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CFTC Grants No-Action Relief from Clearing Requirement for Certain Treasury Affiliates

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On June 4, 2013, the Division of Clearing and Risk (the “Division”) of the US Commodity Futures Trading Commission (the “CFTC”) granted limited no-action relief from the mandatory clearing requirement for swaps entered into by certain treasury affiliates within non-financial corporate groups (the “No-Action Relief”).¹ The relief will permit eligible treasury affiliates that are not otherwise eligible for the end-user exception² to continue to enter into non-cleared hedging transactions for the benefit of their non-financial affiliates, but is subject to certain conditions and limitations.

¹ No-Action Relief from the Clearing Requirement for Swaps Entering into by Eligible Treasury Affiliates, CFTC No-Action Letter No. 13-22 (June 4, 2013), available at <http://www.cftc.gov/ucm/groups/public/@llettergeneral/documents/letter/13-22.pdf>.

² End-User Exception to the Clearing Requirement for Swaps, 77 Fed. Reg. 42,560 (July 19, 2012).

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Background: CFTC Mandatory Clearing Requirement and the End-User Exception

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) provides for the mandatory clearing of OTC derivatives contracts designated by the CFTC. Nonetheless, in recognition of the significant cost and operational challenge that clearing could represent for end-users, Dodd-Frank contains an exception from the clearing requirement available to non-financial³ (i.e., commercial) end-users that use swaps to hedge or mitigate commercial risk and that elect not to clear such swaps and satisfy certain reporting requirements (the “End-User Exception”).⁴

Also, the CFTC has exempted from the mandatory clearing requirement by rule swaps between certain affiliated entities within a corporate group as an alternative to the End-User Exception.⁵

By its terms, though, the End-User Exception does not cover the common hedging structures of some commercial end-users, particularly where hedging activities are undertaken by a separate treasury affiliate that performs other treasury operations for

³ Financial Entities include swap dealers and security-based swap dealers, major swap participants and major security-based swap participants, private funds, commodity pools, certain employee benefit plans and persons predominately engaged 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 of 1956, except depository institutions with less than \$10 billion in total assets.

In the No-Action Relief, the Division noted that a market participant may look to the final guidance issued by the Board of Governors of the Federal Reserve System (the “Federal Reserve”) establishing requirements for determining if a company is “predominantly engaged in financial activities” for purposes of determining whether it is predominantly engaged in activities that are financial in nature for purposes of the “Financial Entity” definition under the Commodity Exchange Act (the “Act”). Under Title I of Dodd-Frank, a company is considered to be “predominantly engaged” in financial activities if either (i) the annual gross revenues derived by the company and all of its subsidiaries from financial activities represent 85 percent or more of the consolidated annual gross revenues of the company or (ii) the consolidated assets of the company and all of its subsidiaries related to financial activities represent 85 percent or more of the consolidated assets of the company. The final guidance of the Federal Reserve establishes, among other things, tests for making this determination and is available at <http://www.gpo.gov/fdsys/pkg/FR-2013-04-05/pdf/2013-07688.pdf>.

⁴ End-User Exception to the Clearing Requirement for Swaps, 77 Fed. Reg. 42,560 (July 19, 2012).

⁵ Clearing Exemption for Swaps Between Certain Affiliated Entities; Final Rule (78 Fed Reg. 21749) (April 11, 2013), available at: <http://www.cftc.gov/u/cm/groups/public/@lrfederalregister/documents/file/2013-07970a.pdf>.

the corporate group. Such an affiliate is not likely to be eligible to elect the End-User Exception as it would generally constitute a Financial Entity by virtue of being a “person predominantly engaged 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.” Although the End-User Exception permits a Financial Entity to enter into a swap as agent on behalf of a non-financial affiliate, in many hedging structures the treasury affiliate enters into swaps on behalf of non-financial affiliates as principal to the swap and not as agent.

The CFTC has issued its first clearing determination for “plain vanilla” interest rate swaps (fixed-to-floating interest rate swaps, forward rate agreements and basis swaps in US dollars, Euro, Sterling or Yen and overnight index swaps in US dollars, Euro or Sterling), and CDX and iTraxx index credit default swaps.⁶ Commercial end-users that are subject to the clearing requirement will be required to clear swaps beginning on September 9, 2013, for swaps entered into on or after that date. However, if an end-user meets the definition of a Financial Entity, then it will be required to clear these swaps beginning on June 10, 2013, for swaps entered into on or after that date.⁷ As a result, beginning as of June 10, the hedging activities of many corporate groups that use a separate treasury affiliate could have been disrupted without the No-Action Relief.

No-Action Relief from Mandatory Clearing Requirement for Treasury Affiliate Swaps

In the No-Action Relief, the Division recognized the concerns of market participants that numerous non-financial companies enter into swaps through a separate treasury affiliate in order to hedge the risks of the entire non-financial company. Many of these swaps are entered into on behalf of the treasury affiliate’s non-financial affiliates, and the treasury affiliate often serves as the primary external market-facing entity for the corporate group. The Division also acknowledged the risk management benefits of this type of hedging structure, which include reduced redundancy, concentration of expertise, aggregation of common risks arising from such hedging transactions and netting of inter-affiliate transactions.

Pursuant to the No-Action Relief, the Division will not recommend that the CFTC commence an enforcement action against an “Eligible Treasury Affiliate” that does not clear a swap subject to a mandatory clearing determination with an unaffiliated counterparty or another Eligible Treasury Affiliate (an “Exempted Swap”) where each of the conditions specified below is satisfied. The mandatory exchange trading requirement, when effective, will similarly not apply to Exempted Swaps.

⁶ Clearing Requirement Determination under Section 2(h) of CEA, 77 Fed. Reg. 74284 (December 13, 2012).

⁷ Pursuant to the CFTC’s decision to delay mandatory clearing of iTraxx index credit default swaps, Financial Entities will be required to clear this category of swaps beginning July 25, 2013, and all market participants will be required to clear such swaps beginning October 23, 2013. See Press Release, CFTC’s Division of Clearing and Risk Announces Revised Compliance Schedule for Required Clearing of iTraxx CDS Indices (February 25, 2013), site: <http://www.cftc.gov/PressRoom/PressReleases/pr6521-13>.

Who Is an Eligible Treasury Affiliate?

The No-Action Relief defines an “Eligible Treasury Affiliate” as a person that meets each of the following qualifications:

- **The person is:**
 - **directly, wholly-owned by a non-Financial Entity or another Eligible Treasury Affiliate (its “non-financial parent”), and**
 - **not indirectly majority-owned by a Financial Entity;**
 - **The person’s ultimate parent is not a Financial Entity and 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 affiliates⁸, 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 swap dealer;**
 - **a major swap participant;**
 - **a security-based swap dealer;**
 - **a major security-based swap participant; or**
 - **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 private fund;**
 - **a commodity pool;**
 - **an employee benefit plan;**
 - **a bank holding company;**
 - **an insured depository institution;**
 - **a farm credit system;**
- An entity is wholly-owned by a person if the person, directly or indirectly, holds 100% of the equity securities of the entity, or the right to receive upon dissolution, or the contribution of, 100% of the capital of a partnership of the entity, and the entity’s financial results are included in the financial statements of the person as prepared on a consolidated basis under GAAP or IFRS.
- An entity is majority-owned by a person if the person, directly or indirectly, holds a majority of the equity securities of the entity, or the right to receive upon dissolution, or the contribution of, a majority of the capital of a partnership of the entity, and the entity’s financial results are included in the financial statements of the person as prepared on a consolidated basis under GAAP or IFRS.

⁸ The No-Action Relief defines the term “related affiliate” with respect to an Eligible Treasury Affiliate as:

- (i) A non-Financial Entity that is, or is directly or indirectly wholly- or majority-owned by, the ultimate parent; or
- (ii) a person that is another Eligible Treasury Affiliate for an entity described in (i).

- a credit union; or
- an entity engaged in the business of insurance subject to regulatory supervision in connection with such business.

Conditions to the No-Action Relief

In order to rely on the No-Action Relief, an Eligible Treasury Affiliate's swap trading activity must comply with the following conditions, as well as the reporting conditions (discussed further below).

- The Eligible Treasury Affiliate enters into the Exempted Swap for the sole purpose of hedging or mitigating the commercial risk⁹ 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 (a "Financial Affiliate"), 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.

While many corporate hedging arrangements are likely to satisfy these conditions, it is possible that compliance with these conditions will prove difficult for some. There may be corporate groups, for example, where the Eligible Treasury Affiliate does not operate pursuant to a parent guarantee but otherwise satisfies the relevant conditions, or that do not satisfy the majority of non-Financial Entities test. There may also be questions as to whether the conditions may potentially restrict certain hedging activities of the Eligible Treasury Affiliate for its own account. In addition, as noted below, for entities that are public companies, it will be necessary to obtain board approval in order to rely on the No-Action Letter.

Reporting Conditions to the No-Action Relief

An Eligible Treasury Affiliate that enters into an exempted swap in reliance on the No-Action Relief must ensure that the information specified below is reported to a swap data repository (an "SDR"). The information that must be reported is similar to that which must be reported under the End-User Exception. As with the End-User Exception, the reporting counterparty, as determined by the CFTC's swap data reporting rules, must report the information to the SDR; if the

⁹ For further information as to the definition of the term "hedging or mitigating commercial risk," you may wish to refer to our Corporate End-User's Handbook for Dodd-Frank Title VII Compliance (Version 2.0), available at <http://www.shearman.com/files/Publication/9f6be0f7-d19b-4fd9-ac78-bbdab2499906/Presentation/PublicationAttachment/08fda0e3-1017-4fb4-ba7e-987ad4d75a87/Corporate-End-Users-Handbook-for-Dodd-Frank-Title-VII-Compliance-Ver-2-FIA-121712.pdf>

Eligible Treasury Affiliate is not the reporting counterparty, it must provide the information to the reporting counterparty.¹⁰

For each exempted swap, the reporting counterparty is required to provide notice of the election and confirmation that the electing party satisfies the conditions of the No-Action Relief. The reporting counterparty must have a reasonable basis to believe that the electing counterparty meets these conditions. The reporting counterparty must also report how the electing counterparty generally meets its financial obligations associated with entering into non-cleared swaps.¹¹ If the Eligible Treasury Affiliate 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 (an "SEC Filer"), then the reporting counterparty must report the relevant SEC Central Index Key number for such counterparty and acknowledgement that an appropriate committee of the board of directors (or equivalent body) of the Eligible Treasury Affiliate has reviewed and approved the decision to enter into swaps that are exempt from the mandatory clearing and exchange trading requirements of the Act. The Eligible Treasury Affiliate can report the information regarding how it meets its financial obligations related to non-cleared swaps and the information related to its status as an SEC Filer in an annual filing. If there is more than one Eligible Treasury Affiliate party to a particular swap, the information specified above must be reported with respect to each such party.

Eligible Treasury Affiliates relying on the No-Action Relief will not be required to comply with the reporting conditions until September 9, 2013.

¹⁰ Pursuant to the CFTC's swap data reporting rules, where the Eligible Treasury Affiliate's swap counterparty is a registered swap dealer, the swap dealer will be the reporting counterparty. In the No-Action Relief, the Division confirmed that the CFTC No-Action Relief for Inter-Affiliate Swap Reporting applies in the case of a swap between two Eligible Treasury Affiliates that is not cleared in reliance on the No-Action Relief. For further information regarding the CFTC Inter-Affiliate Swap Reporting No-Action Relief, you may wish to refer to our publication on this topic, available at <http://www.shearman.com/files/Publication/90dc20fb-82a6-4177-890c-0ef7a833d989/Presentation/PublicationAttachment/5541da12-43d5-4d2e-9f26-d2b92a3c37ab/CFTC-Swap-Reporting-No-Action-Relief-Granted-Other-Dodd-Frank-Deadlines-Approaching-DSP-04.pdf>.

¹¹ The Division specified several options for an Eligible Treasury Affiliate to select when reporting how it meets its financial obligations, namely (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; or (iv) the electing counterparty's available financial resources. The Division also provided a catch-all "other" category for those who meet their financial obligations in other ways.