CLIENT UPDATE

CFTC FINAL RULES ON END-USER EXCEPTION AND PROPOSED RULES ON COOPERATIVE EXCEPTION FROM SWAP CLEARING

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Section 723(a)(3) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") amends the Commodity Exchange Act (the "CEA") by adding Section 2(h)(1),[1] which requires all swaps to be submitted for clearing to a derivatives clearing organization ("DCO"). However, Section 2(h)(7)(A) provides an exception to this clearing requirement (the "end-user exception") where one of the counterparties to the swap (1) is not a "financial entity," (2) is using swaps to hedge or mitigate commercial risk and (3) notifies the CFTC how it generally meets its financial obligations associated with entering into non-cleared swaps. On July 10, 2012, the Commodity Futures Trading Commission (the "CFTC") adopted the final rules to implement this end-user exception (the "Final Rules").

The Final Rules (i) establish the criteria for determining whether a swap hedges or mitigates commercial risk for purposes of the end-user exception, (ii) specify the information that counterparties must report to satisfy the notification requirement associated with the end-user exception, (iii) establish an exemption for small financial institutions and (iv) require reporting of certain information to be used by the CFTC to monitor compliance with, and prevent abuse or evasion of, the end-user exception.

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[1] All section references in this client update are to the CEA unless otherwise specified.

DEFINITION OF FINANCIAL ENTITIES

In the adopting release accompanying the Final Rules (the "Adopting Release"), the CFTC declines to categorically exempt entities based on their activities and specifies that if a party wishes to obtain an exemption, it may request one, but such an exemption will only be granted on a case-by-case basis.

The Final Rules only sets forth the general requirements of the end-user exception, the first of which is that one of the counterparties to the swap must not be a "financial entity."

A "financial entity" is defined as:

- a swap dealer or a security-based swap dealer;
- a major swap participant or a major security-based swap participant;
- a commodity pool;
- a "private fund" as defined in Section 202(a)(29) of the Investment Advisers Act of 1940;
- an "employee benefit plan" as defined in Section 3(3) of the Employee Retirement Income Security Act of 1974; and
- any 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 of 1956.

Foreign and International Entities and Governmental Entities

In the Adopting Release, the CFTC states that foreign governments, foreign central banks and international financial institutions ("Exempt Foreign or International Entities") should not be subject to the clearing requirement of Section 2(h)(1)(A). However, the CFTC notes that where an Exempt Foreign or International Entity enters into a non-cleared swap with a counterparty who is subject to the CEA and the CFTC regulations with regard to that transaction, the counterparty must comply with the CEA and the CFTC regulations as they pertain to non-cleared swaps (e.g., recordkeeping and reporting obligations under Parts 23 and 45 of the CFTC regulations).

State and Local Government Entities

The CFTC declines to exclude state and local governmental entities (specifically housing finance agencies) from the "financial entity" definition. In the Adopting Release; however,

the CFTC notes that, even assuming that many state and local government entities may engage in some limited activities that fall into these categories, most state and local government entities are not likely to be "financial entities" as such activities are likely to be incidental, not primary, activities of those entities.

Affiliate Exception

In the Adopting Release, the CFTC notes that, under Section 2(h)(7)(D), certain affiliates ("Excluded Affiliates") of persons that qualify for the end-user exception ("Excluded Principals") may themselves qualify for such exception even if they are financial entities, if the swap and the affiliate relationship otherwise comply with the requirements of the end-user exception. Section 2(h)(7)(D)(i) thus provides that an Excluded Affiliate may qualify for the exception only if (1) acting on behalf of and as an agent of the Excluded Principal, such Excluded Affiliate uses the swap to hedge or mitigate the commercial risk of the Excluded Principal or another affiliate of the Excluded Principal and (2) the Excluded Principal or such another affiliate is not a financial entity. However, this affiliate exception (the "affiliate exception") does not apply where the affiliate that otherwise would qualify as an Excluded Affiliate is a swap dealer, major swap participant, security-based swap dealer, major security-based swap participant, an issuer that is exempt from the Investment Company Act of 1940 pursuant to Section 3(c)(1) or 3(c)(7) of that Act, a commodity pool or a bank holding company with over $50 billion in consolidated assets.[2]

The CFTC declines to expressly exclude from the "financial entity" definition wholly-owned treasury subsidiaries of non-financial companies which engage in swap transactions solely to hedge or mitigate the commercial risks of an entire corporate group. In the Adopting Release, the CFTC states that such an entity, like any other affiliate of an Excluded Principal, may elect the end-user exception on behalf of such non-financial company only if one of the specific affiliate exception provisions of the statute applies. However, if the treasury function is undertaken by the parent or another corporate entity, and if such parent or other corporate entity enters into swaps in its own name in order to hedge or mitigate the aggregate commercial risks of an entire corporate group, then the application of the end-user exception to those swaps would be analyzed from the perspective of the parent or other corporate entity directly. If such parent company or other corporate entity is engaged predominantly in non-financial business (e.g., manufacturing) and does not fall into any of the first seven types of financial entities

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[2] The CFTC declines to determine whether specific types of entities, namely a nonprofit, tax-exempt cooperative of which the Excluded Affiliate is a member and which is not a depository institution, would qualify for the affiliate exception.

listed above, then it may, in its own right, elect the end-user exception, as it is not a "financial entity."

The CFTC also does not provide an explicit exemption from clearing for inter-affiliate swaps. Therefore, the fact that a swap is between two affiliates would not change the analysis of whether one of the parties to the swap may elect the end-user exception, although the CFTC acknowledges that various commenters have raised enough issues with respect to inter-affiliate swaps that it is considering further review and alternative regulations for inter-affiliate swaps.

Captive Finance Companies

Section 2(h)(7)(C)(iii) excludes from the definition of "financial entity" any entity whose primary business is providing financing, and which uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, at least 90 percent of which "arise from financing that facilitates the purchase or lease of products," at least 90 percent of which are manufactured by the parent company or another subsidiary thereof (the "captive finance company exception").

In the Adopting Release, the CFTC states that the requirement that at least 90 percent of the products be manufactured by the parent or a subsidiary thereof will be interpreted broadly to include service, labor, component parts and attachments related to the product. The CFTC also notes that the two 90 percent prongs will be read separately, such that an entity must satisfy both prongs in order to be eligible for the captive finance company exception. Additionally, the CFTC clarifies that a given product, in order to qualify as "manufactured" by the parent company or subsidiary thereof, need not be comprised of components 90 percent or more of which are manufactured by such parent or subsidiary, so long as the final product being purchased or sold is manufactured by such parent or subsidiary.

Further, the CFTC indicates that "financing that facilitates the purchase or lease of products" will be measured on a consolidated basis that includes the entity's consolidated subsidiaries and will be interpreted broadly to include financing that may indirectly help to facilitate the purchase or lease of products (e.g., facilitating the sale of a finished product by financing the sale of a component thereof).

REPORTING REQUIREMENTS

The CEA requires that, for the end-user exception to apply, one of the counterparties to the swap must notify the CFTC in the manner required by the CFTC "how it generally meets its financial obligations associated with entering into non-cleared swaps." The Final Rules require one of the counterparties (the "reporting counterparty"), at the time the electing party elects the end-user exception, to provide, or cause to be provided, to a registered SDR (or to the CFTC if no registered SDR is available) certain information, including (1) notice of the election of the exception, (2) the identity of the electing counterparty to the swap and (3) certain additional information, unless such information has previously been provided by the electing counterparty in a current annual filing as required by the Final Rules.

In the Adopting Release, the CFTC notes that it has determined not to grant any exemption from the reporting requirements for smaller parties or certain types of swaps. The CFTC has not provided an alternative to SDR reporting, such as the opportunity to submit hard copy records, where neither party to a given swap is a swap dealer or major swap participant. The Final Rules provide that the reporting counterparty will be determined in accordance with the swap data recordkeeping and reporting rules set forth in Rule 45.8. With respect to the information that must be reported on a swap-by-swap basis, the CFTC declines to permit electing counterparties who are not swap dealers or major swap participants to report directly to an SDR or the CFTC, as swap dealers and major swap participants are reporting parties under Rule 45.8.

Frequency and Content of Reporting

The Final Rules require swap-by-swap reporting only with respect to the election of the end-user exception and the identity of the electing counterparty and only annual filings with respect to related additional information.

In the Adopting Release, the CFTC states that a reporting counterparty will be required to check at least three boxes for each swap for which the end-user exception is elected, indicating (1) the election of the exception, (2) which party is the electing counterparty and (3) whether the electing counterparty has already provided the additional required information through an annual filing. If the third box is checked "no," the reporting counterparty must provide the additional required information for the individual swap.

The following information may be reported on a swap-by-swap or an annual basis:

- whether the electing counterparty is a "financial entity" and, if so, whether it is electing the exception in accordance with either the captive finance company exception or the affiliate exception (such financial entities being referred to as "finance affiliates"), or is exempt from the definition of "financial company" as a "small financial institution";
- whether the swap for which the electing counterparty is electing the exception is used by the electing counterparty to hedge or mitigate commercial risk;
- how the electing counterparty generally meets its financial obligations associated with entering into non-cleared swaps by identifying one or more of the following: (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 third-party guarantee, (d) the electing counterparty's available financial resources or (e) any other means of meeting such obligations; and
- whether the electing counterparty is an issuer of securities registered under Section 12, or is required to file reports under Section 15(d), of the Securities Exchange Act of 1934 (the "Exchange Act"), and if it is, it must also provide (a) the relevant SEC Central Index Key number for that counterparty and (b) whether an appropriate committee of that counterparty's board of directors or equivalent body ("board") has reviewed and approved the decision to enter into non-cleared swaps for which the end-user exception is elected.

How an Electing Counterparty Meets Its Financial Obligations

The Final Rules require a reporting party to report how the electing counterparty generally meets its financial obligations associated with entering into all types of uncleared swaps, rather than how it expects to meet its financial obligations associated with entering into any individual swap. The Final Rules clarify that the parties are required to check all applicable boxes if multiple sources of financial resources may be used. The Adopting Release specifies that where the parties have a credit support arrangement subject to an agreed-upon unsecured credit threshold, the reporting counterparty will be required to check one or more of the following: (1) the box for "a written credit support agreement" if the credit support arrangement is subject to such an agreement, (2) the box for "pledged or segregated assets" if the credit support arrangement provided for pledging or segregating assets and (3) the box for "a written third-party guarantee" if the electing counterparty will use available financial resources to cover any amount up to the threshold listed in the credit support agreement. Additionally, the CFTC notes that, where no collateral is used

to satisfy the financial obligations, the reporting counterparty should check the box for "the electing counterparty's available financial resources."

Board Approval for SEC Filers

The end-user exception for clearing and the exemption from the requirement to execute a swap through a board of trade or swap execution facility ("SEF") are available to a counterparty that is an "issuer of securities" registered under Section 12 of the Exchange Act or that is required to file reports pursuant to Section 15(d) of the Exchange Act (an "SEC Filer"), but only if an committee of the issuer's board with the appropriate authority has reviewed and approved the decision to enter into "swaps that are subject to such exemptions." The Final Rules clarify that board approval may be granted on a general basis and is not required for each swap that is exempt from the clearing requirement. Further, the board must approve the decision to enter into swaps that are neither cleared nor executed on a designated contract market ("DCM") or SEF. Under the Final Rules, entities have the option to report board approval information annually or on a swap-by-swap basis. In the Adopting Release, the CFTC notes that it expects an SEC Filer's board will set appropriate policies governing the SEC Filer's use of swaps subject to the end-user exception and will review those policies at least annually and more often upon a triggering event (e.g., where a new hedging strategy is to be implemented that was not contemplated in the original board approval).

Liability for Reporting

The Final Rules provide that each reporting counterparty must have a "reasonable basis" to believe that the electing counterparty meets the requirements for an exception to the clearing requirement. The Adopting Release permits the electing counterparty to rely on reasonable representations by the reporting counterparty that the notification information has been properly transmitted and would not be subject to adverse consequences (and the swap would not be deemed ineligible for the end-user exception) if the reporting party actually fails to properly report the information.

HEDGING OR MITIGATING COMMERCIAL RISK

To benefit from the end-user exception, a swap must be used to hedge or mitigate commercial risk. In other words, a swap must:

- be economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where the risks arise from the six categories of commercial risks identified by the CFTC;

- qualify as bona fide hedging for purposes of an exemption from position limits under the CEA; or
- qualify for hedging treatment under Financial Accounting Standards Board Account Standards Codification Topic 815, Derivates and Hedging (formerly known as Statement No. 133) or Governmental Accounting Standards Board Statement 53, Accounting and Financial Reporting for Derivative Instruments.

In addition, that swap must not be used:

- for a purpose that is in the nature of speculation, investing or trading; and
- to hedge or mitigate the risk of another swap or security-based swap position, unless that other position itself is used to hedge or mitigate commercial risk as defined by the Final Rules.

Treatment of Commodity Risks and Financial Risks

The CFTC declines to exclude the hedging of commercial "financial" risks from the end-user exception. In the Adopting Release, the CFTC indicates that it does not believe the end-user exception was intended to apply only to physical commodity hedging, explaining that an entity that may elect the end-user exception may be subject to financial risks related to its commercial activities, which risks may be commercial in nature.

Facts and Circumstances Test

The CFTC clarifies in the Adopting Release that counterparties should look to the facts and circumstances that exist at the time a swap is executed in order to determine whether the swap satisfies the criteria for hedging and mitigating commercial risk. The CFTC also notes that nothing in the Final Rules would require ongoing reporting or testing of a swap's hedge effectiveness if the swap meets all the requirements, including the hedging or risk mitigation requirement, at the time the election was made.

Commercial Status of Electing Counterparty

In the Adopting Release, the CFTC confirms (1) that the determination of whether the risk being hedged or mitigated is "commercial" will be based on the underlying activity to which the risk relates, rather than the type of entity claiming the end-user exception and (2) that this distinction applies to all potential electing counterparties, including governmental entities, both domestic and foreign, and non-profit entities.

Economically Appropriate Standard and "Commercial Risks"

The Final Rules provide that a swap is used to "hedge or mitigate commercial risk" if the swap is "economically appropriate" to the reduction of any of the following six categories of commercial risk:

- the potential change in value of assets that a person owns, produces, manufactures, processes or merchandises or reasonably anticipates owning, producing, manufacturing, processing or merchandising in the ordinary course of business of the enterprise;
- the potential change in value of liabilities that a person has incurred or reasonably anticipates incurring in the ordinary course of business;
- the potential change in value of services that a person provides, purchases or reasonably anticipates providing or purchasing in the ordinary course of business;
- the potential change in value of assets, services, inputs, products or commodities that a person owns, produces, manufactures, processes, merchandises, leases, or sells or reasonably anticipates owning, producing, manufacturing, processing, merchandising, leasing or selling in the ordinary course of business;
- any potential change in 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.

Speculation, Investing or Trading

A swap does not hedge or mitigate commercial risk if it is used for a purpose that is in the nature of "speculation, investing or trading." In the Adopting Release, the CFTC acknowledges that some swaps that may be characterized as "arbitrage" transactions in certain contexts may also reduce the permitted categories of commercial risks. Thus, not all arbitrage swaps are necessarily speculative. The CFTC declines to provide an express, categorical exception for swaps related to physical commodity positions as such swaps are not always hedging or mitigating commercial risk. Finally, the CFTC notes that a party's ability to elect the end-user exception for a particular swap is a function of the purpose of the particular swap in question. Therefore, the fact that a party enters into other unrelated swaps for the purpose of speculating, investing or trading will not affect the

counterparty's assessment of whether its other swaps meet the requirements of the Final Rules.

Swaps Hedging Other Swaps

Under the Final Rules, "matched book" or "back-to-back" swaps that hedge or mitigate the risk of another swap or security-based swap (the "underlying swap") may qualify for the end-user exception, so long as both the back-to-back swap and the underlying swap are used to hedge or mitigate commercial risk. In the Adopting Release, the CFTC notes that this provision allows successive swaps in a chain of back-to-back swaps to qualify for the exception if the first underlying swap so qualifies and each successive swap is used by a party that otherwise qualifies for the end-user exception to hedge or mitigate commercial risk. However, if the "last" qualifying entity in a chain of qualifying entities hedges its qualifying swap by entering into a qualifying swap (the "hedging swap") with a non-qualifying financial entity, then although the qualifying entity can elect to use the end-user exception with respect to its hedging swap, the financial entity cannot elect the end-user exception for any further swap it uses to hedge or mitigate the risk from its own position.

Additionally, the CFTC notes in the Adopting Release that a swap that hedges an existing hedge is not necessarily speculative. The CFTC explains that a swap originally designed to hedge commercial risk may, over time, no longer fully serve its original hedging purpose (if, for instance, the underlying commercial risk hedged by the original swap no longer exists or changes due to market conditions or changes in business needs of the electing counterparty) such that the risk now posed by the original swap itself is like other commercial risks that arose in the ordinary course of business.

In the Adopting Release, the CFTC clarifies that, in order to qualify for the end-user exception, the swap (1) must not be used for the purpose of speculation, investing or trading *and* (2) must not be used to hedge or mitigate the risk of another swap or security-based swap, unless the other position itself is used to hedge or mitigate commercial risk. Because this test is conjunctive, a swap will be disqualified from the end-user exception if it fails to meet *either* of these two requirements.

Portfolio and Dynamic Hedging and Hedge Effectiveness Testing

The CFTC states in the Adopting Release that a swap that facilitates portfolio hedging or "dynamic" hedging may be eligible for the end-user exception if the swap hedges or mitigates commercial risk.

Swap-by-Swap or Swap Portfolio Approach

Under the Final Rules, whether a commercial risk is being hedged or mitigated will be determined for each swap, not for all or a portion of a party's swap portfolio. In the Adopting Release, the CFTC rejects both the suggestion that an entity using *some* swaps to hedge or mitigate commercial risk will automatically be eligible for the end-user exception with respect to *all* of its swaps and the suggestion that the end-user exception should be limited to entities that use swaps *solely* to hedge or mitigate commercial risk. The CFTC also rejects the "portfolio approach", which would render an entity using a certain minimum percentage of its swaps to hedge or mitigate commercial risk automatically eligible for the end-user exception with respect to all of its swaps.

SMALL FINANCIAL INSTITUTIONS EXEMPT FROM "FINANCIAL ENTITY" DEFINITION

For the purposes of the end-user exception, a person that is a "financial entity" solely because it is "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 of 1956" is exempt from the definition of "financial entity" if it satisfies the following two requirements:

- it is organized: (a) as a bank, as defined in Section 3(a) of the Federal Deposit Insurance Act (the "FDIA"), the deposits of which are insured by the Federal Deposit Insurance Corporation (the "FDIC"); (b) as a savings association, as defined in Section 3(b) of the FDIA, the deposits of which are insured by the FDIC; (c) as a farm credit system institution chartered under the Farm Credit Act of 1971 (a "FCS bank"); or (d) as an insured Federal credit union or State-chartered union under the Federal Credit Union Act; and
- it had total assets of $10 billion or less on the last day of its most recent fiscal year.

Under the Final Rules, small financial institutions ("SFIs") qualifying for this exemption may elect not to clear swaps that are otherwise eligible for the end-user exception.

ADDITIONAL CONSIDERATIONS

Consultation with Other Regulatory Agencies; Jurisdictional Issues

The CFTC declines to revise the Final Rules in response to comments recommending that the CFTC consult and coordinate with other regulatory agencies and state commissions (e.g., Federal Energy Regulatory Commission ("FERC") and California Public Utilities Commission ("CPUC")) to ensure regulatory consistency. In the Adopting Release, the

CFTC notes that it does not believe there is any conflict between the Final Rules and the other regulations.

Implementation and Compliance

While the Final Rules will become effective 60 days after publication in the Federal Register, the CFTC notes that compliance with the Final Rules will not be necessary or possible until swaps become subject to the clearing requirement. The CFTC's proposed compliance and implementation schedule for the clearing requirement gives non-financial entities at least 270 days to comply after the CFTC issues a clearing requirement determination for a swap or group, category or class of swaps. Moreover, the CFTC has stated that no such clearing requirement determinations will become effective until the CFTC adopts certain related rules.

PROPOSED RULE: CLEARING EXEMPTION FOR SWAPS ENTERED INTO BY COOPERATIVES

On July 10, 2012, the CFTC proposed Section 39.6(f) (the "Proposed Rule") for an exemption from swap clearing (the "cooperative exemption") which would permit a cooperative that is a "financial entity" to elect not to clear certain swaps that are otherwise required to be cleared under Section 2(h)(1)(A), provided the following qualifications are met:

- it was formed and exists pursuant to Federal or state law as a cooperative;
- it is a "financial entity" solely because it is "predominantly engaged in activities that are in the business of banking, or…are financial in nature" (as provided in Section 2(h)(7)(C)(i)(VIII) of the CEA);
- each of its members is a non-financial entity, an SFI or itself a cooperative (formed under Federal or state law) whose members each fall into one of these categories (any cooperative satisfying the requirements of prongs (1), (2) and (3), an "exempt cooperative");
- the swap in question is (a) entered into with a member of the exempt cooperative in connection with originating a loan or loans for such member and (b) hedges or mitigates commercial risk related to loans to members or arising from a swap or swaps that is entered into with a member of the exempt cooperative in connection with originating a loan for such member.

In the proposing release accompanying the Proposed Rule (the "Proposing Release"), the CFTC notes that Section 2(h)(7) of the CEA does not differentiate cooperatives from other

types of entities. As such, absent any special exemption, cooperatives that are "financial entities" would be prohibited from electing the end-user exception unless they qualify for the SFI exemption. As noted above, the CFTC declined to extend the SFI exemption to cooperatives that are financial entities with total assets of over $10 billion. In the Proposing Release, the CFTC notes that some cooperatives have more than $10 billion in total assets, but act on behalf of members that are non-financial entities, SFIs or other cooperatives whose members consist of such entities.

In the Proposing Release, the CFTC reasons that cooperatives that are financial entities generally serve as the collective asset liability manager for their members, facing the financial markets on their behalf and using their size and resources to provide more efficient financing and hedging than the members might achieve on their own (e.g., by borrowing money on a wholesale basis and then lending those funds to their members).

In the Proposing Release, the CFTC states that prongs (3) and (4) of the cooperative exemption would assure that it would only be available as a pass through for swaps with members who would themselves be able to elect the end-user exception and for swaps that hedge or mitigate risk in connection with member loans and swaps, as would be required for those member swaps to qualify for the end-user exception. Noting the "unique relationship between cooperatives and their member owners,"[3] the CFTC declined to expand this exemption to include swaps with non-member entities with which the cooperative may do business (other than swaps used to hedge risks related to member loans or swaps). Furthermore, the CFTC emphasized that expanding the exemption to cooperatives entering into non-cleared swaps with non-members or swaps that serve purposes other than hedging member loans or swaps would give the cooperatives, which are large financial entities, an unwarranted market advantage over their competitors.

The CFTC stresses that the proposed exemption would be available to all qualifying cooperatives, including those with total assets greater than $10 billion. As larger financial institutions pose wider risk to the financial system than smaller financial institutions given their tendency to be interconnected with a broader set of market participants, the CFTC reasons that the exemption must be limited to swaps entered in connection with member loans.

The Proposed Rule would require exempt cooperatives electing this exemption to comply with the reporting requirements of Rule 39.6(b). Under the Proposed Rule, the exempt

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[3] In the Proposing Release, the CFTC notes that member owners of a cooperative collectively have full control and governance of the cooperative such that the cooperative is practically inseparable from its member owners.

cooperative would be the electing counterparty and the reporting counterparty would report that the cooperative exemption is being elected.

Please do not hesitate to contact us if you have any questions.

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July 19, 2012