

Guide to Dodd-Frank Act's End-User Exception from Clearing Requirement

Background

Prior to passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”), transactions in energy commodities (including both energy goods and services) were generally exempt from regulation by the Commodity Futures Trading Commission (“CFTC” or “Commission”), except for CFTC anti-fraud and anti-manipulation authority. The Dodd-Frank Act repealed this exemption and authorized the CFTC to regulate a broad array of swaps, including energy swaps.

Swaps that are subject to CFTC jurisdiction are potentially subject to a myriad of regulations such as registration requirements, business conduct standards, clearing and exchange trading, capital and margin requirements, position limits, and various reporting and recordkeeping duties (collectively “swap regulations”). There are detailed exceptions to and varying thresholds for these rules, but there are no exceptions to the CFTC anti-manipulation and anti-fraud rules.

This summary focuses on an energy company’s ability to rely on an exception to one of those swap regulations – the CFTC’s clearing requirement. The requirement to clear swaps was added by the Dodd-Frank Act and was intended to lower systemic risk to the economy because increased clearing of swaps arguably lowers default risk, promotes transparency, and bolsters risk management. However, clearing also increases the cost of using swaps. Therefore, Congress provided in the Dodd-Frank Act an exception to the clearing requirement (known as the “end-user exception”) so that non-financial businesses could continue to use non-cleared swaps to hedge their commercial risk.

End-User Exception Overview

According to Sections 2(h)(1) of the Commodity Exchange Act (“CEA”), which was amended by Section 723(a)(3) of the Dodd-Frank Act, all swaps must be cleared (“the clearing requirement”). CEA § 2(h)(8)(A) provides that swaps subject to the clearing requirement must be executed on a designated contract market (“DCM” – *i.e.*, a CFTC-designated board of trade) or a swap execution facility (“SEF”) (“the trade execution requirement”). CEA § 2(h)(8)(B), however, provides that the trade execution requirement does not apply if a swap counterparty elects the end-user exception. The end-user exception requirements are listed in CEA § 2(h)(7).

The CFTC has codified the end-user exception at 17 C.F.R. § 50.50, which explains that a counterparty may elect the end-user exception to the clearing requirement for a swap if the counterparty:

1. is not a financial entity within the meaning of the CEA;¹
2. is using the swap to hedge or mitigate commercial risk pursuant to CFTC regulations;² and
3. provides, or causes to be provided, certain information about the swap and the counterparty either to a registered swap data repository (“SDR”) or, if no SDR is available, to the CFTC.³

Also, note that for companies registered with or reporting to the Securities Exchange Commission (“SEC”), an “appropriate committee” of the Board of Directors must approve the decision to elect the end-user exception.⁴

End-User Exception Elements

End-User Exception Element (i) – Status as a Non-Financial Entity

The first element of the CFTC’s end-user exception, found at 17 C.F.R. § 50.50(a)(1)(i), states that to elect the end-user exception, a swap counterparty must not be a financial entity, as defined in the CEA. Section 2(h)(7)(C)(i) of the CEA defines the term “financial entity” to include a swap dealer, a security-based swap dealer; a major swap participant; a major security-based swap participant; a commodity pool; a private fund; certain employee benefit plans; and a person “predominantly engaged in the business of banking.”

End-User Exception Element (ii) – Hedging or Mitigating Commercial Risk

The second element of the CFTC’s end-user exception, found at 17 C.F.R. § 50.50(a)(1)(ii), states that to elect the end-user exception, a swap counterparty must use “the swap to hedge or mitigate commercial risk as provided in [17 C.F.R. § 50.50(c)].”

The applicable criteria for determining whether a swap “hedges or mitigates commercial risk” are set forth in 17 C.F.R. § 50.50(c), which provides that a swap “hedges or mitigates commercial risk” for purposes of the CFTC’s end-user exception if the swap:

1. is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise;⁵ or
2. qualifies as bona fide hedging for purposes of an exemption from position limits under the CEA;⁶ or
3. qualifies for hedging treatment under the Financial Accounting Standards Board Accounting Standards Codification Topic 815, Derivatives and Hedging or the Government Accounting Standards Board Statement 53.⁷

In addition to meeting at least one of the above three criteria, the swap must:

¹ [17 C.F.R. § 50.50\(a\)\(i\)](#) (2013).

² *Id.* § [50.50\(a\)\(ii\)](#).

³ *Id.* § [50.50\(b\)\(1\)](#).

⁴ *Id.* § [50.50\(b\)\(1\)\(iii\)\(D\)\(2\)](#).

⁵ *Id.* § [50.50\(c\)\(1\)\(i\)](#).

⁶ *Id.* § [50.50\(c\)\(1\)\(ii\)](#). As of September 6, 2013, the CFTC’s Position Limits Rule remains vacated, but the CFTC has said that its definition of “bona fide hedge,” found at 17 C.F.R. § 151.5, is still valid for purposes of the end-user exception. See *Interpretation of Bona Fide Hedging in Commission Regulation 4.5: Restatement of Terms Incorporated by Reference*, [CFTC Letter No. 12-19](#) (Oct. 12, 2012) (“October 2012 No-Action Letter 12-19”) (finding that, because the CFTC intended to incorporate Regulation 151.5 substantively as an exception to Regulation 4.5(c)(2)(iii), which was not vacated along with the Position Limits Rule, Regulation 151.5 remains valid for the purpose of the Regulation 4.5 exception).

⁷ *Id.* § [50.50\(c\)\(1\)\(iii\)](#).

4. not be used for speculation, investing, or trading, or to hedge or mitigate the risk of another swap that does not itself qualify for the end-user exception;⁸ and
5. not be used to hedge or mitigate the risk of another swap or security-based swap position, unless that other position itself is used to hedge or mitigate commercial risk.⁹

End-User Exception Element (iii) – Reporting Requirements

As stated in 17 C.F.R. § 50.50(a)(1)(iii), the third element of the end-user exception requires that the counterparty electing the end-user exception provide, or cause to be provided, certain information to a registered SDR or, if no registered SDR is available to receive the information from the reporting counterparty, to the CFTC. These reporting requirements are outlined in 17 C.F.R. § 50.50(b).

Swap-by-Swap Reporting: When a counterparty elects the end-user exception, one of the counterparties shall provide the following information to an SDR (or to the CFTC if no SDR is available) on a swap-by-swap basis:

- (1) notice of election of the exception;¹⁰
- (2) the counterparty’s identity;¹¹ and
- (3) certain information (listed below), unless such information has been provided using an annual filing.¹²

This information will be reported by the swap’s reporting counterparty pursuant to the CFTC’s reporting party hierarchy, outlined in 17 C.F.R. § 45.8.

Annual Reporting: Most end-users will rely on the annual filing mechanism to fulfill end-user exception requirements.¹³ The annual basis reporting requirement provides that the party that elects to use the end-user exception (electing counterparty) must file with the SDR (or if no SDR is available, with the CFTC) the information provided in 17 C.F.R. § 50.50(b)(2) regarding: status as a “financial entity;” purpose of the swap; ability to meet financial obligations; and status as an SEC filer.

End-users could choose to use the form provided by the Depository Trust & Clearing Corporation (“DTCC”) Data Repository to make an annual filing. The DTCC form and instructions are available at:

http://www.dtcc.com/downloads/products/derivserv/DDR_Annual_EndUser_Exception_Form.pdf.

The annual end-user filing is effective for 365 days following the date of the report. In addition, the filing must be updated as necessary to reflect any material changes to the reported information.

⁸ *Id.* § [50.50\(c\)\(2\)\(i\)](#).

⁹ *Id.* § [50.50\(c\)\(2\)\(ii\)](#).

¹⁰ *Id.* § [50.50\(b\)\(i\)](#).

¹¹ *Id.* § [50.50\(b\)\(ii\)](#).

¹² *Id.* § [50.50\(b\)\(iii\)](#); see also End-User Exception Rule at p. [42,565](#), which states in pertinent part:

In practice, the reporting counterparty will be required to check at least three boxes for each swap for which the end-user exception is elected, indicating: (1) The election of the exception; (2) which party is the electing counterparty; and (3) whether the electing counterparty has already provided the additional required information through an annual filing. If the third box is checked “no,” the reporting counterparty will have to provide the additional required information for that swap.

¹³ Such “annual” information may also be reported on a swap-by-swap basis, if the end-user so elects. See End-User Exception Rule at p. [42,566](#).

As of September 6, 2013, the CFTC only requires that two types of swaps—certain credit default swaps and interest rate swaps—to be cleared. The clearing requirement for these two types of swaps takes effect on September 9, 2013. Thus, an end-user who plans to rely on the exception to clearing for their CDSs or interest rate swaps must submit its annual filing by that date. The CFTC is expected to list energy swaps as swaps required to be cleared at some point in the near future. Until the CFTC determines that such transactions must be cleared, energy swaps are not required to be cleared.

The following table highlights key “end-user exception” elements and suggests actions to ensure compliance.

End-User Exception Elements	Compliance Actions
<p><u>Not Financial Entity</u></p> <p>Electing entity must not be a financial entity.</p>	<ul style="list-style-type: none"> • Periodically review swap activity of business units to ensure it remains below applicable threshold levels to avoid being a swap dealer (“SD”) or major swap participant (“MSP”).
<p><u>Commercial Risk Management</u></p> <p>Swap must be used to hedge or mitigate commercial risk. This means that the swap is economically appropriate to reduce the risk; qualifies as a bona fide hedge for purposes of applicable position limits; or qualifies for hedge accounting treatment under the Financial Accounting Standards Board (“FASB”). This also means the swap cannot be used for speculation or to hedge another swap that does not itself qualify for the end-user exception.</p> <p>The CFTC has also emphasized that the use by non-financial entities of the end-user exception for financial risk hedging, such as interest rate hedging, must be an incidental part of (<i>i.e.</i>, not central to) the electing counterparty’s business.</p>	<ul style="list-style-type: none"> • Maintain “Risk Management Policy and Hedging Plan” to ensure swaps are used appropriately and update as necessary. • Ensure proper training of traders regarding the use of swaps for “hedging or mitigating commercial risk.” • Put review structures in place to identify future swap transactions that may not qualify as “hedging or mitigating commercial risk.”

End-User Exception Elements	Compliance Actions
<p><u>Accurate Reporting</u></p> <p>Electing entity must ensure accurate information about the swap and the counterparty are reported to a registered SDR or to the CFTC.</p>	<ul style="list-style-type: none"> • Ensure annual filing is kept up to date. • Ensure annual filing to claim the interest rate swap clearing exception is filed by September 9, 2013. • Ensure continued adherence to ISDA/IECA Protocols or other notification methods to communicate end-user status and qualifications to counterparties.
<p><u>Appropriate Corporate Policies</u></p> <p>Companies that are issuers of securities registered under Section 12 or required to file reports under Section 15 of the Securities Exchange Act of 1935 (“SEC filing companies”) must have an appropriate committee of the Board of Directors approve the decision to use the end-user exception.</p> <p>A committee is an “appropriate committee” “if it is <i>specifically authorized</i> to review and approve the SEC Filer’s decision to enter into swaps.”</p> <p>The CFTC has stated that the Board of Directors has reasonable discretion to determine the appropriate committee for approving decisions on swaps for its subsidiaries or affiliates.</p> <p>The CFTC expects an SEC Filer’s board or appropriate committee to “set appropriate policies governing the SEC Filer’s use of swaps subject to the end-user exception and to review those policies at least annually and, as appropriate, more often upon a triggering event (<i>e.g.</i>, a new hedging strategy is to be implemented that was not contemplated in the original board approval.)”</p>	<ul style="list-style-type: none"> • Ensure the Board or designate committee are specifically authorized to review and approve the use of swaps that will not be cleared. • Ensure the Board or a designated audit committee reviews and approves the election of the end-user exception for the swap activity. • Review policies at least annually or when there is a triggering event (<i>i.e.</i>, a new hedging strategy is to be implemented that was not contemplated in the original board approval). • Review any changes to hedging strategies. • Maintain appropriate policies for the use of the end-user exception. • Once CFTC position limits and clearing requirements are issued (note: interest rate swap clearing effective 9/9/13), ensure compliance and create/modify corporate policies as appropriate.