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The End-User Exception to the Mandatory Clearing of Swaps

October 5, 2012

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or "Dodd-Frank") amended the Commodity Exchange Act (the "CEA") by establishing, among other things, a requirement for mandatory clearing of swaps through a derivatives clearing organization that is registered or exempt from registration. On July 10, 2012, the Commodity Futures Trading Commission (the "CFTC") adopted final rules[1] implementing an end-user exception ("End-User Exception") from the clearing requirement. To exercise the End-User Exception, end-users and their swap counterparties will be required to modify their existing swap-related agreements and documentation.

When can the End-User Exception be used when trading swaps?

The End-User Exception can be used when trading swaps that are required to be cleared when one of the counterparties to the swap:

- Is not a financial entity;[2]
- Is using swaps to hedge or mitigate commercial risk; and
- Notifies the CFTC how it generally meets its financial obligations associated with entering into non-cleared swaps.

The new rules implement the end-user exception set forth in the Dodd-Frank Act by establishing the criteria for determining whether a swap hedges or mitigates commercial risk and by spelling out the reporting requirements for the use of the exception.

How do I determine whether I qualify as an end-user?

The regulatory regime put into place by the Dodd-Frank Act includes

various types of counterparties, including swap dealers, major swap participants, financial entities and end-users. The definitions for the first three of these entities are fairly elaborate and require a careful examination of the facts and circumstances surrounding their use of swaps. Subject to limited exclusions discussed below, an end-user would not satisfy the definition of swap dealer, major swap participant or financial entity.

Swap Dealer

At its core, a "swap dealer" is an entity that: (i) holds itself out as a dealer in swaps; (ii) is a market maker in swaps; (iii) regularly enters into swaps in the ordinary course of business for its own account; or (iv) is engaged in activity causing itself to be commonly known in the trade as a dealer or market maker in swaps.

The determination of whether an entity is a swap dealer focuses on the activities that are usual and normal in the entity's course of business and that are identifiable as a swap-dealing business. A de minimis exemption from the definition of swap dealer applies to entities whose aggregate gross notional amount of swaps entered into over the prior 12 months in connection with dealing activities does not exceed $3 billion[4]. In addition, swap dealers must comply with onerous record-keeping, reporting and business conduct standards.

Major Swap Participant

An entity is a major swap participant if any of the following applies:

- The entity maintains a substantial position in any of the major swap categories, excluding positions held for hedging or mitigating commercial risk and positions maintained by certain employee benefit plans for hedging or mitigating risks in the operation of the plan;
- The entity's outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the US banking system or financial markets; or
- The entity is a financial entity that is highly leveraged (ratio of total liabilities to equity is greater than 12 to 1) relative to its capital and that is not subject to capital requirements established by an appropriate federal banking agency and that maintains a substantial position in any of the major swap categories.

Swap dealers and certain financing affiliates are excluded from the definition of major swap participant.

Financial Entity

A "financial entity" is a swap dealer; a security-based swap dealer; a major swap participant; a major security-based swap participant; a commodity pool; a private fund; an employee benefit plan under ERISA; or a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in Section 4(k) of the Bank Holding Company Act. These entities, therefore, are not eligible for the

End-User Exception unless another exception, as discussed below, applies:

- Certain captive finance entities, which would otherwise fall within the definition of a "financial entity," are excluded. An excluded captive finance entity is an entity "whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company.''[5]
- The CFTC also excludes certain small financial institutions with less than $10 billion of total assets from the definition of "financial entity." The CFTC estimated that approximately 90 percent of banks, savings associations, farm credit system institutions and credit unions would qualify for the small financial institution treatment under the $10 billion threshold.

In addition to the exclusions discussed above, certain entities may be eligible for the End-User Exception even if they are not an end-user. An affiliate of an entity that qualifies for the End-User Exception may qualify for the End-User Exception itself, even if it is a financial entity, if the affiliate and the swap otherwise meet the requirements of the End-User Exception. Such affiliate must be acting on behalf of the entity that qualifies for the End-User Exception, as an agent, and must use the swap to hedge or mitigate the commercial risk of such entity or other affiliate of such entity that is not a financial entity. The affiliate exception, however, does not apply to certain types of entities, such as swap dealers and major swap participants.

What does it mean to "hedge or mitigate commercial risk"?

Whether a position is used to hedge or mitigate commercial risk must be determined by the facts and circumstances at the time of the execution of the swap. This review does not require ongoing reporting or testing of a swap's hedge effectiveness.

To be eligible for the "hedge or mitigate commercial risk" treatment, a swap must:

- Not be used for a purpose that is in the nature of "speculation, investing, or trading;"[6] and
- Not be used to hedge or mitigate the risk of another swap or security-based swap position unless that other swap or swap position itself is used to hedge or mitigate commercial risk.[7]

The "speculation, investing, or trading" condition focuses on the purpose for which the swap is entered. According to the CFTC, positions executed primarily for the purpose of taking an outright view on market direction or to obtain an appreciation in the value of the swap position itself and not primarily for hedging or mitigating underlying commercial risks of a commercial enterprise, are generally speaking, positions entered into for

the purpose of speculation, investing, or trading. The condition related to trading does not refer to simply buying and selling. The act of entering into or exiting swaps will not be considered "trading" if the swaps are used for the purpose of hedging or mitigating commercial risks incurred in the ordinary course of business.

Further, the swap must satisfy one of the following conditions to allow end-users to use the End-User Exception:

- Be "economically appropriate" to the reduction of risks of a commercial enterprise;
- Qualify as bona fide hedging for purposes of an exemption from position limits under the CEA; or
- Qualify for hedging treatment under FASB Accounting Standards Codification Topic 815 or GASB Statement 53.

A swap is "economically appropriate" to the extent it is targeted to address the risks of a commercial enterprise arising from a change in:

- The value of assets that an entity owns, produces, manufactures, processes, or merchandises or reasonably anticipates doing so in the ordinary course of business;
- The value of liabilities that an entity has incurred or reasonably anticipates incurring in the ordinary course of business of the enterprise;
- The value of services that an entity provides, purchases, or reasonably anticipates providing or purchasing in the ordinary course of business of the enterprise;
- The value of assets, services, inputs, products, or commodities that a person owns, produces, manufactures, processes, merchandises, leases, or sells, or reasonably anticipates doing so in the ordinary course of business of the enterprise;
- The value related to any of the foregoing arising from interest, currency, or foreign exchange rate movements associated with such assets, liabilities, services, inputs, products, or commodities; or
- Any fluctuation in interest, currency, or foreign exchange rate exposures arising from a person's current or anticipated assets or liabilities.

Is there additional guidance related to "hedge or mitigate commercial risk"?

The CFTC has also clarified several points relevant to the new rules:

- *Financial risks*: The End-User Exception applies not only to physical commodity hedging. Financial risks related to an entity's commercial activities, such as interest, currency, or foreign exchange risks, may also constitute "commercial risk" for purposes of the "hedge or mitigate commercial risk" requirement of the End-User Exception. However, due to the potential for abuse arising from the use of the financial risk hedging for the End-User Exception, the CFTC emphasized that such financial risk hedging or mitigation must be an incidental part of the electing entity's business.

- *Swaps hedging other swaps*: "Matched book" or "back-to-back" swaps that hedge or mitigate risks of other swaps may qualify for the End-User Exception if the swap is used to reduce risks in the conduct and management of a commercial enterprise and the other swap itself qualifies for the End-User Exception.
- *Portfolio and dynamic hedging*: A swap that facilitates portfolio hedging or dynamic hedging may be eligible for the End-User Exception if that swap hedges or mitigates commercial risk.

How do I comply with the notification and reporting requirements?

To meet the third condition of the End-User Exception, an end-user claiming the exception ("electing counterparty") must notify the CFTC how it generally meets its financial obligations associated with entering into non-cleared swaps. In this regard, the rules require the end-user to provide, or cause to be provided, to a registered swap data repository ("SDR"), or if no registered SDR is available, to the CFTC, on a ***swap-by-swap basis***: [8]

- Notice of the election of the exception; and
- The identity of the electing counterparty to the swap.

The following information must also be reported, either ***in an annual filing or on a swap-by-swap basis***:

- Whether the electing counterparty is a financial entity, and, if so, which exception to the "financial entity" exclusion it is relying upon;
- Whether the swap hedges or mitigates commercial risk;
- How the electing counterparty generally (i.e., not specifically for each swap) expects to meet its financial obligations of entering into non-cleared swaps by indicating any of the following that apply:
  - A written credit support agreement;
  - Pledged or segregated assets (including posting or receiving margin pursuant to a credit support agreement or otherwise);
  - A written third-party guarantee;
  - The electing counterparty's available financial resources; or
  - Other means; and

- Whether the electing counterparty is an issuer of securities registered under Section 12 or required to file reports under Section 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act"), and if so:
  - The Central Index Key number for the counterparty; and
  - Whether an appropriate committee of the counterparty's Board of Directors (or equivalent body) has reviewed and approved the decision to enter into swaps that are exempt from the clearing requirement.

In its reporting, the end-user must have a reasonable basis to believe that it meets the End-User Exception and must update the information in its annual filing continually to reflect material changes.[9]

Inter-affiliate swaps must be reported in the same manner as non-affiliate

swaps. However, in reporting whether the electing counterparty is a "finance affiliate" under one of the exceptions to the "financial entity" definition, only information on financial entities acting as affiliates needs to be provided and no identification of non-financial entities acting as agents for affiliated entities is necessary.

The new rules do not envision a process for CFTC approval of a counterparty's election of the End-User Exception, but an eligible entity must meet its notification and reporting obligations to qualify for the End-User exception.

Do I have to seek Board approval to use the End-User Exception?

Issuers of securities registered under Section 12 or required to file reports under Section 15(d) of the Exchange Act ("SEC Filers") may qualify for the End-User Exception if an appropriate committee of the Board of Directors (or equivalent body) has reviewed and approved the decision to enter into swaps that are subject to clearing exceptions. In addition, issuers will be deemed to be SEC Filers for purposes of the End-User Exception if they are controlled by an SEC Filer within the meaning of this exception. This approval will be necessary at the time an end-user enters into a swap for which there is a clearing requirement.

- *Board approval on a general basis*: The CFTC does not require Board approval of each decision (i.e., swap-by-swap approval) to enter into an exempt swap. Only approval of the decision to enter into such swaps on a general basis is required. Recall that the reporting counterparties have the option of reporting the Board approval information annually or on a