

CLIENT UPDATE

CFTC PROPOSES CLEARING EXEMPTION FOR SWAPS BETWEEN CERTAIN AFFILIATED ENTITIES

NEW YORK

Byungkwon Lim
blim@debevoise.com

Emilie T. Hsu
ehsu@debevoise.com

Aaron J. Levy
ajlevy@debevoise.com

Section 723(a)(3) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) amended the Commodity Exchange Act (the “CEA”) by adding Section 2(h)(1)(A), which requires all swaps to be submitted for clearing to a derivatives clearing organization unless an exemption applies. In response to numerous comments that requested a clearing exemption for inter-affiliate swaps, the Commodity Futures Trading Commission (the “CFTC”) proposed rules to exempt swaps between certain affiliated entities within a corporate group from clearing subject to certain conditions (the “Proposed Rules”).

The Proposed Rules were published in the Federal Register on August 21, 2012, and comments must be received by September 20, 2012. The text of the Proposed Rules can be found at <http://cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-20508a.pdf>.

INTER-AFFILIATE SWAP CLEARING EXEMPTION

The Proposed Rules permit affiliated counterparties to elect not to clear a swap if:

- both parties elect not to clear the swap;
- (a) one counterparty directly or indirectly holds a majority ownership interest in the other, or a third party directly or indirectly holds a majority ownership interest in both counterparties and (b) the financial statements of both counterparties are reported on a consolidated basis (“eligible affiliate counterparties”); and
- certain conditions, as described below, are satisfied (the “Proposed Conditions”).

For this purpose, a counterparty or third party holds a “majority ownership interest” in another entity if it directly or indirectly holds a majority of the equity securities of that entity, or the right to receive upon dissolution, or the contribution of, a majority of the capital of a partnership.

PROPOSED CONDITIONS FOR INTER-AFFILIATE SWAP CLEARING EXEMPTION

To qualify for this clearing exemption, the CFTC requires the parties to:

- document the basic terms of the swap;
- subject the swap to a centralized risk management program;
- collateralize the swap unless an exception applies;
- be located in the United States, or in a jurisdiction that has clearing requirements for swaps comparable to those of the United States, or be otherwise subject to clearing requirements with non-affiliated parties, or not enter into swaps with non-affiliates; and
- comply with certain reporting requirements with respect to the swap.

Written Documentation of Swap Transaction

The counterparties electing the inter-affiliate clearing exemption would be required to execute a written swap trading relationship document, which must include all basic terms governing the trading relationship between them. The trading relationship document must contain terms addressing payment obligations, netting of payments, events of default or other termination events, calculation and netting of obligations upon termination, transfer of rights and obligations, governing law, valuation and dispute resolution procedures. In

the proposing release accompanying the Proposed Rules (the “Release”), the CFTC notes that affiliates may use a master agreement to document the terms of their inter-affiliate swaps.

If one of the eligible affiliate counterparties is also a swap dealer (“SD”) or a major swap participant (“MSP”), this condition will be satisfied by that party’s compliance with the rules adopted by the CFTC, which require all SDs and MSPs to document their swap transactions in written swap trading relationship documents.

Centralized Risk Management

The Proposed Rules require inter-affiliate swaps to be subject to a centralized risk management program reasonably designed to monitor and manage the risks associated with such swaps. If one of the eligible affiliate counterparties is a SD or MSP, this centralized risk management requirement will be satisfied by that party’s compliance with the internal business conduct rules adopted by the CFTC, which require all SDs and MSPs to implement certain risk management policies.

In the Release, the CFTC notes that, while it anticipates that the program would be implemented and run by the parent company or by an affiliate used by the corporate group to trade outward facing swaps (e.g., a “centralized treasury”), the Proposed Rules provide the flexibility to the parties to determine how to satisfy this requirement.

Variation Margin for Financial Entities

With the exception of swaps entered into by affiliates that are 100% commonly-owned and commonly-guaranteed, where the common guarantor is also 100% commonly-owned, for swaps between eligible affiliate counterparties that are both financial entities¹, the Proposed Rules require that each counterparty must pay and collect variation margin for each inter-affiliate swap exempt from clearing. With respect to swaps subject to this margin requirement, the Proposed Rules require that the swap trading relationship document must:

¹ “Financial Entity” means (i) a SD, (ii) a security-based swap dealer, (iii) a MSP, (iv) a major security-based swap participant, (v) a commodity pool, (vi) a private fund as defined in section 202(a) of the Investment Advisers Act of 1940, (vii) an employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 and (viii) a 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.

- set forth and describe the methodology to be used to calculate variation margin with sufficient specificity to allow the counterparties, the CFTC and any appropriate prudential regulator to calculate the margin requirement independently;² and
- specify for each counterparty where, and under what terms, margin assets will be held.

There is an exception for entities that are 100% commonly-owned and 100% commonly-guaranteed by a common guarantor that is also under 100% common ownership because the CFTC deems those affiliates to have economic interests that are fully aligned. In the Release, the CFTC notes that this exception is intended to apply to swaps between two wholly-owned subsidiaries of a common parent or in instances where one affiliate is wholly owned by the other. For example, if an entity within a corporate group of affiliates acts as a “centralized treasury” by entering into swaps with third-party SDs and entering into back-to-back swaps with its own affiliates, then the margin requirement will not apply to back-to-back swaps with the 100% commonly-owned affiliates.

Under the Proposed Rules, the 100% ownership must be absolute and not be subject to any contingent right or obligation to sell or otherwise transfer equity ownership to another entity. Similarly, an entity that only has a contingent right or obligation to acquire the ownership of another entity will not be deemed to have 100% ownership of that entity until the time when the 100% ownership interest is actually acquired.

Counterparties Are U.S. Affiliates or Foreign Affiliates Subject to Comparable Regime

In order to deter evasion of the clearing requirement as required by the CEA, the Proposed Rules would only permit this clearing exemption for swaps between two counterparties, each of which:

- is located in the United States;
- is located in a jurisdiction that has a comprehensive regulatory regime for swap clearing that is comparable to that of the United States;
- is required to clear swaps with third parties in compliance with U.S. law; or
- does not enter into swaps with third parties.

In the Release, the CFTC clarifies that the counterparties need not both qualify for the same prong of this requirement, so long as they each meet one of the prongs.

² Variation margin calculations and payments would start on the business day after the swap is executed and continue each business day until the swap is terminated.

Satisfaction of Additional Reporting Requirements

Pursuant to the swap data reporting requirements under the CEA, one of the counterparties to an uncleared swap must report swap data to a Swap Data Repository (“SDR”) or to the CFTC if no SDR will accept such information. In addition to the general swap data reporting requirements, the Proposed Rules would impose reporting requirements specific to uncleared swaps for which the inter-affiliate exemption is elected.

Under the Proposed Rules, the reporting counterparty to such a swap must provide a SDR, or the CFTC if no SDR is available to receive such information, the following:

- “Transaction Specific Information”: confirmation that both counterparties to the swap (a) are electing not to clear the swap, (b) are eligible affiliate counterparties and (c) satisfy each of the Proposed Conditions (including these reporting requirements);
- “Creditworthiness Information”: a description of the manner in which each counterparty generally meets its financial obligations associated with non-cleared swaps by identifying one or more of the following categories, as applicable:
 - a written credit support agreement;
 - pledged or segregated assets (including posting or receiving margin pursuant to a credit support agreement or otherwise);
 - a written guaranty from another party;
 - the counterparty’s available financial resources; or
 - any other means.

Additionally, if a counterparty to such a swap is an issuer of securities registered under Section 12 or is required to file reports under Section 15(g) of the Securities Exchange Act of 1934 (such counterparty, a “SEC Filer”), the SEC Filer must:

- notify the SDR (or the CFTC) of its SEC Filer status by submitting its SEC Central Index Key number; and
- report to the SDR (or to the CFTC) that an appropriate committee of the board of directors (or equivalent body) of the SEC Filer has reviewed and approved the decision not to clear the swap.

While the Transaction Specific Information as described above must be provided on a swap-by-swap basis, the Creditworthiness Information and the additional information required of SEC Filers may be provided either on a swap-by-swap basis or in an annual filing in anticipation of electing this inter-affiliate clearing exemption for a swap or a group

of swaps. Throughout the 365-day period following such an annual filing, the affiliate would be required to amend the information as necessary to reflect any material changes to the reported information.³

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Please do not hesitate to contact us with any questions.

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³ In the Release, the CFTC notes that, for most corporate groups, it anticipates affiliates will submit identical annual reports.