

# CLIENT UPDATE

## FINAL CFTC RULES ON CLEARING EXEMPTION FOR SWAPS BETWEEN CERTAIN AFFILIATED ENTITIES

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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) of the CEA, which requires certain swaps to be submitted for clearing to a derivatives clearing organization (“DCO”).

The Commodity Futures Trading Commission (the “CFTC”) is authorized under section 2(h)(2) of the CEA to determine from time to time that a particular swap or group, category, type or class of swaps is required to be cleared. As of today, mandatory clearing is limited to four classes of interest rate swaps and two classes of credit default swaps,<sup>1</sup> listed in section 50.4 of the CFTC regulations<sup>2</sup> (such six classes, together with any other swap or group, category, type or class of swaps that are required to be cleared in the future, “covered swaps”).

Covered swaps must be cleared on and after (i) March 11, 2013, when entered into between swap dealers (each, an “SD”), major swap

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<sup>1</sup> For a list of covered swaps, see Appendix B to our client memorandum, “Recent Developments Regarding CICI Requirements and Looming Deadlines for Compliance by End-Users of Swaps”  
<http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=a80a0ca5-96ee-42e9-95b5-0098fb68ef32>

<sup>2</sup> Unless otherwise specified, all section references are to sections of the CFTC regulations.

participants (each, an “MSP”) or active funds,<sup>3</sup> (ii) June 10, 2013, when entered into between commodity pools, private funds or persons predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature under section 4(k) of the Bank Holding Company Act, other than third-party subaccounts, or between such parties and SDs, MSPs or active funds and (iii) September 9, 2013 when entered into between all other entities not electing an exception from clearing under section 2(h)(7) of the CEA, including third-party subaccounts and ERISA plans.

In response to numerous comments requesting a clearing exemption for inter-affiliate swaps, on August 21, 2012, the CFTC proposed rules to exempt swaps between certain affiliated entities within a corporate group from clearing subject to certain conditions (the “Proposed Rules”). On April 1, 2013, the CFTC adopted final rules to exempt swaps between certain affiliated entities (the “Final Rules”) with certain modifications to and clarifications from the Proposed Rules.

The Final Rules will become effective 60 days following their publication in the Federal Register. However, in the adopting release accompanying the Final Rules (the “Release”), the CFTC provides that until the Final Rules become effective, the clearing requirement under section 2(h)(1)(A) of the CEA and part 50 of the CFTC regulations (“Part 50”) shall not apply to a swap executed between parties that are “eligible affiliate counterparties” (as defined in the Final Rules) and elect not to clear such swap.

The text of the Final Rules can be found at

<http://cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister040113.pdf>.

## **ELIGIBLE AFFILIATE COUNTERPARTIES FOR INTER-AFFILIATE SWAP CLEARING EXEMPTION**

Subject to certain conditions (the “Clearing Conditions”), the Final Rules permit two affiliated counterparties to elect not to clear a swap if they are both “eligible affiliate counterparties.” The counterparties to a swap are eligible affiliate counterparties if:

- (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

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<sup>3</sup> Since security-based swap dealers and major security-based swap participants were not yet required to register with the Securities and Exchange Commission at the time that the CFTC issued its clearing determination for covered swaps, they are subject to the June 10, 2013 compliance date.

Standards (“IFRS”), and such consolidated financial statements include the financial results<sup>4</sup> of the majority-owned counterparty; or

- (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.

### **CONDITIONS FOR INTER-AFFILIATE SWAP CLEARING EXEMPTION**

To qualify for this clearing exemption, the CFTC requires the eligible affiliate counterparties to a covered swap to satisfy the following Clearing Conditions:

- both counterparties elect not to clear the swap;
- the counterparties document the terms of the swap, as further described below;
- the swap is subject to a centralized risk management program that is reasonably designed to monitor and manage the risks associated with the swap, as further described below;
- when entering into a covered swap with an unaffiliated counterparty, each eligible affiliate counterparty:
  - complies with the clearing requirements under section 2(h) of the CEA,
  - complies with clearing requirements under a foreign jurisdiction’s clearing mandate, subject to certain determinations by the CFTC,
  - complies with an exception or exemption from clearing under section 2(h)(7) of the CEA<sup>5</sup> or Part 50,
  - complies with an exception or exemption from clearing under a foreign jurisdiction’s clearing mandate, subject to certain determinations by the CFTC, or

<sup>4</sup> In the Release, the CFTC clarifies that the term “financial results” in this context refers to financial statements, reports or other material of the majority-owned counterparty or counterparties that must be consolidated with the majority owner’s financial statements.

<sup>5</sup> Section 2(h)(7) of the CEA provides an exception to the clearing requirement when one of the counterparties to a swap (1) is not a financial entity, (2) is using the swap to hedge or mitigate commercial risk and (3) notifies the CFTC how it generally meets its financial obligations associated with entering into uncleared swaps.

- clears such swap through a registered DCO or a clearing organization that is subject to supervision by appropriate government authorities in the home country of the clearing organization and has been assessed to be in compliance with the Principles of Financial Market Infrastructures (“PFMIs”);<sup>6</sup> and
- the counterparties comply with certain reporting requirements with respect to the swap.

## WRITTEN DOCUMENTATION OF SWAP TRANSACTION

The Final Rules require eligible affiliate counterparties to enter into a written swap trading relationship document that includes all terms governing the trading relationship between the counterparties. In contrast to the Proposed Rules, the CFTC has eliminated a non-exclusive list of contractual terms that must be specified in the inter-affiliate swap document.<sup>7</sup> In the Release, the CFTC notes that this more general rule formulation signals that market participants retain the flexibility to craft appropriate documentation for their affiliated entities.

Further, in the Release, the CFTC notes that affiliates may use a master agreement to document the terms of their inter-affiliate swaps, but are not obligated to use the ISDA Master Agreement or any other master agreement.

If one of the eligible affiliate counterparties is an SD or MSP, the documentation condition will be satisfied by that party’s compliance with section 23.504, which requires all SDs and MSPs to document their swap transactions in written swap trading relationship documents.<sup>8</sup>

## CENTRALIZED RISK MANAGEMENT

The Final 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

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<sup>6</sup> As described below, the Final Rules provide certain alternative compliance frameworks for circumstances in which one of the eligible affiliate counterparties is located in the European Union, Japan or Singapore, on the one hand, or another foreign jurisdiction, on the other.

<sup>7</sup> The enumerated terms for which documentation would have been required under the Proposed Rules include payment obligations, netting of payments, transfer of rights and obligations, governing law, valuation and dispute resolution.

<sup>8</sup> In the Release, the CFTC clarifies that for swaps between affiliates where one or both of the affiliates is an SD or MSP, the confirmation rules under section 23.501 are incorporated into section 23.504. Therefore, such affiliates must confirm all the terms of their transactions according to the applicable timeframes set forth under section 23.501. By contrast, for swaps between non-SD/MSPs, the provisions of section 23.501 do not apply and formal confirmation is not required. However, the CFTC notes that the terms of the swap will be documented by the affiliates and confirmation of those terms will be reported to a swap data repository under the CFTC’s reporting rules.

swaps. If at least one of the eligible affiliate counterparties is an 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 clarifies that this centralized risk management requirement is intended to be flexible with respect to non-SD/MSPs and does not require the same level of policies and procedures as required under the CFTC's internal business conduct rules for SDs and MSPs. The CFTC further clarifies that under the Final Rules, a company is free to structure its centralized risk management program according to its unique needs as long as the program reasonably monitors and manages the risks associated with its uncleared inter-affiliate swaps. Finally, the CFTC notes that in all likelihood, if a corporate group already has a centralized risk management program in place that reasonably monitors and manages the risks associated with its inter-affiliate swaps as part of current industry practice, it is likely that the program will fulfill the centralized risk management requirement.

### **NO VARIATION OR INITIAL MARGIN**

In contrast to the Proposed Rules, the CFTC has determined not to require variation or initial margin as a condition for electing the inter-affiliate exemption in the Final Rules.

### **OUTWARD-FACING SWAPS CONDITION**

In order to deter evasion of the clearing requirement as required by the CEA, the Final Rules provide that each counterparty that enters into a covered swap with an unaffiliated counterparty must comply with one of the following five requirements (collectively, the "outward-facing swaps condition") with respect to such swap.

- Such eligible affiliate counterparty must comply with the clearing requirements under section 2(h) of the CEA with respect to such outward-facing swap.
- Such eligible affiliate counterparty must comply with the clearing requirements for such outward-facing swap 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 (the "Comparable Foreign Mandate Requirement").

In the Release, the CFTC reiterates that, in determining whether the Comparable Foreign Mandate Requirement is satisfied, it will not require an identical regime to the U.S. clearing framework. Instead, the CFTC anticipates making a jurisdiction-specific

comparability determination by comparing the regulatory requirements of a foreign jurisdiction's clearing regime with the requirements and objectives of the Dodd-Frank Act. The CFTC notes that it anticipates that the product-specific comparability determination will be made on the basis of whether the applicable swap is included in a class of covered swaps.

- Such eligible affiliate counterparty must comply with an exception or exemption under section 2(h)(7) of the CEA or Part 50.
- Such eligible affiliate counterparty must comply with an exception or exemption under a foreign jurisdiction's clearing mandate. However, in order to rely on an exception or exemption under a foreign jurisdiction's clearing mandate to satisfy the outward-facing swaps condition, the Comparable Foreign Mandate Requirement must be satisfied and the exception or exemption must be comparable to an exception or exemption under section 2(h)(7) of the CEA or Part 50, in each case as determined by the CFTC.

In the Release, the CFTC notes that, in determining whether an exemption or exception under a comparable foreign clearing mandate is comparable to an exception or exemption under the CEA or Part 50, the CFTC anticipates that it would review the foreign jurisdiction's laws and regulations with respect to its mandatory clearing regime, as well as the relevant exception or exemption. In doing so, the CFTC would exercise broad discretion to determine whether the requirements and objectives of such exemption or exception are consistent with those under the Dodd-Frank Act and that such objectives are being met. The CFTC indicates in the Release that it therefore expects that comparability determinations with respect to a foreign jurisdiction's exemption or exception from clearing could be made at either the entity level or based on the transaction type, as appropriate.

- Such eligible affiliate counterparty must clear the outward-facing swap through a registered DCO or a clearing organization that is subject to supervision by appropriate government authorities in the home country of the clearing organization and has been assessed to be in compliance with PFMI. <sup>9</sup>

In response to comments seeking additional clarity as to the CFTC's comparability determination process, the CFTC clarifies in the Release that it will review the

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<sup>9</sup> In the Release, the CFTC notes that if an eligible affiliate counterparty that is not located in the United States or in a comparable and comprehensive jurisdiction prefers to clear its covered swaps pursuant to the clearing requirement regime in the United States or in a comparable and comprehensive jurisdiction, rather than clearing its covered swaps through a clearing organization that has been assessed to be in compliance with PFMI, it may do so.

comparability and comprehensiveness of a foreign jurisdiction's clearing mandate by reviewing:

- the foreign jurisdiction's law and regulations with respect to its mandatory clearing regime (i.e., jurisdiction-specific review), and
- the foreign jurisdiction's clearing determinations with respect to each class of covered swaps (i.e., product-specific review).

In response to comments seeking clarification as to what will trigger a CFTC comparability determination, the CFTC states in the Release that it anticipates rendering jurisdiction-specific and product-specific comparability determinations: (1) upon the adoption of clearing regimes in foreign jurisdictions for classes of covered swaps, (2) upon the request of a counterparty that is located in a foreign jurisdiction or (3) upon receipt of a request from another appropriate party.

The CFTC indicates in the Release that it anticipates that once a comparability determination is made with respect to a foreign jurisdiction's clearing regime, and with respect to a particular class of covered swaps, eligible affiliates domiciled in such jurisdiction may rely on such determination without further CFTC action.

Additionally, the CFTC states in the Release that, to the extent the CFTC proposes a change to its regulations governing the clearing requirement generally or with respect to any particular product class, it will reevaluate whether the proposed change would affect the basis upon which the CFTC made the comparability determination and, to the extent there are any discrepancies between the foreign jurisdiction and the proposed change, the CFTC anticipates that it would issue additional guidance or notifications to market participants to determine how affected entities may address such discrepancy.

## **TIME-LIMITED ALTERNATIVE COMPLIANCE FRAMEWORKS**

In addition to the modifications of the Proposed Rules described above, the Final Rules also provide a transition period with alternative compliance frameworks, in response to concerns raised by commenters regarding the timing and sequencing of the implementation of the inter-affiliate exemption.<sup>10</sup>

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<sup>10</sup> Specifically, commenters noted that the comparability requirement in the Proposed Rules was dependent upon the adoption of clearing regimes by other jurisdictions, and that since the U.S. clearing requirement is likely to take effect before other jurisdictions finalize their clearing regimes, non-U.S. affiliates effectively would not be able to rely on the inter-affiliate exemption when the CFTC's initial requirement takes effect.

### *Eligible Affiliate Counterparties in Japan, the European Union and Singapore*

For eligible affiliate counterparties located in Japan, the European Union and Singapore (jurisdictions that have adopted mandatory swap clearing regimes and are currently in the implementation phase), the Final Rules provide a transition period of 12 months from the first compliance date of the U.S. clearing mandate, until March 11, 2014. During that one-year period, affiliates domiciled in such foreign jurisdictions may satisfy the outward-facing swaps condition through the following:

- each eligible affiliate counterparty, or a third party that directly or indirectly holds a majority interest in both eligible affiliate counterparties, pays and collects full variation margin daily on all swaps entered into between the eligible affiliate counterparty located in the European Union, Japan or Singapore and an unaffiliated counterparty; or
- each eligible affiliate counterparty, or a third party that directly or indirectly holds a majority interest in both eligible affiliate counterparties, pays and collects full variation margin daily on all of the eligible affiliate counterparties' swaps with other eligible affiliate counterparties.

Additionally, the Final Rules provide that if one of the eligible affiliate counterparties is located in the European Union, Japan or Singapore, the outward facing swaps condition does not apply to such counterparty until March 11, 2014, provided that:

- the counterparty that holds a majority interest in the other counterparty or a third party that holds a majority interest in both counterparties is not a "financial entity" as defined in section 2(h)(7)(C)(i) of the CEA;<sup>11</sup> and
- neither eligible affiliate counterparty is affiliated with an entity that is an SD or MSP.<sup>12</sup>

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<sup>11</sup> In the Release, the CFTC notes that, for purposes of satisfying this requirement until March 11, 2014, the holding company (i.e., the ultimate parent of the corporate group) may not be considered to be a financial entity under certain circumstances. The holding company must identify all affiliates that meet the requirements of the eligible affiliate counterparty definition. Of those identified, a predominant number must qualify for the end-user exception under section 50.50. If those conditions are satisfied, the holding company may treat the activities of all of its affiliates meeting the requirements of the eligible affiliate counterparty definition as if the holding company was engaged directly in such activities and consider such affiliates' activities on a cumulative basis with the holding company's other activities when assessing whether the holding company 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" under section 2(h)(7)(C)(i)(VIII) of the CEA. Thus, for purposes of determining whether a holding company is predominantly engaged in activities that are in the business of banking or are financial in nature, the activities of its subsidiaries will be attributed to it.

<sup>12</sup> In the Release, the CFTC notes that this condition is consistent with comments requesting that the exchange of variation margin requirement, to the extent retained, be limited to SDs and MSPs.

In the Release, the CFTC notes that while this temporary alternative compliance framework is limited to jurisdictions that currently have the legal authority to adopt mandatory clearing regimes, any jurisdiction that later adopts such a regime will be eligible for a comparability determination for purposes of the Final Rules.

### *Eligible Affiliate Counterparties Located in Other Foreign Jurisdictions*

For eligible affiliate counterparties that are located in foreign jurisdictions other than the European Union, Japan or Singapore, the Final Rules provide another temporary alternative compliance framework for satisfying the outward-facing swaps condition.

Specifically, if an eligible affiliate counterparty located in the United States enters into covered swaps with eligible affiliate counterparties located in jurisdictions other than the United States, the European Union, Japan and Singapore, and the aggregate notional value of such covered swaps does not exceed five percent of the aggregate notional value<sup>13</sup> of all covered swaps held by such U.S. counterparty, then the swaps will be deemed to satisfy the outward-facing swaps condition until March 11, 2014, provided that:

- each eligible affiliate counterparty, or a third party holding a majority interest in both such eligible affiliate counterparties, pays and collects full variation margin daily on all swaps entered into between the eligible affiliate counterparties located in the foreign jurisdiction (other than the European Union, Japan and Singapore) and an unaffiliated counterparty; or
- each eligible affiliate counterparty, or a third party holding a majority interest in both such counterparties, pays and collects full variation margin daily on all of such counterparties' swaps with other eligible affiliate counterparties.

In the Release, the CFTC clarifies that eligible affiliate counterparties that are eligible to comply with either of the two alternative compliance frameworks set forth above and choose to pay and collect variation margin daily on either all of their inter-affiliate swaps or all of their third-party swaps will have flexibility in tailoring their daily variation margin arrangements, including with respect to establishing appropriate prices for purposes of marking to market and threshold levels at which margin will be settled.

In the Release, the CFTC notes that, notwithstanding these alternative compliance frameworks, the CFTC believes that the requirement that eligible affiliates clear swaps entered into with unaffiliated counterparties is the most appropriate method in which to

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<sup>13</sup> The Final Rules provide that the notional value for this purpose will be measured in each instance in U.S. dollar equivalents and calculated for each calendar quarter.

prevent evasion of the clearing requirement and to help protect the U.S. financial markets and encourages all eligible affiliate counterparties to clear such swaps on a voluntary basis in order to best mitigate risks.

Notably, the CFTC declined to limit the outward-facing swaps condition or the alternative compliance frameworks described above to SDs and MSPs, noting that the mandatory clearing requirement of section 2(h)(1)(A) of the CEA applies to all market participants not able to elect an exception under section 2(h)(7) of the CEA, not just to SDs and MSPs.

### **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. Under the Final Rules, where the inter-affiliate clearing exemption is elected, the reporting counterparty to such a swap (determined in accordance with section 45.8) must provide an SDR, or the CFTC if no SDR is available to receive such information, the following:

- *“Transaction Specific Information”*: confirmation that both eligible affiliate counterparties to the swap are electing not to clear the swap and each counterparty satisfies the Clearing Conditions applicable to it;
- *“Creditworthiness Information”*: a description of the manner in which each counterparty generally meets its financial obligations associated with uncleared 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 electing counterparty’s available financial resources; or
  - any other means.
- *“SEC Filer Additional Information”*: 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(d), of the Securities Exchange Act of 1934 (such counterparty, an “SEC Filer”), the SEC Filer must provide:
  - its SEC Central Index Key number; and

- an acknowledgement that an appropriate committee of the board of directors (or equivalent body) of the SEC Filer has reviewed and approved the decision to enter into swaps that are exempt from the clearing requirement, under section 2(h)(1) of the CEA, and the requirement that covered swaps be executed on a designated contract market or swap execution facility, under section 2(h)(8) of the CEA.

While the Transaction Specific Information as described above must be provided on a swap-by-swap basis, the Creditworthiness Information and the SEC Filer Additional Information 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 only be required to amend the information as necessary to reflect any material changes to the reported information.

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Please feel free to contact us with any questions.

April 4, 2013