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Capital Markets/Derivatives

May 2013

CFTC Approves Final Regulations Governing Clearing Exemption for Swaps Between Certain Affiliated Entities and Provides No-Action Relief From Certain Reporting Requirements for Certain Inter-Affiliate Swaps

On April 1, 2013, the Commodity Futures Trading Commission ("CFTC") approved a final rule (Regulation 50.52) exempting swaps between certain affiliated entities from the clearing requirements of the Commodity Exchange Act ("CEA") and CFTC regulations. This rule will become effective on June 10, 2013.¹ Additionally, on April 5, 2013, the CFTC issued a no-action relief letter, having immediate effect, exempting parties from certain reporting requirements in connection with intra-group swaps, subject to certain conditions discussed below.

Clearing Requirement

Section 723(a)(3) of the Dodd-Frank Wall Street Reform and Consumer Protection Act amended the CEA making it unlawful for any person to engage in a swap unless that person submits the swap to a derivatives clearing organization ("DCO") that is either registered or exempt from registration under the CEA, if the swap is required to be cleared. A swap is required to be cleared if it is accepted for clearing by a DCO and the CFTC has determined that the swap must be cleared. End-users currently have a clearing exception, if they satisfy certain requirements; however, most other market participants remain subject to the mandatory clearing requirement. This new rule approved by the CFTC offers a new clearing exemption. Specifically, this final rule exempts swaps between certain affiliated entities within a corporate group ("inter-affiliates") from the clearing requirement.

Exemption for Swaps Between Affiliates: 17 C.F.R. § 50.52

Affiliated counterparties to a swap may elect not to clear a swap as required by 2(h)(1)(A) of the CEA subject to certain conditions. To be considered an "eligible affiliate counterparty" that may elect not to clear a swap subject to the clearing requirement, the following requirements must be satisfied: (1) one counterparty must directly or indirectly hold a majority ownership interest in the other counterparty or a third-party directly or indirectly holds a majority ownership interest in both counterparties; and (2) the affiliated counterparties financial statements, including the results of both swap counterparties, must be reported on a consolidated basis under GAAP or IFRS. A party directly or indirectly holds a majority ownership interest if it directly or indirectly holds a majority of the equity securities of an entity or the right to receive upon dissolution, or the contribution of, a majority of the capital of a partnership.



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¹ Note: June 10, 2013 is the compliance date for December 13 clearing determination for Category 2 entities (commodity pools and private funds).

The exemption is premised on the following conditions:

- First, both counterparties must elect not to clear the swap.
- Second, Swap Dealers (“SDs”) and Major Swap Participants (“MSPs”) must satisfy the requirements of 17 C.F.R. § 23.504 or if neither counterparty is an SD or MSP, the terms of the swap must be documented in writing and include all the terms governing the trading relationship between the counterparties.
- Third, the swap must be subject to a centralized risk management program reasonably designed to manage and monitor the risk of the swap. For SDs and MSPs, this requirement is satisfied by complying with 17 C.F.R. § 23.600. For non-SDs and non-MSPs, the requirements are more flexible and do not require the same level of procedures as required for SDs and MSPs. The CFTC confirmed that a company is free to structure its risk management program according to its individual needs so long as the program monitors and manages the risks associated with its uncleared inter-affiliate swaps. Corporate groups with existing centralized risk management programs established to monitor and manage inter-affiliate swap risk as part of current industry practice are likely sufficient to comply with this new regulation.

The CFTC was concerned that the inter-affiliate swap clearing exemption could lead to the transfer of swap activity to foreign affiliates as a means of circumventing US clearing requirements. The CFTC, therefore, also imposed rules governing swaps between an eligible affiliate counterparty and non-affiliated counterparties. For swaps that are required to be cleared and are entered into between an eligible affiliate counterparty and an unaffiliated counterparty, the following conditions below must be satisfied. The eligible affiliate counterparty must:

- Comply with the requirements of Section 2(h) of the CEA
- Comply with a foreign jurisdiction’s clearing requirements that are comparable and comprehensive to the requirements of Section 2(h) of the CEA, as determined by the CFTC
- Comply with an exception or exemption under Section 2(h)(7) of the CEA or 17 C.F.R. pt. 50
- Comply with a foreign jurisdiction’s exception or exemption provided the *clearing requirement* is comparable and comprehensive to Section 2(h) of the CEA or 17 C.F.R. pt. 50 and the *exception or exemption* is comparable and comprehensive to Section 2(h)(7) of the CEA or 17 C.F.R. pt. 50, each as determined by the CFTC or
- Clear such swap through a registered DCO subject to appropriate governmental supervision in the home country of the clearing organization and that has been assessed to be in compliance with the Principles for Financial Market Infrastructures

Generally, parties to an outward-facing swap may comply with the CFTC clearing requirements by complying with a foreign jurisdiction’s clearing regulations, provided those regulations are comparable, if not identical, to the CFTC clearing requirement. Likewise, if the parties rely on an exemption to the CFTC clearing requirement, the foreign jurisdiction’s exemption must be comparable, if not identical, to the CFTC exemption. The result of this being that eligible affiliated counterparties may need to clear swaps outside the United States that would not be subject to mandatory clearing in the United States if a comparable exemption is not available in the foreign jurisdiction.

Reporting Requirements

Affiliated counterparties relying on this inter-affiliate exemption remain subject to certain reporting requirements. When electing to use this inter-affiliate exemption, the reporting counterparty is required to provide certain information to a registered swap data repository (“SDR”) or if no registered SDR is available to the CFTC, in the form and manner specified by the CFTC.

- The reporting counterparty must provide confirmation that both counterparties to the swap are electing not to clear the swap and that they each satisfy the conditions of the exemption.
- The reporting counterparty must provide information on how the counterparty generally meets its financial obligations associated with entering into non-cleared swaps.
- If the reporting counterparty 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, it must provide the relevant SEC Central Index Key number as well as an acknowledgement that an appropriate board of directors, or equivalent body, of the counterparty has reviewed and approved the decision to enter into swaps exempt from the requirements of Sections 2(h)(1) and 2(h)(8) of the CEA.

These latter two reporting requirements may be submitted on an annual basis and will be effective for 365 days from the date of such reporting.

No-Action Relief Letter

On April 5, 2013, the Division of Market Oversight and the Division of Clearing and Risk issued CFTC Letter 13-09 granting conditional no-action relief to certain entities (other than SDs or MSPs) from certain reporting obligations under Part 45 and Part 46 of the Commission’s regulations and the reporting requirements related to the end-user exception from required clearing under regulation 50.50(b) with respect to certain intra-group swaps. Note, this no-action relief is not available to entities relying on the inter-affiliate swap-clearing exemption described above; the reporting requirements of that rule apply in those circumstances.

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The Divisions are granting relief from reporting requirements of Part 45 and the end-user exception to mandatory clearing for intra-group swaps involving *wholly owned* affiliated counterparties, that are neither SDs or MSPs nor affiliated with an SD, MSP or systemically important financial institution (“SIFI”), provided:

- The swap is not executed on a trading facility or submitted for clearing
- All outward-facing swaps with unaffiliated counterparties are reported to an SDR registered with the CFTC and
- The reporting counterparties retain records of the intra-group swaps and maintain as part of these records, internally generated swap identifiers for each swap

The Divisions also are granting relief from reporting requirements of Part 45 and the end-user exception to mandatory clearing for intra-group swaps involving *majority-owned* affiliates. Reporting for swaps between majority-owned affiliates will be permitted on a quarterly basis, subject to similar conditions as applicable to wholly owned affiliates.

No-action relief is also provided to wholly owned and majority-owned affiliates that are not SDs, MSPs or SIFIs from certain historical swap data reporting for intra-group swaps to an SDR under Part 46, subject to conditions substantively similar to those outlined above.

We note the requirement that outward-facing swaps with unaffiliated counterparties must be reported to an SDR registered with the CFTC. Unless alternative means are offered for complying with this requirement in the cross-border context, this would force the reporting of swaps between two non-US counterparties to a registered SDR in the event one of these non-US counterparties also enters into a related inter-affiliate swap with a US affiliate and wishes to take advantage of this no-action relief.

Conclusion

This final rule and no-action relief offers a limited reprieve from the CFTC’s mandatory clearing and reporting requirements. While the goal is to ease the burden of these requirements, the relief is not available in all circumstances. The overall effectiveness of the relief provided remains to be seen.

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