Treatment of Commercial End-Users of Swaps

April 7, 2015
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Agenda

• End User Exception for Clearing
• No-action Letter for Treasury Affiliates
• Uncleared Swaps Margin Proposed Rules and Commercial End Users
• Ownership and Control Reporting
• SDR Reporting for Swaps between End-Users
• Residual Interest Final Rule
• Utility Operations Swaps with Utility Special Entities Final Rule
• Proposal for Record-keeping Relief for Commercial End Users on Swap Execution Facilities (SEFs)
• Forwards with Embedded Optionality Proposal
• Position Limits Proposal
Mandatory Clearing/End-User Exception

• Many swaps (IRS and index CDS) are now subject to mandatory clearing, but there is an exception under Section 2(h)(7) of the Commodity Exchange Act and CFTC Rule 50.50 for end-users.

• In order to qualify for the end-user exception, an entity must:
  • not be a “financial entity”
    • limited exceptions for financial entities such as small banks, captive finance companies, and entities acting as agent on behalf of an affiliate that is not a financial entity;
  • use the relevant swap or swaps to “hedge or mitigate commercial risk”; and
  • fulfill certain reporting requirements by providing or causing to be provided to a swap data repository (“SDR”) information as to applicability of the end-user exception.
Mandatory Clearing/End-User Exception

To qualify as a non-financial entity, an entity must not be:

- a swap dealer or major swap participant;
- a security-based swap dealer or a major security-based swap participant;
- a commodity pool;
- a private fund (a subset of investment companies as defined in the Investment Company Act of 1940);
- an employee benefit plan or governmental plan (as defined under the Employee Retirement Income Security Act of 1974); or
- a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature (as defined under the Bank Holding Company Act of 1956)

The last prong has raised the most questions
Mandatory Clearing/End-User Exception

- In addition, the relevant swap must be used to hedge or mitigate commercial risk, which requires that such swap:
  - qualify as a bona fide hedging under the CEA position limit rules; or
  - qualify for hedging treatment under FASB standards; or
  - be “economically appropriate” to reduce, in the ordinary course of business, risks arising from a change in: the value of assets that the entity owns, produces, manufactures, processes or merchandises; the value of liabilities due to fluctuations in interest, currency or foreign exchange rates, or the interest, currency or foreign exchange rate exposures arising from a person’s assets, services or liabilities; and
  - not be used for a purpose that is in the nature of speculation, investing or trading and not be used to hedge or mitigate the risk of another swap, unless that other swap itself is used to hedge or mitigate commercial risk.
Mandatory Clearing/End-User Exception

- In order for an end-user to elect the end-user exception, it must ensure that the reporting party provides, or cause to be provided, information to a registered SDR.
- Because of the CFTC’s reporting hierarchies in its swap data reporting rules, it is unlikely that the end-user will be a reporting party.
Mandatory Clearing/End-User Exception

- The information to be provided to an SDR includes the following:
  - notice of the election of the end-user exception;
  - the identity of the electing counterparty to the swap; and
  - confirmation that the electing party is not a “financial entity”;
  - confirmation that the swap or swaps for which the end-user is electing the end-user exception are to hedge or mitigate commercial risk;
  - an explanation of how the electing party meets its financial obligations associated with entering into swaps that are not cleared; and
  - whether the electing party is a public company and, if so, confirmation that an appropriate committee of its board of directors (or equivalent body) has reviewed and approved the decision to enter into swaps that are exempt from mandatory clearing
- Much of this information can be reported on a yearly basis
Mandatory Clearing-Treasury Affiliate Exception

- For “treasury affiliates” of end-users, the CFTC issued an no-action letter on June 4, 2013 providing relief from mandatory clearing for certain swaps between such treasury affiliates and unaffiliated counterparties.
- For purposes of the letter, “treasury affiliate” is defined as an entity that meets the definition of “financial entity” solely under section 2(h)(7)(C)(i)(VIII) of the CEA because they are predominately engaged in activities that are financial in nature, when such financial entities are acting on behalf of non-financial affiliates within a corporate group.
Mandatory Clearing-Treasury Affiliate Exception

• Relief applies when swaps entered into by treasury affiliates hedge or mitigate commercial risk of non-financial affiliates.
• No-action letter recognizes that many non-financial companies execute a significant portion of their swaps through a wholly-owned treasury affiliate that hedges risks for the consolidated non-financial company by, among other things, entering into swaps on behalf of non-financial affiliates, with the treasury affiliate often serving as the primary external market-facing entity for the entire corporate group.
Mandatory Clearing-Treasury Affiliate Exception

• Numerous conditions must be satisfied for this relief to apply, including:
  • the treasury affiliate seeking the exception must not be owned by a financial entity and must be a financial entity as defined in section 2(h)(7)(C)(i)(VIII) of the CEA solely as a result of acting as principal to swaps with, or on behalf of, one or more of its related affiliates, or providing other services that are financial in nature to such related affiliates;
  • the eligible treasury affiliate must enter into the relevant swap for the sole purpose of hedging or mitigating the commercial risk of one or more related affiliates that was transferred to the eligible treasury affiliate by operation of one or more swaps with such related affiliates;
  • the eligible treasury affiliate must not enter into swaps with its related affiliates or unaffiliated counterparties other than for the purpose of hedging or mitigating the commercial risk of one or more related affiliates;
  • each swap entered into by the eligible treasury affiliate must be subject to a centralized risk management program; and
  • reporting requirements, comparable to those applicable in connection with the end-user exception to mandatory clearing, must be satisfied.
Mandatory Clearing-Treasury Affiliate Exception

• ISDA developed a “Treasury Affiliate Representation Letter” to be used by swap dealers with treasury affiliate counterparties to facilitate compliance with this no-action relief.
• The letter is intended to provide parties relying on the Treasury Affiliate Letter with a means for making relevant elections and representations in order to establish the conditions for relief in the Treasury Affiliate Letter are met.
Margin Obligations

• The CFTC and the Prudential Regulators proposed margin rules last fall
• As a baseline matter, the proposed rules by their terms generally apply to swaps involving
  • swap entities (swap dealers and major swap participants); and
  • “financial end users” (as opposed to commercial end users)
Margin Obligations

• What is a financial end user?
• Definition is based on a list of enumerated financial market status types under various U.S. statutes and regulations
• Examples:
  • banks
  • broker-dealers
  • investment companies
  • insurance companies
  • commodity pools
  • ERISA plans
Margin Obligations

• The requirements with respect to non-financial end users contained in the proposed rules are quite modest
  • The prudential regulators would require swap entities to collect margin from any counterparties at such times and amounts (if any) that appropriately address credit risk
  • The CFTC would, in certain circumstances, require swap entities, as a risk management tool, for transactions with nonfinancial entities, each day to calculate hypothetical margin amounts as if the non-financial end user were a swap entity
Margin Obligations

- The Business Risk Mitigation and Price Stabilization Act of 2015, which has been signed into law, states that margin requirements “shall not apply to a swap in which a counterparty qualifies for an exception under section 2(h)(7)(A)” of the Commodity Exchange Act.
- Section 2(h)(7)(A) of the CEA is the exception to mandatory clearing for end users.
  - In order to make use of this exception, an entity must not be a financial entity.
- The language begs the question: what about swaps that do not fit into the end-user exception?
- Could margin requirements apply if:
  - a swap is not subject to mandatory clearing
  - a swap is not strictly a hedge, or
  - required reporting for end-user exception fails to occur?
Margin Obligations

• We will understand the answers better when the regulators issue their final margin rules
• However, given the modest requirements with respect to end users in the proposed margin rules, and the requirements of the Business Risk Mitigation and Price Stabilization Act of 2015, it seems unlikely that the final margin rules will have a material impact on margin obligations for end-users
Ownership and Control Reporting

• The CFTC issued a final rule regarding ownership and control reporting (the “OCR Rule”) in October, 2013
• Goal is to enhance CFTC’s ability to identify swaps and futures market participants
• The OCR Rule updated certain reporting forms and introduced new reporting forms
• The OCR Rule requires swap dealers, FCMs and clearing members to obtain additional identification and market participant data on new and updated forms
• After the rule’s requirements go into effect, end-users will likely receive requests for additional trader and account information from such reporting entities to address the requirements of the OCR Rule
Ownership and Control Reporting

- Among other fields, the new and updated forms require the reporting of the following information:
  - New Form 102A: a position-based reporting form, which requires the reporting of special accounts
    - A special account is an account that contains a “reportable position,” a position at the close of the market on any business day at least equal to the CFTC’s reporting level for the underlying commodity
  - New Form 102B: requires the reporting of trading accounts that exceed a stated volume threshold during a single trading day, regardless of whether these positions remain open at the end of the day.
  - New Form 102S: requires position-based reporting of consolidated accounts with reportable positions in the swaps market.
Ownership and Control Reporting

- New Form 40/40S: sent by the CFTC to reporting traders via special call to collect identifying information regarding traders
  - The CFTC’s new rules relating to the new Form 40S rules require the commercial entity that receives such a special call once to continue to supplement and update the Form 40S, regardless of whether the entity receives another special call from the CFTC

- The OCR Final Rule also amended CFTC rule 18.05 to impose additional recordkeeping obligations upon traders that own, hold or control reportable futures or options positions
- Such traders must now keep books and records in connection with any related swap
Ownership and Control Reporting

- No-Action Relief:
  - The CFTC issued a no-action letter in July, 2014 granting relief from many aspects of the new reporting requirements.
  - It extended that relief in a further no-action letter in February of this year (CFTC Letter No. 15-03).
  - The new no-action letter gives conditional relief from the new requirements until dates ranging from September 30, 2015 to February 13, 2017.
SDR Swap Reporting (Part 45)

- Traditional swaps must be reported electronically in real-time to SDRs
- SDs, MSPs, and financial entities generally have the reporting obligation, as well as exchanges and clearinghouses
- Commercial end users must report only OTC uncleared swaps with:
  - Other non-registrants with which the commercial end user agrees to act as the reporting counterparty or
  - Non-U.S. persons
End User Part 45 Reporting

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<th>Creation Data (OTC Uncleared Swaps)</th>
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<tr>
<td><strong>Primary Economic Terms</strong></td>
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<td><strong>Confirmation Data</strong></td>
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* As soon as technologically possible

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<th>Continuation Data (OTC Uncleared Swaps)</th>
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<tr>
<td><strong>Creation Data</strong></td>
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<td><strong>Changes to Primary Economic Terms</strong></td>
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<td><strong>Valuation Data</strong></td>
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Residual Interest Final Rule

- CFTC rules require FCMs to maintain their own funds – referred to as the FCM’s “residual interest” – in customer segregated accounts to cover aggregate customer margin deficits for the prior date, and to make deposits by a specified deadline.

- CFTC rules provided that the deadline is 6:00pm on the clearing settlement date, but was set to automatically move to 9:00am on that date, as of December 31, 2018.

- Deadline for FCMs to deposit their own funds affects the deadline for its customers (e.g., commercial end users) to post margin in response to margin calls.

- Final rule published by the CFTC in the Federal Register on March 24, 2015, eliminates the provision that automatically moves the deadline and would require CFTC to issue a separate rulemaking to change the deadline.
Utility Special Entities

- On September 26, 2014, the CFTC published a final rule permitting a person to exclude “utility operations-related swaps” entered into with “utility special entities” in calculating the aggregate gross notional amount of swaps positions for purposes of the *de minimis* exception from SD registration applicable to swaps with special entities.

- Utility special entities are special entities (federal, state and local governments, certain ERISA plans and endowments) that own or operate electric or natural gas facilities; supply natural gas or electric energy to other special entities; have certain public service obligations under federal, state, or local law; or is a federal power marketing agency.
Utility Special Entities

• Utility operations related swaps are swaps where one party is a utility special entity that is using the swap to hedge commercial risk, the swap is related to an exempt (e.g. energy, metals) or agricultural commodity, and is an electric energy or natural gas swap or associated with certain activities related to electric energy or natural gas.
• No limitation on the other counterparty (i.e. it may be a bank).
• The final rule means that such swaps are now subject to the general $8 billion notional de minimis threshold for registration (which is set to fall to $3 billion) rather than the much lower threshold of $25 million for other special entities.
• The final rule supersedes and expands previous no-action relief.
Recordkeeping for SEF Trading

- General Rule: All swap counterparties (including commercial end users) are required to keep “full, complete and systematic records, together with all pertinent data and memoranda” of their swaps.
- Swaps traded on SEFs are subject to additional recordkeeping requirements under CFTC Regulation 1.35 and SEF rules.
Recordkeeping for SEF Trading

• The following records must be kept when trading on SEFs:
  • “Original source documents,” or all documents on which trade information is originally recorded;
  • Full, complete and systematic records for swaps and any cash or forward transactions related to (i.e., hedged by) the swap;
  • Written records must be kept in a form and manner identifiable and searchable by transaction; and
  • All written communications concerning quotes, solicitations, bids, offers, instructions, trading, and prices that lead to the execution of a transaction in a commodity interest (e.g., swaps) and related cash or forward transactions
Recordkeeping for SEF Trading

- CFTC published a proposed rule on November 14, 2014 that would amend reg. 1.35 for members of Designated Contract Markets or SEFs that are not required to be registered with the CFTC (i.e. commercial end users) from the requirements to:
  - Retain text messages,
  - Maintain records in a searchable format, and
  - Maintain records in a form and manner that allows for identification of a particular transaction
- Comment period closed on Jan. 13, 2015; rule currently pending
- Proposal would codify staff no-action relief for commercial end users (CFTC staff letter no. 14-72)
Forwards with Embedded Volumetric Optionality

• Broad statutory definition of “swap” goes well beyond “traditional” understanding of swaps (exchanges of series of payments between parties calculated by reference to a notional amount)
• Includes options “of any kind” – whether physically or financially settled
• So…commodity options that call for physical settlement are swaps
• Excludes forward contracts for nonfinancial commodities
• Primary purpose of a forward contract is to transfer ownership of the commodity and not solely its price risk – *i.e.*, commercial merchandizing transactions
• Forwards may contain embedded optionality, including with respect to the amount of commodity to be delivered (i.e., volumetric optionality)
• CFTC has developed a test to determine whether such forwards should be considered excluded forwards or commodity options.
Forwards with Embedded Volumetric Optionality

• 7-Part Test (Original from 2012 Rulemaking). A transaction qualifies as a forward, notwithstanding it contains embedded volumetric optionality when:

  (1) The embedded optionality does not undermine overall nature of the agreement as a forward contract;
  (2) predominant feature of the agreement is actual delivery;
  (3) embedded optionality cannot be severed and marketed separately from the overall agreement;
  (4) seller intends to deliver if the option is exercised;
  (5) buyer intends to take delivery if the option is exercised;
  (6) both parties are commercial parties; and
  (7) the exercise or non-exercise of the embedded option is based primarily on physical factors, or regulatory requirements, that are outside the control of the parties and are influencing demand for, or supply of, the nonfinancial commodity.
Forwards with Embedded Volumetric Optionality

- Note: under the 7-part test, there must be a non-nominal amount of delivery for the contract to qualify as a forward.
- If there is no minimum delivery requirement specified in the contract, then it is a commodity option and not a forward.
- Peaking or swing natural gas supply contracts with no minimum delivery requirement thus are considered commodity options (but likely are trade options).
- Other contracts that have volumetric optionality, the exercise of which is not primarily due to physical factors or regulatory requirements outside the parties’ control, are commodity options.
- Physical factors include load growth, weather and certain operational considerations (e.g., available transportation capacity to deliver physical natural gas purchased on the spot market).
Proposed Interpretation of 7-Part Test

• The 7-part test – particularly its 7th prong – has been controversial with market participants.

• Issues raised by commenters include:
  • At time of contracting it may not be know if the exercise of optionality is in fact due to physical factors outside of the parties’ control.
  • Counterparties may disagree about the control they have over factors influencing demand for or supply of the nonfinancial commodity.

• CFTC issued proposed interpretation on Nov. 20, 2014 to clarify the 7-part test

• Under the proposal, the 4th and 5th prongs would be slightly modified to clarify that the test applies to embedded volumetric optionality in the form of both puts and calls.
Proposed Interpretation

• But, most significantly, the proposal would modify the 7th prong as follows:

  “The embedded volumetric optionality is primarily intended, at the time that the parties enter into the agreement, contract, or transaction, to address physical factors or regulatory requirements that reasonably influence demand for, or supply of, the nonfinancial commodity.”

• Compare to original 7th prong:

  “The exercise or non-exercise of the embedded option is based primarily on physical factors, or regulatory requirements, that are outside the control of the parties and are influencing demand for, or supply of, the nonfinancial commodity.”
Proposed Interpretation

- Modified 7\textsuperscript{th} prong is meant to reduce uncertainty as to reason for exercise of the option by making inquiry about the intent of the parties at the time of contracting.
- Also recognizes that the parties may have \textit{some} degree of influence or control over physical or regulatory requirements affecting supply and demand as opposed to their being wholly “outside their control.”
- Indicates that the “physical factors” would be construed broadly to include any fact or circumstance that would reasonably influence the parties’ supply or demand issues.
- Interpretation also expressly states that commercial parties could rely on counterparty representations regarding the intended purpose of the embedded option.
- Important to note that the proposed interpretation does not change the test’s non-nominal delivery requirement.
- Signals CFTC is likely to take a more relaxed view of the 7-part test.
Proposed Position Limits Rule

- CFTC re-proposed in November 2013 position limit rules that had been vacated by a federal district court in September 2012
- Proposal is substantially similar to vacated rules in prescribing spot month and non-spot month limits (single month and all-months-combined) for 28 physical commodity agricultural, metal, and energy core referenced contracts and “economically equivalent” futures, options, and swaps
- CFTC also re-proposed aggregation rules
- The CFTC held staff roundtable and two advisory committee meetings, the most recent that of the Energy and Environmental Markets Advisory Committee (EEMAC) on Feb. 26, 2015
- Comment period was re-opened on certain energy-related issues and closed on March 30, 2015
- Final action not expected until year end
Proposed Position Limits Rule

- Key issues in the proposed rules include:
  - Setting position limit levels, whether based on exchange rules or CME’s updated estimates of deliverable supply
  - Limitation of hedge exemptions to enumerated hedges and cumbersome process for obtaining a non-enumerated exemption;
    - At EEMAC meeting, energy market participants complained that many common hedging transactions would be ineligible under the proposed rule;
  - Conditional spot month exemption for cash-settled referenced contracts set at 5x the limit for physically delivered reference contracts (requires that market participant hold no physically-delivered reference contracts); and
  - The aggregation rules based solely on equity ownership as opposed to account ownership or control over trading, with difficult requirements to meet for greater than 50% ownership
Proposed Position Limits Rule

- Unclear how close final rules are to completion and vote
  - Chairman Massad: “We must make sure that the market works for commercial end-users seeking to hedge routine risk through bona fide hedging. We have received substantial public input on this rule, and we are going to take our time to get it right.”
  - Commissioner Bowen: “[T]hese rules have been discussed for years now, and it is time for the Commission to make the decisions it needs to make to get the rules finalized.” FIA Expo November 2014
- Exchange-set limits remain in effect, which may be enforced by both the exchanges and CFTC
- Recent enforcement actions against commercial end users for position limit and related violations: Thrasher ($525,000 penalty), Olam ($3 million penalty), Marubeni America ($800,000 penalty) and Kraft Foods/Mondelez Global (pending)
Questions?

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