

Securities Regulation and Compliance Alert

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New CFTC Swap Clearing Rules to Require Board Review and Approval of the Election to Rely on the "Commercial End-User Exception"

New Commodity Futures Trading Commission (CFTC) swaps clearing rules will force non-financial entities to stop uncleared trading of certain interest-rate swaps (IRS) and index credit default swaps (index CDS) starting on **September 9, 2013**, unless such entities qualify for and claim the "commercial end-user exception" included in those rules.¹

The CFTC adopted the swaps clearing rules² to implement the Dodd-Frank Act provision that requires that any swap of a group, type or category of swaps that the CFTC requires to be cleared to be submitted for clearing to a clearinghouse, also referred to as a derivatives clearing organization or "DCO."³ So far, the CFTC has required that only specific types of IRS and index CDS be cleared under a phased-implementation schedule that runs over the course of 2013, with non-financial entities required to begin clearing on September 9, 2013.⁴ The CFTC's swaps clearing rules also implement a significant statutory exception to the mandatory clearing requirement — the commercial end-user exception.⁵

Commercial end-user exception. A company will be eligible to claim the commercial end-user exception if it satisfies the following criteria:

- It is not a "financial entity"⁶;
- It enters into the swap to "hedge or mitigate its commercial risk";⁷
- It provides (or its counterparty provides) certain information to a swap data repository (SDR), or if no SDR is available, to the CFTC; and
- If it is a reporting company,⁸ an "appropriate committee" of the company's board or governing body reviews and approves the decision to claim the end-user exception for swaps that are subject to the clearing mandate and exchange trading mandate.

Board or committee approval. Although the commercial end-user exception specifically states that an "appropriate committee" of the company's board must review and approve the decision to claim the exemption, CFTC staff has indicated that review and approval by either an appropriate committee or the full board will satisfy the requirements of the exception. The CFTC will consider a committee to be "appropriate" if it is specifically authorized to review and approve the company's decision to enter into swaps.⁹

Approval by the board or committee to enter into swaps subject to the commercial end-user exception can be done either on a swap-by-swap basis or on a general basis. If the approval is general, it must be reviewed no less than annually. Although not required by the rules, the CFTC also expects a board or committee

that approves the use of the exception to set appropriate policies governing the use of swaps subject to the exception and to review those policies at least annually and, as appropriate, more often upon the occurrence of a triggering event (such as the implementation of a new hedging strategy that was not previously contemplated by the board or committee).¹⁰ Subsidiaries and other controlled persons of reporting companies also must obtain board or committee approval in order to rely on the exception.

Next steps. Reporting companies that intend to rely on the commercial end-user exception should begin to develop and implement approval policies and procedures so that they are in place prior to *September 9, 2013*. Among other things, companies should:

- Determine whether the board or a committee of the board will review and approve the decision to claim the exception;
- If a board committee will perform the requisite functions,
 - o review the charters of existing committees to determine if any committee is currently authorized to review and approve swaps; and
 - o if necessary, establish a new committee or delegate authority to an existing committee to review and approve the company's decision to enter into swaps (by a board resolution and/or an amendment to such committee's charter);
- Have the board or committee review and discuss with management the company's current and proposed hedging strategies and use of swaps and review and set policies governing the use of the end-user exception;
- Have the board or committee approve a resolution that the company may enter into swaps that are excepted from the clearing and execution requirements; and
- Have the board or committee add to its annual schedule a review of the company's policies and renewing its approval to use the end-user exception.

END NOTES

- 1 **See** End-User Exception to the Clearing Requirement for Swaps, 77 Fed. Reg. 42,560 (July 19, 2012).
- 2 **See** Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. 74,284 (Dec. 13, 2012).
- 3 7 U.S.C. § 2(h)(1) (providing that it "shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing to a derivatives clearing organization ... if the swap is required to be cleared"). There also is a statutory exchange trading requirement that provides that swaps that are required to be cleared and "made available to trade" on a designated contract market (DCM) or swap execution facility (SEF) must be executed on a DCM or SEF. CEA Section 2(h)(8). The CFTC has not yet finalized rules to implement this exchange-trading requirement.
- 4 **See** 77 Fed. Reg. at 74,336 for the chart of swaps that currently are subject to the clearing mandate. The CFTC has not yet proposed that the clearing mandate apply to any other types of swap. Notably, on Feb. 25, 2013, the CFTC extended the compliance date for non-financial entities to clear swaps on iTraxx CDS indices or claim the end-user exception to clearing for iTraxx CDS indices until Oct. 23, 2013; however, the compliance date for non-financial entities to clear IRS and CDX CDS indices remains Sept. 9, 2013. **See** CFTC Press Release: PR6521-13 (Feb. 25, 2013), available at, <http://www.cftc.gov/PressRoom/PressReleases/pr6521-13>.
- 5 This exception also will apply to the exchange-trading requirement once the CFTC adopts implementing rules. Further, in addition to the commercial end-user exception, the CFTC has proposed but not yet finalized two exemptions from the clearing mandate. **See** Clearing Exemption for Certain Swaps Entered Into by Cooperatives, 77 Fed. Reg. 41940 (July 17, 2012); Clearing Exemption for Swaps Between Certain Affiliated Entities, 77 Fed. Reg. 47169 (Aug. 7, 2012).
- 6 Among those considered to be "financial entities" are commodity pools, private funds, employee benefit plans as defined in paragraphs (3) and (32) of Employee Retirement Income Security Act of 1974, as amended (ERISA), and persons predominately engaged in activities that are in the business of banking or that are financial in nature, as defined in Section 4(k) of the Bank Holding Company Act of 1956. **See** 7 U.S.C. § 2(h)(7)(C)(i). The analysis of who is or is not a "financial entity" can be complicated by the banking regulators' broad definition of "activities that are financial in nature" and uncertainty over how to determine whether a person is "predominantly engaged" in such activities.

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- 7 The rules provide several alternatives for meeting the “hedge or mitigate” standard, including where the swap qualifies for hedging treatment under Financial Accounting Standard Board Accounting Standards Codification Topic 815, Derivatives and Hedging and other anti-speculative conditions are met.
- 8 A reporting company is an issuer of securities registered under Section 12 of the Securities Exchange Act of 1934 (Exchange Act), a reporting company under Section 15(d) of the Exchange Act, or an affiliate or subsidiary of a reporting company.
- 9 See 77 Fed. Reg. at 42,569.
- 10 *Id.*