

# CFTC Provides Inter-affiliate Swap Clearing and Reporting Relief

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In advance of swap reporting and clearing deadlines, the CFTC adopted a **final rule** providing an exemption for inter-affiliate swap clearing and the staff issued a **no-action letter** providing limited relief for inter-affiliate swap reporting. Both sets of relief are subject to significant conditions that may limit their utility for many swap counterparties. The CFTC staff also extended the commencement date for swap data repository (“SDR”) reporting of swaps for certain counterparty types and products, as described in the final section of this memorandum.

## The Inter-affiliate Clearing Exemption

### Mandatory Clearing Requirement

The Commodity Exchange Act prohibits any person from transacting a swap that has been designated by the CFTC as subject to mandatory clearing (a “**Designated Swap**”) unless the person submits the swap for clearing to a CFTC-registered derivatives clearing organization or a derivatives clearing organization that is exempt from registration.

To date, the CFTC has designated the following classes of interest rate swaps (“**IRS**”) and credit default swaps (“**CDS**”) as being subject to mandatory clearing:

- *IRS*. Specified tenors of fixed-to-floating, floating-to-floating, forward rate agreement and overnight indexed swaps denominated in U.S. dollars, euros, British pounds and Japanese yen.
- *CDS*. Specified tenors of recent series of the untranching CDX North American Investment Grade and High Yield indices and the untranching iTraxx Europe, iTraxx Europe Crossover, and iTraxx Europe HiVol indices.

The sidebar on the next page shows the mandatory clearing deadlines for the first set of IRS and CDS described above. The CFTC is likely to add additional Designated Swaps over time.

There is only one statutory exception (the “**end-user clearing exception**”) from the mandatory clearing requirement, which is available to “commercial end-users” and certain of their affiliates that are using the Designated Swap to hedge or mitigate commercial risk. There is no general statutory exception from clearing for Designated Swaps entered into by affiliates.

### The Inter-Affiliate Clearing Exemption

The inter-affiliate clearing exemption provides a rule-based exemption from the clearing of Designated Swaps between qualifying affiliates (“**Inter-affiliate Designated Swaps**”). The exemption is subject to several

**Mandatory Clearing Dates for First Determination Products:**

- **March 11, 2013** for designated swaps between Category 1 entities, other than iTraxx CDS indices;
- **April 26, 2013** for swaps on iTraxx CDS indices between Category 1 entities;
- **June 10, 2013** for designated swaps between Category 2 entities, and between Category 1 and Category 2 entities, other than iTraxx CDS indices;
- **July 25, 2013** for swaps on iTraxx indices between Category 2 entities, and between Category 1 and Category 2 entities;
- **September 9, 2013** for designated swaps involving all other market participants, including those with a "third-party subaccount," other than iTraxx CDS indices; and
- **October 23, 2013** for swaps on iTraxx indices involving all other market participants, including those with "third-party subaccounts."

**Category 1** entities include CFTC-registered swap dealers and major swap participants and "active funds." An "active fund" is any private fund, other than a third-party subaccount, that executes 200 or more swaps per month based on a monthly average over the preceding 12 months, beginning on November 1, 2012.

**Category 2** entities include commodity pools, private funds, other than active funds, and persons predominantly engaged in banking or financial activities, other than third-party subaccounts and ERISA plans.

**All other market participants** include "third-party subaccounts" and ERISA plans. A "third-party subaccount" is a client account managed by an unaffiliated and independent investment manager that is responsible for the documentation necessary for the account's owner to clear swaps.

conditions, including qualifications for the affiliated counterparties and documentation, risk management and reporting requirements.

To qualify for the exemption, affiliates must clear all of their Designated Swaps with unaffiliated counterparties ("**Outward-Facing Designated Swaps**") at certain recognized clearinghouses or satisfy an exception from clearing under U.S. law or an exemption deemed comparable by the CFTC under foreign law. Recognizing that foreign jurisdictions have started, but have not completed, implementing mandatory swap clearing regimes, the CFTC has provided temporary alternative compliance mechanisms to meet this condition.

An affiliate that is eligible to elect both the inter-affiliate clearing exemption and the end-user clearing exception for an Inter-affiliate Designated Swap is permitted to rely on either the exemption or the exception. However, as discussed below, because the inter-affiliate clearing exemption's conditions may be significantly more burdensome for many swap counterparties and because using the inter-affiliate clearing exemption disqualifies counterparties from certain inter-affiliate reporting relief, many swap counterparties are likely to choose to rely on the end-user clearing exception rather than the inter-affiliate clearing exemption where both are available.

**Conditions Relating to the Inter-affiliate Designated Swaps**

*Relationship Between the Affiliates*

The inter-affiliate clearing exemption is only available for Inter-affiliate Designated Swaps between "eligible affiliate counterparties" that have a "majority ownership" relationship. Such a relationship exists where:

- One counterparty (the "**majority-owner affiliate**") is, directly or indirectly, a majority owner of the other (the "**majority-owned affiliate**"); or
- A third party (the "**common-owner affiliate**") is, directly or indirectly, a majority owner of both affiliate counterparties.

For this purpose, "majority ownership" is defined as in the sidebar on the next page.

The affiliates also must meet a consolidated financial statement requirement. Specifically, where there is a majority-owner affiliate, the majority-owner affiliate must report its financial statements on a consolidated basis and must include the majority-owned affiliate in its financial results. Where there is a common-owner affiliate, the common-owner affiliate must report its financial statements on a consolidated basis and must include both affiliate counterparties in its financial results. All financial statements must be prepared under either Generally Accepted Accounting Principles or International Financial Reporting Standards.

*Written Trading Documentation*

An Inter-affiliate Designated Swap must be documented in writing. Where one of both of the eligible affiliate counterparties is a swap dealer ("**SD**") or

### Majority Ownership

A majority-owner affiliate or common-owner affiliate “directly or indirectly holds a majority ownership interest if it directly or indirectly holds a majority of the equity securities of an entity, or the right to receive upon dissolution, or the contribution of, a majority of the capital of a partnership.”

### Reporting Counterparty

The determination of which counterparty to a swap is the “reporting counterparty” for swap data reporting is determined as follows:

- If only one counterparty is an SD, the SD is the reporting counterparty.
- If neither counterparty is an SD, but one is an MSP, the MSP is the reporting counterparty.
- If both counterparties to a swap are end-users and only one counterparty is a U.S. person, that U.S. person is the reporting counterparty.
- If both counterparties are U.S. person end-users, and only one is a financial entity, the financial entity is the reporting counterparty.
- In all other cases, the counterparties choose which is the reporting counterparty.

major swap participant (“**MSP**”), this requirement is met by the SD or MSP satisfying its swap trading relationship documentation requirements under CFTC Regulation § 23.504. Where neither eligible affiliate counterparty is an SD or MSP, the written documentation for the Inter-affiliate Designated Swap must include all terms governing the trading relationship between the eligible affiliate counterparties. This documentation is not required to be in the form of a formal master agreement or confirmations.

### Centralized Risk Management Program

The Inter-affiliate Designated 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 is satisfied by the SD’s or MSP’s compliance with its requirement under CFTC Regulation § 23.600 to have a comprehensive risk management program.

### Reporting Requirements

Eligible affiliate counterparties that elect the inter-affiliate clearing exemption must report specified information to an SDR. Some information must be reported on a swap-by-swap basis, while other information may be reported annually. The information that must be reported is similar to information that must be reported under the end-user clearing exception.

**Swap-by-swap reporting.** The “reporting counterparty” for an Inter-affiliate Designated Swap for which the inter-affiliate clearing exemption is used must report to an SDR a confirmation that both eligible affiliate counterparties elect not to clear the swap and that they satisfy the exemption’s conditions. This reporting requirement must be fulfilled on a swap-by-swap basis. The “reporting counterparty” is determined by reference to the CFTC’s general SDR reporting rules, which are described in the accompanying sidebar.

**Annual reporting.** The reporting counterparty may report to an SDR annually, in advance of relying on the inter-affiliate clearing exemption:

- how each eligible affiliate counterparty meets its financial obligations associated with uncleared swaps; and
- if an eligible affiliate counterparty is a public company, the relevant SEC Central Index Key number and an acknowledgement that an appropriate committee of the board of directors of the counterparty has approved the decision to enter into swaps that are exempt from clearing.

The reporting counterparty also must notify the SDR of any material changes to the information originally reported.

### Conditions Relating to Outward-Facing Designated Swaps

The CFTC expressed concerns that an inter-affiliate clearing exemption could potentially be used to evade U.S. clearing requirements or that it could lead to uncleared swap risk being imported into the United States. The adopting release discusses, in particular, concerns about inter-affiliate transfers of risk into the United States originating through swaps with

unaffiliated third parties that are located in jurisdictions without comparable swap regulatory regimes.

To address these concerns, the inter-affiliate clearing exemption requires eligible affiliate counterparties to meet conditions relating to their Outward-Facing Designated Swaps. Generally, an eligible affiliate counterparty, whether a U.S. person or not, must clear all Outward-Facing Designated Swaps or be eligible for an exception or exemption from clearing. *Importantly, in order to use the inter-affiliate clearing exemption, market participants may be required to clear swaps between non-U.S. persons that otherwise would not be subject to U.S. jurisdiction.*

### ***The Outward-Facing Swap Condition***

In order to elect the inter-affiliate clearing exemption for any Designated Swap, each eligible affiliate counterparty must, for **each** Outward-Facing Designated Swap to which it is a counterparty:

- clear the Outward-Facing Designated Swap in compliance with the CFTC's clearing requirement;
- clear the Outward-Facing Designated Swap in compliance with the clearing mandate of a foreign jurisdiction that the CFTC has deemed "comparable, and comprehensive but not necessarily identical" to the CFTC's clearing requirement;
- qualify for, and comply with the conditions of, the CFTC's end-user clearing exception for the Outward-Facing Designated Swap;
- qualify for, and comply with the conditions of, a clearing exception or exemption of a foreign jurisdiction that the CFTC has deemed "comparable, and comprehensive but not necessarily identical" to the CFTC's clearing requirement and for which the exception or exemption used for the Outward-Facing Swap is deemed by the CFTC to be comparable to a CFTC clearing exception; or
- clear the Outward-Facing Designated Swap at a CFTC-registered designated clearing organization or at a clearing organization that is subject to supervision by appropriate government authorities in the home country of the clearing organization and that has been assessed to be in compliance with the Principles for Financial Market Infrastructures established by the Bank for International Settlements.

An eligible affiliate counterparty must meet one of the above conditions for **each** Outward-Facing Designated Swap to which it is a counterparty (though not necessarily the same condition for each such swap) — *even if the risk of the Outward-Facing Designated Swap is not transferred via inter-affiliate swaps.*

### ***Alternative Compliance Mechanisms***

The Outward-Facing Designated Swap condition is predicated on the idea that there will be foreign jurisdictions with clearing requirements that are comprehensive and comparable to, though not necessarily identical to, those of the CFTC. While foreign jurisdictions have begun developing and

implementing such clearing requirements, the requirements are not yet generally effective. As a result, the CFTC has adopted alternative compliance mechanisms that eligible counterparty affiliates can use, until March 11, 2014, to meet the Outward-Facing Designated Swap condition.

The available alternative compliance mechanisms are different for eligible counterparty affiliates in jurisdictions where implementation of the clearing requirement is already underway — specifically the European Union, Japan and Singapore (the “**Clearing Law Jurisdictions**”) — and eligible counterparty affiliates outside of the Clearing Law Jurisdictions.

**Swaps Entered into by a Non-Financial Entity Majority-Owner or Common-Owner Affiliate, with at Least One Affiliate in a Clearing Law Jurisdiction, with Neither Having SD or MSP Affiliates**

Until March 11, 2014, an Inter-affiliate Designated Swap between a U.S. eligible affiliate counterparty and an eligible counterparty affiliate in a Clearing Law Jurisdiction will be considered to be in compliance with the Outward-Facing Swap condition as long as:

- the majority-owner affiliate, or the common-owner affiliate, is not a “financial entity”; and
- neither eligible affiliate counterparty has an affiliate that is an SD or MSP.

For this purpose, “financial entity” has the same definition as for the CFTC’s end-user clearing exception. However, the CFTC has provided additional guidance applicable to whether a “holding company” is a financial entity for this purpose. This guidance is summarized in the accompanying sidebar.

**“Financial Entity” Treatment of Holding Companies**

A “holding company” (the ultimate parent of a corporate group) may be eligible for treatment as a non-“financial entity” if:

- the holding company is able to identify all eligible affiliate counterparties
- a predominant number of eligible affiliate counterparties qualify for the CFTC’s end-user clearing exception

If these conditions are met, the holding company may “look through” to the activities of its eligible affiliate counterparties for purposes of determining whether it is a financial entity.

**Swaps Entered Into Between Other Types of Eligible Affiliate Counterparties, with at Least One Affiliate in a Clearing Law Jurisdiction**

Until March 11, 2014, an Inter-affiliate Designated Swap between a U.S. eligible affiliate counterparty and an eligible affiliate counterparty in a Clearing Law Jurisdiction will be deemed to meet the Outward-Facing Swap condition if the eligible affiliate counterparties, or the common-owner affiliate, pay and collect full variation margin daily on either:

- all of the outward-facing swaps (whether Designated or not) entered into by the eligible affiliate counterparty in the Clearing Law Jurisdiction; or
- all of the eligible affiliate counterparties’ inter-affiliate swaps (whether Designated or not) with other eligible affiliate counterparties.

**Swaps Entered Into with an Affiliate in a Non-Clearing Law Jurisdiction**

Until March 11, 2014, an Inter-affiliate Designated Swap between a U.S. eligible affiliate counterparty and an eligible affiliate counterparty in a foreign jurisdiction other than a Clearing Law Jurisdiction (a “**non-Clearing Law Jurisdiction**”) will be deemed to satisfy the Outward-Facing Swap condition if:

- the aggregate notional value of the U.S. affiliate’s Inter-affiliate Designated Swaps entered into with eligible affiliate counterparties

in non-Clearing Law Jurisdictions does not exceed 5% of the aggregate notional value of Designated Swaps entered into by the U.S. affiliate, measured in U.S. dollar equivalents and calculated for each calendar quarter; and

- the eligible affiliate counterparties, or the common-owner affiliate, pay and collect full variation margin daily on either:
  - all outward-facing swaps (whether Designated or not) entered into by the eligible affiliate counterparty in the non-Clearing Law Jurisdiction; or
  - all of the eligible affiliate counterparties' inter-affiliate swaps (whether Designated or not) with other eligible affiliate counterparties.

The CFTC does not clarify how and when the quarterly calculations must be made.

Whether in a Clearing Law or non-Clearing Law Jurisdiction, an eligible counterparty affiliate, rather than complying with the alternative compliance mechanism, may meet the Outward-Facing Swap condition by voluntarily clearing its Outward-Facing Designated Swaps, as described above. For U.S. persons whose Inter-affiliate Designated Swaps with affiliates in non-Clearing Law Jurisdictions is greater than 5% of all of its Designated Swap activity, such voluntary clearing by eligible counterparty affiliates in non-Clearing Law Jurisdictions appears to be the only way to retain the ability to use the inter-affiliate clearing exemption.

## Swap Reporting Relief

### Inter-affiliate Reporting No-Action Relief

On April 5, the CFTC's Division of Market Oversight and Division of Clearing and Risk published a no-action letter providing relief (the "**inter-affiliate reporting relief**") for certain otherwise reportable inter-affiliate swaps from the historical swap reporting requirements in Part 46 of the CFTC's regulations, the SDR reporting requirements in Part 45 of the CFTC's regulation, and the end-user clearing exception reporting requirements under Rule 50.50(b) of the CFTC's regulations.

Like the inter-affiliate clearing exemption, the inter-affiliate reporting relief specifies conditions for the inter-affiliate swap that is not reported as well as conditions on swaps that affiliates enter into with unaffiliated counterparties. The inter-affiliate reporting relief provides no additional relief from the Part 43 real-time public reporting requirements beyond the exclusion provided in Part 43, itself, for non-"publicly reportable swap transactions," which include swaps between wholly-owned subsidiaries of the same parent entity. In addition, eligible affiliate counterparties electing the inter-affiliate reporting relief remain subject to the recordkeeping and other non-reporting requirements of Part 45, Part 46 and Rule 50.50(b), and must make the records available to the CFTC upon request. As part of these recordkeeping requirements, the reporting counterparty must create

**New End-User Reporting Deadlines**

**Financial entities**

- **September 30, 2013** to report historical swaps under Part 46, which include any swap executed prior to April 10, 2013;
- **12:01 a.m. eastern time on May 29, 2013** to commence reporting equity swaps, foreign exchange swaps and other commodity swaps in accordance with Part 43 and Part 45<sup>1</sup>; and
- **April 10, 2013** to commence reporting interest rate and credit swaps in accordance with Part 45 and Part 43.

**Non-financial entities**

- **October 31, 2013** to report historical swaps under Part 46, which include any swap executed prior to April 10, 2013;
- **12:01 a.m. eastern time on August 19, 2013** to commence reporting equity swaps, foreign exchange swaps and other commodity swaps in accordance with Part 43 and Part 45<sup>2</sup> and
- **12:01 a.m. eastern time on July 1, 2013** to commence reporting interest rate and credit swaps in accordance with Parts 43 and 45.<sup>3</sup>

internally generated swap identifiers for swaps subject to Part 45 and Rule 50.50(b) relief.

**Conditional Relief from Part 46 Historical Swap Reporting**

The Part 46 historical swap reporting relief is available for swaps between two eligible affiliate counterparties, defined the same as under the inter-affiliate clearing exemption. To benefit from the relief, an otherwise reportable swap:

- may not be entered into by an eligible affiliate counterparty that is an SD or MSP, or that is affiliated with an SD, MSP or financial company designated as “systemically important” by the Financial Stability Oversight Council;
- may not be executed on or pursuant to the rules of specified trading platforms, including designated contract markets, swap execution facilities, foreign boards of trade, trading facilities or any other trading platform where the orders of the eligible affiliate counterparties may be exposed to potential execution against unaffiliated counterparties; and
- may not be submitted for clearing to a derivatives clearing organization by any counterparty.

**Additional Conditional Relief from Part 45 SDR Reporting and Rule 50.50(b) Clearing Exemption Reporting Relief**

Part 45 and Rule 50.50(b) reporting relief is available to eligible affiliate counterparties that meet the same conditions for the Part 46 historical swap reporting relief described above, as long as the inter-affiliate clearing exemption is not used for the inter-affiliate swap in question. *In addition, to benefit from the Part 45 and Rule 50.50(b) reporting relief, all swaps entered into between either of the eligible affiliate counterparties and an unaffiliated counterparty (regardless of the location of the affiliated counterparty) must be reported to an SDR registered with the CFTC, pursuant to, or as if pursuant to, parts 43, 45, and 46 of the CFTC’s regulations.* This condition appears comparable in purpose and effect to

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<sup>1</sup> To rely on this no-action relief, a financial entity must, by 12:01 a.m. eastern time on June 29, 2013, backload and report to an SDR all swap transaction data, for the period from April 10, 2013, to May 29, 2013, that the financial entity would have been required to report in accordance with Part 45, in the absence of the no-action relief.

<sup>2</sup> To rely on this no-action relief, a non-financial entity must, by 12:01 a.m. eastern time on September 19, 2013, backload and report to an SDR all swap transaction data, for the period from April 10, 2013, to August 19, 2013, that the non-financial entity would have been required to report in accordance with Part 45, in the absence of the no-action relief.

<sup>3</sup> To rely on this no-action relief, a non-financial entity must, by 12:01 a.m. eastern time on August 1, 2013, backload and report to an SDR all swap transaction data, for the period from April 10, 2013, to July 1, 2013, that the non-financial entity would have been required to report in accordance with Part 45, in the absence of the no-action relief.

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the Outward-Facing Swap condition of the inter-affiliate clearing exemption—namely, it appears meant to avoid evasion of the reporting requirement through inter-affiliate swaps with foreign affiliates, and thereby imposes U.S. requirements on non-U.S. affiliates for swaps with non-U.S. counterparties as a condition of the relief. This condition may limit the utility of relying upon this relief for many counterparties. For example, non-U.S. affiliated eligible counterparties may find it overly burdensome to report their historical swaps with unaffiliated, non-U.S. counterparties, which swaps otherwise may not have been subject to a U.S. reporting requirement.

If the two eligible affiliate counterparties have a majority ownership relationship, but the majority-owner affiliate does not wholly own the majority-owned affiliate or if a common-owner affiliate does not wholly own the two eligible affiliate counterparties, the inter-affiliate reporting relief is only available if:

- the swap is not a “publicly-reportable swap” required to be reported under the CFTC’s Part 43 real-time reporting rules; and
- the reporting counterparty reports all swap data to an SDR under Part 45 no later than 30 days following the end of each fiscal quarter, beginning with the fiscal quarter ending June 30, 2013.

### Timing Relief

On April 9, 2013, the CFTC staff provided [reporting relief](#) from most of the April 10 swap reporting deadlines for reporting counterparties that are not SDs or MSPs. The new deadlines, which are different for financial entity reporting counterparties and non-financial entity reporting counterparties and depend on the asset class of the swap, are summarized in the sidebar on the previous page. In several cases, the relief is contingent on the reporting counterparty subsequently “backloading” information to the SDR for swaps benefiting from the delay, as described in the footnotes accompanying the sidebar.

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