SPEECHES & TESTIMONY

Statement of Dissent of Commissioner Rostin Behnam before the Open Commission Meeting on June 4, 2018

De Minimis Exception to the Swap Dealer Definition

June 4, 2018

Introduction

I respectfully dissent from the Commodity Futures Trading Commission's (the "Commission" or "CFTC") notice of proposed rulemaking addressing the de minimis exception to the swap dealer definition (the "Proposal"). I have a number of concerns with specific criteria of the various exceptions proposed and contemplated in the Proposal. However, my gravest concern is that the Commission is moving far beyond the task before it— setting the aggregate gross notional amount threshold for the de minimis exception— to redefine swap dealing activity absent meaningful collaboration with the Securities and Exchange Commission ("SEC"), as required by the Dodd-Frank Act,[1] and to the detriment of market participants eager for regulatory certainty. Equally concerning, the Proposal's various ancillary components not only detract from its core purpose, but may signify the Commission's willingness to exploit the de minimis exception to undermine the swap dealer definition and circumvent Congressional intent.

As discussed in the preamble to the Proposal, the regulatory history sets forth a clear path towards— and a deadline to complete— today's determination to propose an amendment that would set the aggregate gross notional amount ("AGNA") threshold for the de minimis exception at $8 billion in swap dealing activity entered into by a person over the preceding 12 months prior to the termination of the phase-in period on December 31, 2019.[2] Since the Commission's first Order Establishing a New De Minimis Threshold Phase-in Termination Date in 2016,[3] market participants have endured undue and prolonged uncertainty because the Commission has not acted decisively on the de minimis threshold. When the Commission punted again in October 2017, I urged the Commission to take further action now or let the current rule take effect.[4]

It is now June 2018. Given the twelve month lookback for calculating the AGNA, absent Commission action, market participants will need to start tracking their swap dealing activity on January 1, 2019 to determine whether their dealing activity would require registration when the phase-in period ends on December 31, 2019. The Commission has less than six months to either finalize the Proposal or kick it down the road again by issuing a third order establishing yet another phase-in termination date sometime in the future.

Six months is an ambitious time frame for even a simple rule. While CFTC-specific data is not available, at least one study concluded that the average amount of time for federal regulatory agencies to finalize rules is generally between 14 and 20 months.[5] The Part 49 amendments that we also voted on today, for example, took over 16 months between the Commission proposal and a final rule, and that rule only

addressed a single industry comment letter that was nine pages long. However, given our extensive history with the AGNA for the de minimis exception, I believe that had the Commission observed the course it was on, and focused on the task at hand, it could have crafted the Proposal to address the issues most critical to market participants (the de minimis threshold, the exclusion for insured depository institution swaps in connection with originating loans to customers or "IDI Swap Dealing Exclusion," and the hedging swap exclusion), consistent with requirements of the Commodity Exchange Act (the "CEA" or "Act") and Congressional intent and within the six month window we are now in.

Instead, the Commission, having waited too long to address these critical issues jointly with the SEC, veered off course, and relies too heavily on an alternative means to reach its destination: the de minimis exception.[6] Though this alternative path is within the Commission's authority, I believe that in utilizing the de minimis exception to address longstanding concerns with the IDI and physical hedging exclusions, the Commission stopped respecting the difference between what is permissible and what is proper. As a consequence, the Proposal morphed into a loophole for the Commission to explore the extent to which it may unilaterally alter the swap dealer definition. Such overreach not only may call into question the integrity of this agency, but it could prolong the uncertainty currently plaguing market participants as they (and the general public) sort through the matters ancillary to the de minimis AGNA threshold, which alone raise over 50 individual questions in requests for comments.

Commission Authority under Regulation 1.3, Swap Dealer, (4)(v)

Under paragraph 4(v) of the swap dealer definition, the Commission may change the requirements of the de minimis exception by rule or regulation, and may do so independent of the SEC ("De Minimis Exception Authority").[7] While this authority permits the Commission to revisit the de minimis threshold, in the SD Definition Adopting Release, the Commission stated that in determining whether to revisit the threshold, it intended to focus on whether the de minimis exception (1) results in a swap dealer definition that encompasses too many entities whose activities are not significant enough to warrant full Title VII regulation; (2) results in an undue amount of dealing activity to fall outside of the regulatory framework; or (3) leads to inappropriate reductions in counterparty protections.[8]

While the Commission's authority with respect to the de minimis exception is broad, the Commission cannot lose sight of its purpose, as set forth in the CEA[9], and the underlying Congressional intent.[10] As well, this authority is not intended to provide a de facto means to alter the swap dealer definition, by for example, excepting from consideration swaps that are exchange-traded and/or cleared when calculating the AGNA for purposes of the de minimis threshold, or excepting from such consideration entire categories of swaps.

Exclusions vs. Exceptions

IDI De Minimis Provision

Turning to the Proposal, and the critical issues, I am concerned with the Commission's use of its De Minimis Exception Authority to address longstanding concerns that the IDI

Swap Dealing Exclusion, which was jointly adopted with the SEC as paragraph (5) to the swap dealer definition ("SD Definition), is unnecessarily restrictive, lacks clarity, and limits the ability of IDIs to serve customers in connection with their lending activity— which is inconsistent with the CEA.[11] As explained in the Proposal, "rather than proposing to revise the scope of activity that constitutes swap dealing," which would require a joint rulemaking with the SEC, the Commission is proposing to amend paragraph (4) of the SD Definition, which addresses only the de minimis exception. Accordingly, the Proposal is to include both the IDI Swap Dealing Exclusion and a separate, slightly broader IDI De Minimis Provision in the SD Definition.

Conducting a side-by-side comparison of the current text of paragraph (5) and proposed paragraph (4)(i)(C) of the SD Definition, it is difficult to understand what hurdles may have prevented the CFTC and SEC from engaging in a joint rulemaking to address these relatively modest differences, which are generally well supported by the record. It's especially noteworthy given the close working relationship between the two agencies and ongoing harmonization efforts.[12] The end result is that, if finalized, instead of simply disregarding or "excluding" all swap activity that meets a single set of criteria, IDIs will have to develop an additional analysis to address swap activity that cannot be excluded from their determinations for purposes of the SD Definition, but might nevertheless be excepted from their AGNAs when calculating dealing activity for the purpose of the de minimis threshold. It is difficult to understand why the Commission would want to create additional regulatory burdens in the context of this Proposal, and the document provides no explanation other than that the Commission has discretion under its De Minimis Exception Authority.

Hedging De Minimis Provision

I am similarly concerned that the Commission's use of its De Minimis Exception Authority to provide greater regulatory certainty with respect to swaps entered to hedge physical or financial exposures (the "Hedging De Minimis Provision") will— out of an abundance of caution— be utilized by market participants as a limitation on the universe of hedging swaps they consider to be outside their swap dealing activity. In this instance, instead of amending the Physical Hedging Exclusion,[13]which is in the nature of a safe harbor and provides that, subject to certain requirements, swaps entered into by a person for hedging physical positions are not considered for purposes of determining whether that person is a swap dealer, the Commission is proposing an exception with respect to a person's AGNA for the de minimis threshold for swaps entered to hedge financial or physical positions. While this exception will, if finalized, exist in the Commission regulations alongside the Physical Hedging Exclusion, it is not truly a safe-harbor and could end up limiting the discretion inherent in the SD Definition.

An exception, as proposed for the Hedging De Minimis Provision, ostensibly creates a precise rule, leaving compliance staff or even regulatory enforcement agencies with limited discretion when evaluating difficult scenarios. As the Commission has stated, "In general, entering into a swap for the purpose of hedging is inconsistent with swap dealing."[14] The Commission also has emphasized that all relevant facts and circumstances about a swap ought to be considered when determining whether a person is a swap dealer.[15] It seems that an exception limited solely to determining

whether a person has exceeded the AGNA de minimis threshold may prove unduly limiting and inconsistent with the SD Definition.[16]

Premature Delegation

The Proposal purports to create Commission authority to determine the methodology to be used to calculate the notional amount for any group, category, type, or class of swaps for purposes of the AGNA de minimis threshold calculation and immediately delegates that authority to the Director of the Division of Swap Dealer and Intermediary Oversight ("DSIO"). The Commission has, to my knowledge, not released public guidance on this issue since 2012.[17] The Proposal cites two letters, one responding to the Chairman's recent Project KISS initiative, and the other responding to the request for comments on the Swap Dealer De Minimis Exception Preliminary Report,[18] in support of the inherent need to empower the Director of DSIO to independently— and without limitation—provide clarity about the appropriate notional amount calculation methodologies for purposes of the de minimis threshold in a timely manner. As well, both the public guidance and requests cited in the Proposal address or respond to the need for clarity regarding commodity swaps, further calling into question the breadth of the proposed delegation.

For most swaps, calculation of notional amount is a matter of standard industry practice. There is not any controversy as to how notional amount is calculated. Giving the Director of DSIO broad authority to determine how this calculation is made for all categories of swaps is a remedy that is not commensurate to the limited issue of how to determine the notional value of commodity swaps. It also provides an opportunity for mischief. This provision could subsume the entire de minimis threshold by giving the Director of DSIO broad authority to determine what swaps count toward the threshold – and perhaps more importantly, what swaps do not.

I'm concerned that the Commission is proposing to both establish its authority and immediately delegate such authority without any internal discussion, without any public deliberation, and within this Proposal. The Commission has simply not articulated a sound rationale for moving abruptly forward on this rule proposal without fulsome consideration of its legal authority, potential risks, and possible alternatives. Indeed, upon review of the Proposal, it came to my attention that the Commission's proposed delineation of authority to determine the methodology for calculating notion amounts in proposed paragraph (D)(vii)(A) of the SD Definition may contradict its De Minimis Exception Authority.

The De Minimis Exception Authority provides that the Commission may by rule or regulation change the requirements of the de minimis exception. Given that the methodology for calculating notional amounts for purposes of the AGNA for the de minimis threshold would be a "requirement" of that exception, one could assume that the authority to alter it resides with the Commission, and that the Commission would need to engage in rulemaking to establish a methodology. Of course, theDe Minimis Exception Authority includes a "may" versus a "shall," and therefore the Commission has discretion to engage in rulemaking, but I believe the "may" applies more generally to suggest that the Commission may change the requirements of the de minimis exception, and if it chooses to do so, rulemaking is the vehicle. My point is that the

Commission's precise authority and attendant parameters are unclear, and it would therefore be more prudent to first, define the parameters of the notional amount calculation issue, conduct additional research and explore our options to address it, and then propose a more cogent solution in a separate rulemaking so as not to further detract from the more salient and critical issues before the Commission as part of this Proposal.

Ancillary Matters

Having become comfortable with using its De Minimis Exception Authority, the Commission appears to have determined to use this Proposal to seek comment on "other potential considerations for the de minimis threshold." These considerations run the gamut from re-considering the merits of using AGNA by itself by seeking comment on adding alternative criteria in the form of a dealing counterparty or dealing transaction count threshold to excepting from consideration when calculating the AGNA for purposes of the de minimis threshold (1) swaps that are exchange-traded and/or cleared and (2) swaps that are categorized as non-deliverable forward transactions. These "considerations" result in the combined inclusion of more than 50 individual requests for comment, detracting from any reasonable market participant's (or the public's) ability to provide comments on the more critical issues raised by this Proposal. Moreover, each "potential consideration" raises individual concerns as to whether the Commission is attempting to undermine the swap dealer definition and circumvent Congressional intent.

Dealing Counterparty Count and Dealing Transaction Count Thresholds

The Commission is seeking comment on whether an entity should be able to qualify for the de minimis exception if its level of swap dealing activity is below any one of three criteria: (1) an AGNA threshold; (2) a proposed dealing counterparty count threshold; or (3) a proposed dealing transaction count threshold. In support of its request for comment, already limited Commission staff resources were utilized to construct an alternative to the proposal aimed at suggesting that, despite its analysis in the Proposal in support of setting the AGNA threshold for the de minimis exception at $8 billion, a $20 billion AGNA "backstop" threshold was appropriate. This analysis and attendant request for comment suddenly appeared in the Proposal after hours on May 31, 2018, providing my office less than 17 hours to respond before DSIO intended to submit a final voting copy to the Commission's Office of the Secretariat.

Not only is the inclusion of this request for comment in this Proposal overwhelmingly misplaced, but its inclusion at such a late hour in the process undermines the inherent fairness of the rulemaking process. Foremost, the Commission already rejected the use of counterparty and transaction count thresholds as determinative criteria for the de minimis threshold.[19] Moreover, the Commission is required to take the Swap Dealer De Minimis Exception Final Staff Report ("Final Staff Report") and comments into account when weighing further action on the de minimis exception at the end of the phase-in.[20] According to the Final Staff Report, "many of the commenters stated that the Commission should not use the alternative factors of Counterparty and/or Transaction Count as part of a de minimis exception because they are misleading or arbitrary indicators of dealing activity."[21] The footnote cites 11 comment letters

representing at least 12 entities including major industry and trade organizations.[22] In comparison, only two commenters supported the use of the alternative factors.[23]

While I believe it may be appropriate for the Commission to explore other factors or criteria in defining the scope of the de minimis threshold, inclusion of even a request for comments on dealing counterparty count and dealing transaction count thresholds should be out of scope—even as a request for comment— for this Proposal, which speaks directly to the end of the phase-in, and is proceeding on a constrained time schedule such that even providing Commissioners the courtesy of ample opportunity to evaluate the merits of including this line of questioning was dispensed with.

Exchange-Traded and/or Cleared Swaps

Similar to the dealing counterparty and transaction count threshold, the Commission has already rejected arguments that swaps executed on an exchange should not be considered in determining if a person is a swap dealer.[24] However, beyond that, the breadth of the request for comment suggests that a discussion regarding how the utilization of exchange trading and/or clearing in the swap market may address the underlying policy goals of swap dealer registration is significant and raises issues that should be considered in the context of a joint discussion with the SEC and prudential regulators regarding the SD Definition. Even further, it may require Congressional action to amend the statutory swap dealer definition, which does not distinguish exchange traded and/or cleared swaps from over-the-counter swaps, and in fact, may suggest that there is no distinction given the focus on market making, which significantly occurs on exchanges.[25] In responding to this request for comment, I hope that commenters address whether an exception for exchange-traded and/or cleared swaps—even if limited to consideration when calculating the AGNA for purposes of the de minimis threshold—would be consistent with the statutory definition of "swap dealer" in CEA section 1a(49) and Congressional intent.

Non-Deliverable Forwards

Similarly, I believe that the issue of whether the Commission should consider an exception for NDFs from consideration when calculating the AGNA of swap dealing activity for purposes of the de minimis threshold is inappropriate. Such an exception ignores that the SD Definition is activities-based.[26] The real issue that should be addressed is whether NDFs are swaps and, if so, whether they ought to be excluded from consideration in the SD Definition.[27] Instead of attempting to begin a conversation through use of its De Minimis Exception Authority, the Commission should use its relationships with the Secretary of the Treasury, the SEC and prudential regulators and engage in a meaningful dialog regarding the appropriate categorization and consideration of NDFs outside of this Proposal.

Conclusion

I am disappointed with today's Proposal and would have liked to been able to support the portions that were well supported by the data and analysis and could lead to a clear and legally sound resolution of the de minimis threshold, providing much needed regulatory certainty for a critical cohort of market participants. I am hopeful that market

participants have sufficient time to evaluate and respond to the most critical aspects of this Proposal and do not get overwhelmed or overly optimistic with regard to lines of questioning that take us further afield from Congressional intent and therefore are less likely to come to fruition. I understand that messaging creates expectations; sometimes, we must focus on what's right and not what seems easy.

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[1] The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203 § 712(d), 124 Stat. 1376, 1644 (2010) (the "Dodd-Frank Act"). Additionally, with respect to rulemakings and orders regarding swap dealers, among other things, § 712(a) requires the CFTC to consult and coordinate to the extent possible with the SEC and the prudential regulators to ensure consistency and comparability, to the extent possible. Such consultation must occur before the CFTC commences such rulemaking or order issuance. The Proposal indicates only that the Commission "is consulting with the SEC and prudential regulators regarding the changes to the SD Definition discussed in this Proposal," indicating that the Commission may not have adhered to the letter or spirit of § 712(a) or (d) of the Dodd-Frank Act with respect to the Proposal.

[2] Since the initial establishment of the AGNA at $3 billion in May 2012, and initial five year phase-in period during which the AGNA threshold was set at $8 billion, the Commission issued two successive orders extending the phase-in, and issued preliminary and final staff reports concerning the de minimis threshold, as required by paragraph 4(ii)(B) of the swap dealer definition. Additionally, the Commission has more than five years of swap dealer oversight experience; given that the first swap dealers submitted applications for preliminarily registration in December 2017. *See* Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 FR 30596 (May 23, 2012) ("SD Definition Adopting Release"); Order Establishing De Minimis Threshold Phase-In Termination Date, 81 FR 71605 (Oct. 18, 2016) ("Initial Phase-In Termination Date Order"); Order Establishing a New De Minimis Threshold Phase-In Termination Date, 82 FR 50309 (Oct. 31, 2017) ("Second Phase-In Termination Date Order")*;* 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;* 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*

[3] Initial Phase-In Termination Date Order, *supra* note 2.

[4] Second Phase-In Termination Date Order, *supra* note 2; Rostin Behnam, *Statement on De Minimis Threshold* (Oct. 11, 2017), https://www.cftc.gov/PressRoom/SpeechesTestimony/behnamstatement101117a.

[5] Jason Webb Yackee and Susan Webb Yackee, *Delay in Notice and Comment Rulemaking: Evidence of Systemic Regulatory Breakdown?*, *in* REGULATORY BREAKDOWN: THE CRISIS OF CONFIDENCE IN U.S. REGULATION 169 (Cary Coglianese ed., 2012).

[6] *See*17 CFR 1.3, Swap dealer, ¶ (4)(v), providing that the Commission may by rule or regulation change the requirements of the de minimis exception described in paragraphs (4)(i) through (iv).

[7] *Id.; see also* SD Definition Adopting Release, 77 FR at 30634, n. 464

[8] SD Definition Adopting Release, 77 FR at 30634-5.

[9] *See* CEA § 1a(49)(D), 7 U.S.C. 1a(49)(D).

[10] *See* SD Definition Adopting Release, 77 FR at 30629, n. 413 ("Congress incorporated a de minimis exception to the swap dealer definition to ensure that smaller institutions that are responsibly managing their commercial risk are not inadvertently pulled into addition regulations."(quoting 156 Cong. Rec. S6192 (daily ed. July 22, 2010) (letter from Senators Dodd and Lincoln to Representatives Frank and Paterson).

[11] *See* CEA 1a(49)(A), 7 U.S.C. 1a(49)(A) (providing that "in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer."

[12] *See, e.g.* CFTC (@CFTC), @CFTC & @SEC_News teams are hard at work on Title VII harmonization, TWITTER (Feb. 27, 2018, 4:53 PM), https://twitter.com/CFTC/status/968605066889515009; Chris Giancarlo (@giancarloCFTC), TWITTER (Feb. 27, 2018, 9:18 PM) https://twitter.com/giancarloCFTC/Status/968671749737992192.

[13] 17 C.F.R. 1.3, Swap dealer, ¶ (6)(iii).

[14] SD Definition Adopting Release, 77 FR at 30611.

[15] *See, e.g.,* CFTC Fact Sheet: Final Rules Regarding Further Defining "Swap Dealer," "Major Swap Participant and "Eligible Contract Participant" (Apr. 18, 2012), *available at* https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/msp_ecp_factsheet_final.pdf.

[16] *See* Frequently Asked Questions (FAQ)—[DSIO] Responds to FAQs About Swap Entities (Oct. 12, 2012), *available at* https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/swapentities_faq_final.pdf.

[17] *Id.*

[18] *See* n.152 of the Proposal, Letter from CEWG; Letter from Natural Gas Supply Association (Jan. 15, 2016), available at https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=60595&SearchText=.

[19] SD Definition Adopting Release, 77 FR at 30630.

[20] *Id.* at 30634.

[21] Swap Dealer De Minimis Exception Final Staff Report, *supra* note 2 at 15.

[22] *Id.*at note 45.

[23] *Id*. at note 49.

[24] *See* SD Definition Adopting Release, 77 FR at 30610.

[25] *See*, *e.g.*, *Id.* at 30608.

[26] *Id.*

[27] As noted in the Proposal, the Secretary of the Treasury, pursuant to authority in section 1a(47)(E) of the CEA, 7 U.S.C. 1a(47)(E), declined to exempt NDFs from the CEA's definition of "swap."