

CFTC Proposes Clearing Exemption for Inter-Affiliate Swaps

August 20, 2012

On August 16, 2012, the CFTC proposed rules that would permit affiliated swap counterparties to elect an exemption from mandatory swaps clearing, subject to various conditions. These conditions include reporting, documentation, risk management and other obligations, and, for swaps between financial entities, a requirement to provide variation margin.¹

The Commodity Exchange Act requires swaps that have been designated by the CFTC as subject to mandatory clearing to be submitted for clearing to a designated clearing organization – unless a counterparty qualifies for an exemption from the clearing requirement. In proposing the inter-affiliate exemption from the clearing requirement, the CFTC recognized the risk management benefits and efficiencies that uncleared inter-affiliate swaps may provide for large financial and other organizations, but also noted its concerns about the “systemic risk repercussions” of uncleared inter-affiliate swaps. These concerns are reflected in the proposed conditions that would apply to affiliated counterparties seeking to rely on the exemption.

The CFTC’s proposed requirements for the use of the exemption are highly controversial. In particular, CFTC Commissioners Sommers and O’Malia voted against releasing the proposal because, in their view, the variation margin requirement is unwarranted.

The comment period for the proposed rules will end 30 days after publication of the proposal in the *Federal Register*, which is expected to occur shortly.

Requirements for Using the Inter-Affiliate Exemption

The proposed rules set forth several conditions and other requirements that must be satisfied in order to use the exemption.

Majority Ownership

To use the exemption: (i) one counterparty directly or indirectly must hold a majority ownership interest in the other; **or** (ii) a third party directly or indirectly must hold a majority ownership interest in both counterparties. In addition, the financial statements of the affiliated counterparties must be reported on a consolidated basis.

Trading Documentation

The inter-affiliate swap is required to be formally documented, a requirement which will represent a change from current practice at many institutions. Specifically:

- an eligible affiliate counterparty that is a swap dealer (“**SD**”) or major swap participant (“**MSP**”) must satisfy the swap trading documentation requirements under the CFTC’s general trading documentation rule; or
- if neither eligible affiliate counterparty is an SD or MSP, the swap must be documented in writing and include all terms governing the trading relationship, including payment obligations, netting of payments, events of default or other termination events, calculation and netting of

¹ CFTC, Proposed Rule, Clearing Exemption for Swaps Between Certain Affiliated Entities (Aug. 16, 2012), available [here](#).

obligations upon termination, transfer of rights and obligations, governing law, valuation, and dispute resolution procedures.

Risk Management

The inter-affiliate swap must be subject to a centralized risk management program that is “reasonably designed to monitor and manage the risks associated with the swap.” If one of the eligible affiliate counterparties is an SD or MSP, this requirement will be satisfied by complying with applicable CFTC risk management rules.

Variation Margin

If both counterparties are “financial entities” they must each collect and post variation margin. In addition:

- documentation between the counterparties must set forth the methodology for variation margin calculation with sufficient specificity to allow the counterparties, the CFTC, and any applicable prudential regulator to calculate the margin requirement independently;
- variation margin calculations and payments must begin on the business day after the swap is executed and must continue each business day until the swap is terminated;
- each counterparty must pay when due the entire variation margin amount, as calculated per the swap trading relationship documentation; and
- the swap trading relationship documentation must also specify where margin assets will be held and under what terms.

The CFTC does not propose that variation margin posted in respect of inter-affiliate swaps be required to be held in a segregated account or be otherwise unavailable for use and rehypothecation by the counterparty holding such variation margin.

There is a limited exemption from the variation margin requirement for 100% commonly-owned and commonly-guaranteed affiliates, where the common guarantor is also 100% commonly-owned.

In their joint statement dissenting from the proposal, CFTC Commissioners Sommers and O’Maila noted that the variation margin requirement imposes administrative burdens and creates operational risk while unnecessarily reducing liquidity in the marketplace by tying up capital that could be used for investment.

Jurisdictional Requirements

Out of concern that firms may seek to use the inter-affiliate exemption to evade the clearing requirement under the Commodity Exchange Act, the CFTC proposed to limit the availability of the exemption to swaps in which each counterparty either:

- is located in the United States;
- is located in a jurisdiction that has a clearing requirement that is “comparable and comprehensive to” the clearing requirement in the United States;
- is required to clear swaps with non-affiliated counterparties in compliance with U.S. law; or
- does not enter into swaps with non-affiliated counterparties.

These requirements are likely to limit significantly the scope of the exemption, as many non-U.S. jurisdictions where an affiliated counterparty might be located do not currently have, and may not enact, comparable and comprehensive clearing regimes.

Reporting Requirements

The “reporting counterparty” (as determined under the CFTC’s swap data repository reporting rule) must furnish to a registered swap data repository confirmation that both affiliated counterparties are electing not to clear the swap and have satisfied the other conditions of the exemption. In addition, the following information must also be reported in connection with each swap, or alternatively, on an annual basis: identification of how each counterparty generally meets its financial obligations associated with uncleared swaps and if the counterparty is a registered issuer under Section 12, or required to file reports under Section 15(d), of the Securities Exchange Act of 1934, the relevant SEC Central Index Key number and acknowledgement that an appropriate committee of the board of directors has approved the decision not to clear the swap.

Other Significant Aspects of the Release

The CFTC release proposing the exemption includes a number of other notable points, including:

- clarification that an affiliate that qualifies for the commercial end-user exemption from clearing may elect to rely either on the inter-affiliate exemption or the end-user exemption; and
- requests by the CFTC for comment on various issues, including whether the rule should also provide a parallel exemption from the general requirement that swaps subject to mandatory clearing be executed on a designated contract market or a swap execution facility.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Daniel N. Budofsky	212 450 4907	daniel.budofsky@davispolk.com
Susan C. Ervin	202 962 7141	susan.ervin@davispolk.com
Annette L. Nazareth	202 962 7075	annette.nazareth@davispolk.com
Lanny A. Schwartz	212 450 4174	lanny.schwartz@davispolk.com
Priya Bindra	212 450 4250	priya.bindra@davispolk.com
E. Ashley Harris	212 450 4780	ashley.harris@davispolk.com
Jai R. Massari	202 962 7062	jai.massari@davispolk.com

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