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

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Futures and Derivatives

On November 18, 2015, the Staff of the Commodity Futures Trading Commission (CFTC) issued a preliminary report regarding the *de minimis* exception to the definition of swap dealer (Preliminary Report).[1] The Preliminary Report, issued pursuant to the CFTC's swap dealer definition,[2] is intended to provide the Commission with information regarding the potential effects if the threshold of the *de minimis* exception is lowered from $8 billion in aggregate notional swap dealing activity to $3 billion, which will occur on December 31, 2017 without action by the Commissioners.[3] With respect to dealing activity in interest rate swaps (IRS) and credit derivative swaps (CDS), the Preliminary Report indicates that:

- If the *de minimis* threshold remains at $8 billion, 129 entities would be registered as swap dealers per the Staff's methodology;[4]
- If the *de minimis* threshold is lowered to $3 billion, an additional 83 entities (for a total of 212 entities) would potentially have to register as swap dealers; and
- Lowering the *de minimis* threshold to $3 billion would only increase the number of transactions, and notional activity, subject to swap dealer regulation by about 1%.[5]

The Preliminary Report Depends Heavily on Assumptions

Because the swap data reported to swap data repositories does not include a data field to indicate whether a transaction is entered into for dealing purposes, CFTC Staff had to make a number of assumptions to attempt to identify those transactions that could possibly constitute dealing.[6] In addition, gross notional value data was only available for IRS and CDS transactions. The gross notional value data for FX Derivatives, Equity Swaps, and Non-Financial Commodity Swaps was not reliable.[7] These limitations on the data available to CFTC Staff, and the assumptions it needed to make as a result, limit the value of the findings in the Preliminary Report.

[1] CFTC Staff, Swap Dealer *De Minimis* Exception Preliminary Report, November 18, 2015, available at: http://www.cftc.gov/idc/groups/public/@swaps/documents/file/dfreport_sddeminis_1115.pdf.
[2] 17 C.F.R. § 1.3(ggg)(4)(ii)(B).
[3] *Id.* at 1-3.
[4] As of December 7, 2015, there are 105 provisionally registered swap dealers. See http://www.cftc.gov/LawRegulation/DoddFrankAct/registerswapdealer.
[5] *Id.* at 48-49.
[6] *Id.* at 11-18.
[7] *Id.* at 18. Because of this limitation on data on these asset classes, we focus here on IRS and CDS transactions.

Policy Considerations and Regulatory Impact

In the Preliminary Report, CFTC Staff addressed the policy considerations it considered important to any determinations regarding the *de minimis* threshold. For example, a broad *de minimis* exception could enhance efficiency by encouraging new market participants and allowing market participants to accommodate clients who enter into swaps on a limited basis in conjunction with other services, without incurring unnecessary regulatory costs, but at the same time could undermine the regulatory goals of counterparty protections and reduction in systemic risk.[8] By contrast, a narrow *de minimis* exception would create barriers to entry and require entities for whom swap dealing is only an ancillary activity to register as swap dealers. Such a result could increase costs, but could also increase regulatory protections to counterparties and the financial system.[9]

One sector the Preliminary Report focuses on with regard to regulatory impact is small and mid-sized banks. Specifically, the Preliminary Report, based on comments previously received by the CFTC, addresses whether "small and mid-sized banks swaps activity supports a reduced regulatory burden for those entities."[10] In light of statutory constraints limiting how broadly the CFTC can craft an exclusion from the *de minimis* calculation for swaps entered into by insured depository institutions in connection with lending activities, CFTC Staff explored whether relief could be provided for particular classes of market participants or a particular level of dealing activity.[11] However, the Preliminary Report notes that some small and mid-sized banks have a high number of unique counterparties and swap transactions, a possible indicator of swap dealing activity.[12] Accordingly, CFTC Staff indicated that "excluding small and mid-sized banking enterprises from regulation based solely on asset size might be inconsistent with the Commission's interest in promoting counterparty protections and swap market transparency, orderliness, and efficiency."[13]

Requests for Comment

The Preliminary Report seeks comments addressing over 50 questions by January 19, 2016. At a high level, CFTC Staff seeks comment regarding the following:

- Considering the limitations in swap data, the best techniques to identify transactions that constitute swap dealing;[14]
- The appropriate policy considerations for constructing the *de minimis* exclusion;[15]
- The impact of the *de minimis* threshold on small and mid-sized banking enterprises;[16] and

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[8] *Id.* at 35-37.
[9] *Id.*
[10] *Id.* at 43.
[11] *Id.* at 46.
[12] *Id.*
[13] *Id.*.
[14] *Id.* at 20.
[15] *Id.* at 38.
[16] *Id.* at 46-47.

- Whether alternate approaches (*e.g.*, a multi-factor approach) to the *de minimis* threshold would better serve regulatory goals.[17]

Commissioner Giancarlo's Statement

Commissioner J. Christopher Giancarlo released a statement addressing the Preliminary Report, in which he criticized the regulatory approach taken in formulating the *de minimis* exception in 2012. Commissioner Giancarlo urged the Commission to change that approach ahead of the December 31, 2017 date in which the *de minimis* threshold would be lowered.[18] Specifically, Commissioner Giancarlo reiterates his position that the "current and contemplated *de minimis* thresholds set by the Commission in 2012 are completely arbitrary."[19] He further notes that the Preliminary Report provides little insight into the amount of swap dealing in the marketplace because of the number of assumptions CFTC Staff had to make due to shortcomings in swap data.[20] Finally, he argues that a reduction in the *de minimis* threshold would increase regulatory burdens on a "significant number of market participants" without any corresponding "appreciable impact on coverage of the marketplace as measured by notional amount, transactions or unique counterparties."[21]

Conclusion

The Preliminary Report provides the Commission, as well as market participants, with a preliminary indication of the effect that lowering the *de minimis* threshold to $3 billion could have. Although preliminary in nature, and based largely on assumptions, the Preliminary Report is indicative of the framework CFTC Staff will utilize as it moves to issue a final report ahead of the *de minimis* threshold reduction in December 2017. Importantly, the report also gives market participants an opportunity to provide meaningful comments to CFTC Staff ahead of its final report and Commission action on the *de minimis* threshold.

If you have any questions concerning the material discussed in this alert, please contact a member of our Futures and Derivatives Practice:

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[17] *Id.* at 56-57.
[18] Statement of Commissioner J. Christopher Giancarlo Swap Dealer De Minimis Exception Preliminary Report, available at: http://www.cftc.gov/PressRoom/SpeechesTestimony/giancarlostatement111815.
[19] *Id.*
[20] *Id.*
[21] *Id.*

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