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Client Alert

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CFTC Issues No Action Relief from Swaps Clearing Requirement for Eligible End-User Financial Entities

The Division of Clearing and Risk (the "Division") of the Commodity Futures Trading Commission (the "CFTC") recently issued no-action relief for certain treasury affiliates within non-financial companies from the clearing requirements of Section 2(h)(1) of the Commodity Exchange Act ("CEA"). In CFTC Letter No. 13-22 (the "No-Action Letter"), the Division indicated that it was issuing the relief in response to a number of comments received from non-financial companies with wholly-owned treasury affiliates that hedge risks for the entire non-financial company group. Absent the no-action relief, many such entities would have been required to clear swaps subject to the CEA starting on June 10, 2013. Counterparties electing the relief provided under the No Action Letter will now be required to comply with the reporting requirements described below as of September 9, 2013. The text of the No-Action Letter is available at: http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-22.pdf.

Background

The CEA, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the *"Dodd-Frank Act"*), generally requires a swap to be cleared through a derivatives clearing organization, be reported to a swap data repository (*"SDR"*), and, if the swap is subject to a clearing requirement, be executed on a designated contract market or swap execution facility. Section 2(h)(7)(A) of the CEA provides a so-called "end-user" exception whereby the clearing requirement does not apply if one of the counterparties to the swap is not a "financial entity," is using swaps to hedge commercial risk, and notifies the CFTC how such counterparty generally meets its financial obligations with respect to non-cleared swaps. The term "financial entity" is defined in Section 2(h)(7)(C)(i) of the CEA as including, among other entities, swap dealers, major swap participants, and persons predominantly engaged in activities that are financial in nature (as defined in Section 4(k) of the Bank Holding Company Act). Section 2(h)(7)(D)(i) of the CEA provides that an affiliate of a person that qualifies for the end-user exception may qualify for the exception only if the affiliate, acting on behalf of the person and as an agent, uses the swap to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity.

In the adopting release for the end-user exception (the *"Adopting Release"*)[1], several commenters to the proposed rules were cited as noting that entities which centralize their risk management through a hedging affiliate were likely to meet the definition of a swap dealer, major swap participant, or financial entity, and asking the CFTC for further guidance or further exemption, particularly for wholly-owned subsidiaries that solely engage in swap transactions to hedge or mitigate the commercial risks of an entire corporate group. In particular, the CFTC was asked to amend the proposed rule to clarify that any such affiliate that would otherwise meet the definition of a "financial entity" be deemed to satisfy the criteria of "acting on behalf of the person and as an agent" as required by the CEA. In response, the CFTC noted that the specificity with which Congress defined "financial entity" and set forth when affiliates may elect the end-user exception constrained the CFTC from any such discretion. In the Adopting Release, the CFTC reiterated that treasury affiliates that are separate legal entities, and whose primary function is to undertake activities that are financial in nature, would meet the definition of "financial entities."

The CFTC also noted in the Adopting Release that unlike the treasury affiliates described above that would not qualify for the end-user exception, for entities which engage in hedging risks of the entire corporate group at the parent level, and which enter into swaps in such

[1] 77 Fed. Reg. 42,563 (July 19, 2012) (to be codified at 17 C.F.R. pt. 39).

parent's name, the application of the end-user exception would be analyzed from the perspective of the parent directly. Presumably, any such parent entity would not meet the definition of a "financial entity" by virtue of not being predominantly engaged in finance activities, and the end-user exception would apply. For example, the CFTC noted that if a parent entity that is predominately engaged in a non-financial activity (i.e. manufacturing, agriculture, energy, etc.) enters into swaps with an affiliate that hedges or mitigates commercial risk of such affiliate, the affiliate may elect the end-user exception for those inter-affiliate swaps (so long as the affiliate is not itself a financial entity). In addition, if the parent then aggregates the commercial risk of those swaps with the other risks of the commercial enterprise and hedges the combined risk with a swap dealer, the parent entity may itself elect the end-user exception.

This dichotomy in treatment of companies that engage in swaps at either the parent level or at the level of a wholly-owned treasury subsidiary presented no small degree of consternation and frustration for many market participants. In an April 10, 2013 speech before the U.S. Chamber of Commerce, CFTC Chairman Gary Gensler noted that his staff had many meetings with non-financial end-users with treasury affiliates and that the CFTC was taking a close look at how to address this issue.

No-Action Relief

The Division notes in the No-Action Letter that it recognizes the benefits that arise from the use of treasury affiliates within corporate groups, including their ability to aggregate risks from different affiliates and enter into one outward-facing swap rather than having each affiliate establish separate trading relationships with third-parties. For this and other reasons, the Division has now granted relief for affiliates of non-financial companies that fall within the definition of "financial entity" solely because they are "predominantly engaged in activities of a financial nature" that otherwise would be eligible to elect the end-user exception when entering into swaps with unaffiliated counterparties or with another "treasury affiliate." The relief is subject to certain important restrictions, as more fully described in the No-Action Letter. Some of the restrictions are summarized below:

Restrictions

Eligible Treasury Affiliate. For purposes of the relief, an eligible "treasury affiliate" must meet each of the following qualifications:

- The person is (A) directly, wholly-owned by a non-financial entity or another eligible treasury affiliate, and (B) is not indirectly majority-owned by a financial entity;
- The person's ultimate parent is (A) not a financial entity, and (B) the ultimate parent must be able to identify all of its wholly- and majority-owned affiliates and, of those identified affiliates, a majority must qualify for the end-user exception;
- The person is a financial entity solely as a result of acting as principal to swaps with, or on behalf of, one or more of its related affiliates, or providing other services that are financial in nature to such related affiliates;
- The person is not, and is not affiliated with, any of the following: (A) a swap dealer; (B) a major swap participant; (C) a security-based swap dealer; (D) a major security-based swap participant; or (E) a nonbank financial company that has been designated as systemically important by the Financial Stability Oversight Council; and
- The person is not any of the following: (A) a private fund; (B) a commodity pool; (C) an employee benefit plan ; (D) a bank holding company; (E) an insured depository institution; (F) a farm credit system institution; (G) a credit union; or (H) an entity engaged in the business of insurance and subject to capital requirements established by an insurance governmental authority

Swap Activity. Furthermore, the relief provided by the No-Action Letter is restricted to the following conditions:

- The eligible treasury affiliate enters into the exempted swap for the sole purpose of hedging or mitigating the commercial risk of one or more related affiliates that was transferred to the eligible treasury affiliate by operation of one or more swaps with such related affiliates;
- The eligible treasury affiliate does not enter into swaps with its related affiliates or unaffiliated counterparties other than for the purpose of hedging or mitigating the commercial risk of one or more related affiliates;
- Neither any related affiliate that enters into swaps with the eligible treasury affiliate nor the eligible treasury affiliate, enters into swaps with or on behalf of any affiliate that is a financial entity, or otherwise assumes, nets, combines, or consolidates the risk of swaps entered into by any financial affiliate;
- Each swap entered into by the eligible treasury affiliate is subject to a centralized risk management program that is reasonably

designed to monitor and manage the risks associated with the swap; and

- The payment obligations of the eligible treasury affiliate on the exempted swap are guaranteed by its non-financial parent, an entity that wholly-owns or is wholly-owned by its non-financial parent, or the related affiliates for which the swap hedges or mitigates commercial risk.

Reporting. For each swap that an eligible treasury affiliate elects not to clear in reliance on the No-Action Letter, the counterparty required to report such swap in accordance with Section 45.8 of the CFTC's regulations must provide the following information to an SDR (or to the CFTC):

- Notice of the election of the relief and confirmation that the electing counterparty satisfies the General Conditions to the Swap Activity of specified in the No Action Leter;

- How the electing counterparty generally meets its financial obligations associated with entering into non-cleared swaps by identifying one or more of the following categories, as applicable: (A) A written credit support agreement; (B) Pledged or segregated assets (including posting or receiving margin pursuant to a credit support agreement or otherwise); (C) A written guarantee from another party; (D) The electing counterparty's available financial resources; or (E) Means other than those described in (A)-(D); and

- If the electing counterparty is an entity that is an issuer of securities registered under Section 12 of, or is required to file reports under Section 15(d) of, the Securities Exchange Act of 1934: (A) The relevant SEC Central Index Key number for such counterparty; and (B) Acknowledgment that an appropriate committee of the board of directors (or equivalent body) of the electing counterparty has reviewed and approved the decision to enter into swaps that are exempt from the requirements of Section 2(h)(1), and if applicable, Section 2(h)(8) of the CEA.

If there is more than one electing counterparty to a swap, the information specified above will need to be provided with respect to each of the electing counterparties. An entity that qualifies for the relief may report the information annually in anticipation of electing the relief for one or more swaps. Any such reporting would be effective for 1 year following the date of such reporting. During that period, the entity will be required to amend the report as necessary to reflect any material changes to the information reported. Each reporting counterparty is also required to have a reasonable basis to believe that the electing counterparty meets the conditions for the relief listed above.

For More Information

To discuss any of the topics covered in this client alert, please contact William Tueting at (312) 845-2956 or tueting@chapman.com or Matthew Hoffman at (312) 845-3458 or mhoffman@chapman.com.

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