

U.S. federal regulators propose making permanent threshold for swap dealer registration, potentially benefitting energy companies and small and mid-size banks

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Pursuant to regulations promulgated under the Dodd-Frank Act, entities that make a market in swaps, hold themselves out as dealers in swaps, or regularly enter into swaps for their own accounts are required to register as swap dealers with the U.S. Commodity Futures Trading Commission (the CFTC). However, pursuant to CFTC regulations finalized in 2012, certain entities do not need to register as swap dealers. Accordingly, pursuant to the so-called “de minimis exception”, entities that have had, over the course of the immediately preceding 12 months, an aggregate gross notional amount of no more than US\$3 billion in swaps have not had to register as swap dealers, subject to a phase-in period, during which the threshold is set at US\$8 billion. The phase-in period was originally scheduled to expire on December 31, 2017 but was subsequently extended to December 31, 2019. On June 5, 2018, the CFTC proposed to permanently set the de minimis exception at US\$8 billion. If finalized as a rule, the permanent de minimis exception would affect small and mid-size banks as well as energy companies that trade derivatives.

In the preamble to the proposed rule, the CFTC also discussed three other considerations with respect to a de minimis threshold:

- The first of these are potential minimum dealing counterparty count and minimum dealing transaction count thresholds. Unlike the de minimis threshold discussed above, which is based on the aggregate notional activity, these alternative thresholds, if enacted, would be based on the actual number of counterparties or transactions. The regulatory concern is that certain entities may marginally exceed the de minimis threshold but otherwise have dealing activity that is considered too limited for the purposes of swap dealer registration. Accordingly, the CFTC is seeking comments on whether it would be appropriate for there to be separate minimum thresholds of 10 counterparties and 500 transactions. Due to the concern that certain entities that may qualify for these thresholds should still be regulated as swap dealers, the CFTC is also seeking comments on whether a US\$20 billion aggregate notional amount “backstop” would be appropriate, meaning that entities that go above the “backstop” would not qualify for the alternative thresholds.
- The second consideration is whether swaps executed on an exchange or designated contract market and/or cleared by a derivatives clearing organization should not be counted towards the de minimis exception calculations. Exchange-traded swaps and cleared swaps are

generally considered to be less risky than over-the-counter swaps (which are executed directly between two counterparties).

- The third consideration is whether non-deliverable foreign exchange forwards should not be counted towards de minimis exception calculations. While deliverable foreign exchange forwards are outside the definition of “swap” and are therefore not currently counted for the de minimis thresholds, the CFTC notes that non-deliverable forwards (which are currently counted) are functionally similar to deliverable forwards and settle on a net rather than gross basis, significantly reducing counterparty risk.

The CFTC is also proposing to modify or add rules regarding certain swaps that are not counted towards the de minimis threshold:

- CFTC rules provide that swaps entered into by insured depository institutions with customers in connection with originating a loan for such customers are not to be counted towards the de minimis thresholds, subject to certain requirements. In a modification that may be significant for small and mid-size banks that enter into swaps with their borrowers in connection with lending activity, the CFTC proposes to allow such swaps to not be counted towards the de minimis exception thresholds if they are entered into at any time after the closing of the loan (rather than within 180 days as currently in force) and if the insured depository institution has at least 5 percent commitment in the overall loan (rather than 10 percent as currently in force). Furthermore, the CFTC proposes to remove the requirement for the aggregate gross notional amount of swaps entered into in connection with the loan to not exceed the principal amount outstanding.
- CFTC rules provide that swaps entered into for purposes of hedging are not to be counted towards the de minimis thresholds. In a modification that could benefit energy companies that hedge both financial and physical exposure, the CFTC proposes to add certain clarifications to the rule to make it clear that swaps entered into for purposes of hedging financial positions qualify under this exception in the same manner as swaps entered into for purposes of hedging physical positions. Accordingly, as stated in the proposed clarification, such swaps must be for the primary purpose of reducing or otherwise mitigating one or more specific risks, including, 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. Entities hoping to qualify for this exemption must not be price makers with respect to such swaps and must not receive a bid/ask spread, fee, commission, or other compensation for entering into such swaps.
- While CFTC rules currently do not address whether swaps resulting from multilateral portfolio compression exercises must be counted towards the de minimis thresholds, a CFTC staff no-action letter issued in 2012 states that CFTC staff will not recommend enforcement action against any entity that fails to include such swaps in its de minimis threshold calculations. The CFTC proposes to exclude such swaps from the de minimis thresholds.

If enacted as a rule, the permanent US\$8 billion de minimis threshold would create more certainty among market participants regarding whether they will need to register as swap dealers. The CFTC’s proposal does not address registration thresholds for security-based swap dealers, who are to be regulated by the U.S. Securities & Exchange Commission and for whom registration is not yet in effect. The CFTC has invited comments on its proposal, which are due on August 13, 2018.

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