

Legal Insight

January 17, 2013

Practice Group:

**Derivatives,
Securitization, and
Structured Products**

Swap Clearing and the Commercial End-User Exception: Corporate Governance and Risk Management Issues for Commercial Companies

By Anthony R. G. Nolan, Juan M. Arciniegas, Anh Q. Tran

Central clearing of over-the-counter derivatives is a central pillar of the financial services reforms that are embodied in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). The presumption of mandatory clearing of swaps portends vast changes to the hedging activities of manufacturing companies, energy producers, natural resources firms, transportation companies and other non-financial companies (“commercial end-users”). Those non-financial companies will be required to start clearing swaps in the third quarter of 2013 unless they qualify for an exception from mandatory clearing (the “Commercial End-User Exception”) and satisfy the requirements to fall outside of the clearing regime.

To Clear or Not to Clear ... That is the Question

Cleared swaps will be similar in many respects to exchange traded financial instruments and will drive hedging towards standardization and homogenization. Swap clearing may benefit commercial end-users by reducing spreads, but it may also have disadvantages. Those could include more limited scope to engage in bespoke hedging for complex businesses, higher margin requirements and operational issues arising from the need to understand and comply with clearinghouse rules.

The Commercial End-User Exception was mandated by the Dodd-Frank Act in order to ensure that non-financial companies can opt out of clearing where it is appropriate for their business needs to continue to transact bilateral swaps. A commercial end-user faced with the choice of whether to enter into a cleared and exchange traded swap or a non-cleared swap will likely make such a decision on the basis of the structure and hedging needs of its particular business as well as commercial considerations of cost, liquidity, and credit risk.

The decision to elect the Commercial End-User Exception implicates corporate governance considerations as well as risk management practices. A commercial end-user that does not wish to clear all or some of its hedging swaps must take affirmative steps to avoid clearing because the Commercial End-User Exception is not self-executing. A company that is required to file reports with the Securities and Exchange Commission pursuant to Section 12 or 15(d) of the Securities Exchange Act of 1934, as amended (“SEC Filers”), must also obtain approval of its board of directors and take certain other actions that implicate corporate governance.

This Alert summarizes the clearing mandate of the Dodd-Frank Act, describes the Commercial End-User Exception, highlights the actions that commercial end-users should take by the middle of this year in order to be prepared for the clearing environment and addresses some of the considerations that a commercial end-user should consider in determining whether or not to clear its swaps.

Swap Clearing and the Commercial End-User Exception

The Clearing Mandate for Swaps

General

Section 2(h)(1)(A) of the Commodity Exchange Act (the “CEA”), as amended by Section 723 of the Dodd-Frank Act, authorizes the CFTC to establish clearing requirements for swaps. It also prohibits any person from entering into a swap that is required to be cleared unless that person submits that swap for clearing to a derivatives clearing organization (a “DCO”) or an exception from clearing exists (principally the Commercial End-User Exception).¹ As a corollary to the clearing requirement, a cleared swap must be executed on a designated contract market (a “DCM”) or swap execution facility (a “SEF”) that is registered or exempt from registration if a DCM or SEF makes the swap “available to trade.”

Initial Clearing Requirement Determination

On November 28, 2012, the CFTC issued its first clearing determination, which applies to certain interest rate swaps and untranched broad-based index credit default swaps.² The initial clearing requirement begins to take effect in the first quarter of 2013, as part of a nine-month phase-in period during which different types of counterparties will become subject to the clearing requirement for the initial designated categories of swaps. The final phase-in date is September 9, 2013. Commercial end-users must clear designated categories of interest rate swaps and credit default swaps that are entered into on or after that date or else be in a position to elect the Commercial End-User Exception for those swaps.

Implications of Clearing

A commercial end-user should take the following steps in order to be prepared for the advent of mandatory clearing:

- be prepared to claim the Commercial End-User Exception from clearing for appropriate categories of subsidiaries or affiliates, as described below;
- assess the legal, commercial and economic differences between cleared and non-cleared swaps and also the differences between available DCOs, DCMs and SEFs; and
- for entities that will enter into cleared swaps, execute the necessary documentation. That documentation generally includes futures and options account agreements, cleared derivatives execution agreements and the ISDA/FIA clearing addendum with which swap dealers (like futures commission merchants or clearing members) would clear swaps on behalf of commercial end-users that enter into cleared swaps.

In light of the timetable for mandatory clearing of swaps by commercial end-users, the foregoing steps should be well underway by the second quarter of 2013.

¹ A swap that the CFTC designates for mandatory clearing would nonetheless not be required to be cleared if it is not offered for clearing by any DCO. The CFTC and DCOs are expected to maintain lists of swaps that are required to be cleared, and each DCO is also required to publicly identify those swaps that are accepted for clearing by that DCO.

² The initial clearing requirement determination applies to certain interest rate swaps and untranched broad-based index credit default swaps. The interest rate swaps at issue involve four types (fixed-to-floating, basis, forward rate agreement and overnight index) and four currencies (U.S. Dollar, Euro, British pound and Japanese yen). See 77 Fed. Reg. 240 (December 13, 2012). Click [here](#) for the CFTC’s FAQs regarding the initial clearing requirement determination. It is expected that future determinations will be made in the future for other swap categories.

Swap Clearing and the Commercial End-User Exception

Commercial End-User Exception

Congress mandated the Commercial End-User Exception in recognition that mandatory swap clearing could have a disruptive effect on the hedging activities of commercial end-users that is disproportionate to the contribution of commercial end-users to the financial market instability that the Dodd-Frank Act seeks to address.

Pursuant to Section 2(h)(7)(A) of the CEA, any applicable clearing requirement of the CFTC will not apply to a swap if at least one of the parties to the swap meets each of the following requirements:

- (i) it is not a “financial entity”;
- (ii) it is using the swap to hedge or mitigate commercial risk; and
- (iii) it notifies the CFTC, in a manner set forth by the CFTC, how it generally meets its financial obligations associated with entering into non-cleared swaps.

Financial Entity

The exclusion of “financial entities” from the Commercial End-User Exception means that large swathes of participants in the over-the-counter derivatives markets are not eligible for this exemption. The term “financial entity” for this purpose is broadly defined and includes (a) regulated swap entities such as swap dealers and major swap participants; (b) private funds and commodity pools; (c) employee benefit plans; and (d) entities that are predominantly engaged in the business of banking or in activities that are financial in nature.³

However, there are several important exceptions to the definition of “financial entity” that are relevant to the financing arms of commercial end-users. These include the following types of relationships:

- **Affiliate of Non-financial Entity.** Affiliates of a non-financial entity that qualify for the Commercial End-User Exception will also qualify for the exception if the affiliate (i) acts on behalf of the non-financial entity as agent, (ii) uses the swap to hedge or mitigate commercial risk of that commercial end-user or another affiliate of that commercial end-user that is not a “financial entity,” and (iii) is not itself a “financial entity” (as defined above).
- **Captive Finance Company.** There is an exception for a “captive finance company” if (i) its primary business is providing financing, (ii) it is using derivatives to hedge commercial risks related to interest rate and foreign currency exposures where 90% or more of those exposures arise from the financing or leasing of products, and (iii) 90% or more of the products whose sale or lease is facilitated by the financing are manufactured by the parent company or another subsidiary of the parent.⁴

³ By covering major swap participants as “financial entities,” Title VII of the Dodd-Frank Act creates a risk that commercial or manufacturing entities with large derivatives trading activity may not be eligible for the exemption from central clearing. For our alerts on the definitions of regulated swap entities, click [here](#) and [here](#).

⁴ In response to comments, the CFTC stated in the adopting release for the implementing rules for the Commercial End-User Exception that it construes the term “products” broadly to include services, labor, component parts, and attachments that are related to the products. The CFTC has also stated in the adopting release that it does not require that 90% of the components of the “products” be manufactured by the parent or affiliate, but instead that the final product being purchased or sold, regardless of its components, be manufactured by the parent company or subsidiary in order to qualify for the exception. The CFTC has also clarified that the term “facilitates” in respect to financing shall be broadly interpreted, including such financing activity that may indirectly help to facilitate the purchase or lease of products. This broad interpretation may include situations where the financing being facilitated is that of a manufacturer of a major component of a product that is being sold by a third-party (e.g., an engine of a boat) and where the product sale or lease being financed is the product that contains the manufacturer’s component. Additionally, the “financing that facilitates the purchase or lease of products” 90% test is measured on a consolidated basis, as opposed to a single-entity basis. See 77 Fed. Reg. 139 at 42564 (July 19, 2012).

Swap Clearing and the Commercial End-User Exception

- Small Banking Institution. The final rule has an exemption from the definition of financial entity for small banks, savings associations, and farm credit institutions with total assets of \$10 billion or less. This would for example exclude a credit card bank or other banking institution that is operated as an adjunct to a retail business.

The CFTC's final rule addresses comments and questions that are generally applicable to the Commercial End-User Exception. Any exemptive or interpretive determinations based on the specific nature or circumstances of a particular entity would need to be addressed on a case-by-case basis. The CFTC is currently declining to determine whether certain specific entities or types of entities (other than already explicitly addressed in the final rules) are exempt from the clearing requirement.

“Hedge or Mitigate Commercial Risk”

In order for a swap to qualify under the Commercial End-User Exception, the non-financial entity must have entered into it in order to “hedge or mitigate commercial risk.” Whether a swap is a hedge to commercial risk is generally determined on a swap-by-swap basis based on the facts and circumstances at the time that the swap is entered into, taking into account, among other matters, the commercial end-user’s overall hedging and risk mitigation strategies.

For a swap to be used to “hedge or mitigate commercial risk,” the swap must (i) not be used for a purpose of speculation, investing, or trading and (ii) not be used to hedge or mitigate the risk of another swap, unless that other swap itself is used to hedge or mitigate commercial risk. In addition to the foregoing, the swap must meet one of the following three requirements: (i) it must be “economically appropriate” to reduce risks in the conduct and management of a commercial enterprise, where such risks arise from a variety of factors (enumerated in the CEA and described immediately below); (ii) it must qualify as “bona fide hedging” for purposes of an exemption from position limits under the CEA;⁵ or (iii) it must qualify for hedge accounting treatment under Financial Accounting Standards Board (FASB) Accounting Standards Codification Topic 815 or other generally accepted accounting standard.

In determining if the swap is “economically appropriate” to reduce certain risks, it is appropriate to take into account the effect of a swap in mitigating certain categories of commercial risks that may arise in the ordinary course of business. These include potential changes in the following value metrics: (i) the value of assets that it owns (or reasonably expects to own), produces, manufactures, processes, or merchandises; (ii) the value of liabilities that it has incurred or reasonably anticipates incurring; (iii) the value of services that it provides, purchases, or reasonably anticipates providing or purchasing; (iv) the value of assets, services, inputs, products, or commodities that it owns, produces, manufactures, processes, merchandises, leases, or sells (or reasonably anticipates any of the foregoing); (v) the value related to any of the foregoing arising from foreign exchange rate movements associated with such assets, liabilities, services, inputs, products, or commodities; or (vi) in interest, currency, or foreign exchange rate exposures arising from a person’s current or anticipated assets or liabilities.

Notification and Reporting Requirements

The third requirement for the use of the Commercial End-User Exception is that the reporting counterparty notify a swap data repository registered with the CFTC (an “SDR”), or in limited circumstances where no SDR is available, to the CFTC, how it generally meets its financial

⁵ *Bona fide hedging for position limits under the CEA and under the CFTC's Part 151 rules must be for the purpose of hedging positions or transactions in 28 categories of physical commodities. To be a bona fide hedge, a transaction must represent a substitute for an actual cash market transaction and must either satisfy specified enumerated volume and type restrictions (an “enumerated transaction”) or be a “pass-through swap” referencing an enumerated transaction. In September 2012 the United States District Court for the District of Columbia vacated the Part 151 rules and remanded them to the CFTC for further rulemaking action consistent with the court's opinion.*

Swap Clearing and the Commercial End-User Exception

obligations associated with entering into non-cleared swaps. The CFTC has clarified that the commercial end-user does not have to make this notification directly. Rather, this requirement can be satisfied if the party to the swap that is designated as the “reporting counterparty” notifies the CFTC of the non-cleared swap and that the commercial end-user is electing to avail itself of the Commercial End-User Exception.⁶

On a swap-by-swap basis, the notice submitted by the reporting counterparty must provide certain basic information: (i) notice of the election of the Commercial End-User Exception; (ii) the identity of the electing counterparty; and (iii) the following information:

- (a) Whether the electing party is a “financial entity” and, whether the financial entity is electing the exception on behalf of an affiliate or as a small financial institution;
- (b) Whether the electing counterparty is using the swap to hedge or mitigate commercial risk;
- (c) Information regarding how the electing counterparty generally meets its financial obligations associated with entering into non-cleared swaps (*e.g.*, a credit support agreement, pledged or segregated assets, third-party guarantee, available financial resources, or some other means); and
- (d) Information as to whether (x) the electing counterparty is an issuer of securities registered under Section 12 of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), or is an SEC Filer, (y) if so, such SEC Filer’s Central Index Key (CIK) number, and (z) information as to whether an appropriate committee of the board of directors (or equivalent body) has reviewed and approved generally the decision to enter into swaps that are exempt from the clearing requirements.

In response to a number of comments by market participants that swap-by-swap reporting of all the information required by the rule would impose unnecessary burdens on commercial end-users, the CFTC permits the information in (iii) above to be reported on an annual basis. However, if it enters into a non-cleared swap under the Commercial End-User Exception before it has filed its annual report for a given year, then the reporting counterparty to the swap must provide the foregoing information at the time of entering into the swap. (This information is distinct from the swap creation and continuation data that the reporting party would be required to report pursuant to Part 45 of the CFTC rules.)

Considerations in Determining Whether to Use the Commercial End-User Exception

The clearing and exchange trading mandate mark significant shifts in the use of derivatives to hedge and mitigate commercial risk. Both public and private companies, particularly those with large international operations, have traditionally used swaps to hedge against currency and interest rate risk, in addition to managing risk exposure from volatility in commodity prices and credit markets.

Companies faced with the choice of whether to enter into a cleared and exchange traded swap or a non-cleared swap will likely make such a decision on the basis of commercial considerations of cost, liquidity, and credit risk.

⁶ Pursuant to designation rules set forth in Section 45.8 of the CEA, a non-financial entity is not generally required to act as the reporting counterparty. The reporting counterparty under most circumstances will likely be the swap dealer or major swap participant. Where two non-financial entity counterparties that are United States persons are engaged in a single non-cleared swap, the parties are permitted to determine amongst themselves which party will act as the reporting counterparty. Where a United States person is a party to a swap with a non-United States person that is not a swap dealer or major swap participant the United States person is the reporting counterparty.

Swap Clearing and the Commercial End-User Exception

Cost

In addition to legal fees for the negotiation of cleared swaps documentation, commercial end-users will be required to post initial and variation margin, as determined by the clearinghouse, together with any additional margin required by the clearing broker above clearinghouse minimums.⁷

Liquidity

Two of the supposed benefits of clearing are enhanced liquidity and transparency, both of which have the potential to reduce the costs associated with cleared swaps by, for example, narrowing bid-offer spreads. As the cleared market evolves and liquidity increases, commercial end-users may develop a preference for clearing certain products. On the contrary, a bifurcated swaps strategy between cleared and non-cleared swaps may have an adverse effect on liquidity, especially in the short term as clearing is implemented.

Credit Risk

A key benefit of central clearing is the reduction of counterparty risk, as the DCO will be interposed between the swap dealer and the commercial end-user, reducing the likelihood of loss from a counterparty default. However, commercial end-users will still face certain risks associated with the clearinghouse and the commercial end-user's clearing brokers. These include risks to excess collateral under the CFTC's margin segregation rules known as "legal segregation with operational commingling" and risks to portability.

For many parties that enter into bilateral over-the-counter swaps, mandatory clearing and exchange trading has the potential to significantly complicate their hedging strategies and may limit the use of derivatives in the normal course of business for risk mitigation.

Special Considerations for Public Companies

An SEC Filer that wishes to avail itself of the Commercial End-User Exception is required to have an "appropriate committee" of its board of directors (or equivalent body) to review and approve the decision to enter into swaps exempt from the clearing requirements.

"Appropriate Committee"

The CFTC has indicated that an "appropriate committee" for purposes of the board approval requirement is one that is specifically authorized by the board to review and approve the issuer's decision to enter into non-cleared swaps. For example, a board resolution or an amendment to a board committee's charter could expressly authorize the committee to review and approve the decisions of the SEC Filer not to clear the swap being reported. In turn, such board committee could adopt policies and procedures to review and approve decisions not to clear swaps, on a periodic basis or subject to other conditions determined to be satisfactory to the board committee. The approval can be general, provided that it is reviewed and renewed at least annually, or can be limited in time or to particular categories of transactions.

Whether the board of an SEC Filer should establish a new committee, such as a risk management committee, to review and approve the decision to enter into non-cleared swaps, or if the board should delegate such authority to a currently existing committee of the board, such as the audit committee, would depend on the facts and circumstances of the SEC Filer and its hedging strategies. Factors that

⁷ The CFTC and the prudential banking regulators have proposed rules that may require that margin be posted to swap dealers and major swap participants on non-cleared swaps, although the CFTC has provided some assurances that it does not intend to impose margin requirements on trades in which a commercial end-user is a party. Once those rules are finalized, commercial end-users may need to consider the amount of margin that will be required in connection with a swap with counterparties who are subject to a variety of regulatory regimes. For our alert on the proposed margin rules for non-cleared swaps, click [here](#).

Swap Clearing and the Commercial End-User Exception

an SEC Filer may consider may include the size and available resources of the SEC Filer and the relative size and nature of the commercial risk and related hedging activities.

Scope of Committee Approval

The CFTC clarified in its final rule release that an appropriate committee of the board (or equivalent body) is not required to approve each swap that the SEC Filer enters into, but that it is only required to generally review and approve the decision to enter into swaps exempt from the clearing requirements under the Commercial End-User Exception. Notwithstanding, the final rule makes clear that a perpetual blanket approval from the committee would not be consistent with the purpose of the Commercial End-User Exception. Instead, the appropriate committee of the board should establish suitable policies governing its use of swaps subject to the Commercial End-User Exception and to review those policies at least annually and, as appropriate, more often upon a triggering event, such as the adoption of a new hedging strategy that was not contemplated in the original board approval.

Basis of Committee Approval

The review and approval of the use of the Commercial End-User Exception by the appropriate committee of the board would be based on the facts and circumstances of each particular SEC Filer, including its present and planned hedging strategies. In light of these circumstances, the SEC Filer would need to analyze the advantages and disadvantages of a third-party central clearinghouse and trading on newly regulated exchanges or SEFs, as compared to bilateral execution.

One factor in this analysis may be that cleared swaps will be subject to initial and variation margin requirements established by the clearinghouse and its clearing members. While clearing swaps is intended to, among other matters, reduce counterparty credit risk, the margin requirements for cleared swaps may have the effect of increasing the cost of conducting swaps. An additional potential factor for evaluation may be an SEC Filer's obligation to establish new relationships with clearing members and other swap intermediaries if it elects to engage in cleared swaps. These new arrangements would invariably require the need for drafting, negotiation and execution of new documentation, and be accompanied by related legal fees and expenses.

A board committee, in determining whether to approve the decision to enter into non-cleared swaps, may evaluate risks related to an SEC Filer's potentially having to limit the terms of its clearable swaps to those that are acceptable to the relevant DCOs. This may potentially result in a less effective swap strategy than a strategy using non-cleared bilateral swaps. Conversely, if an SEC Filer continues to enter into non-cleared swaps on a bilateral basis, new requirements being promulgated and implemented under the Dodd-Frank Act, such as mandatory reporting, record-keeping, documentation, and minimum margin requirements, will remain unavoidable.

As permitted under most committee charters, the committee responsible for review and approval of the use of non-cleared swaps should, as with other vital corporate decisions, seek professional guidance in reaching its fully informed resolution.

Swaps Policies of SEC Filers

The CFTC has stated in the adopting release for the implementing rule that it expects an SEC Filer's board to set appropriate policies governing the SEC Filer's use of swaps subject to the Commercial End-User Exception and to review those policies at least annually and, as appropriate, more often upon a triggering event (*e.g.*, a new hedging strategy is to be implemented that was not contemplated by the original board approval). While the requirement for such a policy review is not included in the final rule itself, prudence suggests that SEC Filers should ensure that their boards or board committees review existing risk management and/or trading policies to account for the SEC Filer's hedging activities.

Swap Clearing and the Commercial End-User Exception

Although most commercial end-users have swap policies, those policies are generally designed for non-cleared over-the-counter swaps and should be reconsidered for consistency with the particular considerations that arise in connection with the Commercial End-User Exception. A commercial end-user that does not already have a swap policy in place should take this opportunity to establish one.

Disclosure Implications of Electing the Commercial End-User Exception

Although there are no public disclosure requirements specified for SEC Filers in the final rules adopting the Commercial End-User Exception, actions taken to benefit from the Commercial End-User Exception would likely result in some form of disclosure in the SEC Filer's public filings. For example, if the board of an SEC Filer establishes a new "appropriate committee" pursuant to Section 2(j) of the CEA to review and approve the decision to enter into non-cleared swaps, or, alternatively, if the board amends the charter of its audit committee to reflect such new responsibilities, then disclosure of these changes might be required in the SEC Filer's public filings.

The potential materiality to a commercial end-user of the compliance obligations under the clearing mandate and of an election to avail itself of the Commercial End-User Exception must be assessed on a case-by-case basis. To the extent that the potential advantages and disadvantages discussed above relating to clearing or to the continued use of non-cleared swaps are material to an SEC Filer, it may be required to provide enhanced disclosure of its hedging activities in filings under the Exchange Act. Disclosure obligations that may be triggered by material changes resulting from an SEC Filer engaging in non-cleared or cleared swaps include:

- risk factor disclosures,
- qualitative and quantitative disclosure regarding market risk (Item 305 of Regulation S-K),
- role of the board in risk oversight (Item 407(h) of Regulation S-K),
- management's discussion and analysis (Item 303 of Regulation S-K),
- notes to financial statements (Regulation S-X), and
- internal control over financial reporting (Item 308 of Regulation S-K).

Because compliance obligations of SEC Filers using non-cleared and/or cleared swaps intersect with the public disclosure requirements under federal securities laws and derivatives rules and regulations, SEC Filers should consider consulting with legal counsel with mutual expertise in these two disciplines.

Conclusion

The Commercial End-User Exception provides significant regulatory relief to commercial end-users and certain of their subsidiaries or affiliates that use swaps for purposes that the CFTC considers not to implicate financial stability in the same way as swaps among financial institutions. However, its application can be complex, and other regulatory obligations remain applicable to commercial end-users that clear. Accordingly, confirming the availability of the Commercial End-User Exception is only the first step toward compliance with the clearing mandate. In light of the phase-in for the initial clearing requirement determination, commercial end-users should endeavor to be prepared to exercise their legal rights to the fullest extent in the new world of cleared swaps. The failure of a commercial end-user to do so could result in a significant cost and operational challenge as well as loss of flexibility in its risk management practices.

Swap Clearing and the Commercial End-User Exception

Authors:

Anthony R. G. Nolan

Anthony.nolan@klgates.com
+1.212.536.4843

Juan M. Arciniegas

Juan.arciniegas@klgates.com
+1.212.536.4844

Anh Q. Tran

Anh.tran@klgates.com
+1.310.552.5083

K&L GATES

Anchorage Austin Beijing Berlin Boston Brisbane Brussels Charleston Charlotte Chicago Dallas Doha Dubai Fort Worth Frankfurt Harrisburg Hong Kong London Los Angeles Melbourne Miami Milan Moscow Newark New York Orange County Palo Alto Paris Perth Pittsburgh Portland Raleigh Research Triangle Park San Diego San Francisco São Paulo Seattle Seoul Shanghai Singapore Spokane Sydney Taipei Tokyo Warsaw Washington, D.C.

K&L Gates includes lawyers practicing out of 46 fully integrated offices located in North America, Europe, Asia, South America, Australia, and the Middle East, and represents numerous GLOBAL 500, FORTUNE 100, and FTSE 100 corporations, in addition to growth and middle market companies, entrepreneurs, capital market participants and public sector entities. For more information about K&L Gates or its locations and registrations, visit www.klgates.com.

This publication is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer.

©2013 K&L Gates LLP. All Rights Reserved.