Client update
CFTC Amends No-Action Relief from Swap Clearing Requirement for Certain Treasury Affiliates

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On November 26, 2014, the Division of Clearing and Risk (the "Division") of the Commodity Futures Trading Commission (the "CFTC") issued a no-action letter (the "2014 Letter")[1] amending the no-action relief previously granted to certain "eligible treasury affiliates" from the clearing requirement in section 2(h)(1) of the Commodity Exchange Act (the "CEA") and Part 50 of the CFTC regulations for swaps entered into by such treasury affiliates on behalf of non-financial affiliates. The 2014 Letter addresses challenges faced by treasury affiliates in complying with certain conditions set forth in the prior no-action letter issued on June 4, 2013 (the "2013 Letter")[2] by altering some of those conditions to permit additional market participants to rely on the relief originally set forth in the 2013 Letter.

BACKGROUND

Section 2(h)(1)(A) of the CEA provides that all swaps required by the CFTC to be cleared at a derivatives clearing organization must be cleared. There are currently four classes of interest rate swaps and two classes of index credit default swaps subject to mandatory clearing in the United States.

Section 2(h)(7) of the CEA and CFTC regulation 50.50 provide an exception (the "end-user exception") from the clearing requirement when one of the counterparties to a swap (1) is not a financial entity, as defined in section 2(h)(7)(C)(i) of the CEA;[3] (2) is using the swap to hedge or mitigate commercial

[1] CFTC Letter No. 14-144, http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-144.pdf.

[2] For additional information on the 2013 Letter, please see our client memorandum, "No-Action Relief from Clearing Requirement for Swaps Entered into by Certain Treasury Affiliates," http://www.debevoise.com/insights/publications/2013/06/noaction-relief-from-clearing-requirement-for-sw__.

[3] All references to the term "financial entity" are to the term as defined in section 2(h)(7)(C)(i) of the CEA.

risk; and (3) notifies the CFTC of how it generally meets its financial obligations associated with entering into uncleared swaps. The determination of whether an entity is or is not a financial entity must be done on an entity-by-entity basis within a corporate group.

In the 2013 Letter, the Division granted, subject to certain conditions, no-action relief from the clearing requirement for swaps entered into by certain affiliates ("treasury affiliates") acting on behalf of affiliates that are not financial entities for the purpose of hedging or mitigating commercial risk. The relief was available only to "eligible treasury affiliates" ("ETAs") and was granted based on the Division's understanding that treasury affiliates were undertaking hedging activities on behalf of non-financial affiliates that were eligible to elect the end-user exception, but such treasury affiliates were themselves "financial entities" ineligible to elect the exception. The relief effectively allowed ETAs, subject to certain conditions, to take advantage of the end-user exception that their non-financial affiliates would otherwise have been eligible to elect had they entered into the swap directly.

2014 LETTER

Since the Division issued the 2013 Letter, market participants have highlighted several conditions of that letter that made the use of the relief impractical for many treasury affiliates. In response to the issues raised by the market participants, the Division removed and modified certain requirements of the 2013 Letter and issued the modified no-action relief set forth in the 2014 Letter.

AMENDMENTS TO 2013 LETTER

The 2014 Letter amends a number of conditions for the no-action relief, including amendments to the definition of "eligible treasury affiliate," set forth in the 2013 Letter.

- The 2014 Letter removes the requirement in the 2013 Letter that the ultimate parent of the treasury affiliate must identify all wholly and majority-owned affiliates within the corporate group and ensure that a majority of such affiliates qualify for the end-user exception.
- The 2014 Letter maintains the requirement in the 2013 Letter that the treasury affiliate itself cannot be a systemically important nonbank financial company; however, the 2014 Letter removes the requirement that the treasury affiliate not be affiliated with such an entity. Instead, the 2014 Letter adds a requirement that the ETA must not enter into transactions with, or on behalf of, an affiliate that is a systemically important nonbank

financial company and must not provide any services, financial or otherwise, to any affiliate that is a systemically important nonbank financial company.

- The 2014 Letter amends the definition of "related affiliate" to allow entities that provide certain financial services on behalf of a financial entity within a corporate group to nonetheless qualify as an ETA. Without the 2014 Letter amendment, an entity that provides certain financial services (e.g., cash pooling functions) for a corporate family that includes a financial entity would not be an ETA.
- With respect to the General Condition that the ETA must enter into the exempted swap for the sole purpose of hedging or mitigating the commercial risk of related affiliates that was transferred to the ETA, the 2014 Letter removes the limitation in the 2013 Letter that the commercial risk must have been transferred to the ETA "by operation of one or more swaps with such related affiliates."[4] However, the 2014 Letter requires that the ETA be able to identify the related affiliate or affiliates on whose behalf the swap was entered into by the ETA.
- With respect to the General Condition in the 2013 Letter that the ETA may 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, the 2014 Letter amends this condition to allow an ETA to enter into hedging transactions for itself.[5]
- With respect to the General Condition that related affiliates entering into swaps with the ETA, or the ETA itself, may not enter into swaps with or on behalf of a financial affiliate, the 2014 Letter amends this condition to clarify that it does not preclude the circumstance where the financial affiliate is an ETA. The Division clarifies that the no-action relief contemplates the use of multiple ETAs within a corporate family.

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[4] The Division recognizes that there are a number of ways for commercial risk to be transferred between affiliates, and that the risk that an ETA may have been seeking to hedge or mitigate would not necessarily be transferred from the operating affiliate to the ETA by way of a swap transaction. The Division further notes that the method by which the risk is transferred can be dependent on the type of risk being hedged; for instance, it may be more common for foreign exchange risk to be transferred through the use of book-entry transfers, as opposed to interest rate risk, where back-to-back swaps are more prevalent.

[5] The Division clarifies that while a treasury affiliate should not lose its status as an ETA simply because it entered into a hedging transaction on its own behalf, such swaps entered into by the ETA on its own behalf would not be "exempted swaps" and may be required to be cleared if subject to the clearing requirement and no other exception or exemption applies. Further, the Division notes that treasury affiliates entering into a speculative transaction (on their own behalf or otherwise) would not be consistent with this condition.

- The 2014 Letter removes the General Condition in the 2013 Letter that the ETA's payment obligations be guaranteed by certain specified entities, in order to accommodate the additional support arrangements that may exist within a corporate structure with regard to the ETA's payment obligations (such as keepwells, letters of credit and revolving credit facilities).

2014 LETTER NO-ACTION RELIEF

With the modifications to the 2013 Letter described above, the Division issues the 2014 Letter, which states that it will not recommend that the CFTC commence an enforcement action against an ETA for its failure to comply with the clearing requirement in section 2(h)(1) of the CEA and Part 50 of the CFTC regulations with respect to a swap with an unaffiliated counterparty or another ETA (an "exempted swap") that is otherwise subject to the clearing requirement under CFTC regulation 50.4, subject to the following conditions:

General Conditions.

- The ETA must enter into the exempted swap for the sole purpose of hedging or mitigating the commercial risk[6] of one or more related affiliates that was transferred to the ETA;
- The ETA may not enter into swaps with its related affiliates or unaffiliated counterparties other than for the purpose of hedging or mitigating its own commercial risk or the commercial risk of one or more related affiliates;
- Neither any related affiliate that enters into swaps with the ETA nor the ETA may enter into swaps with or on behalf of an affiliate that is a financial entity ("financial affiliate"), or otherwise assume, net, combine or consolidate the risk of swaps entered into by a financial affiliate (except in the case of financial affiliates that qualify as ETAs); and
- Each swap entered into by the ETA must be subject to a centralized risk management program reasonably designed to monitor and manage the associated risks and identify the related affiliate or affiliates on whose behalf each exempted swap has been entered into by the ETA.

Reporting Conditions.

For each swap that an ETA (the "electing counterparty") elects not to clear in reliance on the no-action relief, the 2014 Letter requires the "reporting counterparty," as determined under CFTC regulation 45.8, to provide, or cause to

[6] For purposes of this relief, the phrase "hedges or mitigates commercial risk" has the same meaning as it does in the context of the end-user exception (see Regulation 50.50(c)).

be provided, the following information to a registered swap data repository ("SDR") (or, if no registered SDR is available to receive the information, to the CFTC):

- Notice of the election of the relief and confirmation that the electing counterparty satisfies the General Conditions set forth above;
- How the electing counterparty generally meets its financial obligations associated with entering into uncleared swaps by identifying one or more of the following categories, as applicable: (1) a written credit support agreement; (2) pledged or segregated assets (including posting or receiving margin pursuant to a credit support agreement or otherwise); (3) a written guarantee from another party; (4) the electing counterparty's available financial resources; or (5) other means; and
- If the electing counterparty 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: (1) the relevant SEC Central Index Key number for such counterparty; and (2) acknowledgment that an appropriate committee of the board of directors (or equivalent body) of the electing counterparty has reviewed and approved the decision to enter into swaps that are exempt from the clearing requirement in section 2(h)(1), and, if applicable, the trade execution requirement in section 2(h)(8) of the CEA.

If there is more than one electing counterparty to a swap, the information specified above must be provided with respect to each of the electing counterparties. An entity that qualifies for the no-action relief may report this information annually in anticipation of electing the relief for one or more swaps, which report will be effective for 365 days following the date of reporting. During that period, the entity must amend the report as necessary to reflect any material changes to the information reported. Each reporting counterparty must have a reasonable basis to believe that the electing counterparty meets the General Conditions for the no-action relief.

Eligible Treasury Affiliate Definition.

The 2014 Letter defines "eligible treasury affiliate" as a person that meets the following qualifications:

- The person is directly wholly owned[7] by a non-financial entity or another ETA (its "non-financial parent") and is not indirectly majority-owned[8] by a financial entity;
- The top-most, direct or indirect, majority owner of the person in the corporate hierarchy (the person's "ultimate parent") is not a financial entity;
- The person is a financial entity solely as a result of acting as principal to swaps with, or on behalf of, one or more (1) non-financial entities that are, or are directly or indirectly wholly or majority-owned by, the ultimate parent; or (2) persons that are ETAs ("related affiliates") or provide other services that are financial in nature to such related affiliates;
- The person is not, and is not affiliated with, a swap dealer, a major swap participant, a security-based swap dealer or a major security-based swap participant;
- The person is not any of the following: (1) a private fund, as defined in section 202(a) of the Investment Advisors Act of 1940; (2) a commodity pool; (3) an employee benefit plan as defined in section 3 of the Employee Retirement Income Security Act of 1974; (4) a bank holding company; (5) an insured depository institution; (6) a farm credit system institution; (7) a credit union; (8) a nonbank financial company that has been designated as systemically important by the Financial Stability Oversight Council ("FSOC"); or (9) an entity engaged in the business of insurance and subject to capital requirements established by an insurance governmental authority of a state or territory of the United States, the District of Columbia, a foreign country or a political subdivision of a foreign country engaged in the supervision of insurance companies under insurance law; and
- The person does not provide any services, financial or otherwise, to any affiliate that is a nonbank financial company designated as systemically important by FSOC.

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Please do not hesitate to contact us with any questions.

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[7] 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 the entity, and the entity's financial results are included in the financial statements of the person as prepared on a consolidated basis under Generally Accepted Accounting Principles or International Financial Reporting Standards.

[8] The definition of "majority-owned" tracks the definition of "wholly owned" except that the relevant threshold is a majority, rather than 100%.