

CLIENT UPDATE

TEMPORARY NO-ACTION RELIEF FOR SWAPS BETWEEN ELIGIBLE AFFILIATE COUNTERPARTIES

NEW YORK

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On March 6, 2014, the Division of Clearing and Risk (the “DCR”) of the Commodity Futures Trading Commission (the “CFTC”) issued a time-limited no action letter, extending the temporary alternative compliance frameworks available to “Eligible Affiliate Counterparties” (as defined in CFTC regulation 50.52(a)) to claim an exemption from the mandatory clearing swap requirements for swaps between such counterparties pursuant to CFTC regulations 50.52 from March 11, 2014 to December 31, 2014 (the “Clearing No-Action Letter”).¹ On the same day, the Division of Market Oversight (the “DMO”) issued a time-limited no-action letter, providing relief from the mandatory trade execution requirements to swaps between Eligible Affiliate Counterparties (the “Trading No-Action Letter”).²

THE CLEARING NO-ACTION LETTER

On April 11, 2013, the CFTC published a final rule³ providing an exemption from clearing requirement for swaps between certain

¹ CFTC Letter No. 14-25, dated March 6, 2014, <http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-25.pdf>

² CFTC Letter No. 14-26, dated March 6, 2014, <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/letter/14-26.pdf>

³ For more details on the Inter-Affiliate Exemption, see our client memorandum, “Final CFTC Rules on Clearing Exemption for Swaps Between Certain Affiliated Entities” <http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=2dc4b916-e5aa-40ad-be3d-681a597079d3>

Eligible Affiliate Counterparties⁴, subject to specific conditions (the “Inter-Affiliate Exemption”). Among the conditions was a requirement that each Eligible Affiliate Counterparty must comply with the clearing requirements for its outward-facing swaps under either section 2(h) of the Commodity Exchange Act (the “CEA”) or under a foreign jurisdiction’s clearing mandate that is comparable, and comprehensive but not necessarily identical, to the clearing requirements of section 2(h) of the CEA and Part 50, as determined by the CFTC (such requirement, the “Outward-Facing Swaps Condition”).

At the time the CFTC issued the Inter-Affiliate Exemption, no foreign jurisdiction had implemented a mandatory clearing regime; therefore, the CFTC provided for a temporary alternative compliance framework for Eligible Affiliate Counterparties located in Japan, the European Union and Singapore (i.e., jurisdictions that have adopted mandatory swap clearing regimes and are currently in the implementation phase) and another alternative framework for Eligible Affiliate Counterparties located in any other foreign jurisdictions. The temporary relief based on these two alternative compliance frameworks was scheduled to expire on March 11, 2014.

As of today, there still is no foreign jurisdiction with mandatory swap clearing regime so the DCR states in the Clearing No-Action Letter that an extension of the alternative compliance frameworks is warranted to permit an orderly transition period for foreign jurisdictions to continue with the implementation of their clearing regimes and to allow Eligible Affiliate Counterparties that enter into swaps that do not exceed a *de minimis* amount in jurisdictions that have not yet, or will not in the near future, implement such a clearing regime to come into compliance with the Outward-Facing Swaps Condition. Therefore, the DCR will not recommend that the CFTC commence an enforcement action against an entity that continues to rely on the two alternative compliance frameworks provided under CFTC regulations 50.52(b)(4)(ii) or 50.52(b)(4)(iii) until 11:59 pm (Eastern Time) on December 31, 2014, subject to certain conditions.

⁴ The counterparties to a swap are eligible affiliate counterparties if: (i)(a) one counterparty, directly or indirectly, holds a majority ownership interest in the other counterparty, and (b) the counterparty that holds the majority interest in the other counterparty reports its financial statements on a consolidated basis under Generally Accepted Accounting Principles (“GAAP”) or International Financial Reporting Standards (“IFRS”), and such consolidated financial statements include the financial results of the majority-owned counterparty; or (ii) (a) a third party, directly or indirectly, holds a majority ownership interest in both counterparties, and (b) the third party reports its financial statements on a consolidated basis under GAAP or IFRS, and such consolidated financial statements include the financial results of both of the swap counterparties. 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.

These conditions are:

- The Eligible Affiliate Counterparties claiming the Inter-Affiliate Exemption otherwise satisfy all of the requirements of CFTC regulation 50.52;
- A counterparty to the swap must not be located in a non-U.S. jurisdiction in which the CFTC has determined a comparable and comprehensive clearing requirement exists; and
- The Eligible Affiliate Counterparties electing the relief provided by the Clearing No-Action Letter shall promptly provide to the DCR, upon request, documentation regarding their compliance with any aspect of this no-action letter and CFTC regulation 50.52, including information regarding an entity's compliance with an alternative compliance framework.

THE TRADING NO-ACTION LETTER

The CEA requires, among other things, that transactions involving swaps subject to mandatory clearing requirement under CEA section 2(h)(1) be executed on a designated contract market (“DCM”) or swap execution facility (“SEF”) unless no DCM or SEF makes such swaps available to trade or such swaps qualify for a clearing exception under CEA section 2(h)(7) (the “Trade Execution Requirement”).⁵

In February, the International Swaps and Derivatives Association, Inc. (“ISDA”) sent a letter requesting the DMO to provide relief from the Trade Execution Requirement for inter-affiliate swaps that are subject to the mandatory clearing requirement. In the letter, ISDA asserts that applying the Trade Execution Requirement to inter-affiliate swaps, even those that must be cleared, conflicts with the reasons that affiliates execute transactions with one another and will impose unnecessary costs and inefficiencies without any related benefits. For example, ISDA explains that affiliates execute swaps that often are not intended to be arm's length, but instead are intended to manage risk between the affiliates. Further, requiring that inter-affiliate swaps be executed on a SEF or DCM would not promote the pre-trade price transparency and price discovery goals associated with the Trade Execution Requirement because affiliates are not primarily concerned with obtaining fully competitive pricing. ISDA also notes that certain required execution methods would not accommodate swap transactions between affiliates because executing a swap through an order book would not assure that the affiliates' quotes will be matched with one another as intended. Accordingly, ISDA is requesting no-action relief for inter-

⁵ For more information on the Trade Execution Requirement, see our client memorandum “Mandatory Exchange-Trading for Swaps” <http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=d494e9cb-5efb-4321-8759-7719c02ea690>

affiliate swaps to preserve the purposes for which affiliates enter into swaps with one another and to avoid imposing unnecessary challenges to swap-market participants.

The DMO acknowledges the issues and concerns raised by the ISDA letter, and it notes that swaps entered into by Eligible Affiliate Counterparties that elect and comply with the Inter-Affiliate Exemption of CFTC regulation 50.52 would not be subject to the Trade Execution Requirement. Nevertheless, to allow the DMO to continue to evaluate, based on ongoing observations of inter-affiliate swap activities both on and off SEFs and DCMs, whether such swaps should be subject to the Trade Execution Requirement, the DMO has issued the Trading No-Action Letter to grant time-limited no-action relief from the requirements of CEA section 2(h)(8) to Eligible Affiliate Counterparties that transact swaps with one another that involve swaps subject to the Trade Execution Requirement until 11:59 pm (Eastern Time) on December 31, 2014. Until then, the DMO will not recommend that the CFTC take enforcement action against any Eligible Affiliate Counterparty that executes a swap with another Eligible Affiliate Counterparty without complying with the Trade Execution Requirement.

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Please do not hesitate to contact us with any questions.

March 10, 2014