

CFTC Eases Compliance Burdens for Certain Inter-Affiliate Swaps

Counterparties to inter-affiliate swaps may now qualify for recently issued regulatory relief from mandatory clearing or reporting requirements. On April 1, 2013, the US Commodity Futures Trading Commission ("CFTC") approved Regulation 50.52, available [here](#), which provides a narrow exemption from mandatory clearing under the Commodity Exchange Act ("CEA") for inter-affiliate swaps, subject to a number of conditions. A few days later, on April 5, 2013, the Division of Market Oversight and the Division of Clearing and Risk of the CFTC jointly issued no-action relief in CFTC Letter No. 13-09, available [here](#) (the "Inter-affiliate Letter"), which exempts parties from reporting inter-affiliate swaps subject to several conditions. The exemption from mandatory clearing will become effective on June 10, 2013. The no-action relief has immediate effect.

Exemption from Mandatory Clearing for Certain Inter-Affiliate Swaps

Under Regulation 50.4, the CFTC has determined that a wide range of swap products are subject to mandatory clearing (such swaps, "MC Swaps"). Certain entities, particularly end-users that meet certain conditions, are exempt from the requirement to clear MC Swaps, but in general, most other market participants will be required to do so.

To provide relief for entities that cannot use the end-user exemption, but are trading with their own affiliates, Regulation 50.52 exempts inter-affiliate MC Swaps (such swaps "Affiliate Swaps") from mandatory clearing if: (1) one counterparty to the swap holds a majority ownership interest in the other

counterparty, or a third party (a "Majority Parent") holds a majority ownership interest in both counterparties, and (2) the financial statements of the counterparties are included in the same consolidated financial statements (such counterparties being "Majority-owned Affiliates" and, for the purposes of the Regulation, "Eligible Affiliate Counterparties"). In addition, to be eligible for the inter-affiliate clearing exemption:

- both Eligible Affiliate Counterparties must elect not to clear the Affiliate Swap;
- the terms of the Affiliate Swap must be documented in a swap trading document (or, if one of the Eligible Affiliate Counterparties is a swap dealer ("SD") or major swap participant ("MSP"), such party complies with the CFTC's swap trading relationship documentation regulation); and

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- the Affiliate Swap must be subject to a centralized risk management program that is reasonably designed to monitor and manage the risks associated with it (or, if one of the Eligible Affiliate Counterparties is an SD or MSP, such party complies with the CFTC's risk management program regulation).

Clearing rules for outward-facing swaps outside the United States

To address concerns that the use of the inter-affiliate exemption might be used to transfer swap activity with third parties out of the US regulatory framework and thereby increase the risk to the US financial system, the CFTC has also imposed rules governing the activity of an Eligible Affiliate Counterparty with non-affiliated counterparties (each, a "Non-Affiliate Counterparty").

Regulation 50.52 states that where one Eligible Affiliate Counterparty executes an MC Swap (an "outward-facing swap") with a Non-Affiliate Counterparty, the outward-facing swap is subject to mandatory clearing unless a separate exemption (such as the end-user exemption) applies.

However, the parties to an outward-facing swap may use a form of substituted compliance to meet the requirements of Regulation 50.52, by complying with the requirements for swap clearing under a non-US jurisdiction's comprehensive clearing regulations that are comparable (although not necessarily identical) to the CFTC's clearing requirement. If the parties rely on an exemption under the non-US clearing regulations so as not to clear the outward-facing swap, the exemption must also be comparable (although not necessarily identical) to a clearing exemption provided in the CFTC's regulations. The

clearinghouse on which the outward-facing swap is cleared need not be in the same jurisdiction as either of the parties, as long as it is subject to supervision by regulators in its home jurisdiction, and it has been assessed to be in compliance with the Principles for Financial Market Infrastructures published by IOSCO.

As a result, Eligible Affiliate Counterparties using the exemption may be required to clear MC Swaps executed outside the United States that would not ordinarily be subject to mandatory clearing in the relevant non-US jurisdiction, because there is no equivalent exemption under the CFTC's rules to the relevant provision of the non-US jurisdiction.

Transition Period for Certain Jurisdictions

In recognition of the fact that certain jurisdictions that are in the process of implementing their clearing regimes, the CFTC has provided for a deferral period for swaps involving Eligible Affiliate Counterparties located in the European Union, Japan or Singapore (each, a "Transition Jurisdiction"). Eligible Affiliate Counterparties in a Transition Jurisdiction will not be subject to the requirement to clear outward-facing swaps until March 11, 2014, if either:

- each outward-facing swap between such an Eligible Affiliate Counterparty and a Non-Affiliate Counterparty is subject to full mark-to-market margining on a daily basis; or
- each Affiliate Swap involving any Eligible Affiliate Counterparty is subject to full mark-to-market margining on a daily basis.

Compliance with either daily margining requirement is not required, however, if (1) the Eligible Affiliate Counterparty that owns the other Eligible Affiliate Counterparty, or their Majority Parent,

is not a financial entity and (2) no affiliate of either Eligible Affiliate Counterparty is an SD or MSP.

For the purposes of this time-limited exception requirement to clear outward-facing swaps, the CFTC has provided guidance that a Majority Parent will not be a financial entity if (a) it can identify all of its Eligible Affiliate Counterparties, (b) a predominant number of those Eligible Affiliate Counterparties qualify for the CFTC's end-user exemption and (c) if the activities of all such Eligible Affiliate Counterparties were deemed to be undertaken directly by the Majority Parent, the Majority Parent would not be predominantly engaged in the business of banking or in activities that are financial in nature, as defined for the purposes of the CFTC's end-user exemption.

Transition Period for *de minimis* jurisdictions

The CFTC has also provided a transition period for outward-facing swaps executed by Eligible Affiliate Counterparties that are neither in the United States nor a Transition Jurisdiction, as long as the volume of such swaps remains below a specified threshold.

If one of the Eligible Affiliate Counterparties to an Affiliate Swap is located in the United States and the other Eligible Affiliate Counterparty is located in a jurisdiction other than the United States or a Transition Jurisdiction, the Eligible Affiliate Counterparty in the non-US jurisdiction will not be required to clear outward-facing swaps for purposes of this exemption until March 11, 2014, if:

- the aggregate notional value of the Affiliate Swaps between the relevant Eligible Affiliate Counterparties does not exceed five percent of the aggregate notional value of all the swaps that

are in a class subject to mandatory clearing executed by the Eligible Affiliate Counterparty located in the United States (measured in U.S. dollar equivalents and calculated for each calendar quarter).

- each outward-facing swap between such an Eligible Affiliate Counterparty and a Non-Affiliate Counterparty located outside the United States or a Transition Jurisdiction is subject to full mark-to-market margining on a daily basis; or
- each Affiliate swap involving any Eligible Affiliate Counterparty is subject to full mark-to-market margining on a daily basis.

Reporting Requirements for Uncleared Affiliate Swaps

Entities that execute swaps in reliance on the inter-affiliate exemption remain subject to certain reporting requirements. The "reporting counterparty" for any Affiliate Swap is determined using the same hierarchy as for general non-affiliate swaps, under Regulation 45.8.

The reporting counterparty is to report the following information to a swap data repository ("SDR") or if no SDR is available, to the CFTC for each uncleared Affiliate Swap:

- confirmation that both Eligible Affiliated Counterparties to the Affiliate Swap are electing to not clear the Affiliate Swap and that they each satisfy the requirements of the exemption; and
- a description of how the counterparties generally meet their financial obligations associated with entering into uncleared swaps.

The description of how each counterparty meets its financial obligations associated with uncleared

swaps may be reported on an annual basis in anticipation of electing to use this exemption. Additionally, if an Eligible Affiliate Counterparty is subject to the SEC's public reporting requirements, it must report, on an annual basis, to an SDR (or, if no SDR is available, to the CFTC) its SEC Central Index Key number and an acknowledgement that an appropriate committee of the board (or equivalent body) has reviewed and approved the decision to enter into swaps that are exempt from mandatory clearing. Accordingly, public companies that

What does "financial entity" mean?

"Financial entities" include "a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature," excluding certain small banks and credit unions.

The CFTC has indicated that the business activities of affiliates that are in the nature of banking or of a financial nature would be attributed to their holding company for purposes of determining whether a holding company could qualify for certain time-limited relief pursuant to Regulation 50.52(b)(4).

A commenter on the proposed CFTC rulemaking for the inter-affiliate clearing exemption requested that the CFTC clarify when a treasury affiliate would be considered a financial entity. The CFTC stated in the release accompanying the exemption that it intends to address the use of treasury affiliates by separate action.

intend to rely on the inter-affiliate exemption should arrange for an appropriate board committee to review and, if determined to be advisable, approve reliance on this exemption on an annual basis.

No-Action Relief from Reporting Requirements for Certain Inter-Affiliate Swaps

The Inter-affiliate Letter ([CFTC Letter No. 13-09](#)) exempts counterparties to Affiliate Swaps from reporting their Affiliate Swaps to an SDR, subject to several conditions. This no-action relief is available to entities that rely on the end-user exemption from clearing. It is not available to entities that instead rely on the inter-affiliate exemption described above.

Relief for wholly-owned affiliates

The Inter-affiliate Letter provides regulatory relief from obligations to report data regarding certain swaps ("Wholly-owned Affiliate Swaps") pursuant to Regulations 45.3(d)(1), 45.3(d)(3), 45.4(c)(1)(ii), 45.4(c)(2)(ii), 45.5 and 50.50(b) of the CFTC's regulations if the following six conditions are met:

1. one counterparty to the swap holds a 100% ownership interest in the other counterparty, or a third party holds a 100% ownership interest in both counterparties, and the financial statements of these counterparties are included in the same consolidated financial statements;
2. neither of the counterparties is an SD or MSP, is affiliated with an SD or MSP or is affiliated with a

financial company that has been designated as systemically important pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act);

3. the Wholly-owned Affiliate Swap is not executed on or pursuant to the rules of any trading platform where the orders of the affiliated companies may be exposed to potential execution against unaffiliated parties (including a designated contract market, a swap execution facility, a foreign board of trade that is registered with the CFTC);
4. the Wholly-owned Affiliate Swap is not submitted for clearing to a regulated derivatives clearing organization ("DCO");
5. all outward-facing swaps between either of the affiliated counterparties with any unaffiliated counterparty (regardless of the location of the affiliated counterparty) are reported to an SDR registered with the CFTC pursuant to (or as if pursuant to) Parts 43, 45 and 46; and
6. a reporting counterparty relying on this portion of the Inter-affiliate Letter maintains records of Wholly-owned Affiliate Swaps as required by Part 45 of the CFTC's regulations, and such records must include internally generated swap identifiers for each Wholly-owned Affiliate Swap that is not reported in reliance on the Inter-affiliate Letter, and must make such records available to the CFTC promptly upon request.

The fifth condition listed above may pose a significant hurdle for Wholly-owned Affiliate Swaps involving non-US affiliates. This condition would require reporting of all outward facing swaps by the non-US affiliate – including those over which the CFTC would otherwise not have jurisdiction.

As a result, the Inter-affiliate Letter will likely be used only rarely for affiliate swaps involving a non-US affiliate which engages in numerous outward facing swaps with non-US counterparties.

With respect to sixth condition listed above, the swap identifiers should be an alphanumeric code that is unique in relation to all other such codes generated and assigned to any swaps that are entered into by the reporting counterparty or any of its affiliates and not reported to an SDR in reliance on the Inter-affiliate Letter.

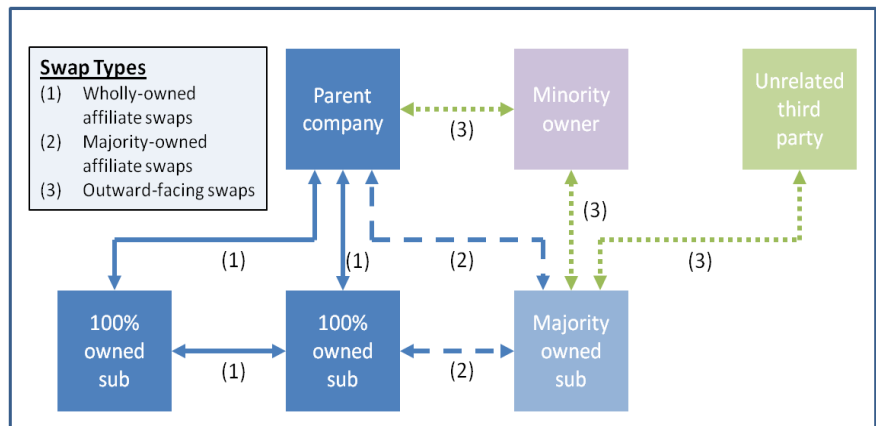
Alternative relief for Majority-owned Affiliates

For swaps ("Majority-owned Affiliate Swaps") between Majority-Owned Affiliates, this no-action letter permits quarterly reporting of swap data to an SDR (no later than 30 days after the end of each fiscal quarter) and provides relief from the reporting requirements of Regulations 45.3(d)(1), 45.3(d)(3), 45.4(c)(1)(ii), 45.4(c)(2)(ii) and 50.50(b) of the CFTC's regulations, if the following seven conditions are met:

1. the parties are Majority-owned Affiliates;
2. neither of the counterparties is an SD or MSP, is affiliated with an SD

or MSP or is affiliated with a financial company that has been designated as systemically important pursuant to the Dodd-Frank Act;

3. the Majority-owned Affiliate Swap is not executed on or pursuant to the rules of any trading platform where the orders of the affiliated companies may be exposed to potential execution against unaffiliated parties (including a designated contract market, a swap execution facility, a foreign board of trade that is registered with the CFTC);
4. the Majority-owned Affiliate Swap is not submitted for clearing to a DCO;
5. all outward-facing swaps between either of the affiliated counterparties with any unaffiliated counterparty (regardless of the location of the affiliated counterparty) are reported to an SDR registered with the CFTC pursuant to (or as if pursuant to) Parts 43, 45 and 46;
6. a reporting counterparty relying on this portion of the Inter-affiliate Letter must maintain records of Majority-owned Affiliate Swaps as required by Part 45 and must make such records available to the CFTC promptly upon request; and



7. the Majority-owned Affiliate Swap is not subject to real time reporting pursuant to Part 43.

Condition number 5 listed above poses the same hurdle for Majority-owned Affiliate Swaps involving non-US affiliates as the equivalent condition for Wholly-Owned Affiliate Swaps. As a result, the Inter-affiliate letter will likely be used only rarely for swaps involving a non-US affiliate which engages in numerous outward facing swaps with non-US counterparties.

The CFTC has provided a short, non-exclusive list of types of swaps that are not at arm's length and therefore not subject to real time reporting pursuant to Part 43. Notably, this list includes Wholly-owned Affiliate Swaps. While the CFTC has not explicitly expanded this list of examples, we believe that the inclusion of a condition related to Part 43 of the CFTC's regulations indicates that at least some of Majority-owned Affiliate Swaps would not be subject to real-time reporting pursuant to Part 43 (because they are not at arm's length).

The first quarterly reports of the Majority-owned Affiliate Swap data pursuant to the Inter-affiliate Letter will be due within 30 days after the end of the first fiscal quarter ending on or after June 30, 2013, and such report must include all swap transaction data

required to be reported under Part 45 for the period between April 10, 2013 and the end of such fiscal quarter. Subsequent quarterly reports would be due no later than 30 days following the end of each fiscal quarter, and such reports must include all Part 45 swap transaction data for the most recently completed fiscal quarter.

Relief from obligations to report historic inter-affiliate swaps data

The Inter-affiliate Letter also provides relief from obligations to report pre-enactment or transition swap data for inter-affiliate swaps pursuant to Regulations 46.3(a) or 46.3(b) of the CFTC's regulations if the following five conditions are met:

1. the parties are Majority-owned Affiliates;
2. neither of the counterparties is an SD or MSP, is affiliated with an SD or MSP or is affiliated with a financial company that has been designated as systemically important pursuant to the Dodd-Frank Act;
3. the swap is not executed on or pursuant to the rules of any trading platform where the orders of the affiliated companies may be exposed to potential execution against unaffiliated parties

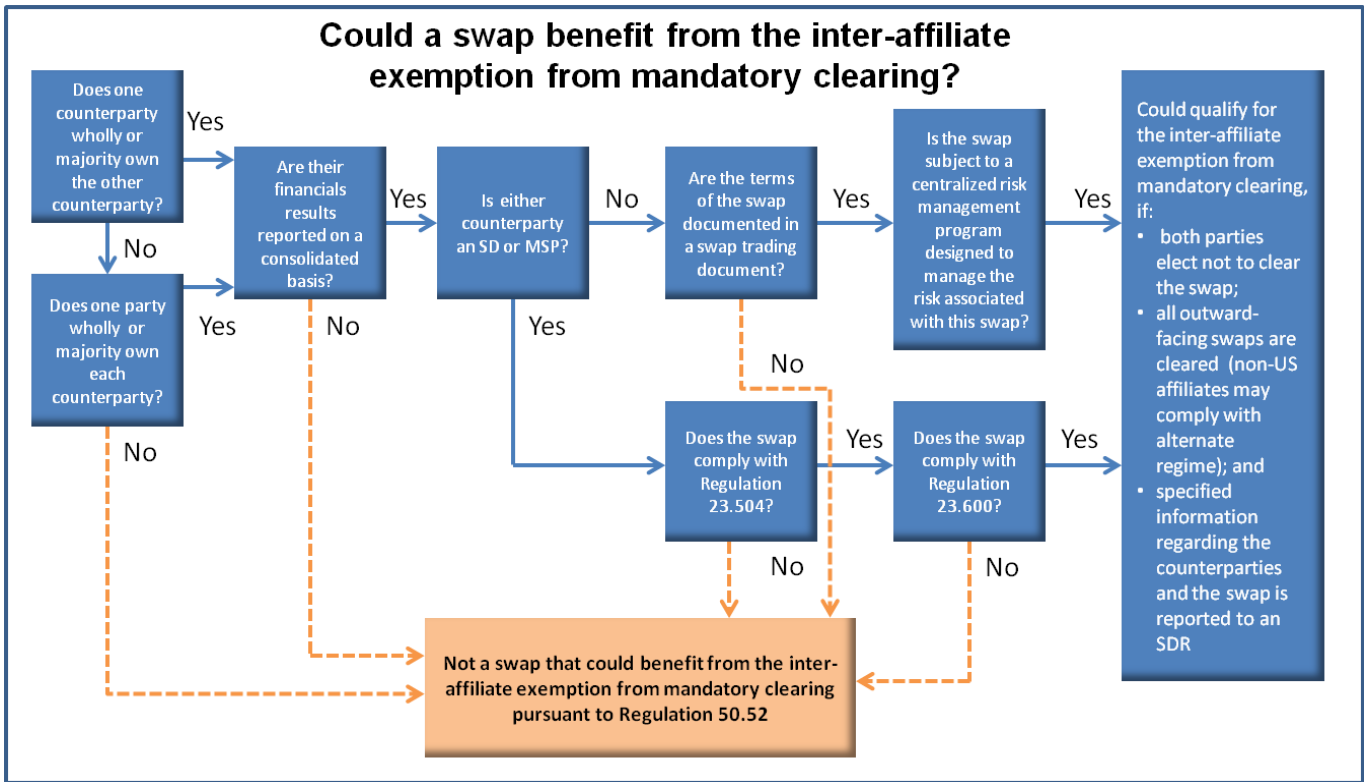
(including a designated contract market, a swap execution facility, a foreign board of trade that is registered with the CFTC);

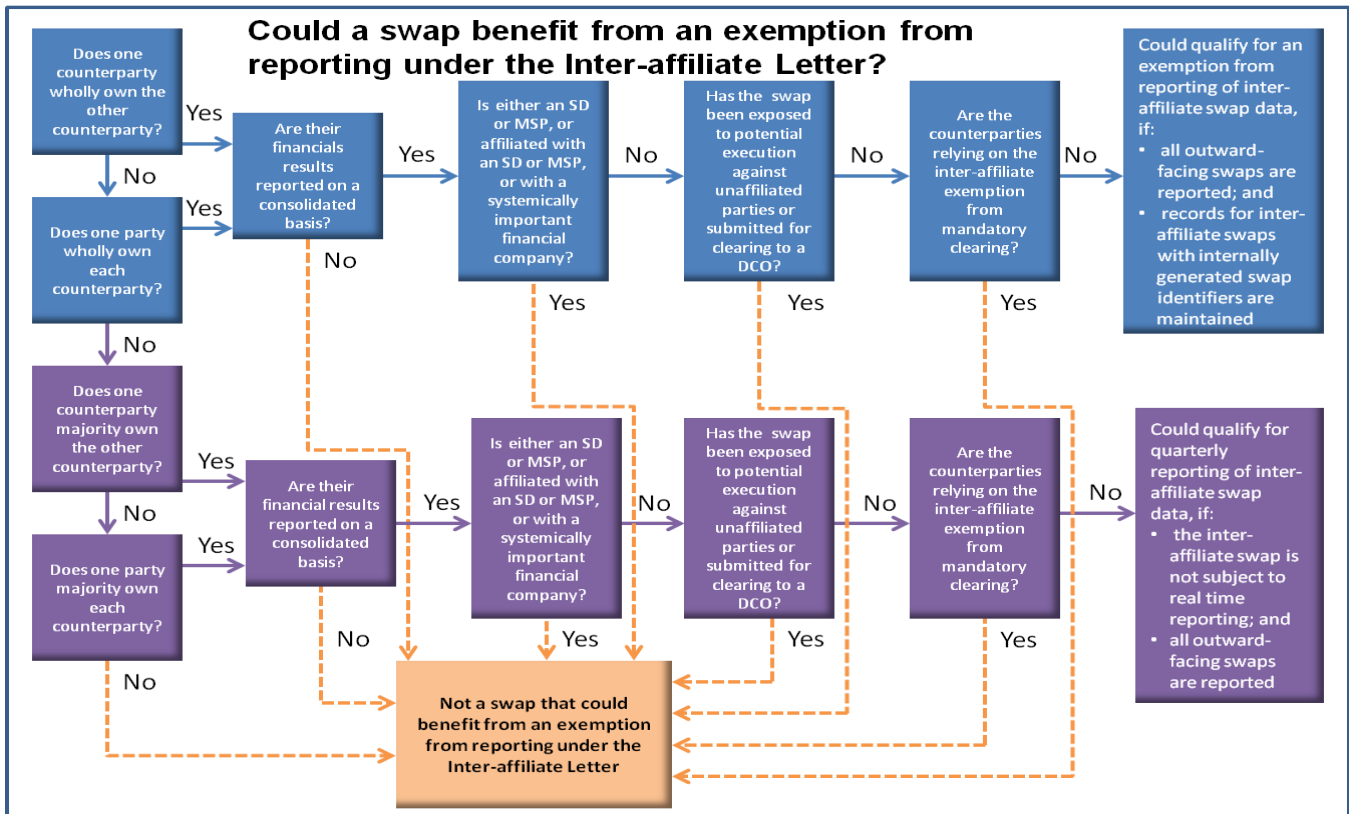
4. the swap is not submitted for clearing to a DCO; and
5. a reporting counterparty relying on this portion of the Inter-affiliate Letter must maintain records of all pre-enactment and transition swap data as required by Part 46 of the CFTC's regulations and must make such records available to the CFTC promptly upon request.

Conclusion

The CFTC's recent rulemaking and no-action relief seeks to mitigate some of the regulatory burdens that would have otherwise applied to inter-affiliate swaps. In each case, the relief is fairly narrow in its scope, and is subject to a number of qualifications that could significantly reduce its benefit to many market participants. As an initial compliance matter, therefore, on a trade-by-trade basis, each market participant will need to analyze whether each of the conditions is in fact met with respect to the relevant exemption, which could significantly increase the burden, and decrease the usefulness, of each of the rules.

Appendix





This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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