SIMPSON THACHER MEMORANDUM

# The CFTC Further Clarifies End-User Exception to the Mandatory Clearing Requirement for Swaps

*July 18, 2012*

Section 2(h) of the Commodity Exchange Act (the "CEA"), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, grants the CFTC authority to require that certain categories of swaps be subject to a mandatory clearing requirement. To the extent the CFTC makes such a determination with respect to a category of swaps, the rule provides that it shall be unlawful for any person to engage in such swaps unless that person submits such swaps for clearing to a derivatives clearing organization ("DCO").[1] However, the CEA also provides an exception from this mandatory clearing requirement if one of the counterparties to a swap: "(i) is not a financial entity; (ii) is using the swaps to hedge or mitigate commercial risk; **AND** (iii) notifies the CFTC, in a manner set forth by the CFTC, how it generally meets its financial obligations associated with entering into non-cleared swaps".[2] Such exception is commonly referred to as the "end-user exception" to mandatory clearing.[3]

In its final rule entitled "End-User Exception to the Clearing Requirement for Swaps" (the "Final Rule"), released on July 11, 2012, the Commodity Futures Trading Commission ("CFTC") clarifies which entities are exempt from the clearing requirement by (i) further defining which entities will be considered "financial entities" and exempting certain entities from such definition; (ii) setting forth criteria for determining whether the swap is being used to hedge or mitigate commercial risk; and (iii) specifying what information an entity needs to provide the CFTC, as well as the methods by which it can provide such information.

## FIRST PRONG: "FINANCIAL ENTITY"

Under the CEA, a "financial entity" is defined as a (i) swap dealer, (ii) security-based swap dealer, (iii) major swap participant, (iv) major security-based swap participant, (v) commodity pool, (vi) private fund,[4] (vii) employee benefit plan,[5] or (viii) person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature.[6]

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1 7 U.S.C. 2(h)(1)(A).

2 7 U.S.C. 2(h)(7)(A).

3 It should be noted that the end-user exception applies on a swap-by-swap basis, and not on a counterparty-by-counterparty basis. Therefore an electing counterparty must perform the analysis for each swap it enters into to determine its eligibility for the end-user exception with respect to such swap.

4 As defined in section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80-b-2(a)).

5 As defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002).

6 7 U.S.C. 2(h)(7)(C)(i). The term "financial in nature" is defined in section 4(k) of the Bank Holding Company Act of 1956.

The CEA also provides for certain entities that would otherwise meet the definition of "financial entity" to be excluded from the definition for purposes of the end-user exception. An affiliate of a non-financial entity, that would otherwise be considered a financial entity, may nonetheless avail itself of the end-user exception if the affiliate is acting on behalf, and as an agent, of such non-financial affiliate and the swaps are being used to hedge the commercial risk of such person or another non-financial entity affiliate of such person.[7] Additionally, the "90 percent rule", excludes certain captive finance companies from the definition of "financial entity". The 90 percent rule excludes from the definition of "financial entity" those entities whose primary business is providing financing, and which use derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposure, i) 90 percent or more of which arise from financing that facilitates the purchase or lease of products, and ii) 90 percent or more of such products are manufactured by the parent company or another subsidiary of the parent company.[8]

In addition to carving out certain entities from the "financial entity" definition under the CEA, Section 2(h)(7)(C)(ii) of the CEA allows the CFTC to consider whether to exempt certain types of financial entities from the definition of "financial entity" for purposes of the end-user exception if such entity's total assets do not exceed a $10 billion threshold. In the Final Rule, the CFTC specifically exempts some smaller banking institutions from the definition of financial entity. Section 39.6(d) of the Final Rule excludes certain financial institutions[9] that have total assets on the last day of the fiscal year of less than $10 billion. Such entities are excluded from the definition of "financial entity" for purposes of the end-user exception even if they otherwise would have met that definition because they are predominately engaged in activities that are in the business of banking, or in activities that are financial in nature.

The release for the Final Rule also includes interpretive guidance from the CFTC regarding certain foreign entities that could be considered financial institutions, such as foreign governments, foreign central banks, and international financial institutions. In paragraph 4 of Section I of the release, the CFTC indicated that foreign governments, foreign central banks and international financial institutions, given considerations of comity, are not subject to the clearing requirement of 2(h)(1) of the CEA.

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7 7 U.S.C. 2(h)(7)(D)(i). It should be noted that the exception for affiliates is not available if such entity is i) a swap dealer; ii) a security-based swap dealer; iii) a major swap participant; iv) a major security-based swap participant; (v) an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3), but for paragraph (1) or (7) of subsection (c) of that Act (15 U.S.C. 80a-3(c)); (vi) a commodity pool; or (vii) a bank holding company with other $50 billion in consolidated assets (CEA 2(h)(7)(D)(ii)).

8 7 U.S.C. 2(h)(7)(C)(iii).

9 In order to qualify for the exemption, the banking institution must be (1) organized as a bank or savings association as defined by the Federal Deposit Insurance Act and have their deposits insured by the Federal Deposit Insurance Corporation; (2) a farm credit system chartered under the Farm Credit Act of 1971; or (3) an insured Federal credit union or State-charted credit union under the Federal Credit Union Act.

## SECOND PRONG: HEDGE OR MITIGATE COMMERCIAL RISK

The second prong of the end-user exception is that such person must be using the swap to hedge or mitigate commercial risk. In the Final Rule, the CFTC lays out certain criteria for determining whether a swap hedges or mitigates commercial risk. These criteria are virtually the same as the criteria used in the definition of "major swap participant". First, the swap must not be used for a purpose that is in the nature of speculation, investing, or trading. Second, it is not used to hedge or mitigate risk of another swap or security-based swap *unless* such underlying position itself is used to hedge or mitigate commercial risk (pursuant to the same criteria). Finally, such swap must meet any of the following three requirements: i) it is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where such risks arise from a specifically enumerated list provided by the CFTC[10]; ii) it qualifies as bona fide hedging for purposes of an exemption from position limits under the CEA; or iii) it qualifies for hedging treatment under either the Financial Accounting Standards Board Accounting Standards[11] or the Governmental Accounting Standards Board.[12]

## THIRD PRONG: REPORTING

The third prong of the end-user exception requires that one of the parties act as the "reporting counterparty" and notify the CFTC of certain information regarding the non-cleared swap.[13] The Final Rule states that the reporting counterparty shall be determined in accordance with Section 45.8 of the CEA, which lays out swap data recordkeeping and reporting rules. Since the electing party for purposes of the end-user exception must not be a "financial entity" by definition, then pursuant to Section 45.8, as long as the other party to the swap is a swap dealer, major swap participant, or a financial entity, such other party will be the reporting party. If, however, both parties are non-financial entities, then the parties themselves must choose who will be the reporting party.

The Final Rule specifies that the reporting counterparty must report three types of information to a registered swap data repository or, if no registered swap data repository is available to receive the information, directly to the CFTC: (i) notice of the election of the exception; (ii) identity of the electing counterparty; and (iii) an enumerated list of information regarding the

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10 (A) The potential change in value of assets that a person owns, produces, manufactures, processes, or merchandises in the ordinary course of business; (B) the potential change in value of liabilities that a person has incurred in the ordinary course of business; (C) the potential change in value of services that a person provides or purchases in the ordinary course of business; (D) the potential change in value of the assets, services, inputs, products, or commodities that a person owns, produces, manufactures, processes, merchandises, lease, or sells in the ordinary course of business; (E) any potential change in value related to any of the foregoing arising from interest, currency, or 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 a person's current or anticipated assets or liabilities.

11 Financial Accounting Standards Board Accounting Standards Codification Topic 815, Derivatives and Hedging (formerly known as Statement No. 133).

12 Governmental Accounting Standards Board Statement 53, Accounting and Financial Reporting for Derivative Instruments.

13 7 U.S.C. 2(h)(7)(A)(iii).

electing counterparty, which is laid out in the bulleted list below under the heading "Required Information". With respect to (iii), the CFTC recognized that providing all of the required information for each individual swap could be overly burdensome. As such, the Final Rule gives parties the option of reporting such information annually in anticipation of electing the end-user exception for one or more swaps. While a party that takes advantage of this option would still need to notify the CFTC each time it enters into a non-cleared swap, electing to file the required information annually would obviate the need to submit any information, other than notice of the election and the identity of the electing party, to the CFTC.

## REQUIRED INFORMATION

The following information regarding the electing counterparty must be provided either (i) by the reporting counterparty on a swap-by-swap basis, or (ii) by the electing counterparty in an annual report, as discussed above:

- whether the electing counterparty is a "financial entity";
  - If "yes", whether such financial entity is:
    - electing the affiliate exception or the 90% rule exception, or
    - a small banking institution that meets the exception requirements set forth in Section 39.6(d) of the Final Rule[14];
- whether the swaps for which the electing counterparty is electing the exception are used to hedge or mitigate commercial risk (as provided in 39.6(c))[15];
- how the electing counterparty generally meets its financial obligations associated with entering into non-cleared swaps by indentifying one or more of the following:
  - a written credit support agreement,
  - pledged or segregated assets,
  - a written third-party guarantee,
  - the electing counterparty's available financial resources, or
  - some other means; and
- whether the electing 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
  - If "yes", the reporting party must:
    - provide the electing counterparty's SEC Central Index Key number, and
    - indicate whether an appropriate committee of that counterparty's board of directors (or equivalent body) has reviewed and approved the decision to enter into uncleared swaps.

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[14] *See* "Financial Entity" Section above.
[15] *See* "Hedge or Mitigate Commercial Risk" Section above.

For more information about any of the foregoing, please contact the following members of the Firm's Derivatives Group: Joyce Xu (jxu@stblaw.com), Solomon Bashi (sbashi@stblaw.com), or Jordan Taylor (jtaylor@stblaw.com).

*This memorandum is for general information purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as our recent memoranda, can be obtained from our website, www.simpsonthacher.com.*

## UNITED STATES

**New York**
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

**Houston**
2 Houston Center
909 Fannin Street
Houston, TX 77010
+1-713-821-5650

**Los Angeles**
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

**Palo Alto**
2550 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

**Washington, D.C.**
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

## EUROPE

**London**
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

## ASIA

**Beijing**
3919 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

**Hong Kong**
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

**Tokyo**
Ark Mori Building
12-32, Akasaka 1-Chome
Minato-Ku, Tokyo 107-6037
Japan
+81-3-5562-6200

## SOUTH AMERICA

**São Paulo**
Av. Presidente Juscelino Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000