Dodd-Frank: End User Exception to Swap Clearing Requirements

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act"),[1] titled "Wall Street Transparency and Accountability," focuses on the over-the-counter ("OTC") swaps market with the intention of creating transparency and minimizing systemic risk from derivatives trading. Title VII of the Act defines the term "swap" broadly to include interest rate swaps, equity and equity index swaps, debt and debt index swaps, credit and credit default swaps, credit spreads, and commodity swaps.[2] The Act defines a "security-based swap" as any swap that "is based on — (I) an index that is a narrow-based security index . . . (II) a single security or loan . . . or (III) the occurrence, nonoccurrence, or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition, or financial obligations of the issuer."[3]

Section 723 of the Act establishes a mandatory clearing requirement for swaps. The Act requires that non-security-based swaps must be submitted for clearing to a regulated derivatives clearing organization and reported to the Commodity Futures Trading Commission (the "CFTC") prior to trading.[4] Participation in swaps has also been limited to eligible contract participants (as defined in §1a of the Commodity Exchange Act ("CEA")), unless the swap is governed by a contract market (as defined in §5 of the CEA). If eligibility to participate is established, the person wishing to engage in a swap must submit the swap for clearing to a derivatives clearing organization, unless an applicable exception applies. Generally, the provisions contemplated by Title VII will go into effect on July 16, 2011.

Due to the breadth of the definition of the term "swap" in the Act, the clearing and other related provisions of the Act intended to increase oversight over the swaps and derivatives markets would apply to a number of swap transactions that are customarily entered into in connection with routine financial transactions.[5] In an effort to circumscribe, to some extent, the application of the Act to end users of swaps that are not intended to be caught up by its provisions, the Act contains an exception which has come to be called the "end user exception." In general, in order to rely on the exception a company must not be a "financial entity," as defined in the Act, must use swaps to hedge commercial risk and must notify the CFTC (in a manner to be established by CFTC rulemaking) as to how it will meet its obligations with respect to non-cleared swaps.

For companies able to meet the foregoing conditions, the process of entering into a swap will likely remain substantially similar to the process today. Swap agreements will be negotiated on a transaction by transaction basis on economic terms negotiated between the parties. Such terms may or may not include the posting of collateral depending on each counterparty's evaluation of the creditworthiness of the other. However, due to the definition of the term "financial entity" (discussed further below), entities such as hedge funds and insurance companies which come with such definition, will be required to enter into swaps that are subject to clearing through swap clearing organizations. It is likely that swaps subject to such clearing arrangements will have standardized terms and margin requirements that will be reflected in the pricing of such swaps. Reporting and/or notice requirements of the clearing organizations will also likely trigger some additional cost in developing compliance functions by swap parties which address the requirements of the new rules (once they are adopted). As an example, an equity swap or an interest rate swap entered into by a hedge fund or an insurance company to hedge portfolio risk would have to be cleared through a clearing organization and so would be subject to the organization's rules. At this juncture it is not possible to predict how these developments will impact the functioning of the swaps market, and whether it will be more or less efficient as a result.

This memorandum focuses on the end user exception and the compliance requirements which must be met in order to rely upon it.

I. The "End User Exception"

Section 723 establishes an exception to the clearing requirements for certain so-called "end user" counterparties engaged in swaps. In order to rely on the exception, the conditions set forth in the Act must be met.

Counterparty Requirements

A swap counterparty desiring to rely on the exception must meet all of the following three criteria:

- First, the counterparty must not be a financial entity. The definition of a financial entity includes each of the following:
  - a swap dealer,
  - a security-based swap dealer,
  - a major swap participant,
  - a major security-based swap participant,[6]
  - a commodity pool,
  - a private fund,[7]
  - an employee benefit plan,[8] or
  - a person predominantly engaged in activities that are in the business of banking, or activities that are financial in nature as defined in the Bank Holding Company Act.[9, 10]
- Second, the counterparty must be using swaps for the purpose of hedging or mitigating commercial risk.
- Third, the counterparty must notify the CFTC, in a manner set forth by the CFTC, how it generally meets its financial obligations associated with entering into non-cleared swaps.

The decision to rely on the exception can be exercised solely at the discretion of the counterparty meeting the applicable conditions.

Additionally, the CFTC has the authority to determine whether other end users are excepted from the clearing requirements on a case by case basis. Such end users may include small banks, savings associations, farm credit system institutions, and certain credit unions with assets of $10 billion or less.

The CFTC is authorized to issue rules and request information from parties claiming to meet the requirements for the exception to avoid abuse of the exception.

Affiliates Entitled to Rely on Exception Subject to Satisfying Conditions

Affiliate Acting as Agent for an Excepted End User: An affiliate of an entity qualifying for the exception to the clearing requirements may also be exempt from the clearing requirement if the affiliate is "acting on behalf of the person and as an agent," and is engaging in a swap for the purpose of mitigating commercial risk of the entity. The affiliate is not eligible for the exception if it is a swap dealer, a security-based swap dealer, a major swap participant, a major security-based swap participant, an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act of 1940, but for paragraph (1) or (7) of subsection (c) of that Act,[11] a commodity pool, or a bank holding company with over $50 billion in consolidated assets.

Affiliate Providing Financing for an Excepted End User: An affiliate, subsidiary, or a wholly owned entity of a person that qualifies for the exception and is predominantly engaged in providing financing for the purchase or lease of merchandise or manufactured goods of the person shall be exempt from the margin requirement and the clearing requirement imposed on swaps dealers with regard to swaps entered into to mitigate the risk of the financing activities for not less than a 2-year period beginning on July 21, 2010, the date of enactment of the Act.

Board Approval for Public Companies

In order for a public company to rely on the exception, such reliance must be approved by the appropriate committee of such company's board of directors or governing body prior to engaging in swaps subject to such exception.[12]

Additional Rules

The CFTC is further required to establish rules "to prevent evasions of the mandatory clearing requirements" and must investigate where swaps have not been properly reported. The Act leaves specific remedial actions to the discretion of the CFTC, so long as the CFTC is acting in the public interest. Such measures may include a financial obligation of the parties to the swap to retain adequate capital.

Reporting Obligations

The counterparty electing to rely on the exception must notify the CFTC of its decision in accordance with rules that will be adopted pursuant to Section 723. Such rules will also require the counterparty to establish that it satisfies the financial obligations for non-cleared swaps.

II. Conclusion

Entities engaging in swap transactions must be prepared to modify their procedures in light of the new clearing, margin and reporting requirements established by the Act. The CFTC will continue to adopt new rules pertaining to swaps and the OTC market over the course of the next year or more. In particular, entities classified as financial entities, such as hedge funds and entities which are engaged in activities that are "financial in nature" such as insurance companies, which heretofore have not been required to adhere to a regulatory framework with respect to their use of swaps, should prepare to adapt to the new clearing requirements as the CFTC promulgates rules under these provisions of the Act.

All swap participants should be prepared to report pre-enactment unexpired swaps as well any new swaps entered into after July 21, 2010. Further details concerning reporting requirements will be determined based on future rules to be promulgated by the CFTC.

Additionally, those counterparties qualifying for and electing to apply the end user exception should:

- adopt a resolution of the board of directors or the appropriate committee indicating the intent to rely on the end user exception prior to the July 16, 2011 effective date of the exception;
- draft a notice to the CFTC establishing how the counterparty generally meets its financial obligations associated with entering into non-cleared swaps; and clearly establish that the entity is not a financial entity, and that its use of swaps is only for the purpose of hedging or mitigating commercial risk. The submission date for such notice will be no earlier than July 16, 2011.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Lynn Schmidt at 212.701.3641 or lschmidt@cahill.com.

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1 The Dodd-Frank Act is available at http://www.govtrack.us/congress/billtext.xpd?bill=h111-4173.

2 *See* Section 721.

3 Section 761.

4 Section 723.

5 For a summary of the provisions of title VII see our Firm Memorandum *Dodd-Frank Title VII: Reforms for the Swaps Marketplace (*August 13, 2010).

6 In general, the terms "swap dealer" and "security-based swap dealer," cover entities that hold themselves out as dealers in swaps, make a market in swaps or regularly enter into swaps for their own account. The terms "major swap participant" and "major security-based swap participant" cover entities that maintain substantial swap positions, excluding positions maintained for hedging purposes or mitigating commercial risk, that have substantial counterparty exposure that could have serious adverse effects on the United States financial system or are highly leveraged relative to the capital they hold and are not subject to the capital requirements established by an appropriate Federal banking agency.

7 As defined in Section 202(a) of the Investment Advisers Act of 1940.

8 As defined in paragraphs (3) and (32) of Section 3 of the Employee Retirement Income Security Act of 1974.

9 Section 4(k) of the Bank Holding Company Act of 1956 defines activities that are "financial in nature" to include (i) lending, transferring, or investing money or securities for others; (ii) insuring, guaranteeing, or indemnifying against loss, and acting as a principal, agent or broker for such purposes; (iii) providing financial, investment or economic advisory services; (iv) issuing or selling asset-backed securities; (v) underwriting, dealing in, or making a market in securities; (vi) engaging in any activity that the Federal Reserve Board has determined to be so closely related to banking or managing or controlling banks as to be a proper incident thereto; (vii) engaging within the United States in activities that a bank holding company may engage in outside of the United States and that the Federal Reserve Board has determined to be usual in connection with banking operations; (viii) acquiring or controlling shares or ownership interests of a company if the ownership interests are not held by a depository institution, such interests are held by a securities affiliate or affiliate of an insurance company as part of an underwriting activity, such interests are held for a period of time to enable the sale of the interests, and while the interests are held, the bank does not manage or operate the company; (ix) acquiring or controlling shares or ownership interests of a company if the ownership interests are not held by a depository institution, such interests are held by an insurance company predominantly engaged in underwriting insurance, such interests represent an investment made in the ordinary course of business, and while the interests are held, the bank does not manage or operate the company.

10 The definition of "financial entity" does not include an entity whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company.

11 These sections of the Investment Company Act cover so-called "private investment companies," including such entities as hedge funds and corporate buy-out funds.

12 For this purpose, a public company is a company which is either an issuer of securities registered under Section 12 of the Securities Exchange Act of 1934 or an entity that is required to file reports pursuant to Section 15(d) of the Securities Exchange Act of 1934.

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