End-User Exception from the Clearing Mandate and the Trade Execution Requirement Under Dodd-Frank Act

Executive Summary

For most commercial end-users of swaps, the mandatory clearing requirement under Dodd-Frank first became applicable on September 9, 2013. Since then, many commercial end-users have relied on the so called “end-user exception” from the clearing mandate to continue executing uncleared swaps with their dealer counterparties. The end-user exception is subject to several conditions, which for SEC filers include undertaking certain corporate governance steps. The generally applicable conditions include reporting of certain information including how the entity relying on the exception generally meets its financial obligations, which reporting may be done annually. In discussing the corporate governance steps that SEC filers must undertake to avail themselves of the exception, the CFTC noted that it expects policies governing the relevant entity’s use of swaps under the end-user exception to be reviewed at least annually (and more often upon triggering events). With the one year anniversary of the initial clearing mandate approaching, this memorandum reviews the scope of the mandate as well as important related requirements and exceptions (including the annual reports and reviews that may be undertaken in the course of qualifying for the exception).

Table of Contents

1. Reliance on End-User Exception by Non-Financial Entities.
2. What is the end-user exception to the Clearing Mandate and the Trade Execution Requirement?
3. What types of entities are permitted to rely on the end-user exception?
4. What types of hedging activities are permitted under the end-user exception?
5. How must an end-user relying on the exception or the end-user’s counterparty go about reporting to an SDR how the end-user meets its financial obligations?
6. What documentation must a swaps end-user relying on the end-user exception provide to its counterparties?
7. May affiliates of non-financial entities, or any other entities rely on the end-user exception?
8. What should an SEC filer do to rely on the end-user exclusion?
Reliance on End-User Exception by Non-Financial Entities.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) grants the Commodity Futures Trading Commission (“CFTC”) the authority to mandate central clearing of swaps. In order to clear a swap, it must be submitted by a futures commission merchant (“FCM”) to a registered derivatives clearing organization (“DCO”). On November 29, 2012, the CFTC issued its first clearing mandate, requiring that four types of interest rate swaps and two types of index credit default swaps must be cleared (the “Clearing Mandate”). In addition, in January 2014, the first four swap “made available to trade” determinations (“MAT Determinations”) became effective and, as a result, certain categories of interest rate swaps and index credit default swaps became subject to mandatory competitive trade execution on a swap execution facility (“SEF”) or designated contract market (“DCM”) (the “Trade Execution Requirement”). The CFTC has, however, provided an exception from the Clearing Mandate and the Trade Execution Requirement for certain risk management swaps entered into by certain commercial end-users that are not “financial entities,” as described herein. Clearing and exchange trading mandates may be implemented by the CFTC for additional classes of swaps in the future.

What is the end-user exception to the Clearing Mandate and the Trade Execution Requirement?

The end-user exception (i) allows an end-user of a swap that would otherwise be subject to the Clearing Mandate to be excused from the Clearing Mandate under certain circumstances and provided that the end-user meets certain requirements, and (ii) acts as an exception from the Trade Execution Requirement that are subject to the Clearing Mandate. Pursuant to the end-user exception, the Clearing Mandate and the Trade Execution Requirement will not apply to any swap in which one of the counterparties to the swap:

- is not a financial entity;
- is using the swap to hedge or mitigate commercial risk; and
- provides certain information to the CFTC, including how it generally meets its financial obligations associated with entering into non-cleared swaps (as discussed below, this notification is required to be provided through a swap data repository, or “SDR”).

In addition, public reporting companies that are registered with the SEC that wish to avail themselves of the end-user exception must take certain corporate actions.

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1 MAT Determinations are self-regulatory organization rulemakings made by a SEF or DCM and are generally submitted to the CFTC under self-certification procedures, meaning that they will become “effective” 10 business days after the filing, unless the CFTC issues a stay (which stay lasts up to 90 days). Pursuant to CFTC rules, thirty days after a MAT Determination becomes effective, bilateral over-the-counter trading in the covered swaps becomes unlawful and all transactions involving such swaps must be competitively executed on a SEF’s or DCM’s order book or through a SEF’s request-for-quote system.
Reliance on the end-user exception is elective at the option of the end-user party and is in all cases non-mandatory. Certain end-users may determine that it is in their best interests not to elect to rely on the end-user exception.

What types of entities are permitted to rely on the end-user exception?
Entities that are non-financial end-users of swaps (i.e., that are not “financial entities”) are allowed to rely on the end-user exception. The following entities are “financial entities” and therefore are not eligible to rely on the end-user exception:

- swap dealers and security-based swap dealers;
- major swap participants and major security-based swap participants;
- commodity pools and private funds;
- employee benefit plans, as defined under Sections 3(3) or 3(32) of ERISA; and
- persons predominately engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in Section 4(k) of the Bank Holding Company Act (“BHCA”). The Dodd-Frank Act provisions regarding the end-user exception and the implementing CFTC materials do not define the term “predominantly engaged.” However, the Federal Reserve Board, which is the federal agency authorized to implement and administer the BHCA, has defined “predominantly engaged” for purposes of the Dodd-Frank Act provisions regarding systemically important nonbank financial institutions. For that purpose, the Federal Reserve Board deems a person to be predominantly engaged in financial activities if 85% or more of its consolidated annual gross revenues or total assets in either of the two most recent fiscal years are derived from activities that are financial in nature and defines “financial in nature” based generally on BHCA Section 4(k).

Each entity seeking to rely on the end-user exception should ensure that it is not a financial entity, or that if it is a financial entity it is able to use one of the following exceptions:


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2 The application of Section 4(k) of the BHCA is complex and highly fact-dependent. Examples of activities that may be “financial in nature” for purposes of Section 4(k) include (a) lending, exchanging, transferring, investing for others, or safeguarding money or securities; (b) insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities, and acting as principal, agent, or broker for purposes of the foregoing, in any State; (c) providing financial, investment, or economic advisory services, including advising an investment company; (d) issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly; (e) underwriting, dealing in, or making a market in securities; (f) engaging in any activity that the Federal Reserve Board has determined to be so closely related to banking or managing or controlling banks; (g) engaging, in the U.S., in any activity that (i) a bank holding company may engage in outside of the U.S., and (ii) the Federal Reserve Board has determined to be usual in connection with the transaction of banking or other financial operations abroad; (h) merchant banking investment activities; and (i) merchant banking investment activities conducted by an insurance company that is predominantly engaged in underwriting life, accident and health, or property and casualty insurance (other than credit-related insurance) or providing and issuing annuities, subject to various conditions, qualifications and limitations. This list is non-exclusive and Section 4(k) of BHCA captures a number of activities that may not be thought of as traditional “financial” activities.
• Treasury Affiliate exception (as discussed in our update dated June 7, 2013 found at http://www.sidley.com/CFTC-Issues-Clearing-Relief-for-Treasury-Affiliates-of-Non-Financial-Swap-End-Users-06-07-2013/)

What types of hedging activities are permitted under the end-user exception?
A swap will be deemed to hedge or mitigate commercial risk, and thereby be eligible for the end-user exception, provided the other requirements of the exception are met, if:

• the swap is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise;

• the swap qualifies as bona fide hedging for purposes of an exemption from position limits under the Commodity Exchange Act (“CEA”); or

• the swap qualifies for hedging treatment under an applicable accounting standard – either FASB ASC Topic 815, Derivatives and Hedging (formerly known as Statement No. 133) or GASB Statement 53, Accounting and Financial Reporting for Derivative Instruments.


Although the types of hedging and risk management permitted under the end-user exception are broad, each entity seeking to rely on the exception should nevertheless put in place policies and procedures designed to ensure that the entity only relies on the exception with respect to swaps that meet one of the foregoing categories of hedging and risk management activities.

How must an end-user relying on the exception or the end-user’s counterparty go about reporting to an SDR how the end-user meets its financial obligations?
If an end-user (i.e., an “electing counterparty”) elects to rely on the end-user clearing exception, either it or its counterparty (either of which would be referred to as the “reporting counterparty”) must provide, or cause to be provided, the following information to an SDR:3

• notice of the election (on a swap-by-swap basis);

• the identity of the electing counterparty (on a swap-by-swap basis); and

• specified additional information (this can be provided on a swap-by-swap basis, or in an annual filing).

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3 Swap data will likely be reported to DTCC Data Repository (U.S.) LLC (“DDR”). Information about DDR is available at: http://www.dtcc.com/products/derivserv/suite/us_swap_data_repository.php. Additional training resources concerning the DDR are available at https://www.dtcclearning.com/learning/gtr/. If no SDR were available to receive the information described in this Memorandum, such information would need to be reported directly to the CFTC. However, it is expected that reporting will be done through the DDR, and not directly with the CFTC.

What documentation must a swaps end-user relying on the end-user exception provide to its counterparties?

CFTC Rules require each swap dealer or major swap participant to “obtain documentation sufficient to provide a reasonable basis on which to believe that its counterparty meets the statutory conditions required for an exception from a mandatory clearing requirement[.]”

The ISDA March 2013 DF Protocol (the “Protocol”) provides an industry standard mechanism for swap dealers and major swap participants to obtain from their counterparties the information required in conjunction with such counterparties’ reliance on the end-user exception. By adhering to the Protocol and completing the Protocol questionnaire, an end-user may make a standing election to rely upon the end-user exception with respect to swaps that would otherwise be subject to the Clearing Mandate and/or the Trade Execution Requirement as well as make a standing representation to its counterparties that it does not intend to satisfy end-user exception reporting requirements by making an annual filing. Furthermore, to the extent the end-user elects not to make annual filings with an SDR, the end-user may provide the reporting counterparty with the “additional information” necessary to allow the reporting counterparty to report such information to an SDR on a swap-by-swap basis by properly completing the Protocol questionnaire. The information provided by the end-user via the Protocol questionnaire will be used by the reporting counterparty for all future swaps for which the end-user exception is elected, unless and until the end-user amends its Protocol questionnaire.

May affiliates of non-financial entities, or any other entities rely on the end-user exception?

Affiliates of non-financial entities (i.e., hedging affiliates)

Subject to certain exceptions, CEA allows an affiliate of a person that qualifies for the end-user exception (including affiliates that are themselves predominately engaged in providing financing for the purchase of the merchandise or manufactured goods of the person) to qualify for the end-user exception if the hedging affiliate, acting on behalf of the person and as an agent, uses the swap to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity.

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4 CFTC Rules § 23.505.

5 This requirement is so narrowly drawn that the “hedging affiliate” category is unlikely to be useful to the majority of swaps end-users.
Treatment of captive finance companies

The CEA carves out from the “financial entity” definition any 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” (i.e., a “captive finance company”).

A person that seeks to fall within the captive finance company exception must be in the “primary business” of providing financing of purchases or leases from its parent company or subsidiaries thereof. The captive finance company exception can be applied when this financing activity finances the purchase or lease of products sold by the parent company or its subsidiaries in a broad sense, including service, labor, component parts, and attachments that are related to the products. The CFTC also interprets the two 90 percent prongs of the test separately: 90 percent or more of the interest rate and currency exposures for which the captive finance company is using derivatives to hedge the related underlying commercial risks must arise from financing that facilitates the purchase or lease of products, and 90 percent or more of the products, the purchase or sale of which are being facilitated by the financing, must be manufactured by the parent company or its subsidiary. An entity must satisfy both prongs to be eligible for the captive finance company exception.

In response to concerns that the CFTC would require a product to have 90 percent or more of its components manufactured by the parent company or subsidiary in order to qualify as “manufactured” by the parent company or a subsidiary, the CFTC indicated that it would require only that the final product being purchased or sold, regardless of its components, be manufactured by the parent company or subsidiary.

Furthermore, the CFTC has indicated that the word “facilitates” in the captive finance exclusion should be interpreted broadly to include financing that may indirectly help to facilitate the purchase or lease of products.

What should an SEC filer do to rely on the end-user exclusion?

Any entity that is a counterparty to a swap and is an issuer of securities registered under Section 12 of the Securities Exchange Act of 1934 (“Exchange Act”) or that is required to file reports pursuant to Section 15(d) of the Exchange Act, or a subsidiary or affiliate that is controlled by such an issuer (referred to herein as an “SEC filer”), and that seeks to rely on the end-user exception should take the following additional actions to ensure its ability to rely on the end-user exception:

- It must ensure that the board of directors or an equivalent governing body (the “Board”) or an appropriate committee of the Board reviews and approves the decision to enter into swaps that are subject to the end-user exception.
  - This approval can be generic and need not be made on a swap-by-swap basis.
If the decision to enter into swaps subject to the end-user exception is to be made by a committee, the Board should adopt resolutions specifically authorizing that committee to make the decision to enter into swaps.6

The decision to enter into swaps does not need to be made on a swap-by-swap basis. It is sufficient that the committee (or Board) have authority to make a generic decision as to whether to enter into swaps. The Board has reasonable discretion to determine which committee is appropriate to exercise this authority or whether to exercise the discretion itself.

In the release accompanying rules relating to the end-user exception, the CFTC states that the Board or an appropriate committee of the Board should set appropriate policies and procedures (“Swaps Policies”) governing the use of swaps subject to the end-user exception. The CFTC also stated that it expects these Swaps Policies to be reviewed by the Board or an appropriate committee of the Board on an annual basis and more frequently upon a triggering event.

It is likely that many SEC filers already have appropriate Swaps Policies. However, some SEC filers may have policies that have not been adopted by the Board or an appropriate committee of the Board or that should be revised in light of CFTC guidance.

SEC filers should evaluate whether new Swaps Policies should be prepared, or whether existing Swaps Policies should be revised and/or formally adopted by the Board or an appropriate committee of the Board.

The CFTC does not address governance issues surrounding reliance on the end-user exception for entities that are not SEC filers.

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6 The CFTC has indicated that a committee will be deemed appropriate if it is specifically authorized to review and approve the SEC filer’s decision to enter into swaps.
execution; post-trade operation, modification, work-out, dispute resolution, remedies and recovery; practice before regulatory authorities; and general consultation.

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