FS Regulatory Brief

Inter-Affiliate Swaps Clearing Exemption

A trade worth making?

April 2013

On April 1, 2013, the Commodity Futures Trading Commission (CFTC) released a final rule providing an exemption from the clearing requirement for swaps between affiliated entities within a corporate group.[1] The exemption had been on the industry's wish list, but came with significant strings attached. In concept, the mechanics of the rule are relatively simple: affiliated counterparties may elect not to clear a swap subject to the CFTC's clearing mandate if the counterparties are eligible. However, the rule is laden with complexities that make it difficult to employ, particularly in a cross border context.

The purpose of this **FS Reg Brief** is to describe the eligible affiliates and conditions that must be satisfied to take advantage of the exemption; to identify the practical implications for global enterprises pursuing the exemption; and to discuss the rule's approach to substituted compliance and whether it may be a roadmap for possible cross border relief in July.

The terms and conditions of the inter-affiliate exemption

In order to take advantage of the exemption, the affiliated entities must be majority-owned and must satisfy a number of conditions with regard to documentation, reporting and risk management. A key condition is that outward facing swaps – those swaps between an affiliate and an unaffiliated third party – must either be cleared (in the US or in another jurisdiction with a comparable clearing mandate) or be subject to some exemption from clearing requirements. This condition in particular is driven by the CFTC's concern about evasion of the clearing mandate (through, e.g., back-to-back trading between foreign affiliates and unaffiliated foreign counterparties) and by fears of risk flowing back to the US in times of stress. In recognition of the fact that clearing mandates are not yet in place in other jurisdictions, the CFTC has provided temporary relief from this outward facing swaps condition, but in so doing added an additional layer of complexity, as detailed below.

Which affiliate counterparties can elect the clearing exemption?

Majority-owned affiliated counterparties whose financial statements are reported on a consolidated basis are eligible for the exemption. Majority ownership can be either at the affiliate level (one affiliate is a majority owner of the other) or at the parent level (both affiliates are majority-owned, directly or indirectly, by a common third party). The consolidated financial statements must include the financial results of both counterparties to the swap and be prepared under GAAP or IFRS.[2]

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[1] The exemption will be effective June 10, 2013. Until the effective date, inter-affiliate swaps between eligible affiliates will not be subject to the CFTC's mandatory clearing requirements.

[2] Where the majority ownership is at the *affiliate level* (i.e., one affiliate is a majority owner of another), the majority interest holder must report its financial statements on a consolidated basis that includes the affiliate counterparty. Where the majority ownership is at the *parent level*, the parent must report its financial statements on a consolidated basis that includes both affiliates.

What are the conditions?

Eligible affiliate counterparties must comply with the following conditions to elect the exemption from mandatory clearing, with the condition regarding outward facing swaps being critical:

- *Both* affiliate counterparties must elect not to clear the swap.
- The terms of the swap must be documented and include all the terms governing the trading relationship between the affiliated counterparties.
- The swap must be subject to a centralized risk management program.
- The reporting affiliate must report the election not to clear for each eligible swap, and adhere to the swap data reporting rules generally.[3] Swap-by-swap or on an annual basis, the reporting affiliate must state how each affiliate counterparty meets its financial obligations for uncleared swaps.[4]
- An affiliated counterparty that enters into an outward facing swap must clear the swap if the swap is included in a class that is subject to CFTC mandatory clearing or must comply with an exemption from clearing. The condition can be satisfied by complying with US clearing rules or with foreign rules determined to be comparable by the CFTC. Where no US or foreign rules apply, the condition can be satisfied by clearing through a US registered derivatives clearing organization or comparable foreign organization subject to home country supervision, in compliance with Principles for Financial Market Infrastructure.

One important change from the proposed rule is the elimination of variation margin for inter-affiliate swaps. However, this change will not benefit swaps by a *US insured depository institution* (IDI) with an affiliate. Sections 23A and 23B of the Federal Reserve Act as amended by Section 608 of Dodd-Frank subject swap transactions between an IDI and an affiliate[5] to a number of restrictions intended to limit risk to the IDI.[6]

Why the concern over outward facing swaps?

The required clearing condition for outward facing swaps addresses the CFTC's concern that market participants could use the inter-affiliate exemption to evade a Dodd-Frank clearing mandate. For example, a US affiliate that is part of a global enterprise could avoid a US clearing requirement for a swap with a foreign counterparty by interposing an inter-affiliate swap with an eligible foreign affiliate. Through this back-to-back booking mechanism, the US affiliate would avoid clearing and wind up indirectly exposed to the risk associated with the outward facing swap. A default by the unaffiliated third party that causes the failure of the foreign affiliate could then have contagion effects, threatening the US affiliate and potentially the entire enterprise, and beyond.

The CFTC granted temporary relief from the outward facing swap clearing condition until

[3] However, real-time reporting may not be required. Since inter-affiliate swaps subject to the exemption are unlikely to be considered "arm's length," they are unlikely to meet the definition of "publicly reportable swap transaction[s]" under CFTC part 43.

Separately, with respect to reporting, on April 5th the CFTC issued no-action relief for swaps entered into between affiliates of certain wholly-owned and majority-owned market participants from regulatory and historical reporting requirements under parts 45, 46, and regulation 50.50(b) of the CFTC's regulations, subject to several conditions. The relief does not apply to the reporting requirements under the inter-affiliate exemption or to affiliate groups including a swap dealer or major swap participant.

[4] The reporting affiliate must also provide certain other information if the affiliate counterparty is a registered issuer of securities or is required to file reports under the Securities Exchange Act of 1934.

[5] Transactions between an IDI and its subsidiary are generally exempted from Sections 23A and 23B. However, transactions between a subsidiary of an IDI and an affiliate are covered by the sections.

[6] The scope of these restrictions on derivatives transactions between an IDI and an affiliate have yet to be determined by the Federal Reserve under Section 608.

March 11, 2014 to address the reality that there are not yet any implemented foreign clearing mandates or exemptions that would enable substituted compliance for foreign-to-foreign swaps. In crafting this relief, the CFTC provided preferred treatment for the three jurisdictions that have enacted, but not yet implemented, clearing mandates – the European Union, Japan and Singapore. If an eligible affiliate counterparty is located in one of these preferred jurisdictions, each eligible counterparty (or a third party owner) can satisfy the condition by paying and collecting full variation margin on a daily basis on their swaps with unaffiliated counterparties or, alternatively, on their swaps with eligible affiliate counterparties. However, this variation margin will not be required of enterprises that are similar to those that would qualify for the commercial end-user exception to the CFTC clearing mandate – i.e., those where the majority owner (whether an affiliate or third party) is not a financial entity and where the group does not include a swap dealer or major swap participant.

For swaps between an eligible US affiliate counterparty and an eligible affiliate located in a foreign country other than the EU, Japan and Singapore, the variation margin solution is also available as an alternative to clearing. However, there is no end-user exception, and there is a limit on the notional value of inter-affiliate swaps that can be executed under the relief. For swaps in a class that is subject to mandatory clearing in the US, the aggregate notional value of such swaps between a US affiliate and affiliates located in a foreign jurisdiction (without a clearing mandate) cannot exceed 5% of the aggregate value of all swaps in the same class entered into by the US affiliate.

The temporary relief will ease some of the competitive disadvantages faced by foreign affiliates required to clear their outward facing swaps in jurisdictions not yet subject to a mandatory clearing requirement. As the CFTC noted, during this transitional period the temporary relief likely will be less expensive for financial entities than central clearing, requiring only variation margin, rather than initial and variation margin and clearing fees.

Business implications of pursuing the exemption

Global financial entities must decide if the exemption is worth pursuing given its complexity. Foreign swap dealers' booking models in particular may be affected. Because the outward facing swap conditions only apply to classes of swaps currently subject to the CFTC clearing mandate, the impact of the rule will vary across trading desks and geographic regions. The scope of the condition also will increase over time as additional classes of swaps are added to the clearing mandate.

For global enterprises, determining whether to elect the exemption or use the temporary relief for swaps with foreign affiliates that enter into outward facing swaps will depend on the results of a tangle of decisions. Moreover, use of the inter-affiliate clearing exemption – as is the case with other exemptions promulgated by the CFTC, such as the *de minimis* dealer exemption – may require comprehensive and expensive monitoring for compliance. Groups will have to identify:

- Eligible affiliates based on majority ownership, consolidated financials and centralized risk management programs;
- The geographic locations of their eligible affiliates engaged in outward facing swaps – separating those in the US, EU, Japan and Singapore from the rest of the world; and
- For inter-affiliate swaps outside the EU, Japan and Singapore, the aggregate notional value of in scope swaps by class, by country and by affiliate.

Firms should consider the relative costs of complying with the exemption conditions on an ongoing business-as-usual basis in deciding whether to elect the inter-affiliate clearing relief. Alternatively, firms should consider whether changes to their booking model or other business strategies could make election of the exemption cost-effective.

Once the exemption is elected, the group will have to ensure that each of the conditions required to satisfy the exemption continues to be met for each future inter-affiliate swap. Firms should consider whether they have, or are prepared to build, globally integrated systems related to: clearing, calculation and collection of variation margin for uncleared inter-affiliate and outward facing swaps, inter-affiliate relationship documentation and overall risk management.

Cross border implications

The CFTC's inclusion of foreign clearing mandates and exemptions as a way to meet the clearing condition for outward facing swaps is the CFTC's first use of a substituted compliance approach in a final Dodd-Frank rule.[7] The CFTC's clarification of how it will determine clearing comparability is significant not only for this final inter-affiliate clearing rule, but also, potentially, for other cross-border contexts.

Substituted compliance – clearing under home country rules permitted

In its proposed cross-border guidance in July 2012, the CFTC stated its intention to permit non-US swap dealers (and major swap participants) to comply with the requirements of their home jurisdiction's law and regulations as a substitute for compliance with CFTC requirements. The CFTC must find that such foreign requirements are comparable to requirements under US law (they need not be identical).

In the final inter-affiliate clearing rule, the CFTC, for the first time, explicitly provided for such substituted compliance and clarified that for clearing determinations, it will review the comparability and comprehensiveness of a foreign jurisdiction's clearing mandate by conducting a "jurisdiction-specific" and a "product-specific" review (comparing each class of swaps subject to the foreign clearing mandate to those of the CFTC).

The CFTC also said it will take a similar approach to evaluating *exemptions* from foreign clearing requirements – exercising broad discretion to determine whether the requirements and objectives of an exemption are consistent with those under Dodd-Frank (like the commercial end-user exception), and whether such objectives are being met notwithstanding that the foreign exemption may not be identical to those under Dodd-Frank and CFTC rules.

Time-limited inter-affiliate relief – a roadmap for the CFTC's approach to broader transitional cross border relief?

The time-limited relief from the requirement to clear foreign-to-foreign outward facing swaps favors the three foreign jurisdictions that have enacted a clearing mandate (EU, Japan, and Singapore), despite the fact that those mandates are not yet fully implemented.

As discussed above, for inter-affiliate swaps in those preferred jurisdictions, until March 11, 2014 there is no limit on the notional value of such swaps, and non-financial enterprises can avoid paying variation margin. Where an eligible affiliate is located in a jurisdiction that has not yet enacted a central counterparty clearing mandate, the time-limited relief is far more onerous.

This approach may be a roadmap for how the CFTC will deal more generally with transitional cross-border relief when its exemptive order expires in July. Several CFTC Commissioners have expressed a growing sense of inevitability that the exemptive order will have to be extended because foreign regulatory requirements continue to lag behind the US, and negotiations to harmonize cross-border requirements have not been completed. The CFTC's approach to the time-limited relief in the inter-affiliate rule may signal that if the CFTC decides to extend the exemptive order (or provide other relief

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[7] The rule's clearing condition is also significant because it stretches the CFTC's extraterritorial reach beyond its earlier proposed cross border guidance by covering foreign-to-foreign outward facing swaps. The CFTC issued a Final Exemptive Order, due to expire July 12, 2013, that provided relief for non-US swap dealers (and major swap participants) from certain requirements, which also included proposed guidance with respect to the definition of a "US person" for purposes of applying CFTC swap requirements extraterritorially. The foreign-to-foreign reach of the outward facing swap condition in the inter-affiliate exemption extends beyond the scope of that proposed US person definition. See *PwC FS Reg Brief: Cross-Border Clarity – CFTC provides guidance and additional time for industry to address cross-border swaps.*

pending implementation of international requirements and regulatory coordination), it may tailor the terms of such relief to the status of G20 reforms in each foreign jurisdiction. For those foreign jurisdictions that the CFTC deems more comparable and further along, the CFTC may design less onerous conditional relief than will be available in other less comparable locations.

Global firms should consider the status of G20 reforms in their primary operating jurisdictions to get a sense of whether transitional relief beyond July 12, 2013 is likely to be available and meaningful. There will be considerable pressure on the CFTC to extend the cross-border relief, but like in the inter-affiliate rule, the CFTC may opt to favor jurisdictions that have advanced the G20 agenda.

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