

## CFTC Finalizes the End-User Exception from Mandatory Clearing and Proposes to Extend It to Certain Cooperatives

July 11, 2012

Yesterday, the Commodity Futures Trading Commission (CFTC) approved a final rule to implement the end-user exception from mandatory clearing (the Final Rule) and a proposed rule to extend the scope of the end-user exception to certain cooperatives (the Proposed Rule).

The following discussion is based on CFTC staff fact sheets, Q&As and statements made by CFTC Commissioners and staff during an open meeting held yesterday all of which, along with an archived webcast of yesterday's meeting, are available on the CFTC's [website](#). A [pre-publication draft](#) of the Final Rule was issued earlier today.

### The End-User Exception from Mandatory Clearing

One of the goals of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) is to reduce risk in the over-the-counter derivatives market. To further this goal, Section 723 of the Dodd-Frank Act provides that it shall be unlawful for any person to engage in a swap unless such swap is submitted for clearing. "Clearing" refers to the replacement of a single trade between two counterparties with two distinct trades, with the same economic terms as the original trade, whereby a clearinghouse becomes the counterparty to both sides of a transaction. As a result of central clearing, the legal and credit risk that was initially borne by the counterparties to a trade is mutualized among the clearinghouse and its members.

Title VII of the Dodd-Frank Act contains an exception from the mandatory clearing requirement for non-financial entity<sup>1</sup> end-users that use swaps to hedge or mitigate commercial risk. The Final Rule implements the end-user exception by (1) defining the term "hedging or mitigating commercial risk" and (2) establishing certain reporting requirements for end-users electing to avail themselves of the end-user exception.

According to the CFTC staff, the definition of "hedging or mitigating commercial risk" in the Final Rule is virtually the same as the definition of that term contained in the major swap participant definition that was finalized earlier this year.<sup>2</sup> Determining whether a swap hedges or mitigates commercial risk requires a facts and circumstances determination that takes a person's overall hedging and risk mitigation strategies into account and is made at the time a swap is entered into. Among other things, the term includes bona fide hedging transactions, as defined in [CFTC Rule 1.3\(z\)](#).

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<sup>1</sup> The following are defined as "financial entities" in Section 723 of the Dodd-Frank Act: swap dealers, security-based swap dealers, major swap participants, major security-based swap participants, commodity pools, private funds, employee benefit plans and persons predominantly engaged in activities that are in the business of banking or that are "financial in nature" (as defined in § 4(k) of the Bank Holding Company Act of 1956).

<sup>2</sup> For more information, please see Sutherland's Legal Alert, ["CFTC and SEC Define 'Swap Dealer' and 'Major Swap Participant.'"](#)

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With respect to reporting requirements, for each swap, the Final Rule will require a reporting counterparty<sup>3</sup> to report to a swap data repository (1) the election of the exception and (2) the identity of the electing counterparty. Certain annual reporting requirements will also be imposed.

Last, the Final Rule extends the end-user exception to “small financial institutions,” which are defined as banks, savings associations, farm credit system institutions and credit institutions with total assets of \$10 billion or less.

### Proposed Extension of the Exception to Certain Cooperatives

The Proposed Rule would extend the end-user exception to cooperatives that have total assets in excess of \$10 billion and, as such, would not qualify for the end-user exception. Pursuant to the Proposed Rule, a cooperative with total assets in excess of \$10 billion may avail itself of the end-user exception if:

1. All of its members are either (a) non-financial entities, (b) financial entities that are small financial institutions eligible for the end-user exception, or (c) cooperatives, each of whose members fall into categories (a) or (b); and
2. The cooperative engages in swaps in connection with originating loans for members or to hedge or mitigate risks associated with member loans or member loan-related swaps. It is anticipated that the Proposed Rule release will clarify how the phrase “in connection with” should be interpreted.

According to the CFTC staff, the Proposed Rule is intended to permit members of cooperatives with total assets in excess of \$10 billion to continue to access the financial markets through their cooperatives while still receiving the benefits of the end-user exception. The Proposed Rule would impose reporting requirements on affected cooperatives that are essentially identical to the reporting requirements for entities electing to avail themselves of the end-user exception.

The CFTC will accept public comments in response to the Proposed Rule for 30 days following its publication in the Federal Register, which is expected to occur in the coming days.



*If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.*

<a href="#">James M. Cain</a>	202.383.0180	<a href="mailto:james.cain@sutherland.com">james.cain@sutherland.com</a>
<a href="#">Jacob Dweck</a>	202.383.0775	<a href="mailto:jacob.dweck@sutherland.com">jacob.dweck@sutherland.com</a>
<a href="#">Catherine M. Krupka</a>	202.383.0248	<a href="mailto:catherine.krupka@sutherland.com">catherine.krupka@sutherland.com</a>
<a href="#">David T. McIndoe</a>	202.383.0920	<a href="mailto:david.mcindoe@sutherland.com">david.mcindoe@sutherland.com</a>

<sup>3</sup> The reporting requirements in the Final Rule will be in line with the CFTC’s [final recordkeeping and reporting rules](#) in that swap dealers and major swap participants serve as the “reporting counterparty” with respect to this information when engaging in transactions with end-user counterparties availing themselves of the exception. In end-user to end-user transactions, however, one of the end-users will need to be designated as the “reporting counterparty.”



<a href="#">R. Michael Sweeney, Jr.</a>	202.383.0921	<a href="mailto:michael.sweeney@sutherland.com">michael.sweeney@sutherland.com</a>
<a href="#">Paul B. Turner</a>	713.470.6105	<a href="mailto:paul.turner@sutherland.com">paul.turner@sutherland.com</a>
<a href="#">Warren N. Davis</a>	202.383.0133	<a href="mailto:warren.davis@sutherland.com">warren.davis@sutherland.com</a>
<a href="#">William H. Hope II</a>	404.853.8103	<a href="mailto:william.hope@sutherland.com">william.hope@sutherland.com</a>
<a href="#">Meltem F. Kodaman</a>	202.383.0674	<a href="mailto:meltem.kodaman@sutherland.com">meltem.kodaman@sutherland.com</a>
<a href="#">Mark D. Sherrill</a>	202.383.0360	<a href="mailto:mark.sherrill@sutherland.com">mark.sherrill@sutherland.com</a>
<a href="#">Cheryl I. Aaron</a>	202.461.2621	<a href="mailto:cheryl.aaron@sutherland.com">cheryl.aaron@sutherland.com</a>
<a href="#">Ann M. Battle</a>	202.383.0842	<a href="mailto:ann.battle@sutherland.com">ann.battle@sutherland.com</a>
<a href="#">Doyle Campbell</a>	212.389.5073	<a href="mailto:doyle.campbell@sutherland.com">doyle.campbell@sutherland.com</a>
<a href="#">Meghan R. Gruebner</a>	202.383.0933	<a href="mailto:meghan.gruebner@sutherland.com">meghan.gruebner@sutherland.com</a>
<a href="#">Alexander S. Holtan</a>	202.383.0926	<a href="mailto:alexander.holtan@sutherland.com">alexander.holtan@sutherland.com</a>
<a href="#">Raymond A. Ramirez</a>	202.383.0868	<a href="mailto:ray.ramirez@sutherland.com">ray.ramirez@sutherland.com</a>