into to Hedge Financial or Physical Positions

In addition to the IDI exclusion, the proposal would also address hedges of financial or physical positions. The CFTC's current regulations provide that swaps entered into by a person for purposes of hedging physical positions are not considered in determining whether the person is a swap dealer. However, they do not include a specific exclusion for swaps entered into for purposes of hedging financial positions. Based on comments from market participants in connection with the CFTC's Project KISS initiative, the CFTC believes that the absence of an explicit exclusion in the regulations for swaps entered into for purposes of hedging financial positions has caused uncertainty in the marketplace regarding whether swaps that hedge, for example, interest rate risk, credit risk, or foreign exchange risk, would need to be counted toward the de minimis threshold.[15]

The proposal would add a new paragraph (4)(i)(D) to the swap dealer definition, which the release describes as the "Hedging De Minimis Provision," that would permit entities to not count towards their de minimis calculations hedging swaps when such swaps meet certain conditions. Similar to the proposed IDI De Minimis Provision, the Hedging De Minimis Provision does not propose to revise the scope of activity that constitutes swap dealing, but would set out factors an entity can consider for purposes of determining whether its hedging swaps must be counted towards the de minimis calculation. The release clarifies that a swap that meets the existing requirements of the exclusion of swaps hedging physical positions in paragraph (6)(iii) of the swap dealer definition would also meet the requirements of the proposed Hedging De Minimis Provision. However, meeting the requirements of the existing physical hedging exclusion is not a prerequisite for application of the proposed Hedging De Minimis

[13] See id. at 27,461-62. See also 17 CFR 75.2(s).

[14] See 83 Fed. Reg. at 27,462.

[15] See id.

Provision. Moreover, the release clarifies that if a swap does not satisfy the requirements of the Hedging De Minimis Provision, that does not necessarily mean the swap is swap dealing activity; rather, all of the facts and circumstances should then be considered to determine if the person entering the swap is engaging in dealing activity.[16]

In order for a swap to qualify under the proposed Hedging De Minimis Provision, the swap must be entered into by a person for the primary purpose of reducing or otherwise mitigating one or more of the 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, foreign exchange risk, or similar risks arising in connection with existing or anticipated identifiable assets, liabilities, positions, contracts or other holdings of the person or any affiliate. In addition, the person entering into the swap must not:

- Be the price maker of the hedging swap;
- Receive or collect a bid/ask spread, fee, or commission for entering into the hedging swap; and
- Receive other compensation separate from the contractual terms of the hedging swap in exchange for entering into the hedging swap.[17]

Certain additional requirements must also be satisfied that are consistent with the exclusion for hedging physical positions in current regulations. Under these requirements, 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;
- Must be entered into in accordance with sound business practices; and
- Must not be in connection with activity structured to evade designation as a swap dealer.[18]

Swaps Resulting from Multilateral Portfolio Compression Exercises

The proposal would add a new paragraph (4)(i)(E) to the swap dealer definition, which would allow a person to exclude from its de minimis calculation swaps that result from multilateral portfolio compression exercises, consistent with no-action relief issued by CFTC staff on December 21, 2012 ("Staff Letter 12-62").[19] Staff Letter 12-62 stated that the CFTC's DSIO would not recommend that the Commission take enforcement action against any person for failure to include in its de minimis calculation the terminations of swaps (in whole or in part) or 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). The proposed provision essentially codifies this relief, stating that solely for purposes of determining whether the person has exceeded the de minimis threshold, the person may

[16] See id. at 27,463.

[17] See id.

[18] See id.

[19] 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/@lrlettergeneral/documents/letter/12-62.pdf.

exclude swaps that result from multilateral portfolio compression exercises as defined in CFTC Reg. 23.500, to the extent the person does not enter into the multilateral portfolio compression exercise in connection with activity structured to evade designation as a swap dealer.[20]

Methodology for Calculating Notional Amounts

The proposal would add new paragraph (4)(vii) to the swap dealer definition, which would provide that the CFTC may approve or establish methodologies for calculating notional amounts for purposes of determining whether a person exceeds the AGNA de minimis threshold. Further, the Commission is proposing to delegate to the Director of DSIO the authority to make such determinations. The CFTC did not prescribe specific calculation methodologies for notional amounts (except for leveraged swaps) in the release further defining the term swap dealer issued in 2012. Subsequent to that release, DSIO issued interpretive responses to frequently asked questions regarding calculating notional amounts for purposes of the de minimis exception. Noting that it has received requests for clarity regarding how notional amounts should be calculating for nonfinancial commodity swaps for purposes of determining whether a person exceeds the AGNA de minimis threshold, and certain differences between methodologies described in the DSIO guidance and other sources, the CFTC believes that additional clarity about the appropriate notional amount calculation methodologies of the swap dealer de minimis threshold would be beneficial.

The proposed rules would provide for a mechanism for the Commission on its own motion or upon written request by a person to determine the methodology to be used to calculate the notional amount for any group, category, type, or class of swaps for purposes of whether a person exceeds the AGNA de minimis threshold. The proposed rules would require that such methodologies be economically reasonable and analytically supported, and that any determination be made publicly available and posted on the CFTC website. Once a determination is made, all persons would be able to rely upon the determination. In order to ensure that such determinations be issued in a timely manner, the Commission would delegate authority to DSIO to determine the methodology to be used to calculate the notional amount for any group, category, type, or class of swaps for purposes of the AGNA de minimis threshold.[21]

Requests for Comment

In addition to the proposed rule changes discussed above, the proposal seeks comment on three other potential considerations for the de minimis threshold, including:

- Adding a minimum dealing counterparty count and a minimum dealing transaction count threshold to the de minimis AGNA threshold;
- Excepting swaps that are exchange-traded and/or cleared from the de minimis threshold calculation; and
- Excepting swaps that are categorized as NDFs from the de minimis threshold calculation.

[20] See 83 Fed. Reg. at 27,463-64.

[21] See id. at 27,464-66.

With respect to the addition of counterparty and transaction counts, the Commission states that it is reconsidering the merits of using AGNA—by itself—to determine if an entity's swap dealing activity is de minimis. It specifically requests comment on whether an entity should be able to qualify for the de minimis exception if its level of swap dealing activity is below any of the following three criteria: (1) an AGNA threshold, (2) a proposed dealing counterparty count threshold, or (3) a proposed dealing transaction count threshold. The CFTC requests comment on whether such an approach would better assist the CFTC in identifying those entities whose dealing activity is limited and reduce instances of "false positives" of any one measure of activity, such as where an entity's dealing activity may marginally exceed the $8 billion AGNA threshold, but still be so limited in nature that it does not warrant swap dealer registration. The CFTC also requests comment on whether a dealing counterparty count threshold of 10 counterparties and a dealing transaction threshold of 500 transactions would be appropriate. Further requests for comment address how counterparties should be counted and whether a "backstop" AGNA should be adopted, specifically $20 billion, above which entities would have to register as swap dealers regardless of their counterparty or transaction counts.[22]

Concerning exchange-traded and cleared swaps, the CFTC is seeking comment on whether an exception from the de minimis calculation for swaps executed on an exchange (i.e., a swap execution facility or designated contract market) and/or cleared by a derivatives clearing organization is appropriate. In that regard, the Commission notes that systemic risk concerns should be less significant for swaps that are cleared, and clearing may be encouraged if cleared swaps are not counted for purposes of the de minimis threshold. Moreover, counterparty protection considerations may be less significant for exchange-traded swaps because counterparty protections and trade terms would generally be provided by the exchange. That said, the CFTC also notes that such an exception could result in entities that engage in a significant amount of swap dealing activity in exchange-traded and/or cleared swaps not having to register as swap dealers, and requests comment on whether to establish an AGNA backstop, similar to that in connection with counterparty and transaction counts, above which an entity would have to register, or alternatively provide an exchange-traded and/or cleared swaps count, but establish a haircut on the notional amounts for purposes of the de minimis calculation.[23]

With respect to NDFs, the CFTC states that it understands that NDFs are economically and functionally similar to deliverable foreign exchange forwards that were exempted from most of the CEA's requirements by the Secretary of the Treasury. It requests comment as to whether it should except NDFs from consideration when calculating AGNA of swap dealing activity for purposes of the de minimis exception and whether there are other foreign exchange derivatives that should be excepted.[24]

CONCLUSION

Many market participants will find much to like with respect to the CFTC's proposal if adopted. Not having the de minimis threshold drop to $3 billion, expanding the IDI De Minimis criteria, and providing clarity regarding financial hedges should all be helpful, especially for small and regional banks that may find themselves butting up against the

[22] See id. at 27,466-68.

[23] See id. at 27,468-70.

[24] See id. at 27,470.

de minimis threshold under the current rules. It is unclear how much of this proposal will be adopted in the final rules by the Commission before the end of the year—which must occur or another extension of the phase-in termination issued—in light of the number of topics addressed and numerous comment requests in addition to those noted above. Indeed, Commissioner Behnam in his dissent argued that in proposing the rule amendments, the Commission "is moving far beyond the task before it" in terms of setting the de minimis threshold by addressing ancillary issues like the IDI exclusion, financial hedges and many others. Nonetheless, market participants may want to consider commenting on aspects of the proposal they find most significant to their businesses to establish a record for any future Commission action.

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