

July 30, 2012

CFTC Finalizes End-user Exception to the Clearing and Trade Execution Requirement for Swaps

On July 19, 2012, the Commodity Futures Trading Commission (“**CFTC**”) published a final rule (the “**Final Rule**”) clarifying the end-user exception to the mandatory swap clearing requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “**Dodd-Frank Act**”).¹ A non-financial entity may elect to except from the clearing requirements of the Dodd-Frank Act any swap entered into for the purpose of hedging or mitigating commercial risk. The Final Rule clarifies which entities qualify for the end-user exception, establishes criteria for determining whether a swap hedges or mitigates commercial risk and specifies the information that must be reported to the CFTC with respect to each excepted swap. Companies with reporting obligations under the Securities Exchange Act of 1934 will require board approval to elect the end-user exception. The Securities and Exchange Commission will separately issue regulations clarifying the end-user exception to the mandatory clearing requirements with respect to security-based swaps.

Background

Section 2(h)(1)(A) of the Commodity Exchange Act (“**CEA**”) makes it unlawful to engage in any swap that the CFTC requires to be cleared, unless the swap is submitted to a registered clearing organization to be cleared. Section 2(h)(7)(A) of the CEA provides an exception to the clearing requirement (the “**End-User Exception**”) if:

- (1) one of the parties to the swap is not a financial entity,
- (2) such party enters into the swap to hedge or mitigate commercial risk, and
- (3) such party notifies the CFTC, in a manner set forth by the CFTC, how it generally intends to meet its financial obligations under non-cleared swaps.

The End-User Exception is intended to permit non-financial swap counterparties to continue to enter into swaps to hedge risks associated with their underlying business without the potentially burdensome obligations that accompany central clearing of swaps. The Final Rule clarifies the conditions a swap counterparty must meet in order to be able to avail itself of the End-User Exception.

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¹ 77 FR 42560 (July 19, 2012) (17 C.F.R. Part 39 – End-User Exception to the Clearing Requirement for Swaps), available at <http://www.cftc.gov/ucm/groups/public/@lfederalregister/documents/file/2012-17291a.pdf>.

Non-Financial Entity

The End-User Exception is available to non-financial entities and small banking institutions² only. Non-financial entities generally include end-users that are not swap dealers, major swap participants, private funds, ERISA funds and entities primarily engaged in the business of banking.³

Affiliates of non-financial entities that enter into a swap on behalf of, or as agent for, a non-financial entity, may elect to make use of the End-User Exception with respect to any swap that otherwise meets the requirements of the End-User Exception, even if the affiliate entering into the swap is a financial entity.⁴

Hedging or Mitigating Commercial Risk

The Final Rule sets out the criteria for what constitutes hedging or mitigating commercial risk for purposes of the End-User Exception. A swap hedges or mitigates commercial risk if:

- the swap is economically appropriate to the management or reduction of risks of a commercial enterprise associated with:
 - the change in value (or the reasonable anticipation of change in value) of assets or inputs owned, produced, processed, manufactured or merchandised in the ordinary course of business of the commercial enterprise,
 - the change in value (or the reasonable anticipation of change in value) of liabilities incurred in the ordinary course of business of the commercial enterprise,
 - the change in value (or the reasonable anticipation of change in value) of services rendered or purchased in the ordinary course of business of the commercial enterprise, or
 - any fluctuation in interest, currency or foreign exchange rate exposures arising from current or anticipated assets or liabilities;

² Entities that otherwise meet the definition of "financial entity" and are (A) organized (i) as a bank (as defined in 3(b) of the Federal Deposit Insurance Act), the deposits of which are secured by the Federal Deposit Insurance Corporation; (ii) a farm credit system institution chartered under the Farm Credit Act of 1971; or (iii) an insured Federal credit-union or State-chartered credit union under the Federal Credit Union Act, and (B) have total assets of \$10 billion or less on the last day of their most recent fiscal year are exempted from the definition of "financial entity." See 17 C.F.R. Part 39.6(d).

³ "Financial entity" is defined to include swap dealers, security-based swap dealers, major swap participants, major security-based swap participants, commodity pools, private funds, employee benefit plans under ERISA and persons predominantly engaged 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. See Section 2(h)(7)(C) of the CEA.

⁴ Section 2(h)(7)(D) of the CEA. It should be noted that swap dealers, security-based swap dealers, major swap participants, major security-based swap participants, issuers that would be an investment company under the Investment Company Act of 1940, commodity pools and bank holding companies with more than \$50 billion in consolidated assets may not make use of the End-User Exception even when entering into a swap on behalf of, or as agent for, a non-financial entity affiliate.

- the swap qualifies as a bona fide hedge for purposes of an exemption from the CFTC's position limits,⁵ or
- the swap qualifies for hedging treatment under accounting rules.

Swaps used for speculation, investing or trading do not qualify for the End-User Exception. Swaps that hedge or mitigate the risk of another swap or security-based swap may qualify for the End-User Exception only if the underlying swap or security-based swap itself was entered into to hedge or mitigate commercial risk. Such swaps will qualify for the End-User Exception even if the original hedged risk no longer exists or has changed.

The CFTC intends to use a facts and circumstances test that takes into account an entity's overall hedging and risk mitigation strategy and actual or anticipated risks at the time the swap is entered into. Whether the risk being hedged is "commercial" depends on the nature of the underlying activity to which the risk relates and not on the legal status of the electing counterparty. Swaps entered into for the purpose of hedging or mitigating commercial risk may, over time, no longer fulfill their original purpose. Such swaps will still qualify for the End-User Exception. Ongoing reporting or testing as to a swap's hedge effectiveness is not required. Portfolio and dynamic hedging can qualify for the End-User Exception if the swap hedges or mitigates commercial risk in an economically appropriate manner.

Swaps that qualify for hedging treatment under either the Financial Accounting Standards Board Accounting Standards or the Governmental Accounting Standards Board Statement 53 are deemed to hedge or mitigate commercial risk, but swaps need not qualify for hedge accounting treatment to be eligible for the End-User Exception.

Reporting Requirements

Electing Counterparty Information

To be eligible for the End-User Exception, a non-financial entity or small banking institution electing the exception (the "**electing counterparty**") must notify the CFTC how it generally intends to meet its financial obligations under non-cleared swaps. To prevent abuse of the End-User Exception, the identity and legal status of entities claiming the exception must also be reported. In all cases, required information will be reported to swap data repositories (or to the CFTC if no swap data repository is available to accept the information) as part of the mandatory regulatory reporting required for all swaps. These reporting requirements apply to all swaps for which the End-User Exception is elected, including inter-affiliate swaps.

The reporting counterparty for this purpose will be the "Reporting Party" designated as such for purposes of real-time and regulatory reporting obligations under Part 45.8 of the CFTC

⁵ For a summary of the CFTC's position limits see Client Memorandum entitled "CFTC Adopts Position Limits Rule, Proposes to Extend Temporary Exemptive Relief From the Applicability of Certain Swap Provisions of the Dodd-Frank Act" available at <http://www.paulweiss.com/media/102309/10Nov11-DF.pdf>.

regulations.⁶ In practice, the reporting counterparty will need to provide the following information for each swap where a party elects the End-User Exception:

- (1) notice of the election of the End-User Exception,
- (2) the identity of the electing counterparty, and
- (3) additional required information, unless such information already has been provided to the CFTC through an annual filing.

The reporting counterparty must have a reasonable basis to believe that the electing counterparty meets the eligibility requirements of the End-User Exception and that the additional information has been made available to the CFTC within the previous 365 days. In the CFTC's view, it would be reasonable in most circumstances for the reporting counterparty to establish such belief through representations made by the electing counterparty. In return, the electing counterparty may rely on representations from the reporting counterparty as to accurate reporting.

Annual Reporting by Electing Counterparty

To relieve reporting burdens on swap counterparties, the CFTC revised the earlier proposed rule to allow annual filing of the additional required information on qualification for the End-User Exception (as opposed to swap-by-swap reporting). The annual filing must include:

- whether or not the electing counterparty is a financial entity;
- whether the swaps for which the electing counterparty is electing the End-User Exception are used by the electing counterparty to hedge or mitigate commercial risk; and
- how the electing counterparty generally meets its financial obligations with respect to uncleared swaps, specifying one or more of the following categories:
 - written credit support agreement
 - pledged or segregated assets (including posting margin under a credit support agreement or otherwise)
 - written third party guarantee
 - the electing counterparty's available financial resources
 - means not otherwise described above

In practice, the annual filing likely will be made by the electing counterparty upon first use of the End-User Exception and then updated every year thereafter.⁷ If the electing counterparty has not made the annual filing, the reporting counterparty will need to provide all required

⁶ See 17 C.F.R. Part 39.6(b). For a summary of the rules designating the "Reporting Party" for purposes of Part 45.8 of the CFTC regulations see Client Memorandum entitled "*CFTC Adopts Swap Data Recordkeeping and Reporting Requirements*" available at http://www.paulweiss.com/media/103326/7Feb12_CDS.pdf.

⁷ An electing counterparty's annual filing will remain valid for 365 days following the date of filing and must be amended to reflect any material changes to the information reported. See 17 C.F.R. Part 39.6(b)(2).

information on a swap-by-swap basis as part of the real-time and regulatory reporting requirements.

SEC Filers

If the electing counterparty is an entity that issues securities registered under Section 12 of the Securities Exchange Act of 1934 or is required to file reports under Section 15(d) of the Securities Exchange Act of 1934 (such entity, an “**SEC Filer**”), it must also provide the CFTC with additional information with respect to board or appropriate committee approval of its decision to enter into swaps on a non-cleared basis. In addition to its SEC Central Index Key number, an SEC Filer must report to the CFTC that its board of directors or an appropriate committee of its board of directors has reviewed and approved the decision to enter into swaps that are neither cleared nor executed on a designated contract market or swap execution facility.

The CFTC has made clear that the board of directors of an SEC Filer (or an appropriate committee thereof) may approve election of the End-User Exception on a general basis (rather than separately for each swap). The CFTC views a committee “appropriate” if it is specifically authorized to approve the entity’s decision to enter into swaps or decide its hedging strategy. The CFTC expects such approval to be reviewed on an annual basis or more frequently following a triggering event (e.g. implementation of a new hedging strategy).

Mandatory clearing of certain interest rate and credit default swaps is expected to commence in the fourth quarter of 2012 or the first quarter of 2013. Most non-financial end-users should expect to be required to clear these swaps (if not electing the End-User Exception) by the second quarter of 2013. An SEC Filer desiring to elect the End-User Exception should take steps to have its board of directors (or appropriate committee) approve entry into non-cleared swaps in anticipation of the clearing requirement.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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