

CFTC Takes Steps to Implement the Clearing Regime for Swaps and Finalizes the Exception From Clearing for Commercial End-Users

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Over the past month, the Commodity Futures Trading Commission (CFTC) has taken some major steps to implement a key piece of Dodd-Frank swap market regulation — the clearing requirement for swaps. On July 24, the CFTC released a proposal to subject a broad range of interest rate swaps and index credit default swaps (CDS) to the clearing mandate and simultaneously released final rules setting forth the implementation schedule for the clearing mandate.¹ Two weeks earlier, the CFTC adopted final rules governing the commercial end-user exception to the clearing mandate.²

This client alert explains how these final rules and the proposed clearing mandate fit together. Importantly, this flurry of rulemaking activity does not impose any immediate compliance obligations on market participants. Instead, it is now clear that no swaps will be required to be cleared until at least the first quarter of 2013, and no swaps involving commercial end-users, ERISA plans and various other entities will be subject to the clearing mandate for approximately one year. Consequently, commercial end-users will not have to take the steps necessary to elect the commercial end-user clearing exception for approximately one year.

Proposed Clearing Determination for IRS and CDS

The clearing mandate for swaps in Section 2(h)(1) of the Commodity Exchange Act (CEA) is a cornerstone of Dodd-Frank's financial reforms. Clearing through a derivatives clearing organization (DCO) mutualizes counterparty credit risk. Congress entrusted the CFTC with the task of determining which swaps should be subject to the clearing mandate by reviewing all swaps cleared by DCOs. The CFTC began this review earlier this year, and the proposed clearing determination reflects the results of this review with respect to index CDS and interest rate swaps.³ Comments on the CFTC's proposal must be received on or before September 6, 2012.

The proposal would require clearing of interest rate swaps denominated in dollars, euro, pounds and yen that are classified as fixed-to-floating swaps, basis swaps, forward rate agreements, or overnight index swaps and that have the specifications provided in Appendix A on page 4. The proposal would not require clearing for swaps with optionality, conditional notional amounts⁴ or that are denominated in dual currencies. The CFTC also has proposed to require clearing of certain dollar-denominated CDS based on untranching North American and European corporate indices. The precise specifications for the proposed CDS clearing mandate are listed in Appendix B on page 5.

¹ See Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. 47170 (August 7, 2012); and Swap Transaction Compliance and Implementation Schedule: Clearing Requirement Under Section 2(h) of the CEA, 77 Fed. Reg. 44441 (July 30, 2012).

² See End-User Exception to the Clearing Requirement for Swaps, 77 Fed. Reg. 42560 (July 19, 2012).

³ The CFTC intends to issue proposed clearing determinations for other types of swaps in the future.

⁴ The CFTC notes that a swap has a conditional notional amount if the notional amount can change over the term of the swap based on a condition established by the parties upon execution, such that the notional amount of the swap is contingent on the occurrence of some future event. If the notional amount of a swap changes over the term of the swap based on a schedule of notional amounts known at the time the swap is executed, the swap will not be considered to have a conditional notional amount.

Phase-in for Compliance With the Clearing Mandate

The CFTC adopted a clearing mandate compliance schedule simultaneously with the proposed clearing determination for CDS and interest rate swaps. Compliance with the clearing mandate will be phased-in over nine months after the CFTC finalizes its clearing determination. Based on statements made by CFTC Chairman Gary Gensler, the compliance dates for interest rate swaps and index CDS could be as early as the first quarter of 2013 or as late as the third quarter of 2013, depending upon the identity of the counterparties to the swap.⁵

The CFTC's compliance schedule divides swap market participants into three groups:

- Category 1 – swap dealers, major swap participants, security-based swap dealers, major security-based swap participants and active funds;⁶
- Category 2 – commodity pools, private funds that are not active funds and persons who predominantly are engaged in activities that are in the business of banking or financial in nature as defined in section 4(k) of the Bank Holding Company Act, provided that the entity is not a third-party subaccount;⁷ and
- All other market participants, including commercial end-users, ERISA plans and third-party subaccounts.

A swap between two Category 1 entities will be subject to the clearing mandate 90 days after the clearing determination for that swap is published in the Federal Register, as early as the first quarter of 2013. A swap between a Category 1 entity and a Category 2 entity or between two Category 2 entities will be subject to the clearing mandate 180 days after the clearing determination for that swap is published in the Federal Register, as early as the second quarter of 2013. All swaps that have at least one counterparty that is not a Category 1 or Category 2 entity will be subject to the clearing mandate 270 days after the clearing determination for that swap is published in the Federal Register, as early as the third quarter of 2013. However, market participants may choose to submit an eligible swap to clearing at any time prior to the applicable compliance date.

Commercial End-User Exception

Section 2(h)(7) of the CEA provides an exception from the clearing mandate for a swap if at least one counterparty: i) is not a financial entity; ii) is using the swap to hedge or mitigate commercial risk; iii) notifies the CFTC how it generally meets its financial obligations associated with entering into uncleared swaps; and iv) elects not to clear the swap. The CFTC's final rules implementing the commercial end-user exception provide additional guidance that end-users will need to follow when they elect to use the exception. End-users and their counterparties should be prepared to comply with these rules nine months after the clearing mandate takes effect for a swap. The clearing determination for interest rate swaps and index CDS may be finalized in October or November, so the earliest date that end-users will need to claim the exemption for these swaps (or any swaps at all) would be in July or August of 2013.

⁵ The clearing schedule adopted by the CFTC applies only to the interest rate swaps and index CDS that are subject to the CFTC's proposed clearing determination. The CFTC may decide to use this schedule for other clearing determinations, but has no obligation to do so. We expect the CFTC to specify in future clearing determinations whether the phased-in compliance schedule, or some other compliance schedule, will apply. See Rule 50.25(b).

⁶ Active funds are private funds (as defined in Section 202(a) of the Investment Advisors Act of 1940) that are not "third-party subaccounts" and that execute an average of 200 or more swaps per month over the 12 months preceding the clearing determination.

⁷ Third-party subaccounts are accounts managed by an investment manager that is independent of and unaffiliated with the account's beneficial owner or sponsor, and is responsible for the documentation necessary for the account's beneficial owner to clear swaps.

What types of entities can claim the commercial end-user exception?

The end-user exception only is available to a person that is not a “financial entity.” “Financial entities” are swap dealers, major swap participants, security-based swap dealers, major security-based swap participants, commodity pools, private funds, ERISA plans and others engaged primarily in activities that are financial in nature as defined in the banking laws. Subject to some fairly strict limitations, a finance affiliate of a nonfinancial entity may not be considered a financial entity and may be able to use the commercial end-user exception. In addition, banks, savings associations, farm credit system institutions and credit unions with total assets of less than \$10 billion will not be considered financial entities.

When does a swap hedge or mitigate commercial risk?

Under the final rules, a swap is used to hedge or mitigate commercial risk if the swap is “economically appropriate to the reduction” of any of six broad categories of commercial risks that cover, among other things, risks arising from potential changes in the value of assets, liabilities, services, inputs, products or commodities relating to a commercial end-user’s business as well as risks arising from changes in interest rates, currencies or foreign exchange rates. In addition, swaps that qualify as bona fide hedging for purposes of the exemption from position limits and swaps that qualify for hedge accounting treatment under FASB ASC Topic 815 (formerly known as Statement 133) or GASB Statement 53 are considered to be used to hedge or mitigate commercial risk. Swaps that are used for speculative, trading or investing purposes generally will not qualify as hedging or mitigating commercial risk.

What information must a commercial end-user provide to satisfy the end-user exception?

Special reporting requirements will apply to swaps for which the end-user exception is invoked. Specifically, the reporting party (typically a swap dealer) would need to provide a registered Swap Data Repository or the CFTC: i) notice of the election of the end-user exception; ii) the identity of the commercial end-user counterparty; and iii) specified information about the commercial end-user’s business and how the end-user meets its financial obligations regarding uncleared swaps, unless the end-user provides such specified information in an annual filing. As a practical matter, we expect most end-users to make the annual filing to avoid providing the required information to their swap dealer counterparties. Swap dealers likely will request additional representations from end-user counterparties including that the end-user is not a financial entity and has made the annual filing regarding its business and how it meets its financial obligations for uncleared swaps. Industry trade groups are developing an addendum to the ISDA Master Agreement to address these and other requirements that will apply to swap dealers.

End-users that are registered under Section 12 of the Securities Exchange Act of 1934 or that are required to file reports pursuant to Section 15(d) of the Securities Exchange Act of 1934 (collectively, “SEC Filers”) must receive approval from “an appropriate committee” of their board to use the end-user exception. In the preamble to the final rules, the CFTC notes that it expects an SEC Filer’s board that approves the use of the end-user exception to set appropriate policies governing the use of swaps not cleared pursuant to the end-user exception and to review those policies at least annually or more often, as necessary. The final rules clarify that board approval will not be required for each swap, rather a blanket approval will suffice. If a market participant is a subsidiary of an SEC Filer, the board of the SEC Filer will need to approve the subsidiary’s use of the end-user exception. Since end-users will have about a year to obtain board or committee approval, they may wish to consider taking this step at a regularly scheduled board or committee meeting.

Appendix A: Interest Rate Swaps

Specification	Fixed-to-Floating and Basis Swap Classes			
1. Currency	USD	EUR	GBP	JPY
2. Floating Rate Indexes	LIBOR	EURIBOR	LIBOR	LIBOR
3. Stated Termination Date Range	28 days - 50 years	28 days - 50 years	28 days - 50 years	28 days - 30 years
4. Optionality	No	No	No	No
5. Dual Currencies	No	No	No	No
6. Conditional Notional Amounts	No	No	No	No

Specification	Forward Rate Agreement Class			
1. Currency	USD	EUR	GBP	JPY
2. Floating Rate Indexes	LIBOR	EURIBOR	LIBOR	LIBOR
3. Stated Termination Date Range	3 days - 3 years	3 days - 3 years	3 days - 3 years	3 days - 3 years
4. Optionality	No	No	No	No
5. Dual Currencies	No	No	No	No
6. Conditional Notional Amounts	No	No	No	No

Specification	Overnight Index Swap Class		
1. Currency	USD	EUR	GBP
2. Floating Rate Indexes	FedFunds	EONIA	SONIA
3. Stated Termination Date Range	7 days - 2 years	7 days - 2 years	7 days - 2 years
4. Optionality	No	No	No
5. Dual Currencies	No	No	No
6. Conditional Notional Amounts	No	No	No

Appendix B appears on the next page.

Appendix B: Credit Default Swaps

Specification	North American Untranching CDS Indices Class
1. Reference Entities	Corporate
2. Region	North America
3. Indices	CDX.NA.IG CDX.NA.HY
4. Tenor	CDX.NA.IG: 3Y, 5Y, 7Y, 10Y CDX.NA.HY: 5Y
5. Applicable Series	CDX.NA.IG 3Y: Series 15 and all subsequent series, up to and including the current series CDX.NA.IG 5Y: Series 11 and all subsequent series, up to and including the current series CDX.NA.IG 7Y: Series 8 and all subsequent series, up to and including the current series CDX.NA.IG 10Y: Series 8 and all subsequent series, up to and including the current series CDX.NA.HY 5Y: Series 11 and all subsequent series, up to and including the current series
6. Tranching	No

Specification	European Untranching CDS Indices Class
1. Reference Entities	Corporate
2. Region	Europe
3. Indices	iTraxx Europe iTraxx Europe Crossover iTraxx Europe HiVol
4. Tenor	iTraxx Europe: 5Y, 10Y iTraxx Europe Crossover: 5Y iTraxx Europe HiVol: 5Y
5. Applicable Series	iTraxx Europe 5Y: Series 10 and all subsequent series, up to and including the current series iTraxx Europe 10Y: Series 7 and all subsequent series, up to and including the current series iTraxx Europe Crossover 5Y: Series 10 and all subsequent series, up to and including the current series iTraxx Europe HiVol 5Y: Series 10 and all subsequent series, up to and including the current series
6. Tranching	No