
CFTC's Final Rule on the End-User Exception to the Mandatory Clearing of Swaps

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The Commodity Futures Trading Commission (CFTC or Commission), recently adopted a rule (Final Rule)¹ under which non-financial entities and certain financial entities that choose to do so will be able to claim an exception from the mandatory clearing requirements (the Exception) of the Dodd-Frank Act.² By adhering to the conditions of the Final Rule, these entities (End-Users or Electing Counterparties) will be able to conduct swaps on a bilateral basis, without the potentially burdensome obligations attendant to mandatory clearing. These include, among others: (a) clearing the swap through a derivatives clearing organization; (b) reporting the terms of the swap to a swap data repository (SDR); and (c) executing the swap on a designated contract market or swap execution facility. The following discussion answers three main questions about the Exception: (a) Who is eligible for the Exception?; (b) What conditions must be met to use the Exception?; and (c) What are the reporting requirements when the Exception is used?

I. Who is Eligible for the Exception?

In general, non-financial entities and certain financial entities that enter into swaps to hedge or mitigate commercial risks are eligible for the Exception, and may elect to use it.

(a) *Non-Financial Entities*. The Exception was designed primarily to meet the needs of non-financial entities, which do not include:

- (1) swap dealers (SDs) or security-based swap dealers (SSDs);
- (2) major swap participants (MSPs) or major security-based swap participants (MSSPs);
- (3) commodity pools;
- (4) private funds;
- (5) employee benefit plans; or

(6) “person[s] predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature.”³

(b) *Certain Financial Institutions*. In addition to non-financial entities, certain financial institutions are also permitted to claim the Exception. They are:

(1) *Small Financial Institutions*. Small (*i.e.*, with \$10 billion or less in assets) banks, savings associations, farm credit institutions, and credit unions are excluded from the definition of “financial entity,” thereby, making them eligible to use the Exception. These entities, however, cannot also be SDs, MSPs, private funds, etc.

(2) *Captive Finance Companies (“90-90 Rule”)*. Financial entities are also eligible for the Exception if their “primary business” is providing financing, and they use swaps to hedge commercial risk related to interest rate and foreign currency exposures: (1) 90 percent or more of which exposures arise from financing that facilitates the purchase or lease of products; *and* (2) 90 percent or more of which products are manufactured by the parent company or another subsidiary of the parent company.

(3) *Affiliates of Non-Financial Entities*. Affiliates of End-Users that act on behalf, and as agents, of End-Users in entering into swaps to hedge or mitigate the commercial risk of the End-Users or their non-financial affiliates, are also eligible for the Exception.⁴

(c) *Certain Governmental Entities*. The Commission, in response to several comments and with the expectation of reciprocity from foreign governments,⁵ determined that foreign governments, foreign central banks, and international financial institutions (*i.e.*, the World Bank and the International Monetary Fund) are excluded from the mandatory clearing requirement altogether. This exclusion does not extend, however, to their counterparties, which must comply with the CEA and the Commission’s regulations if they are subject to them.

The Exception also is not available to sovereign wealth funds or similar entities, which remain subject to the mandatory clearing requirement. They are not excluded from the “financial entity definition” because of the “predominantly commercial nature of their activities.”⁶

Similarly, state and local governmental entities that engage in commercial activities, such as investment pools and employee benefit plans, are *not* exempted from the “financial entity” definition.

II. What Conditions Must be Met to Use the Exception?

As discussed above, the conditions for using the Exception are: (1) that one of the counterparties must be a non-financial entity or a financial entity that may claim an exception; and (2) that the swap must “hedge or mitigate commercial risks.”⁷

(a) *Hedging or Mitigation*. Swaps eligible for the Exception are those entered into for the *purpose* of hedging or mitigating risk, as opposed to those entered into for the *purpose* of speculating, investing or trading, *i.e.*, taking positions “principally and directly” to make a profit. The eligibility of a swap for the Exception is determined, therefore, by its purpose and

not necessarily by its type, so that even “arbitrage” positions could potentially be eligible for the Exception if they met the other requirements.⁸

(b) *Commercial Risk*. Whether a risk is “commercial” is based on the underlying activity creating the risk, not on the nature of the business that the End-User generally conducts. Commercial risk may thus include “financial” risks if they are related to the End-User’s commercial activities. The Commission notes, however, that the use of the Exception for the hedging and mitigation of financial risk must be “an incidental part of (*i.e.*, not central to)” the entity’s business and that it intends to monitor this area for potential abuse.⁹

Also, the determination of whether a risk is “commercial” will be based on each individual swap, not on the entity’s overall portfolio of swaps, or some percentage thereof. Thus, the fact that an entity claims the Exception for some swaps does not mean that other swaps into which it enters for non-hedging purposes would be eligible for the Exception.

(c) *Swaps Used to Hedge Other Swaps or Risks Posed by Other Swaps*. Swaps used to hedge other swaps, including “matched book” or “back-to-back” swaps, are eligible for the Exception if the underlying swap (or security-based swap) is used to hedge commercial risk. This principle applies as well for each successive swap in a chain of back-to-back swaps *as long as each successive swap is used by a party that qualifies for the Exception*.¹⁰

Also, swaps entered into to hedge *the risk* posed by another swap (or security-based swap) may also be eligible for the Exception. The Commission notes that while a swap (or security-based swap) may be entered into originally to hedge a commercial risk, over time the swap (or security-based swap) may no longer serve its purpose and may actually create a risk for the End-User. In that circumstance, if the End-User enters into a swap to hedge the risk posed by this original swap (or security-based swap), the second swap would be eligible for the Exception since the original risk was a commercial risk.

(d) *Portfolio Hedging or Dynamic Hedging*. Swaps that facilitate portfolio hedging or dynamic hedging are also eligible for the Exception, if they otherwise meet the requirements. The Commission recognizes, however, that the Exception is “more easily abused” in portfolio and dynamic hedging contexts and therefore intends to monitor this area carefully for potential abuse.

III. What are the Reporting Requirements When the Exception is Used?

(a) *Annual Reporting*. Responding to numerous comments from End-Users supporting more “cost-effective” reporting requirements, the Commission added an annual reporting option. End-Users are therefore able to provide most of the information on the swaps subject to the Exception in an annual filing *or* on a swap-by-swap basis.¹¹ The information that may be submitted in *either* of these two forms is:

(1) whether the Electing Counterparty is a financial entity and, if so, which Exception to the “financial entity” restriction it is using;

(2) whether the swap hedges or mitigates commercial risk (the annual filing must state that the Electing Counterparty will only elect the Exception for swaps that hedge or mitigate commercial risk);

(3) how the Electing Counterparty *generally* (*i.e.*, not specifically for each swap) expects to meet its financial obligations of entering into uncleared swaps (to be completed in a check-the-box format¹² by checking all the following means that apply):

- (i) a written credit support agreement;
- (ii) pledged or segregated assets (including posting or receiving margin pursuant to a credit support agreement or otherwise);
- (iii) a written third-party guarantee;
- (iv) the Electing Counterparty's available financial resources; or
- (v) other means; and

(4) whether the Electing Counterparty is an issuer of securities and, if so, whether an "appropriate committee" of its Board of Directors (Board) has approved the decision not to clear the swap(s).¹³

(b) *Swap-by-Swap Reporting*. The election of the Exception and the identity of the End-User must be reported by the counterparty that is required to make the report (Reporting Counterparty),¹⁴ on a swap-by-swap basis. This report must be made to a registered SDR or the Commission (if no registered SDR is available).¹⁵

(c) *Exemptions*. The Commission did not grant any exemptions from the reporting requirements. All swaps that are entered into under the Exception must be reported, including inter-affiliate swaps.¹⁶

Next Steps

The Final Rule will be effective 60 days after publication in the *Federal Register*, but compliance will not be required until swaps are subject to the mandatory clearing requirement.¹⁷ The Adopting Release leaves open the possibility of exemptive or interpretive relief on a case-by-case basis for financial entities based on a facts-and-circumstances approach, which would apply both to determining which entities are "affiliates" and to allowing financial institutions that do not satisfy any of the exclusions described above to use the Exception.

¹ Final Rule on the End-User Exception to the Clearing Requirement for Swaps, 77 Fed.Reg. 42560 (July 19, 2012) (Adopting Release).

²The Dodd–Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111-203, H.R. 4173) was signed into law by President Barack Obama on July 21, 2010. The Commission also proposed a rule to extend the Exception to cooperatives with End-User members, which would be eligible for the Exception if: (a) the cooperatives are not SDs, MSPs, private funds, etc.; (b) they have more than \$10 billion in assets; (c) all their members are eligible for the Exception, because they are either non-financial entities, small financial institutions, or themselves cooperatives of which all the members are non-financial entities or small financial institutions; and (d) the swaps are entered

into by the cooperative with its members in connection with originating loans to their members, or they hedge or mitigate risks associated with loans to members or member loan-related swaps. Comments are due by August 16, 2012. Proposed Rule on the Clearing Exemption for Certain Swaps Entered into by Cooperatives, 77 Fed.Reg. 41940 (July 17, 2012) (Proposing Release).

³Section 2(h)(7)(C)(1) of the Commodity Exchange Act (CEA).

⁴This affiliate exception does not apply to SDs, SSDs, MSPs, MSSPs, issuers, commodity pools, or bank-holding companies with assets greater than \$50 billion. Also, the Final Rule does not provide a blanket exemption from the clearing requirement for all inter-affiliate swaps. Each such swap would have to meet the requirements of the Exception independently.

⁵This decision is premised on the expectation that the foreign governments would reciprocate by not subjecting to regulation swaps entered into in their jurisdictions by the US Federal Government, US Federal Reserve Banks, or international financial institutions of which the US is a member.

⁶Adopting Release at n. 18.

⁷Section 2(h)(7)(A)(2) of the CEA.

⁸Adopting Release at 42574. The criteria used for hedging or mitigating risk in the Final Rule (Section 39.6(c)) are very similar to those used in the MSP rule (Section 1.3(kkk)). See 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). The Adopting Release notes, however, that while these definitions are consistent, they serve different purposes and may be modified in different ways in the future.

⁹Given, however, that the entities electing to use the Exception are not required to report on the risk being hedged (see Section III on reporting below), it is unclear how the Commission will monitor this activity.

¹⁰The Commission further explains that if, for instance, there is a chain of successive swaps (based on an underlying swap that qualifies for the Exception) that are all entered into by parties that are eligible for the Exception, but then the last swap is entered into with a financial entity that is not eligible for the Exception, any further swap used by the non-eligible financial entity to hedge the position will break the chain, and is not eligible. Adopting Release at 42574.

¹¹The End-User may not be the party required to make the swap-by-swap reporting. See *infra* note 14.

¹²In its cost-benefit analysis, the Commission estimates that the annual filing should take 30 to 90 minutes to complete, and the swap-by-swap reporting should take one to five minutes per swap.

¹³This information will not be publicly disseminated. Also, entities are expected to update the information in the annual filing continually to reflect any “material” changes. Public companies can only invoke the Exception after gaining approval from their Board. Notably, the Board does not have to approve each individual swap, but rather the overall decision not to clear swaps generally. The Commission also expects these Boards to implement policies governing the use of the Exception, which they should review at least annually.

¹⁴The specific requirements for determining the Reporting Party are outlined in the Commission’s Rule 45.8. Generally, if one of the parties to the swap is a SD or MSP, it will be the Reporting Counterparty.

¹⁵Indication of the election of the Exception will be publicly disseminated as required in Part 43.

¹⁶The Commission, however, suggests that it may grant exemptions to this on a case-by-case basis, stating “[t]he Commission has determined not to grant any exemptions to the § 39.6 reporting requirements at this time because any such determinations require a consideration of all relevant facts-and-circumstances.” Adopting Release at 42566.

¹⁷The Commission’s proposed compliance and implementation schedule for the clearing requirement provides that non-financial entities would have a minimum of 270 days to comply after the Commission issues a clearing requirement determination. Adopting Release at 42580.

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