

Clients & Friends Memo

CFTC Releases Swap Dealer *De Minimis* Report

November 20, 2015

CFTC Staff's Preliminary Report on whether to modify the swap dealer *de minimis* threshold highlights the difficulty in identifying swap dealing activity and problems with swap data reporting

When the U.S. Commodity Futures Trading Commission ("CFTC" or the "Commission") defined the activity that would require an entity to register as a swap dealer, it provided an exception for entities that engage in a volume of dealing activity below a certain threshold ("*de minimis* threshold"). Initially, the CFTC established a phase-in period during which the *de minimis* threshold is set at \$8 billion in notional amount of dealing swaps over a rolling twelve-month period (\$25 million for swaps with special entities). If the CFTC does not take further action before the end of the phase-in period, the *de minimis* threshold automatically drops to \$3 billion on December 31, 2017.

In the interim, the CFTC's rules require the CFTC to issue for public comment a report on topics relating to the scope of swap dealing activity and the size of the *de minimis* threshold itself.¹ On November 18, 2015, staff from the Division of Swap Dealer and Intermediary Oversight and the Office of the Chief Economist of the CFTC (collectively, "Staff") released the Swap Dealer *De Minimis* Exception Preliminary Report ("the Preliminary Report") for public comment. Comments to the Preliminary Report are due January 19, 2016.

The Preliminary Report generally addresses: (1) the statutory and regulatory requirements (Section II of the Preliminary Report); (2) the available swap data and assumptions made as part of the CFTC's analysis (Section III of the Preliminary Report); (3) the policy objectives and considerations relating to the *de minimis* exception (Section IV of the Preliminary Report); and (4) alternatives to the *de minimis* exception (Section V of the Preliminary Report).

Market participants hoping to gain insight into the nature of swap dealing activities or the potential impact of decreasing or increasing the *de minimis* threshold may be disappointed by the

¹ CFTC Rule 1.3(ggg)(4)(ii)(B); Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-based Swap Participant" and "Eligible Contract Participant", 77 Fed. Reg. 30596 (May 23, 2012).

Preliminary Report. Staff did not identify the nature of activities that are indicative of dealing, nor did it make a recommendation regarding adjusting the *de minimis* threshold. In fact, Staff acknowledges that their analysis “has limited value for setting a more effective single *de minimis* threshold for the entire swap market.” Instead, the Preliminary Report provides an overview of the substantive and significant limitations of the swap data that the CFTC is currently receiving, and then outlines several potential alternatives to the current framework for the *de minimis* exception. Staff intends to review the public comments to the Preliminary Report, and thereafter, draft a final report with Staff recommendations on the definition of dealing and the size of the *de minimis* threshold. The final report will similarly be subject to public comment.

Below is a brief summary of the key issues addressed in the Preliminary Report.

I. Swap Data, Methodology, and Analysis (Section III of the Preliminary Report)

To assess the likely impact of modifying the *de minimis* threshold, Staff analyzed swap data received from swap data repositories (“SDRs”). The Preliminary Report explains the assumptions Staff made regarding whether certain activity was dealing activity based on the swap data and to what extent modifying the *de minimis* threshold might alter the number of swap dealer registrants.

Staff acknowledged several limitations to relying on SDR data to determine the impact of modifying the *de minimis* threshold. First and foremost, SDR data does not indicate whether a particular swap represents a dealing swap. The data only identifies the parties to the swap and the primary economic terms. To counteract the limitations of the SDR data, Staff made several underlying assumptions depending on the swap asset class in order to identify dealing activity as compared to non-dealing activity. Essentially, the Staff assumptions place each entity in a likely-dealer or non-dealer category. For the dealer category, the Staff counted all swaps toward the *de minimis* threshold. For the non-dealer category, the Staff did not count any swaps toward the *de minimis* threshold.

A. Staff Assumptions to Identify Dealing Activity in the Interest Rate and Credit Default Swap Asset Classes

For the interest rate and credit default swaps asset classes, Staff assumed that collective investment vehicles, foreign central banks and other government related international financial institutions, cooperatives, insurance companies and non-bank financing companies did not engage in dealing activity, so Staff did not count swaps for these types of entities toward the *de minimis* threshold. If an entity was not excluded, Staff assumed that as the notional value of an entity’s swap transactions increased, it was more likely that the entity was engaged in dealing activity. As a result, Staff assumed that entities that enter into swaps with higher notional value were engaging in dealing activity. For these likely-dealing entities, Staff attempted to exclude inter-affiliate transactions and certain transactions involving non-U.S. persons.

B. Staff Assumptions to Identify Dealing Activity in the Equities, FX, and Non-Financial Commodity Swap Asset Classes

For the equities, FX, and non-financial commodity swaps asset classes, Staff indicated that it could not rely on notional amount data due to errors in the data reported to SDRs. Consequently, Staff could not evaluate the impact of modifying the *de minimis* threshold and therefore developed a different approach to identify swap dealing activity for these asset classes. First, Staff assumed that certain entities likely do not engage in regulated swap dealing activity or are not within the CFTC's jurisdiction.² For all entities that were not excluded, Staff evaluated whether entering into more CFTC-jurisdictional swap transactions with a greater number of counterparties is indicative of swap dealing activity. Staff acknowledged such metrics are not determinative in identifying dealing activity and requested comments on alternative techniques to use to more accurately identify swap dealing activity.

II. Findings of the Preliminary Report

Although the swap dealer *de minimis* threshold is based upon total notional amount across all swap asset classes, the Preliminary Report only evaluated the impact of modifying the *de minimis* threshold for interest rate and credit default swap asset classes due to data limitations for the other asset classes. After assuming a level of swap dealing activity for various entities in the interest rate and credit default swap asset classes, Staff attempted to identify the number of entities that would be subject to swap dealer registration if the CFTC were to increase or decrease the *de minimis* threshold. For example, Staff concluded that reducing the *de minimis* threshold to \$3 billion would result in up to 83 additional entities being subject to swap dealer registration (approximately 212 entities would be subject to swap dealer registration in total), while increasing the threshold to \$15 billion would result in as many as 22 fewer entities being subject to swap dealer registration (approximately 107 entities would be subject to swap dealer registration in total).³ However, these changes would not have an appreciable impact on regulatory coverage as measured by notional amount attributable to registered swap dealers. In fact, Staff noted that such changes only would impact the amount of notional activity subject to swap dealer regulation by less than one percent.

For the equities, FX, and non-financial commodity swaps asset classes, Staff did not evaluate the impact of modifying the *de minimis* threshold. Rather, Staff evaluated the transaction count and counterparty count for potential swap dealers and compared those counts to the number of

² The entities that Staff assumed do not engage in swap dealing activity include: collective investment vehicles, foreign central banks and other government related international financial institutions, cooperatives, insurance companies, non-bank financing companies, commodity pools whose operators were registered with the Commission as commodity pool operators, entities listed on the SEC's Investment Company Series and Class Report, and entities whose names matched any of a set of keywords that likely indicated the entity was in one of the categories to be excluded (e.g., "fund" or "insurance").

³ Staff noted that the impact of lowering the threshold to \$3 billion would likely be even less than their analysis suggests because their analysis did not allow for Staff to separate out hedging and proprietary trading.

registered swap dealers with similar counts. According to the report, “the 51 to 75 Counterparty Count range is the lowest level at which the majority of Potential Swap Dealing Entities in each asset class were registered swap dealers. Similarly, the 10,001 to 100,000 Transaction Count range was the lowest level at which the majority of Potential Swap Dealing Entities in each asset class were registered.” It is unclear if Staff assumed that counterparty or transaction counts at those levels are indicative of swap dealing.

III. Alternatives to the *De Minimis* Exception (Section V of the Preliminary Report)

The Preliminary Report requests comment regarding several potential “alternative approaches” to the current *de minimis* calculation, including: (1) a notional *de minimis* threshold specific to each asset class; (2) a multi-factor approach that would potentially include Counterparty Count and/or Transaction Count metrics in the *de minimis* exception, in addition to a gross notional dealing threshold; (3) a multi-tiered approach where the regulatory requirements associated with swap dealer registration are commensurate with an entity’s level of dealing activity; and (4) the exclusion from the *de minimis* calculation of swaps that are traded on a registered or exempted swap execution facility (“SEF”) or designated contract market (“DCM”), and/or cleared. Staff does not provide recommendations regarding which of these alternatives is preferable, if any, but does describe some of the possible ramifications with respect to each.

IV. Conclusion

Given the potential for a significant change in the level and methodology for calculating the *de minimis* threshold, market participants should begin to assess the potential impact of the various approaches discussed in the Preliminary Report and the likely time required to implement commercial changes (if any) if the goal is to remain unregistered. Additionally, market participants should take note of the CFTC’s description of deficiencies in swap data reporting, particularly in light of recent enforcement actions and statements made by both the Chairman and Director of Enforcement regarding the Commission’s intention to investigate and address reporting deficiencies through enforcement actions.

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Please contact any member of the Cadwalader team to discuss strategies to address potential risks in these areas.

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