CLIENT UPDATE

NO-ACTION RELIEF FROM CLEARING REQUIREMENT FOR SWAPS ENTERED INTO BY CERTAIN TREASURY AFFILIATES

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On June 4, 2013 the Division of Clearing and Risk (the "Division") of the Commodity Futures Tradingc Commission (the "CFTC") issued a no-action letter[1] granting relief to certain eligible treasury affiliates (as defined below) from the clearing requirement in section 2(h)(1) of the Commodity Exchange Act (the "CEA") and section 50.4 of the regulations of the CFTC (the "Regulations") for swaps entered into by such treasury affiliates on behalf of non-financial entities within a corporate group, subject to certain conditions.

BACKGROUND

Section 2(h)(1)(A) of the CEA requires certain swaps to be submitted for clearing to a derivatives clearing organization. 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, listed in Regulation 50.4 (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").

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1 CFTC Letter No. 13-22, dated June 4, 2013, http://www.cftc.gov/PressRoom/PressReleases/pr6598-13

Section 2(h)(7) of the CEA and 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, (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.

Additionally, Regulation 50.52(a) provides an exemption (the "inter-affiliate swap clearing exemption") from the clearing requirement for swaps between certain affiliated entities, subject to several conditions.[2]

Absent further action by the CFTC, starting on June 10, 2013, all commodity pools, private funds and 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 (collectively, "Category 2 Entities"), will be required to clear all of their covered swaps for which they cannot claim the end-user exception or the inter-affiliate swap clearing exemption.[3] In all likelihood, a treasury affiliate will be a Category 2 Entity.

REQUESTS FOR RELIEF

The Division received a number of inquiries from market participants requesting relief from the clearing requirement for swaps entered into by entities that meet the definition of "financial entity" solely under section 2(h)(7)(C)(i)(VIII) of the CEA because they are "predominantly engaged in activities . . . that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956," when such financial entities are acting on behalf of non-financial affiliates within a corporate group that would otherwise be eligible for the end-user exception when entering into swaps with unaffiliated counterparties or with another treasury affiliate.

While the CFTC has noted that a financial entity acting solely on behalf of and as agent for an affiliate that satisfies the criteria for the end-user exception is deemed to satisfy the statutory criteria for "acting on behalf of the person and as an agent" and therefore may itself qualify for the end-user exception pursuant to section 2(h)(7)(D)(i) of the CEA, [4]

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[2] 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

[3] The June 10, 2013 compliance date applies to covered swaps between two Category 2 Entities or between a Category 2 Entity and a swap dealer, major swap participant or active fund.

[4] Section 2(h)(7)(D)(i) provides that an affiliate of a person that qualifies for the end-user exception may qualify for the exception only if the affiliate, acting on behalf of the person and as agent, uses the swap to hedge or mitigate the commercial risk of the person or other non-financial entity affiliate of the person.

commenters indicated that treasury affiliates often enter into swaps on behalf of non-financial affiliates as principal to the swap and not as agent.

Commenters therefore requested relief from required clearing for swaps entered into by treasury affiliates if the swaps hedge or mitigate commercial risk of non-financial entity affiliates. Commenters represented that many non-financial companies execute a significant portion of their swaps through a wholly-owned treasury affiliate that hedges risks for the consolidated non-financial company by, among other things, entering into swaps on behalf of non-financial entity affiliates, and that the treasury affiliate often serves as the primary external market-facing entity for the entire corporate group.

NO-ACTION RELIEF

Generally

In the no-action letter, the Division states that it will not recommend that the CFTC commence an enforcement action against an eligible treasury affiliate (an "ETA") for its failure to clear a covered swap entered into with an unaffiliated counterparty or another ETA, subject to certain conditions discussed below.[5]

Eligible Treasury Affiliates

The no-action relief is available to an "eligible treasury affiliate," which is defined as a person that meets the following qualifications:

- The person is (1) directly, wholly-owned [6] by a non-financial entity or another ETA (its "non-financial parent"), and (2) is not indirectly majority-owned[7] by a financial entity, as defined in section 2(h)(7)(C)(i) of the CEA;
- The top-most, direct or indirect, majority owner of the person in the corporate hierarchy (the person's "ultimate parent") (1) is not a financial entity, as defined in section 2(h)(7)(C)(i) of the CEA and (2) is able to identify all of its wholly- and majority-

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5 A covered swap between an ETA and an affiliate that is using the swap to hedge or mitigate its commercial risk will not be required to be cleared in reliance on the end-user exception if the conditions for such exception are satisfied. See our client memorandum on the end-user exception http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=55afe714-de09-4954-9cb1-2de1baf17a52

6 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 (if the entity is a partnership), 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.

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

owned affiliates and, of those identified affiliates, a majority qualify for the end-user exception;

- The person is a financial entity as defined in section 2(h)(7)(C)(i)(VIII) of the CEA[8] solely as a result of acting as principal to swaps with, or on behalf of, one or more non-financial entities that are, or are directly or indirectly wholly- or majority-owned by, the ultimate parent, or persons that are ETAs for such entities ("related affiliates"), or providing 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, a major security-based swap participant or a nonbank financial company that has been designated as systemically important by the Financial Stability Oversight Council; and
- 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; or (8) 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.

Conditions

In order to rely on the no-action relief described above with respect to a swap (an "exempted swap"), the following conditions must be satisfied:

General Conditions to the Swap Activity

- The ETA must enter into the exempted swap for the sole purpose of hedging or mitigating the commercial risk[9] of one or more related affiliates that was transferred to the ETA by operation of one or more swaps with such related affiliates;

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8 The CFTC notes that market participants that otherwise meet the conditions of this no-action relief, for the sole purpose of determining whether they are "predominantly engaged in financial activities" and are therefore eligible for such relief, may look to the final rule recently issued by the Board of Governors of the Federal Reserve System establishing the requirements for determining whether a company is "predominantly engaged in financial activities." See 78 FR 20756 (Apr. 5, 2013).

9 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)).

- 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;
- Neither any related affiliate that enters into swaps with the ETA nor the ETA may enter into swaps with or on behalf of any affiliate that is a financial entity ("financial affiliate"), or otherwise assume, net, combine or consolidate the risk of swaps entered into by any financial affiliate;
- Each swap entered into by the ETA must be subject to a centralized risk management program reasonably designed to monitor and manage the risks associated with the swap; and
- The ETA's payment obligations on the exempted swap must be guaranteed by its non-financial parent, an entity that wholly-owns or is wholly-owned by its non-financial parent, or the related affiliates for which the swap hedges or mitigates commercial risk.

Reporting Conditions

With respect to each swap that an ETA ("electing counterparty") elects not to clear in reliance on the no-action relief described above, beginning on September 9, 2013, the reporting counterparty (as determined under Regulation 45.8) must provide or cause to be provided the following information to a registered swap data repository (an "SDR") or, if no registered SDR is available to receive the information, to the CFTC, in the form and manner specified by the CFTC:

- **Notice of Election:** Notice of the election of the relief and confirmation that the electing counterparty satisfies each of the General Conditions to the Swap Activity listed above;
- **Financial Obligations Information:** 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:
  - a written credit support agreement;
  - pledged or segregated assets (including posting or receiving margin pursuant to a credit support agreement or otherwise);
  - a written guarantee from another party;
  - the electing counterparty's available financial resources; or
  - any other means.

- **SEC Information and Acknowledgment:** 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:
  - the relevant SEC Central Index Key number for such counterparty; and
  - 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 and, if applicable, the trade execution requirement under section 2(h)(8) of the CEA.

If there is more than one electing counterparty to a swap, the information specified in the Reporting Conditions listed above must be provided with respect to each of the electing counterparties.

An entity that qualifies for the foregoing relief may report the Financial Obligations Information and the SEC Information and Acknowledgment annually in anticipation of electing the relief for one or more swaps. Any such reporting will be effective for 365 days following the date of such reporting. During that period, the entity must amend the report to reflect any material changes to the information reported.

Finally, each reporting counterparty must have a reasonable basis to believe that the electing counterparty meets the General Conditions to the Swap Activity listed above.

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Please do not hesitate to contact us with any questions.

June 7, 2013