

# CFTC ISSUES NO-ACTION RELIEF FOR FLOOR TRADERS TO EXCLUDE SEF-EXECUTED CLEARED SWAPS FROM THE SWAP DEALER *DE MINIMIS* CALCULATION

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## Investment Management Alert

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## INTRODUCTION

On June 27, 2019, the Commodity Futures Trading Commission ("CFTC") issued no-action relief for floor traders to "encourage new liquidity providers to trade cleared swaps on registered venues without regulatory uncertainty, benefiting market participants seeking to access liquid, competitive cleared swaps markets" (the "No-Action Relief").<sup>[1]</sup> The No-Action Relief allows registered floor traders to exclude cleared swaps executed on, or subject to, the rules of a Designated Contract Market ("DCM") or Swap Execution Facility ("SEF") from the *de minimis* threshold when determining whether they are a swap dealer ("SD"). Thus, a floor trader may, under this guidance, trade cleared swaps executed on, or subject to, the rules of a DCM or SEF without being designated as an SD.

The No-Action Relief builds on the rulemaking and principles that were initially articulated by the CFTC following the enactment of Title VII of the Dodd-Frank Act.<sup>[2]</sup> However, it is unclear whether the No-Action Relief will provide long-term regulatory certainty because it was issued by agency leadership immediately after announcing their imminent departure from the CFTC.<sup>[3]</sup>

## REGULATORY BACKGROUND OF FLOOR TRADER EXCLUSION FROM SD REGISTRATION

The No-Action Relief builds on the CFTC's prior regulatory guidance regarding floor traders and whether they should be required to register as an SD.<sup>[4]</sup> Title VII of the Dodd-Frank Act amended the definition of "Floor Trader" specifically to encompass activities involving any swaps. In subsequent rulemaking in 2012, the CFTC indicated that it would lead to potentially duplicative regulation if floor traders engaging in swaps in their capacity as floor traders were also required to register as SDs. As a result, the CFTC stated that it "is appropriate not to consider such swaps when determining whether a person acting as a floor trader ... is a swap dealer."<sup>[5]</sup> In 2013, the CFTC Staff provided relief from certain of the conditions that a floor trader was required to satisfy in order to avoid SD registration. Specifically, a floor trader that participated in a market-making program for futures and rebate programs on SEFs would still be able to avoid swap dealer registration if other conditions were met.<sup>[6]</sup>

When the CFTC proposed to make permanent the *de minimis* exception to the SD definition, it noted that "pursuant to various CFTC regulations, certain swaps, subject to specific conditions, need not be considered in determining whether a person is an SD, including ... swaps entered into by floor traders."<sup>[7]</sup> The CFTC had

previously sought comments on how broadly to exclude floor traders from the requirement to register as an SD, noting that:

- The Floor Trader Exclusion enables floor traders to provide liquidity to exchanges in non-dealing capacities, such as proprietary trading, without potentially triggering SD regulation. However, the Commission notes that the market benefits of the Floor Trader Exclusion may be complemented if the *de minimis* exception also applied to all exchange-traded and/or cleared swaps.[8]

The CFTC indicated that a broader exclusion could result in entities that engage in a significant amount of swap dealing activity not having to register as SDs, and sought feedback on potential regulatory alternatives, such as an aggregate gross notional amount backstop or a haircut to the notional amount of exchange-traded and/or cleared swaps for the *de minimis* calculation.[9] Ultimately, however, CFTC Staff chose to provide regulatory guidance on this topic by issuing the No-Action Relief rather than engaging in the formal rulemaking process.

## FLOOR TRADER EXCLUSION AND IMPACT OF NO-ACTION RELIEF

Regulation 1.3 defines the term "Floor Trader" and states that each swap that a person enters into in its capacity as a floor trader on a SEF or DCM, or subject to the rules of a SEF or DCM, shall not be considered for the purpose of determining whether the person is an SD if certain conditions are met.[10] In addition, such swaps would not be considered when determining whether a floor trader's swap dealing activity exceeds the *de minimis* threshold of \$8 billion during the previous 12 months for SD registration.[11]

The No-Action Relief issued by the CFTC expands the floor trader exclusion by allowing a floor trader to not count its DCM and SEF cleared swaps when determining whether the floor trader is an SD as defined in Regulation 1.3.[12] Therefore, a floor trader can exclude its DCM and SEF cleared swaps from counting toward its SD *de minimis* threshold. This exclusion applies even if the floor trader also enters into swaps other than DCM- and SEF-cleared swaps (though those swaps do count against the SD *de minimis* threshold). The relief also provides that a floor trader is not required to file periodic risk reports. However, a floor trader must still comply with the affiliate aggregation requirements in the SD definition of Regulation 1.3. As a result, floor traders may be able to trade swaps more easily without being required to register as an SD. From the perspective of systemic risk, the No-Action Relief seems to indicate that systemic risk is less of a concern for CFTC Staff at the entity level, so long as the swaps are traded on or subject to the rules of a SEF or DCM and cleared through a derivatives clearing organization ("DCO"). This is reasonable in light of the fact that swap clearing results in the DCO becoming the counterparty to each side of the swap so that the DCO's creditworthiness, rather than that of a floor trader not subject to CFTC minimum financial requirements, is the relevant consideration.

CFTC Commissioners responded to the No-Action Relief issued by CFTC Staff with mixed feedback. Commissioner Berkovitz supported the No-Action Relief, stating that:

- The current floor trader rule has not worked as intended. Potential sources of liquidity have not entered into these markets due to concerns about the potential breadth of the restrictions in the current provision. Addressing the issues with the existing rule will diversify the available sources of liquidity beyond the few large bank dealers that dominate swap trading today.[13]

In contrast, Commissioner Quintenz objected to the No-Action Relief, stating that: "Unfortunately, today the Commission is choosing an end-run around appropriately revising what constitutes a '*de minimis* quantity' of

dealing activity by instead further distorting an archaic floor trader regulatory concept to lure unregistered entities into a 'swap dealer light' registration scheme."<sup>[14]</sup> Notably, it is unusual for a Commissioner to object to no-action relief. Commissioner Quintenz suggested that the CFTC should instead pursue these changes through the formal rulemaking process and introduced as a possible regulatory alternative — a risk-sensitive factor within the *de minimis* exception to more accurately measure an entity's swap dealing activity, such as entity-netted notionals.

On July 8, 2019, CFTC Staff issued a report that presented analysis regarding the SD *de minimis* exception.<sup>[15]</sup> The report detailed the percentage of the swaps market that would be subject to SD regulation under a variety of regulatory scenarios. Under the current \$8 billion *de minimis* threshold, CFTC Staff estimated that 99.95% of the baseline \$221 trillion swaps market is subject to SD regulation. The removal of exchange-traded and cleared swaps from the *de minimis* calculation would not reduce the percentage of swaps-trading activity subject to SD regulation. Commissioner Quintenz called the report "a step in the right direction"<sup>[16]</sup> and said that the CFTC "should move away from using notional value in its registration thresholds and move toward adopting metrics more representative of an entity's actual size and risk in the market."<sup>[17]</sup>

## CONCLUSION

The No-Action Relief builds on earlier regulatory guidance and allows registered floor traders to exclude cleared swaps executed on, or subject to, the rules of a DCM or SEF from the *de minimis* threshold when determining whether it is an SD. This could help floor traders trade more swaps without being required to register as an SD. However, as Commissioner Quintenz noted, the "no-action relief can be withdrawn at any time and with little notice."<sup>[18]</sup> Therefore, it is unclear whether the No-Action Relief will accomplish its goal of providing long-term regulatory certainty, particularly as the CFTC leadership who issued the guidance have indicated that they will be leaving the agency later this summer.

Heath Tarbert will soon be sworn in as the next CFTC Chairman in July. Therefore, market participants will need to stay updated on any deviation from CFTC Chairman Giancarlo's agenda by the new Chairman. The futures and derivatives team at K&L Gates continues to follow these and other upcoming developments at the CFTC, including changes to the swaps-trading rules, cross-border guidance, and position limits. Our futures and derivatives team stands ready to assist market participants in the navigation of these developments and the new CFTC agenda.

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### Notes:

[1] See Commodity Futures Trading Commission, CFTC Staff Issues No-Action Relief for Floor Traders Engaged in Swaps Activity, (June 27, 2019), [https://www.cftc.gov/PressRoom/PressReleases/7950-19?utm\\_source=govdelivery](https://www.cftc.gov/PressRoom/PressReleases/7950-19?utm_source=govdelivery).

[2] See Commodity Futures Trading Commission and Securities and Exchange Commission, Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap

Participant," and "Eligible Contract Participant," 77 Fed. Reg. 30595 (May 23, 2012), <https://www.federalregister.gov/documents/2012/05/23/2012-10562/further-definition-of-swap-dealer-security-based-swap-dealer-major-swap-participant-major#footnote-168>.

See also Commodity Futures Trading Commission, De Minimis Exception to the Swap Dealer Definition, 83 Fed. Reg. 56666 (Nov. 13, 2018), <https://www.federalregister.gov/documents/2018/11/13/2018-24579/de-minimis-exception-to-the-swap-dealer-definition#footnote-11-p56666>.

[3] See Commodity Futures Trading Commission, Matthew Kulkan, DSIO Director, to Leave the CFTC, Release No. 7947-19 (June 26, 2019), <https://cftc.gov/PressRoom/PressReleases/7947-19>.

[4] By regulation, a floor trader is defined as: "any person: (1) Who, in or surrounding any pit, ring, post or other place provided by a contract market for the meeting of persons similarly engaged, purchases, or sells solely for such person's own account— (i) Any commodity for future delivery, security futures product, or swap; or (ii) Any commodity option authorized under section 4c of the Act; or (2) Who is registered with the Commission as a floor trader."

See 17 C.F.R. § 1.3, [https://www.ecfr.gov/cgi-bin/text-idx?SID=36761082dae998e315308a3d5ea214b5&mc=true&node=se17.1.1\\_13&rgn=div8](https://www.ecfr.gov/cgi-bin/text-idx?SID=36761082dae998e315308a3d5ea214b5&mc=true&node=se17.1.1_13&rgn=div8).

[5] See Commodity Futures Trading Commission and Securities and Exchange Commission, Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant," 77 Fed. Reg. 30595 (May 23, 2012), <https://www.federalregister.gov/documents/2012/05/23/2012-10562/further-definition-of-swap-dealer-security-based-swap-dealer-major-swap-participant-major#footnote-168>.

[6] See CFTC Letter No. 13-80, No-Action Relief from Certain Conditions of the Swap Dealer Exclusion for Registered Floor Traders (Dec. 23, 2013), <https://www.cftc.gov/sites/default/files/idc/groups/public/@lrllettergeneral/documents/letter/13-80.pdf>. CFTC Letter No. 13-80 also provided relief from the conditions related to aggregating the floor trader's swaps with its affiliates and swap activities with affiliates. The No-Action Letter does not reference CFTC Letter No. 13-80 and does not provide the same relief from affiliate activities. Therefore, there is an outstanding question as to the application of CFTC Letter No. 13-80.

[7] See Commodity Futures Trading Commission, De Minimis Exception to the Swap Dealer Definition, 83 Fed. Reg. 56666 (Nov. 13, 2018), <https://www.federalregister.gov/documents/2018/11/13/2018-24579/de-minimis-exception-to-the-swap-dealer-definition#footnote-11-p56666>.

[8] See Commodity Futures Trading Commission, De Minimis Exception to the Swap Dealer Definition Proposed Rule, 83 Fed. Reg. 27444 (proposed June 12, 2018), <https://www.federalregister.gov/documents/2018/06/12/2018-12362/de-minimis-exception-to-the-swap-dealer-definition>.

[9] *Id.* at 27469.

[10] See 17 C.F.R. § 1.3, [https://www.ecfr.gov/cgi-bin/text-idx?SID=36761082dae998e315308a3d5ea214b5&mc=true&node=se17.1.1\\_13&rgn=div8](https://www.ecfr.gov/cgi-bin/text-idx?SID=36761082dae998e315308a3d5ea214b5&mc=true&node=se17.1.1_13&rgn=div8).

[11] See *id.* "De minimis exception—(i)(A) In general. Except as provided in paragraph (4)(vi) of this definition, a person that is not currently registered as a swap dealer shall be deemed not to be a swap dealer as a result of its swap dealing activity involving counterparties, so long as the swaps connected with those dealing activities into which the person — or any other entity controlling, controlled by or under common control with the person — enters over the course of the immediately preceding 12 months have an aggregate gross notional amount of no more than \$8 billion, and an aggregate gross notional amount of no more than \$25 million with regard to swaps in which the counterparty is a 'special entity.'"

[12] See Commodity Futures Trading Commission, No-Action Relief for Certain Conditions of the Floor Trader Provision, (June 27, 2019), <https://www.cftc.gov/csl/19-14/download>.

[13] See Commissioner Dan M. Berkovitz, Statement of Commissioner Dan M. Berkovitz in Support of the Staff No Action Letter Regarding Floor Traders, (June 27, 2019), <https://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement062719>.

[14] See Commissioner Brian D. Quintenz, Objection of Commissioner Brian Quintenz to No-Action Relief from Certain Conditions of the Floor Trader Provision, (June 27, 2019), <https://www.cftc.gov/PressRoom/SpeechesTestimony/quintenzstatement062719>.

[15] See Community Futures Trading Commission, CFTC Staff Issues Report Regarding the Swap Dealer De Minimis Exception and On-Venue and Cleared Swaps, (July 8, 2019), <https://www.cftc.gov/PressRoom/PressReleases/7958-19>

[16] See Commissioner Brian D. Quintenz, Statement of Commissioner Quintenz Regarding DSIO Staff Report on the Swap Dealer De Minimis Exception, (July 8, 2019), <https://www.cftc.gov/PressRoom/SpeechesTestimony/quintenzstatement070819>

[17] *Id.*

[18] *Id.*

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