Inter-Affiliate Swap Clearing Exemption

CFTC Adopts Final Rules Providing for an Exemption from the Mandatory Clearing Requirement for Inter-Affiliate Swaps

INTRODUCTION

On April 1, 2013, the Commodity Futures Trading Commission (the “CFTC”) voted four to one to adopt final rules implementing an exemption from the mandatory clearing requirement (the “Clearing Mandate”) under section 2(h) of the Commodity Exchange Act, as amended (the “CEA”), for transactions between certain affiliated parties (the “Inter-Affiliate Exemption”). The Inter-Affiliate Exemption finalized previously proposed rules published on August 21, 2012 (the “Proposed Rules”). The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) amended the CEA to require clearing of any swap that the CFTC determines should be subject to mandatory clearing. However, the Dodd-Frank amendments to the CEA did not expressly exempt from this requirement transactions between affiliates. A number of market participants urged the CFTC to adopt a regulatory exemption from the Clearing Mandate for inter-affiliate swaps, arguing that such swaps offer significant benefits and create substantially less risk than do swaps between unaffiliated entities. These market participants also argued that subjecting inter-affiliate swaps to the Clearing Mandate would be burdensome and expensive to corporate groups, without offering countervailing benefits. The Inter-Affiliate Exemption was adopted pursuant to the CFTC’s authority under section 4(c)(1) of the CEA to exempt any transaction or class of transactions from certain provisions of the CEA in order to “promote responsible economic or financial innovation and fair competition.” Reliance on the Inter-Affiliate Exemption is limited to Eligible Affiliates (as defined below) that comply with additional conditions (as described below). The final Inter-Affiliate Exemption will be effective June 10, 2013.
ELIGIBLE AFFILIATES

The Inter-Affiliate Exemption applies only to swaps which are entered into between counterparties that qualify as eligible affiliate counterparties (each, an “Eligible Affiliate”). Eligible Affiliates are defined as two entities with respect to which either:

- one Eligible Affiliate directly or indirectly holds a majority ownership interest in the other Eligible Affiliate; or
- a third party directly or indirectly holds a majority ownership interest in both Eligible Affiliates in the pair.

With respect to the first prong above, the consolidated financial statements of the parent Eligible Affiliate must include the financial results of the subsidiary Eligible Affiliate under the relevant accounting standards. Similarly, with respect to the second prong above, the consolidated financial statements of the third party must include the financial results of both Eligible Affiliates under the relevant accounting standards. Unlike the Proposed Rules, the final Inter-Affiliate Exemption acknowledges that consolidation may be done either under Generally Accepted Accounting Principles or International Financial Reporting Standards. Under the Inter-Affiliate Exemption, a person holds a majority ownership interest if it directly or indirectly holds a majority of: (A) the equity securities of an entity; or (B) the right to receive upon dissolution, the contribution of, or majority of the capital of, a partnership. The CFTC believes that the majority ownership requirement should ensure that counterparty credit risk posed by inter-affiliate swaps is internalized within the corporate group.

ADDITIONAL CONDITIONS

In order to elect to rely on the Inter-Affiliate Exemption, the Eligible Affiliates must comply with certain conditions which include:

- both counterparties electing to rely on the Inter-Affiliate Exemption;
- complying with documentation requirements;
- having a centralized-risk management program;
- complying with certain anti-evasion conditions; and
- complying with certain reporting requirements.

Counterparty Election

The CFTC believes that each Eligible Affiliate should be able to make an independent determination as to whether to clear an inter-affiliate swap and therefore requires both Eligible Affiliates to elect not to clear the inter-affiliate swap in order to rely on the Inter-Affiliate Exemption.
Documentation Requirements

The Eligible Affiliates must comply with certain documentation requirements in order to rely on the Inter-Affiliate Exemption. If one of the Eligible Affiliates is a registered swap dealer or major swap participant, the swap dealer or major swap participant Eligible Affiliate must ensure that the swap complies with the relevant documentation requirements under Part 23 of the CFTC’s regulations.\(^3\) If neither Eligible Affiliate is a swap dealer or major swap participant, the terms of the swap must be reflected in a written swap trading relationship document which includes all terms governing the swap relationship between the Eligible Affiliates. Unlike the Proposed Rules, the final Inter-Affiliate Exemption does not prescribe a non-exhaustive list of terms to be covered in the swap documentation between end-user Eligible Affiliates. The CFTC expressed a belief that, in most circumstances, the required swap documentation should include payment obligations, netting of payments, transfer of rights and obligations, governing law, valuation, and dispute resolution terms (i.e., the enumerated terms in the Proposed Rules). Still, end-user Eligible Affiliates should have some flexibility as to documentation but will be required to ensure that such documentation contains an accurate and thorough written record of their swaps.

The final Inter-Affiliate Exemption requires swap dealers and major swap participants to confirm all the terms of the swap with an Eligible Affiliate in writing. Although end-user Eligible Affiliates are not formally required to confirm the terms of an inter-affiliate swap, the terms of the inter-affiliate swap must be documented and reported to a swap data repository ("SDR") pursuant to Part 45 of the CFTC’s regulations ("Part 45").

In addition, in the release accompanying the Inter-Affiliate Exemption, the CFTC acknowledged that certain inter-affiliate swaps are currently only documented by book-entries. The CFTC noted that this would not be sufficient for the documentation requirements of the Inter-Affiliate Exemption.

Centralized Risk Management

The inter-affiliate swap must be subject to a centralized risk management program in order to rely on the Inter-Affiliate Exemption. The CFTC acknowledged that most market participants have internal risk management policies and procedures in place, at least with respect to affiliates in the same jurisdiction. Under the final Inter-Affiliate Exemption, this type of program must be reasonably designed to monitor and manage the risks associated with inter-affiliate swaps. If one of the Eligible Affiliates is a swap dealer or major swap participant, this program must comply with the requirements of the “Internal Business Conduct Rules”.\(^4\) End-user Eligible Affiliates’ risk management programs need not satisfy the requirements of the “Internal Business Conduct Rules” and there is flexibility in how the risk management program is structured, “provided that the program reasonably monitors and manages the risks associated with its uncleared inter-affiliate swaps.”\(^5\)
Anti-Evasion Conditions

The CFTC imposed certain additional conditions set forth below (the “Anti-Evasion Conditions”) on the Inter-Affiliate Exemption to prevent market participants from evading the Clearing Mandate. The CFTC was concerned that, without these Anti-Evasion Conditions, the Inter-Affiliate Exemption “may create a ready means through which some U.S. entities may be able to evade the clearing requirement.” For example, the CFTC stated that a U.S. entity could enter into swaps with a foreign affiliate that is located in a jurisdiction without mandatory clearing requirements that are as robust as the Clearing Mandate, effectively creating a means for uncleared third-party transactions. The CFTC also expressed concern that, without the Anti-Evasion Conditions, outward facing swaps between Eligible Affiliates and third-party counterparties located in non-U.S. jurisdictions may transfer additional risk to U.S. companies and U.S. financial markets.

Therefore, the CFTC determined that, in order to rely on the Inter-Affiliate Exemption, each Eligible Affiliate that enters into any swap that is part of a class of swaps that the CFTC has determined to be subject to the Clearing Mandate (such swap, a “Mandatory Clearing Swap”) with an unaffiliated third party must meet one of the following Anti-Evasion Conditions with respect to any such Mandatory Clearing Swap:

- comply with the Clearing Mandate;
- comply with the requirements for clearing the Mandatory Clearing Swap under a foreign jurisdiction’s clearing mandate that is comprehensive and comparable, but not necessarily identical, to the Clearing Mandate (a “Qualifying Non-U.S. Mandate”);
- comply with a bona fide exception or exemption from the Clearing Mandate;
- comply with an exception or exemption under a Qualifying Non-U.S. Mandate that is comparable to an exception or exemption from the Clearing Mandate; or
- clear such Mandatory Clearing Swap through a registered derivatives clearing organization or non-US clearing organization that is subject to supervision by appropriate government authorities in its home country of the clearing organization.

The CFTC noted that it will determine whether a Qualifying Non-U.S. Mandate is as comparable and comprehensive as the Clearing Mandate, based on the relevant laws and regulations of the non-U.S. jurisdiction and the non-U.S. jurisdiction’s determinations as to classes of swaps to be mandatorily cleared. Similarly, the CFTC expects to review an exception or exemption from a Qualifying Non-U.S. Mandate by comparing the requirements of and objectives behind such exception or exemption with those under Dodd-Frank. The CFTC intends to make these determinations upon:

- the adoption of a potential Qualifying Non-U.S. Mandate;
- the request of a counterparty in a non-U.S. jurisdiction; or
- the request of another appropriate party.
The CFTC stated in the release accompanying the Inter-Affiliate Exemption that, once it has made such a determination with respect to a Qualifying Non-U.S. Mandate, Eligible Affiliates in the relevant jurisdiction may rely on that determination to satisfy the Anti-Evasion Conditions without further CFTC action.

Compliance with the Anti-Evasion Conditions is, in part, dependent on other non-U.S. jurisdictions adopting Qualifying Non-U.S. Mandates. In this regard, the CFTC acknowledged that the European Union, Japan and Singapore (like the U.S.) have taken steps to implement a mandatory clearing regime. Therefore, the CFTC granted two alternative sets of conditions (in lieu of the Anti-Evasion Conditions) for an Eligible Affiliate located in the European Union, Japan or Singapore for a transition period ending on March 11, 2014:

- The first alternative set of conditions requires, among other things, that such non-U.S. Eligible Affiliates (or a third-party parent of both) exchange variation margin daily on all of its Mandatory Clearing Swaps with unaffiliated counterparties or that variation margin is exchanged daily by both Eligible Affiliates counterparties (or a third-party parent of both) with all other Eligible Affiliates on all such inter-affiliate Mandatory Clearing Swaps.

- As a second alternative set of conditions, an Eligible Affiliate located in the European Union, Japan or Singapore need not comply with the Anti-Evasion Conditions, provided that: (1) the one Eligible Affiliate that directly or indirectly holds a majority ownership interest in the other Eligible Affiliate or the third-party parent that directly or indirectly holds a majority ownership interest in both Eligible Affiliate is not a “financial entity” as defined in section 2(h)(7) of the CEA; and (2) neither Eligible Affiliate is affiliated with a swap dealer or major swap participant.

The CFTC also provided limited time (until March 11, 2014) alternative transition compliance conditions (in lieu of the Anti-Evasion Conditions) for swaps where one of the Eligible Affiliates is located in the United States and the other Eligible Affiliate is located in a non-U.S. jurisdiction other than the European Union, Japan or Singapore. These Eligible Affiliates may comply with the first set of alternative conditions above, provided that the U.S. Eligible Affiliate does not enter into Mandatory Clearing Swaps with the non-U.S. Eligible Affiliate in an amount that represents greater than five percent of all Mandatory Clearing Swaps entered into by the U.S. Eligible Affiliate, based on the notional amounts of such swaps.8

After March 11, 2014, all Eligible Affiliates, regardless of where they are located, must comply with the Anti-Evasion Conditions set forth above.

**Reporting Requirements**

Finally, each swap subject to the Inter-Affiliate Exemption must be reported to an SDR or (if no relevant SDR exists) the CFTC pursuant to Part 45, subject to the no-action relief discussed below.9 The CFTC expressly declined to completely exempt inter-affiliate swaps from the reporting requirements of section 4r of the CEA. However, whether an inter-affiliate swap will be subject to real-time reporting under Part 43 of the CFTC’s regulations ("Part 43") depends on whether the swap is a “publicly reportable swap transaction”.10 In addition, we note that historical inter-affiliate swaps will be subject to reporting requirements under Part 46 of the CFTC’s regulations ("Part 46").11
In order to rely on the Inter-Affiliate Exemption, the Eligible Affiliate that qualifies as the reporting counterparty under Part 45 must report, in addition to other swap data required to be reported, the following information to the relevant SDR or (if no relevant SDR exists) the CFTC:

- confirmation that the Eligible Affiliates have satisfied the conditions of the Inter-Affiliate Exemption and have both elected not to clear the swap;
- information as to how each Eligible Affiliate generally meets its financial obligations associated with entering into non-cleared swaps;\(^\text{12}\) and
- if one of the Eligible Affiliates is an issuer of securities under Section 12 of the Securities Exchange Act or is required to file reports under Section 15(d) of such Act (an “SEC Filer”):\(^\text{13}\)
  (A) the relevant SEC Central Index Key number; and
  (B) acknowledgment that an appropriate committee of the board has reviewed and approved the decision to enter into swaps exempt from the Clearing Mandate.

The third reporting requirement mirrors the requirement in the CFTC’s rules implementing the end-user exception from the Clearing Mandate.\(^\text{14}\) It appears that, as with the end-user exception, the CFTC may expect the relevant committee of an SEC Filer’s board to set appropriate policies governing the SEC Filer’s use of swaps subject to the Inter-Affiliate Exemption and to review those policies at least annually.\(^\text{15}\) This approval can be given by the relevant committee on a periodic basis. An Eligible Affiliate that qualified for the Inter-Affiliate Exemption may report the information required by the second and third prongs above on an annual basis in anticipation of entering into swaps qualifying for the Inter-Affiliate Exemption.

**Reporting No-Action Relief**

On April 5, 2013, the CFTC’s Division of Market Oversight and Division of Clearing and Risk provided relief with respect to certain inter-affiliate swaps from the reporting requirements of Part 45 (the “Inter-Affiliate No-Action Relief”).\(^\text{16}\) This relief is subject to certain conditions which include:

- the swap is an over-the-counter, uncleared swap between Eligible Affiliates;
- neither Eligible Affiliate counterparty is (i) a swap dealer or a major swap participant; (ii) affiliated with a swap dealer or a major swap participant; or (iii) affiliated with a financial company that has been designated as systemically important;
- the swap is not a swap for which both Eligible Affiliates elect the Inter-Affiliate Exemption (i.e., the swap is not a Mandatory Clearing Swap or the swap is subject to the end-user exception); and
- all swaps entered into between either one of the Eligible Affiliates and an unaffiliated third-party counterparty (regardless of the location of the Eligible Affiliate) are reported to an SDR pursuant to, or as if pursuant to, Part 43, Part 45, and Part 46.

The last prong above effectively requires a non-U.S. Eligible Affiliate to ensure that all of its outward-facing swaps are reported to an SDR (either by the non-U.S. Eligible Affiliate or by the unaffiliated counterparty) even if such swaps are with non-U.S. persons. If the counterparties are one-hundred-percent commonly-owned Eligible Affiliates, the reporting counterparty relying on the relief must maintain records of all swap data as required under Part 45 (including internally generated swap identifiers for
each swap subject to the Inter-Affiliate No-Action Relief) and make all such records available to the CFTC upon request.

If the counterparties are not one-hundred-percent commonly-owned Eligible Affiliates (i.e., are only majority-owned Eligible Affiliates), the swap is subject to the following additional conditions:

- The reporting counterparty relying on the Inter-Affiliate No-Action Relief maintains records of all swap data as required under Part 45 and make all such records available to the CFTC upon request.
- The swap is not required to be reported pursuant to Part 43 of the Commission’s regulations (i.e., a “publicly reportable swap transaction”).
- The reporting counterparty reports all inter-affiliate swap data as described in Part 45, on a quarterly basis.

On April 9, 2013, the CFTC’s Division of Market Oversight issued additional no-action relief from the Part 43, Part 45 and Part 46 reporting requirements, extending certain of the reporting deadlines for transactions not covered by the no-action letter on inter-affiliate swaps. Prior to this relief, financial entity end users were required to report credit and interest rate swaps under Part 43 and Part 45 as of April 10, 2013. However, pursuant to the relief, financial entity end users may delay reporting equity, foreign exchange and other commodity swaps under Part 43 and Part 45 until May 29, 2013, provided that each financial entity end user backloads swap data required under Part 45 for such swaps that are executed between April 10, 2013 and May 29, 2013 by June 29, 2013. Financial entity end users will not be required to report any historical swap under Part 46 in any asset class until September 30, 2013.

Non-financial entity end users will not be required to report interest rate and credit swaps under Part 43 or Part 45 until July 1, 2013, provided that each non-financial entity end user backloads swap data under Part 45 for such swaps that are executed between April 10, 2013 and July 1, 2013 by August 1, 2013. Non-financial entity end users may delay reporting equity, foreign exchange and other commodity swaps under Part 43 and Part 45 until August 19, 2013, provided that each non-financial entity end user backloads swap data under Part 45 for such swaps that are executed between April 10, 2013 and August 19, 2013 by September 19, 2013. Non-financial entity end users will not be required to report any historical swap under Part 46 in any asset class until October 31, 2013.

**Variation Margin Requirement**

Pursuant to the Proposed Rules, Eligible Affiliates that are financial entities (as such term is defined in section 2(h)(7) of the CEA) would have been required to exchange variation margin to the extent such Eligible Affiliates were not one-hundred percent commonly-owned and commonly guaranteed. In the final Inter-Affiliate Exemption which covers majority-owned affiliate transactions, the CFTC determined not to adopt any general requirement that Eligible Affiliates exchange variation or initial margin as a condition for relying on the exemption (other than the transitional alternative conditions discussed above). The CFTC
acknowledged that a variation margin requirement may limit the ability of U.S. companies to allocate risk efficiently among affiliates and manage risk centrally.

Financial Entity Definition
In the release accompanying the Inter-Affiliate Exemption, the CFTC also provided some commentary on the definition of financial entity. The CFTC stated that it would not interpret the provisions of the Bank Holding Company Act of 1956, as amended, relating to the term “activities that are financial in nature” – a term that is used, in part, to define “financial entity” in the CEA. The CFTC stated that it declines to interpret a statutory provision within the jurisdiction of other U.S. authorities. On April 3, 2013, the Board of Governors of the Federal Reserve System adopted final rules of the definition of “activities that are financial in nature” for purposes of defining the term “nonbank financial company” under Title I of Dodd-Frank. The CFTC also stated that it would address the use of treasury affiliates (or central hedging affiliates) in a separate CFTC action.

ENDNOTES


3 See CFTC, “Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants”, 77 Fed. Reg. 55904 (Sept. 11, 2012). In particular, a swap dealer or major swap participant must comply with section 23.504 of the CFTC’s regulations relating to swap trading relationship documentation. See 17 C.F.R. § 23.504.

4 See CFTC, “Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants”, 77 Fed. Reg. 20128 (Apr. 4, 2012). In particular, Section 23.600 of the CFTC’s regulations prescribes the scope of a swap dealer’s or major swap participant’s internal risk management program. 17 C.F.R. § 23.600. For more information on this requirement, see our Memorandum to Clients, dated March 8, 2012, entitled “CFTC Adopts Internal Business Conduct Rules: CFTC Adopts Final Rules on Swap Dealer Major Swap Participant Recordkeeping and Reporting, Duties, and Conflicts of Interest Policies and Procedures; Futures Commission Merchant and Introducing Broker Conflicts of Interest Policies and Procedures; Swap Dealer, Major Swap Participant and Futures Commission Merchant Chief Compliance Officer”, available at http://www.sullcrom.com/files/Publication/8d1dc385-17db-40e2-a500-0c017b646f92/Presentation/PublicationAttachment/9c277ff4-ad26-4e13-8294-0c5ce53f61af/SC_Publication_CFTC_Adopts_Internal_Business_Conduct_Rules.pdf.

5 Inter-Affiliate Exemption, 78 Fed. Reg. at 21758.

That is, a swap that the CFTC has identified pursuant to section 50.4 of its regulations.

Because of this five-percent limit, it appears that many counterparties in jurisdictions other than the U.S., the European Union, Japan or Singapore that are part of a corporate group based outside of those jurisdictions may be required to comply with the Clearing Mandate of the U.S. with respect to outward facing Mandatory Clearing Swap in order to rely on the Inter-Affiliate Exemption for inter-affiliate swaps with any U.S.-based affiliates.


A “publicly reportable swap transaction” is at transaction that is executed at arm’s length between two parties that results in a change in the market risk positions between the two parties. The release accompanying Part 43 provided that inter-affiliate swaps between one-hundred percent commonly owned affiliates are not included in this definition. It is unclear whether swaps between majority-owned (but not one hundred percent commonly owned) affiliates would ever constitute “publicly reportable swap transactions”.


This reporting requirement may be satisfied by identifying one or more of the following: (i) a written credit support agreement; (ii) pledged or segregated assets (including posting or receiving margin pursuant to a credit support agreement or otherwise); (iii) a written guarantee from another party; (iv) the electing counterparty’s available financial resources; or (v) some other means.

An Eligible Affiliate “is considered by the [Securities and Exchange Commission] to be an issuer of securities registered under Exchange Act Section 12 or required to file reports pursuant to Exchange Act Section 15(d) if it is controlled by a person that is an issuer of securities registered under Exchange Act Section 12 or required to file reports pursuant to Exchange Act Section 15(d).” 77 Fed. Reg. at 42570.


See CFTC No-Action Letter 13-10 (Apr. 9, 2013).

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