

CFTC Proposes Maintaining Swap Dealer *De Minimis* Registration Threshold at \$8 Billion with Expanded Exceptions

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On June 12, 2018, the CFTC published a [notice of proposed rulemaking](#) that would make permanent the \$8 billion temporary swap dealer *de minimis* registration threshold currently in effect and would make other changes to the *de minimis* exception.

- **De Minimis Registration Threshold Proposal.** As anticipated and foreshadowed by remarks by Chairman Giancarlo, the CFTC proposes to adopt the current *de minimis* registration threshold of \$8 billion.¹ The approach, as discussed in the notice of proposed rulemaking, is supported by data analysis in two prior CFTC staff reports² and more recent staff analysis, as well as a recommendation by the U.S. Treasury in its 2017 report on capital markets.
- **Three New Exceptions to the De Minimis Calculation.** The CFTC would create three new exceptions to the *de minimis* calculation, two of which would expand the availability of existing exclusions from the definition of swap dealer. Swaps that fit within these new exceptions would not need to be counted towards the *de minimis* registration threshold.
 - 1) A new exception for swaps entered into by an insured depository institution (“**IDI**”) in connection with loans to customers (“**IDI De Minimis Exception**”). The new exception would be available in addition to the existing exclusion for swaps entered into by an IDI in connection with loans but would impose less restrictive conditions for swaps to be eligible;
 - 2) A new exception for swaps entered into to hedge financial or physical positions. This exception would, in effect, provide greater certainty about the range of hedging swaps that need not be counted towards the *de minimis* registration threshold; and

¹ This proposal would not change the \$25 million *de minimis* registration threshold for swaps with special entities.

² See 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; 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.

- 3) A new exception for swaps that result from multilateral portfolio compression exercises, codifying the relief provided by [CFTC No-Action Letter 12-62](#).
- **Swap Notional Calculation Methodology Delegation of Authority.** The CFTC proposes to delegate authority to determine the methodology used to calculate the notional amount for any type of swap to the Director of the Division of Swap Dealer Intermediary Oversight (“**DSIO**”).

The CFTC also invites comments on a range of related issues without proposing specific rule amendments, including whether exchange-traded swaps, cleared swaps and non-deliverable foreign exchange forwards should be excluded from the *de minimis* calculation. Notably, the proposed rule is silent on the cross-border counting issues previously addressed in the [2016 proposed rule](#) on the cross-border application of the *de minimis* registration thresholds.

As discussed further below, Chairman Giancarlo has stated that he is committed to finalizing the proposal before the end of 2018 to provide market participants with greater certainty about their potential swap dealer registration requirements. It is possible, therefore, that some of the proposals or other issues not directly related to the level of the *de minimis* registration threshold for which comments are requested may be addressed at a later time through separate rulemakings. Given that Chairman Giancarlo has announced that he does not intend to seek reappointment when his term ends in April 2019 (though he will remain in office until his successor is appointed), it is possible that any such later changes could be made under a new Chairman.

Comments are due by August 13, 2018.

De Minimis Registration Threshold Proposal and Timing Issues

The *de minimis* exception to the swap dealer definition provides that a person is deemed not to be a swap dealer if its swaps entered into in a dealing capacity over the preceding 12-month period, aggregated with the swap dealing positions over the same period of affiliates that are not registered as swap dealers, do not exceed the *de minimis* registration threshold. A person that breaches the threshold must register with the CFTC as a swap dealer within two months of the end of the month in which the breach occurs.

Absent CFTC action, the current *de minimis* registration threshold of \$8 billion would automatically drop to \$3 billion on December 31, 2019.³ Given that the *de minimis* calculation must take into account dealing swaps over a preceding 12-month period, a market participant would need to monitor and

³ The \$8 billion phase-in threshold was originally scheduled to expire on December 31, 2017 but the CFTC has twice issued orders extending the deadline. The [current order](#) is set to expire on December 31, 2019.

manage its dealing swaps towards the lower \$3 billion threshold beginning on January 1, 2019, unless the CFTC takes action. Chairman Giancarlo has recognized the importance of CFTC action well in advance of January 2019 to provide certainty and clarity to market participants that engage in swap dealing activities.

New Exceptions to the *De Minimis* Calculation

IDI De Minimis Exception

Section 721(d)(i) of the Dodd-Frank Act requires that the CFTC and SEC define the term “swap dealer,” and in 2012, the agencies issued a joint final rulemaking defining this term. As part of this effort, the agencies adopted an exclusion that implements the statutory requirement that an IDI not be considered to be a swap dealer to the extent that it offers to enter into a swap with a customer in connection with originating a loan with that customer.

This existing exclusion permits an IDI to exclude swaps it enters into with loan customers when determining whether it is a swap dealer, subject to numerous conditions. In the proposal, the CFTC states that based on information obtained from market participants and analysis of data submitted to swap data repositories, it believes that the existing exclusion is unnecessarily restrictive and limits the ability of an IDI to offer swaps to its customers to properly hedge the risks associated with loans. To address this concern, the CFTC proposes to adopt a new exception to the *de minimis* calculation in paragraph (4) of the swap dealer definition that would contain requirements that mirror many of the conditions in the existing exclusion in paragraph (5) of the swap dealer definition,⁴ but with several key restrictions relaxed or eliminated. Unlike under the existing exclusion, under the IDI *De Minimis* Exception:

- a swap may be entered into more than 180 days following the execution of a loan agreement;
- a swap may be entered into more than 90 days prior to the execution of the loan agreement, provided there is an executed commitment or forward agreement for the loan at the time of the swap’s execution;
- the rate, asset, liability or term underlying a swap need not be *directly* related to a financial term of the loan, so long as the rate, asset, liability or term underlying a swap is *related to* a financial term of the loan;

⁴ The CFTC takes the position that a joint rulemaking between the SEC and CFTC is not required with respect to changes to the *de minimis* exception-related factors in paragraph (4) of the swap dealer definition. 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) . . . which themselves were added by the Dodd-Frank Act.”).

Comparison of the Proposed Hedging *De Minimis* Exception to the Physical Hedging Exclusion

A person would not be required to count a swap towards the swap dealer *de minimis* registration threshold if the swap meets the requirements below (indicating additions and deletions from the Physical Hedging Exclusion):

- ~~Swaps entered into for the purpose of hedging *physical positions*. In~~ Solely for purposes of determining whether a person is a swap dealer, a swap that the person enters into shall not be considered, if: has exceeded the aggregate gross notional amount threshold set forth in paragraph (4)(i)(A) of this definition, the person may exclude swaps that are entered into for the purpose of hedging, subject to the requirements of paragraphs (4)(i)(D)(1) through (4)(i)(D)(6) of this definition.
- The person is entering into the swap for the primary purpose of reducing or otherwise mitigating one or more specific risks for the person, which includes, without limitation, market risk, price risk, rate risk, basis risk, credit risk, volatility risk, foreign exchange risk, liquidity 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 of the person.
- For that swap, the person is not the price maker and does not receive or earn a bid/ask spread, fee, commission, or other compensation for entering into the swap;
- ~~The person enters into the swap for the purpose of offsetting or mitigating the person's price risks that arise from the potential change in the value of one or several~~
- ~~Assets that the person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising;~~
- ~~Liabilities that the person owns or anticipates incurring; or~~
- ~~Services that the person provides, purchases, or anticipates providing or purchasing;~~
- ~~The swap represents a substitute for transactions made or to be made or positions taken or to be taken by the person at a later time in a physical marketing channel;~~
- The swap is economically appropriate to the reduction of ~~the person's~~ risks that may arise in the conduct and management of ~~a commercial an~~ enterprise engaged in the type of business in which the person is engaged;
- The swap is entered into in accordance with sound ~~commercial~~ business practices; and
- The person does not enter into the swap in connection with activity structured to evade designation as a swap dealer.

- a swap does not have to be required by the IDI's underwriting criteria, so long as it is *commercially appropriate* 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;
- an IDI does not have to fund a specified percentage of a syndicated loan, but if the IDI is the source of less than 5% of a loan, the notional amount of all swaps *the IDI* enters into in connection with the financial terms of the loan cannot exceed the principal amount of the IDI's loan;
- the aggregate notional amount of all swaps that *the customer* enters into in connection with the financial terms of the loan is not capped; and
- certain loan credit default swaps and loan total return swaps may be considered valid loan structures that qualify under the exception.

The blackline provided at the end of this memorandum compares the language in the proposed IDI *De Minimis* Exception against the existing exclusion. The CFTC states that any swap that meets the requirements of the existing exclusion, which the proposal would retain without modification, would also meet the requirements of the proposed IDI *De Minimis* Exception.

Hedging *De Minimis* Exception

In defining the term swap dealer, the CFTC and SEC provided an exclusion from the *de minimis* registration threshold for swaps entered into by a person for purposes of hedging physical positions that satisfy specified conditions (the "**Physical Hedging Exclusion**"). A specific exclusion for swaps entered into for purposes of hedging *financial positions* was not adopted. In the proposal, the CFTC states that based on feedback from swap market participants, including in connection with Project KISS, it believes that the absence of such a specific exclusion may have caused unnecessary uncertainty in the marketplace.

To address this concern, the CFTC proposes a new exception that would be available for swaps that hedge either physical or financial positions, subject to conditions (the "**Hedging *De Minimis* Exception**"). For swaps hedging physical positions, the new exception would be available in addition to the Physical Hedging Exclusion, which the proposal would retain without modification. Like the Physical Hedging Exclusion, the Hedging *De Minimis* Exception would be a non-exclusive safe harbor.

To qualify for the Hedging *De Minimis* Exception, a swap would need to be entered into by a person for the "primary purpose of reducing or otherwise mitigating one or more specific risks" to which it is subject. Similar to the Physical Hedging Exclusion, the swap must be economically appropriate to the reduction of the risks that may arise in the conduct and management of an enterprise engaged in the type of business in which the person is engaged and must be entered into in accordance with sound business

practices. Moreover, the swap must not be entered into in connection with activity structured to evade designation as a swap dealer.

Unlike the Physical Hedging Exclusion, the Hedging *De Minimis* Exception contains an explicit condition that the person entering into the hedging swap must not “be the price maker of the hedging swap” and must not receive or collect a bid/ask spread, fee or commission for entering into the hedging swap (or other compensation separate from the contractual terms of the hedging swap). The CFTC explains that these requirements are designed to ensure that the Hedging *De Minimis* Exception is not used to exclude swap dealing activity from the *de minimis* calculation.

The sidebar on the previous page provides a blackline comparing the requirements of the proposed Hedging *De Minimis* Exception against those of the Physical Hedging Exclusion. The CFTC states that any swap that meets the requirements of the Physical Hedging Exclusion would also meet the requirements of the proposed Hedging *De Minimis* Exception.

Definition of Multilateral Portfolio Compression Exercise (CFTC Rule 23.500(h))

Multilateral portfolio compression exercise means an exercise in which multiple swap counterparties wholly terminate or change the notional value of some or all of the swaps submitted by the counterparties for inclusion in the portfolio compression exercise and, depending on the methodology employed, replace the terminated swaps with other swaps whose combined notional value (or some other measure of risk) is less than the combined notional value (or some other measure of risk) of the terminated swaps in the compression exercise.

Portfolio Compression Exception

The proposed rule would permit a person to exclude from the *de minimis* calculation any swap that results from multilateral portfolio compression exercises, as defined in the accompanying sidebar, to the extent that the person does not enter into these compression exercises in connection with activity structured to evade swap dealer designation. This proposal codifies relief provided by [CFTC No-Action Letter 12-62](#). The CFTC states that multilateral portfolio compression exercises advance the policy considerations behind swap dealer regulation by reducing counterparty credit risk, lowering the aggregate gross notional amount of outstanding swaps and reducing operating risks by decreasing the number of outstanding swaps, and thus should not be counted towards a person’s *de minimis* calculation.

Methodology for Calculating Notional Amounts

Where notional amount is not a contractual term of the transaction, the methodology for calculating notional amounts may not be clear and there may not be a uniform industry standard practice. In these situations, to provide some clarity to the market, DSIO has in the past issued [interpretive responses](#) to frequently asked questions. The proposal would essentially formalize this practice by explicitly authorizing the Commission to approve or establish methodologies for calculating notional amounts for purposes of determining whether a person exceeds the *de minimis* registration threshold and delegating to the Director of DSIO the authority to make determinations regarding methodologies for calculating notional amounts.

Other Considerations

In addition to the proposed rule changes, the CFTC is seeking comment on a variety of related issues, some of which could have significant impact on registration requirements for swap dealers. These include whether the swap dealer *de minimis* registration threshold should:

- include a minimum dealing counterparty count threshold (e.g., 10) and transaction count threshold (e.g., 500), one or both of which would need to be breached in addition to the *de minimis* registration threshold of \$8 billion before an entity is required to register as a swap dealer;
- exclude swaps that are exchange-traded and/or cleared; and
- exclude non-deliverable foreign exchange forward transactions.

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Comparison of the Proposed IDI *De Minimis* Exception to the Existing Exclusion

A person would not be required to count a swap towards the swap dealer *de minimis* registration threshold if the swap meets the requirements below (indicating material additions and ~~deletions~~ from the existing exclusion):

- Insured depository institution swaps in connection with originating loans to customers. ~~Swaps entered into by~~ Solely for purposes of determining whether an insured depository institution has exceeded the aggregate gross notional amount threshold set forth in paragraph (4)(i)(A) of this definition, an insured depository institution may exclude swaps entered into by the insured depository institution with a customer in connection with originating a loan ~~with to~~ that customer ~~shall not be considered in determining whether the insured depository institution is a swap dealer, subject to the requirements of paragraphs (4)(i)(C)(1) through (4)(i)(C)(6) of this definition.~~
- ~~An insured depository institution shall be considered to have entered into a swap with a customer in connection with originating a loan, as defined in paragraphs (5)(ii) and (iii) of this definition, with that customer only if:~~
 - Timing of execution of swap. The insured depository institution enters into the swap with the customer no earlier than 90 days before ~~and no later than 180 days after the date of~~ execution of the applicable loan agreement, or no earlier than 90 days before ~~and no later than 180 days after~~ any transfer of principal to the customer by the insured depository institution pursuant to the loan, unless an executed commitment or forward agreement for the applicable loan exists, in which event the 90 day restriction does not apply;
 - Relationship of swap to loan.
 - The rate, asset, liability or other notional item term underlying such swap is, or is directly related to, a financial term of such loan, which includes, without limitation, the loan's duration, rate of interest, the currency or currencies in which it is made and its principal amount; or
 - Such swap is required, as a condition of the loan, either under the insured depository institution's loan underwriting criteria, ~~to be in place or as is commercially appropriate,~~ 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 for risks associated with an excluded commodity) that may affect the borrower's ability to repay the loan;
 - Duration of swap. The duration of the swap does not extend beyond termination of the loan;
 - Level of funding of loan. The insured depository institution is:
 - ~~The sole source of funds to the customer under the loan;~~
 - The insured depository institution is committed to be, under the terms of the agreements related to the loan, the source of at least 40-5 percent of the maximum principal amount under the loan; or
 - If the insured depository institution is committed to be, under the terms of the agreements related to the loan, the source of a less than 5 percent of the maximum principal amount ~~that is greater than or equal to under the loan, then~~ the aggregate notional amount of all swaps entered ~~into~~ by the insured depository institution with the customer in connection with the financial terms of the loan cannot exceed the principal amount of the insured depository institution's loan;
 - ~~The aggregate notional amount of all swaps entered into by the customer in connection with the financial terms of the loan is, at any time, not more than the aggregate principal amount outstanding under the loan at that time; and~~
 - ~~If the swap is not accepted for clearing by a derivatives clearing organization, the insured depository institution reports the swap as required by section 4r of the Act, 7 U.S.C. 6r (except as otherwise provided in section 4r(a)(3)(A), 7 U.S.C. 6r(a)(3)(A), or section 4r(a)(3)(B), 7 U.S.C. 6r(a)(3)(B) of the Act).~~
 - ~~An insured depository institution shall be~~ The swap is considered to have originated been entered into in connection with originating a loan with a customer if the insured depository institution:
 - Directly transfers the loan amount to the customer;
 - Is a part of a syndicate of lenders that is the source of the loan amount that is transferred to the customer;
 - Purchases or receives a participation in the loan; or
 - Under the terms of the agreements related to the loan, is, or is intended to be, the source of funds for the loan; ~~(D) Otherwise is the source of funds that are transferred to the customer pursuant to the loan or any refinancing of the loan.~~
 - The ~~term~~ loan to which the swap relates shall not include:
 - Any transaction that is a sham, whether or not intended to qualify for the exclusion from the definition of the term swap dealer in this rule exception from the de minimis threshold in this definition; or
 - Any synthetic loan, ~~including, without limitation, a loan credit default swap or loan total return swap.~~