CFTC’s End-User Exception

to the Clearing and Trading of Swaps
Brief Overview

• The Commodity Exchange Act (CEA) requires swaps to be cleared by a registered Derivatives Clearing Organization (DCO) if:
  – The CFTC determines that a swap, group of swaps, or type of swap must be cleared, and
  – No exception applies.

• If a swap is subject to a mandatory clearing determination by the CFTC, execution may be required on an exchange, such as a Designated Contract Market (DCM) or Swap Execution Facility (SEF).
Brief Overview

A list of the classes of swaps that are required to be cleared can be found in [CFTC Regulation 50.4](https://www.gpo.gov/fdsys/pkg/FR-2002-05-03/pdf/020503w50fr.pdf) (17 C.F.R. 50.4).

Currently, certain interest rate swaps and credit default swaps are subject to a clearing determination.
End-User Exception from Clearing & Trading

- The CFTC’s end-user exception permits a counterparty to elect not to clear a swap that must otherwise be cleared, but only if certain conditions are satisfied.
How to Qualify for the End-User Exception
Qualifying for the Exception

• Commodity Exchange Act, 7 U.S.C. § 2(h)(7)
• To qualify for the end-user exception, an entity must:
  – Not be a “financial entity”;
    • Banks and thrifts with less than $10 billion in total assets are not considered financial entities
  – Use the swap to hedge or mitigate commercial risk; AND
  – Notify a Swap Data Repository (SDR) or, if no SDR, the CFTC how it generally meets its financial obligations.
Claiming the Exception

- The following information must be reported on a swap-by-swap basis and with respect to each entity electing to be treated as an end-user:
  - Notice of the election of the end user exception;
  - The identity of the electing counterparty to the swap.

- Annual Filing: There is an alternative to reporting on a swap-by-swap basis which allows the electing counterparty to provide, through an annual filing, the following information:
  - Whether the electing counterparty is a “financial entity” and, if so, which exception to the financial entity it is relying on;
  - Whether the swap hedges or mitigates its commercial risk;
  - How the electing counterparty intends to meet its financial obligations of entering into an uncleared swap;
  - Whether the electing counterparty is an entity that is an issuer of securities registered under § 12 of the Securities Exchange Act and, if so, certain other information, including confirmations that its board of directors has approved the election not to clear.

- For 365 days immediately following the submission of the annual filing, swaps entered into by such counterparty may rely on the end user exception and not report information on a swap-by-swap basis.
Reporting Requirement

• Reporting must be made by the “reporting party” (typically a swap dealer or bank) → Look to the CFTC’s regulations at 17 C.F.R. Part 45.

• Each reporting party must have a reasonable belief that each counterparty electing to rely on the end-user exception meets the requirements.
Definition of Financial Entity

• “Financial entities” under the CEA and its regulations are not eligible for the end-user exception.

• The following are financial entities:
  – Registered Swaps Dealers, Security-based Swap Dealers, Major Swap Participants, Major Security-based Swap Participants
  – Commodity Pools
  – Private Funds (as defined in the Investment Advisers Act of 1940)
  – Employee Benefit Plans
  – Persons predominantly engaged in activities of banking or financial in nature (as defined in the Bank Holding Company Act of 1956).
What is Not a Financial Entity

- However, the definition of “financial entity” does not include:
  - Small banks and savings associations with total assets of less than $10 billion
  - Captive finance companies
  - Affiliates of Non-financial entities

*These Entities All Qualify for the End-User Exception*
Hedging or Mitigating Commercial Risk

• A swap is hedging or mitigating commercial risk when the swap:
  – Is exempt from position limit rules because it is a bona fide hedge; or
  – Qualifies for hedging treatment under FASB Topic 85 or Governmental Accounting Standards Board Statement 53; or
  – Is “economically appropriate” to reduce, in the ordinary course of business of a commercial enterprise, risks arising from:
    • Potential change in value of assets; OR
    • Potential change in value of liabilities incurred; OR
    • Potential change in value of services provided; OR
    • Potential change in value of assets, services, inputs products, or commodities; OR
    • Potential change in value related to any of the foregoing arising from forex rate movements; OR
    • Any fluctuation in interest, currency, or forex rate exposure arising from asset liabilities.
"Commercial" Risk

- Determination based on the underlying activity to which the risk related and not on type of entity.
  - May include financial risks and/or commodity risks.
Additional Considerations on Hedging

• The end-user exception is not available if used for speculation, investing, or trading.

• A swap that hedges risk associated with another swap may qualify for the end-user exception, assuming all other requirements are met.
  – Requirement: The first swap must also be used to hedge or mitigate commercial risks for the end-user claiming the exception.

• Swaps that facilitate portfolio hedging or dynamic hedging may be eligible for the end-user exception if they satisfy the rest of the conditions.
  – Note: The CFTC is concerned about abuse in this area and intends to monitor these arrangements carefully.
Generally Meets its Financial Obligations

The electing counterparty must identify one of the more following categories for how it generally meets its financial obligations:

- A written credit support agreement;
- Pledged or segregated assets;
- A written third-party guarantee;
- The electing counterparty's available financial resources; or
- Means other than those described immediately above.
Example

Fact Pattern
• An FDIC insured bank with less than $10 billion in total assets enters into a interest rate swap with a non-financial entity.
• The swap is hedging or mitigating the commercial risk of the non-financial entity.
• As agreed upon by the parties, the bank is the reporting party.
• Swap is subject to a mandatory clearing determination.

Questions:
• Absent an exception, must this swap be cleared? Yes
• May either (or both) counterparties elect to use the end-user exception in this instance? Yes, both counterparties
• Which parties’ commercial risk is being hedged by this swap? Non-financial entity
• Who is responsible for reporting this swap? Bank
• Is the electing party able to meet all its financial obligations associated with non-cleared swaps? Yes
Example (Instructions for Election)

Assuming no annual notice has been filed on behalf of the non-financial entity:

i) Upon the election of the non-financial entity that is using the swap to hedge its commercial risk,

ii) The bank/reporting party will report to an appropriate SDR or the CFTC that the non-financial end user is electing to use the end-user exception for this particular swap that hedges its commercial risk, and

iii) That the counterparty generally meets all its financial obligations associated with uncleared swaps.
Key Takeaway from Example & Instructions

• The electing party must be the counterparty for which the swap is hedging commercial risk.
Documentation Requirements

- The CFTC’s swap trading relationship documentation rules contain specific requirements that registered swap dealers must follow when trading with an entity that is relying on the end-user exception.

- CFTC Regulation 23.505 requires that for every swap excepted from mandatory clearing, a swap dealer must obtain sufficient documentation from the counterparty to provide a reasonable basis on which to believe that its counterparty meets the statutory conditions of the end-user exception. Such documentation must include:
  - The identity of the counterparty,
  - That the counterparty has elected not to clear a particular swap under section 2(h)(7) of the CEA and CFTC Regulations § 50.50,
  - That the counterparty is hedging or mitigating its commercial risk, and
  - That the counterparty generally meets all its financial obligations associated with uncleared swaps.

- CFTC Regulation 23.505 also requires that a swap dealer maintain documents, make them available promptly upon request to any representative of the CFTC or any applicable prudential regulator, or with regard to security-based swap agreements, or any representative of the CFTC, the SEC, or any applicable prudential regulator.
Penalties for Violation of the Rule

- If procedures are not followed, the election is not properly made, or if there is abuse of the end-user exception, then the CFTC may bring an action in the appropriate federal district court to enforce compliance with the relevant rules, regulations, or orders and may seek a civil monetary penalty for non-compliance.

- Dodd-Frank imposes a criminal penalty of $1 million or 10 years in prison, or both, for “abuse” of the end-user exception.

- In response to comments concerning the liability of the electing counterparty that are dependent on reporting counterparties to fulfill the reporting requirements of the rule, the CFTC noted that the electing counterparty is entitled to reasonably rely on the reasonable representations by the reporting counterparty that the notification has been properly transmitted to an SDR or the CFTC.