

Client Update

CFTC Issues Preliminary Report on Swap Dealer *De Minimis* Exception

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On November 18, 2015, the Division of Swap Dealer and Intermediary Oversight (“DSIO”) of the Commodity Futures Trading Commission (the “CFTC”) issued a preliminary report (the “Preliminary Report”)¹ regarding the *de minimis* exception from the swap dealer (“SD”) registration requirement.

The Preliminary Report discusses the background of the *de minimis* exception and SD regulation, as well as the available swap data and the methodology and assumptions used by CFTC staff in developing estimates of swap dealing activity. The Preliminary Report also discusses the potential effects of raising or lowering the threshold and several possible alternative approaches to the *de minimis* exception.

The Preliminary Report provides CFTC staff’s preliminary analysis of the swap data that has been reported to swap data repositories (“SDRs”) under Part 45 of the CFTC regulations (the “Regulations”) since December 31, 2012 (the date on which registered SDs began reporting swap data to SDRs). CFTC staff is seeking public comment on the Preliminary Report and will publish a final report for public comment once it considers comments on the Preliminary Report. Comments on the Preliminary Report must be received on or before January 19, 2016.

BACKGROUND

Under section 1a(49) of the Commodity Exchange Act, a person engaged in more than a *de minimis* amount of swap dealing activity must register with the CFTC as an SD.

Regulation 1.3(ggg)(4) provides that a person will not be deemed to be an SD as long as the positions connected with its dealing activities during the preceding

¹ The text of the Preliminary Report is available at: <http://www.cftc.gov/PressRoom/PressReleases/pr7280-15>.

12-month period do not exceed an aggregate gross notional amount threshold of \$3 billion, subject to a phase-in level of \$8 billion that is currently in effect.²

Regulation 1.3(ggg)(4) requires CFTC staff to publish for public comment a report³ addressing, among other things, the scope of swap dealing activity, the size of the *de minimis* threshold and possible alternatives to the existing exclusions of certain swaps from the *de minimis* calculation (such as the exceptions for interaffiliate swaps, swaps relating to loans made by insured depository institutions (the “IDI Exclusion”) and swaps hedging physical positions). Once public comments on the report have been considered, the CFTC may either set a different termination date or issue a notice of proposed rulemaking to modify the *de minimis* exception (to establish an alternative to the \$3 billion threshold). If the CFTC does not take further action before December 31, 2017, the phase-in period will terminate and the *de minimis* threshold will automatically fall to \$3 billion.

PRELIMINARY REPORT

The Preliminary Report begins with a general discussion of the “swap dealer” definition and the *de minimis* exception, followed by a discussion of the data considered by CFTC staff, including various reporting and data quality limitations, the methodology for analyzing the data (including assumptions made to identify entities engaged in potential dealing activity)⁴ and a set of findings that serve as estimates for measuring swap dealing activity.⁵

² The Regulations provide a separate lower notional amount threshold of \$25 million for dealing swaps for which the counterparty is a “special entity” (e.g., state governments, federal or state agencies, certain government employee benefit plans and endowments).

³ The Preliminary Report states that it is only a preliminary analysis of existing SDR data and that once CFTC staff has considered the comments it receives on the Preliminary Report, it will publish a final report for public comment. Only after considering these comments will the CFTC act to set a termination date or modify the *de minimis* exception (though the CFTC may instead do nothing).

⁴ As the data reported to SDRs does not include fields indicating whether a transaction is entered into for dealing purposes, CFTC staff used certain methods and assumptions to identify entities engaged in potential dealing activity, including excluding certain categories of entities that are not likely engaged in dealing (e.g., collective investment vehicles, cooperatives, insurance companies and non-banking financing companies). For those entities that are not excluded, CFTC staff assumed that entities with a higher notional value of swaps were more likely dealers, and for those entities, attempted to exclude interaffiliate transactions and certain transactions involving non-U.S. persons. (Due to data limitations, CFTC staff was unable to excluded swaps executed pursuant to the IDI Exclusion.)

⁵ CFTC staff attempted to identify the number of entities that would be required to register as SDs if the CFTC were to set the *de minimis* threshold at different levels, based on assumptions as to the level of dealing activity for various entities in the interest rate

The Preliminary Report then addresses the policy objectives and considerations underlying SD registration and regulation and the *de minimis* exception (which form the basis for evaluating the SDR data), as well as several alternative approaches to a *de minimis* exception (described below).

Policy Objectives and Considerations Relating to the *De Minimis* Exception

The adopting release accompanying the final rules (the “Entity Definitions Rules”)⁶ further defining the term “swap dealer” identified the policy goals underlying SD registration and regulation generally to include the reduction of systemic risk, counterparty protections, and market efficiency, orderliness and transparency. The adopted release cited other interests served by “an appropriately calibrated *de minimis* exception,” including providing regulatory certainty, allowing limited swap dealing in connection with other client services, encouraging new participants to enter the market and providing greater regulatory efficiency.

The Preliminary Report addresses each of these policy objectives served by a *de minimis* exception as follows:

- **Regulatory Certainty**: The existing single gross notional *de minimis* threshold provides regulatory certainty by establishing a single objective test for all swap dealing in the aggregate. Conversely, the more variables included in the *de minimis* calculation, the more complex the determination of whether a market participant must register.
- **Allowing Limited Ancillary Dealing**: A *de minimis* exception may allow market participants to accommodate existing clients that have a need for swaps along with other services on a limited basis, enabling end users, for instance, to continue transacting within existing business relationships.

and credit default asset classes. (The Preliminary Report analyzes the impact of modifying the *de minimis* threshold only with respect to these classes due to data limitations for the other asset classes. For the equities, FX and nonfinancial commodity asset classes, CFTC staff analyzed the transaction count and counterparty count for potential swap dealers and compared those counts to the number of registered SDs with similar counts to determine the lowest level at which the majority of potential swap dealers in each asset class were registered.)

⁶ While the Entity Definitions Rules were jointly issued by the CFTC and the Securities and Exchange Commission (and further defined the terms “swap dealer” and “security-based swap dealer,” among others), the CFTC’s Preliminary Report addresses only the swap dealer definition and the corresponding *de minimis* exception under the CEA and the CFTC Regulations. For additional information on these final rules, see our Client Update, “CFTC and SEC Release Joint Final Rule on Key Entity Definitions in Title VII of the Dodd-Frank Act,” <http://www.debevoise.com/insights/publications/2012/06/cftc-and-sec-release-joint-final-rule-on-key-ent>.

- Encouraging New Participants: A *de minimis* exception may promote competition by allowing an entity to initiate some swap dealing activities without immediately incurring the regulatory costs associated with SD registration and regulation. Without the *de minimis* exception, regulation of SDs could become a barrier to entry, while an appropriately calibrated *de minimis* exception could allow smaller entities to gradually expand until the scope and scale of their activity warrants regulation.
- Regulatory Efficiency: The *de minimis* exception may enable the CFTC to focus its finite resources on entities whose dealing activity is sufficient in size and scope to warrant oversight.

In addition, the Preliminary Report assesses the implications of changes in the *de minimis* threshold for two particular sectors of the swap markets that may be more sensitive to such variations: nonfinancial commodity swap market participants and small and mid-sized banking enterprises.

- Nonfinancial Commodity Swap Dealing: To test the proposition that a nonfinancial entity's physical transactions entered into with commodity suppliers and purchasers generally do not involve dealing activity (and are driven by, and incidental to, other related transactions with a counterparty),⁷ CFTC staff compared the counterparty and transaction count for nonfinancial commodity swaps entered into by financial entities to those entered into by nonfinancial entities and determined that a large majority of nonfinancial entities had relatively low counterparty and transaction counts, indicating that many of these entities may be end users. However, the Preliminary Report notes that some nonfinancial entities had counterparty and transaction counts comparable to financial entities, and states that given the significant role nonfinancial entities play in this market, a decision to exclude such firms from SD registration "may require further analysis."
- Small to Mid-Sized Banking Enterprises: To determine whether the limited nature of small and mid-sized banks' swaps activities warrants a reduced regulatory burden for such entities (as certain commenters on the proposed "swap dealer" definition had contended), CFTC staff considered the average counterparty count, transaction and notional amount (in each case for the interest rate and credit default swap asset classes only) for banking organizations with various ranges of total assets. The Preliminary Report notes that while these counts and notional amounts were considerably higher for banking organizations with total assets exceeding \$750 billion, the

⁷ Commenters had raised this argument during the rulemaking process to define the term "swap dealer," but the CFTC ultimately determined that a *per se* exclusion of swaps connected with a physical commodity business, as such swaps may in some circumstances "serve market functions characteristic of the functions served by [SDs]."

absence of a direct correlation between the volume of a banking organization's swap activities and its asset size suggests that a blanket exclusion for certain banking entities based on asset size could exclude banks that engage in significant dealing activity. Applying these findings to CFTC staff's task of assessing alternatives to the IDI Exclusion (which certain commenters have criticized as overly narrow), the Preliminary Report states that excluding small and mid-sized banking organizations from regulation based solely on asset size might be inconsistent with the CFTC's interest in promoting counterparty protections and swap market transparency, orderliness and efficiency.

Alternative Approaches to *De Minimis* Exception

As contemplated by Regulation 1.3(ggg)(4), the Preliminary Report considers whether the *de minimis* threshold should be increased or decreased, as well as whether alternative approaches to a single gross notional *de minimis* exception would more effectively promote relevant regulatory goals. The Preliminary Report requests comment regarding the following alternative approaches:

- A notional *de minimis* threshold specific to each asset class;
- A multifactor approach that could include counterparty count and/or transaction count metrics in the *de minimis* exception, in addition to a gross notional dealing threshold;
- A multitiered approach where the regulatory requirements associated with SD registration are commensurate with an entity's level of dealing activity; and
- The exclusion from an entity's *de minimis* calculation of swaps that are traded on a registered or exempted swap execution facility or designated contract market and/or cleared.

Although it is beyond the scope of the Preliminary Report to evaluate the advantages and disadvantages of various alternative approaches to the *de minimis* exception or to recommend a particular approach, the Preliminary Report notes some of the general policy issues that may be relevant to further consideration of such alternatives.

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Please do not hesitate to contact us with any questions.