

## **CFTC Proposes Rule to Implement End-User Exception to Mandatory Swaps Clearing**

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) amended the Commodity Exchange Act (“CEA”) to require that:

(1) swaps be cleared through a derivatives clearing organization (“DCO”) if they are of a type that the Commodity Future Trading Commission (“CFTC” or the “Commission”) determines must be cleared, unless an exception from mandatory clearing applies;

(2) swaps be reported to a registered swap data repository (“SDR”) or the CFTC; and

(3) if a swap is subject to a clearing requirement, it be executed on a registered swap execution facility or a designated contract market (“DCM”), unless no facility or market is available for execution of such swap. CEA Section 2(h)(1) provides that it shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing to a DCO if the swap is required to be cleared.

However, Section 2(h)(7) of the CEA also provides that a swap otherwise subject to mandatory clearing is subject to an elective exception from clearing if

- one party to the swap is not a financial entity,
- is using swaps to hedge or mitigate commercial risk, and
- notifies the CFTC, in a manner set forth by the CFTC, how it generally meets its financial obligations associated with entering into noncleared swaps (the “end-user clearing exception”).<sup>1</sup>

The Dodd-Frank Act provides the CFTC with authority to adopt rules governing the end-user clearing exception and to prescribe rules, issue interpretations, and request information from persons claiming the end-user clearing exception necessary to prevent abuse of the exception. In December 2010, the CFTC proposed Rule 39.6 to meet this requirement.<sup>2</sup> Comments on the proposed rule must be submitted by February 22, 2011. A copy of the proposed rule is set forth on Annex A to this memorandum. A summary of the proposed rule follows.

### **I. Notice to the CFTC of Election to Use the Exception**

The Commission is proposing in Rule 39.6(b) to require non-financial entities to notify the Commission each time the end-user clearing exception is elected by delivering specified information to a registered SDR or, if no registered SDR is available, the Commission, in the manner required by proposed rules for swaps data recordkeeping and reporting. The specified information would be delivered to the SDR by the reporting

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<sup>1</sup> See our Firm Memorandum *Dodd-Frank: End User Exception to Swap Clearing Requirements* (October 18, 2010), available at [http://www.cahill.com/news/memoranda/100243/res/id=sa\\_File1/CGR%20Memo%20-%20Dodd-Frank%20Swap%20Clearing%20Provisions.pdf](http://www.cahill.com/news/memoranda/100243/res/id=sa_File1/CGR%20Memo%20-%20Dodd-Frank%20Swap%20Clearing%20Provisions.pdf).

<sup>2</sup> Commodity Futures Trading Commission 17 CFR Part 39 RIN 3038–AD10, *End-User Exception to Mandatory Clearing of Swaps*, 75 F.R. 80747 (December 23, 2010) available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2010-31578a.pdf>.

counterparty defined in the swap data recordkeeping and reporting rules together with other information regarding the swap that is subject to the end-user clearing exception to form the central record of the swap held by the SDR.

## **A. Meeting Financial Obligations**

A principal feature distinguishing cleared swaps from non-cleared swaps is that non-cleared swaps do not have a uniform method of mitigating counterparty credit risk. Proposed Rule 39.6(b)(5) would require a person relying on the end-user clearing exception to provide additional information regarding the methods used to mitigate credit risk in connection with non-cleared swaps. If more than one method is used by the person electing to use the end-user clearing exception, information must be provided for each of the methods being used as delineated by the proposed rule.

### **1. Credit Support**

Proposed Rule 39.6(b)(5)(i) requires an indication of whether a written credit support agreement is being used with respect to the non-financial entity or entities in connection with the noncleared swap.<sup>3</sup>

### **2. Pledged or Segregated Assets**

Proposed Rule 39.6(b)(5)(ii) requires an indication of whether payment of all or any portion of the financial obligations associated with the non-cleared swap are secured by collateral that has been pledged pursuant to a documented security arrangement not requiring the transfer of possession of collateral to the swap counterparty.

### **3. Guarantee**

Proposed Rule 39.6(b)(5)(iii) requires an indication of whether all or any portion of the financial obligations associated with the non-cleared swap are guaranteed in writing by a person or entity other than the non-financial entity or entities that are party to the swap.

### **4. Sole Reliance on Available Financial Resources**

Proposed Rule 39.6(b)(5)(iv) requires an indication of whether the non-financial entity or entities that are party to the swap intend to meet the obligations associated with the swap solely by utilizing available financial resources.

### **5. Other Means**

Proposed Rule 39.6(b)(5)(v) requires an indication of whether the non-financial entity or entities that are party to the swap intend to employ means other than those described in proposed Rule 39.6(b)(5)(i) through (iv) to meet the financial obligations associated with a swap. The CFTC notes that this item is intended to categorize separately all other methods that may be used in the markets currently or that may develop in the future.

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<sup>3</sup> The proposing release references ISDA collateralization practices to illustrate what is contemplated by this section of the proposed rule.

## **B. Preventing Abuse of the End-User Exception**

The remaining items of information required by proposed Rule 39.6 are designed to confirm compliance with particular requirements of CEA Section 2(h)(7) or otherwise produce information necessary or useful to aid the Commission in its efforts to prevent abuse of the end-user clearing exception as contemplated by CEA Section 2(h)(7)(F).

### **1. Person Electing to Use the End-User Clearing Exception**

Proposed Rule 39.6(b)(1) requires identification of the swap party that is electing to use the end-user clearing exception.

### **2. Financial Entity Status**

Proposed Rule 39.6(b)(2) requires an indication of whether a person electing to use the end-user clearing exception is a financial entity as defined in CEA Section 2(h)(7)(C)(i). The exception to mandatory clearing of swaps under CEA Section 2(h)(7) is only available to persons that are not financial entities, or are affiliates of non-financial entities satisfying the requirements of CEA Sections 2(h)(7)(C)(iii) or 2(h)(7)(D).<sup>4</sup>

### **3. Finance Affiliate Status**

Proposed Rule 39.6(b)(3) requires an indication of whether a person electing to use the end-user clearing exception is an affiliate of another person qualifying for the exception under CEA Section 2(h)(7), and satisfies the additional requirements of CEA Sections 2(h)(7)(C)(iii) or 2(h)(7)(D). These sections of the CEA contain provisions specially designed for captive finance affiliates of persons qualifying for the end-user clearing exception.

### **4. Hedging or Mitigating Commercial Risk**

Proposed Rule 39.6(b)(4) requires an indication of whether a person electing to use the end-user clearing exception is using the swap being reported to hedge or mitigate commercial risk. The exception to mandatory clearing of swaps under Section 2(h)(7) of the CEA is only available to persons that use such swaps to hedge or mitigate commercial risk. Hedging is defined in following sections of the proposed rule.<sup>5</sup>

### **5. End-User Board Approval**

Proposed Rule 39.6(b)(6) requires all persons electing the end-user clearing exception to indicate whether they are an issuer of securities registered under Section 12 of the Exchange Act, or required to file reports under Section 15(d) of the Exchange Act (“SEC Filer”). When the person electing to use the end-user clearing exception is an SEC Filer, two additional items of information must be provided:

Proposed Rule 39.6(b)(6)(i) requires an SEC Filer electing to use the end-user clearing exception to specify its SEC Central Index Key number.

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<sup>4</sup> It is assumed that the requirement to include this item, as well as confirmation of the reason for using a swap, in the notice is prompted by a desire to prevent abusive use of the exception by requiring an end-user to make affirmative statements with respect to these conditions to use of the exception.

<sup>5</sup> See note 4.

Proposed Rule 39.6(b)(6)(ii) requires confirmation that an appropriately authorized committee of the board of directors or equivalent governing body of the SEC Filer has reviewed and approved the decision of the electing person not to clear the swap being reported, as required by CEA Section 2(j).

## II. “Hedging or Mitigating Commercial Risk” Defined

To qualify to use the end-user clearing exception with respect to a particular swap, CEA Section 2(h)(7)(A)(ii) requires that a non-financial entity must be using the swap to hedge or mitigate commercial risk. While the proposed definition in proposed Rule 39.6(c) includes swaps that are recognized as hedges for accounting purposes or as bona fide hedging<sup>6</sup> for purposes of an exemption from position limits under the CEA, the swaps included within the clearing exception are not limited to those two circumstances. The proposal also covers swaps used to hedge or mitigate any of a person’s business risks, as defined by six categories in the proposal, regardless of their status under accounting guidelines or the bona fide hedging exemption.<sup>7</sup>

Proposed Rule 39.6(c)(2) further provides, however, that a swap is disqualified from the clearing exception if it is held for a speculative, investing, or trading purpose, or if it hedges another swap unless that swap itself is held for hedging purposes. The phrase “hedging or mitigating commercial risk” is the subject of current joint rulemaking by the CFTC and the SEC.

## III. Consideration of a Clearing Exception for Small Banks, Savings Associations, Farm Credit System Institutions, and Credit Unions

Pursuant to CEA Section 2(h)(7)(C)(ii), the Commission is considering whether to except small banks, savings associations, farm credit systems institutions, and credit unions from the Act’s definition of financial entity, including specifically those with total assets of \$10 billion or less (“Small Financial Institutions”). This type of exception would permit Small Financial Institutions to use the end-user exception from the mandatory clearing requirement, which is otherwise unavailable to financial entities.

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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](mailto:jmark@cahill.com); or John Schuster at 212.701.3323 or [jschuster@cahill.com](mailto:jschuster@cahill.com).

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<sup>6</sup> See Proposed Rule 39.6(c)(1)(ii) and (iii).

<sup>7</sup> See Proposed Rule 39.6(c)(1)(i).

## Proposed Rule: 17 CFR Part 39

### § 39.6 Electing to use the end-user exception to mandatory swap clearing.

- (a) A counterparty to a swap (an “electing counterparty”) may elect to use the exception to mandatory clearing under section 2(h)(7)(A)(iii) of the Act if the electing counterparty is not a “financial entity” as defined in section 2(h)(7)(C)(i) of the Act, is using the swap to hedge or mitigate commercial risk as defined in § 39.6(c), and provides or causes to be provided to a registered swap data repository or, if no registered swap data repository is available, the Commission, the information specified in § 39.6(b). More than one counterparty to a swap may be an electing counterparty. If there is more than one electing counterparty to a swap, the information specified in § 39.6(b) shall be provided with respect to each of the electing counterparties.
- (b) When an electing counterparty to a swap elects to use the exception to mandatory clearing under section 2(h)(7)(A)(iii) of the Act, one of the counterparties to the swap (the “reporting counterparty”) shall provide or cause to be provided the following information to a registered swap data repository or, if no registered swap data repository is available, the Commission, in the form and manner required for delivery of information specified under the Commission’s rules:
- (1) The identity of the electing counterparty to the swap;
  - (2) Whether the electing counterparty is a “financial entity” as defined in section 2(h)(7)(C)(i) of the Act;
  - (3) Whether the electing counterparty is a finance affiliate meeting the requirements described in sections 2(h)(7)(C)(iii) or 2(h)(7)(D) of the Act;
  - (4) Whether the swap is used by the electing counterparty to hedge or mitigate commercial risk as defined in § 39.6(c) under the Act;
  - (5) Whether the electing counterparty generally expects to meet its financial obligations associated with its non-cleared swap by using:
    - (i) A written credit support agreement;
    - (ii) Pledged or segregated assets (including posting or receiving margin);
    - (iii) A written third-party guarantee;
    - (iv) Solely the electing counterparty’s available financial resources; or
    - (v) Means other than those described in § 39.6(b)(5)(i), (ii), (iii) or (iv); and
  - (6) Whether the electing counterparty is an entity that is an issuer of securities registered under section 12 of, or is required to file reports under 15(d) of, the Securities Exchange Act of 1934, and if so:
    - (i) The relevant SEC Central Index Key number for that counterparty; and

- (ii) Whether an appropriate committee of the board of directors (or equivalent body) has reviewed and approved the decision not to clear the swap.
- (c) For purposes of section 2(a)(7)(A)(ii) of the CEA and § 39.6(b)(4), a swap shall be deemed to be used to hedge or mitigate commercial risk when:
  - (1) Such swap:
    - (i) Is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where the risks arise from:
      - (A) The potential change in the value of assets that a person owns, produces, manufactures, processes, or merchandises or reasonably anticipates owning, producing, manufacturing, processing, or merchandising in the ordinary course of business of the enterprise;
      - (B) The potential change in the value of liabilities that a person has incurred or reasonably anticipates incurring in the ordinary course of business of the enterprise; or
      - (C) The potential change in the value of services that a person provides, purchases, or reasonably anticipates providing or purchasing in the ordinary course of business of the enterprise;
      - (D) The potential change in the value of assets, services, inputs, products, or commodities that a person owns, produces, manufactures, processes, merchandises, leases, or sells, or reasonably anticipates owning, producing, manufacturing, processing, merchandising, leasing, or selling in the ordinary course of business of the enterprise;
      - (E) Any potential change in value related to any of the foregoing arising from foreign exchange rate movements associated with such assets, liabilities, services, inputs, products, or commodities; or
      - (F) Any fluctuation in interest, currency, or foreign exchange rate exposures arising from person's current or anticipated assets or liabilities; or
    - (ii) Qualifies as bona fide hedging for purposes of an exemption from position limits under the Act; or
    - (iii) Qualifies for hedging treatment under Financial Accounting Standards Board Accounting Standards Codification Topic 815, Derivatives and Hedging (formerly known as Statement No. 133); and
  - (2) Such swap is:
    - (i) Not used for a purpose that is in the nature of speculation, investing, or trading; or
    - (ii) Not used to hedge or mitigate the risk of another swap or securities-based swap, unless that other swap itself is used to hedge or mitigate commercial risk as defined by this rule or the equivalent definitional rule governing security-based swaps promulgated by the Securities and Exchange Commission under the Securities Exchange Act of 1934.