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CFTC Releases No-Action Letter 14-144

The letter modifies previous No-Action Letter 13-22, to expand relief for treasury affiliates entering into swaps on behalf of non-financial end-user affiliates that could otherwise elect the exception in section 2(h)(7) of the CEA and section 50.50 of the Commission's regulations.

On November 26, the U.S. Commodity Futures Trading Commission's (CFTC's) Division of Clearing and Risk (Division) issued No-Action Letter 14-144.[1] The letter provides further relief for eligible treasury affiliates that enter into swaps that are subject to a mandatory clearing requirement under section 2(h)(1) of the Commodity Exchange Act (CEA) and part 50 of the CFTC's regulations. In seeking to address "certain challenges faced by treasury affiliates in undertaking hedging activities on behalf of non-financial affiliates within a corporate group," the new no-action letter expands prior relief granted under No-Action Letter 13-22, issued on June 4, 2013.

Background

Section 2(h)(1)(A) of the CEA and part 50 of the CFTC regulations establish a clearing mandate for certain classes of swaps, unless an exception or an exemption applies. Since the adoption of the Dodd-Frank Act,[2] the CFTC has adopted one exception and one exemption[3] from the clearing requirement. Section 2(h)(7) of the CEA and § 50.50 of the CFTC's regulations provide an "end-user exception" from clearing requirements to a counterparty, where such counterparty (a) is not a "financial entity," (b) is using swaps to hedge or mitigate commercial risk, and (c) satisfies certain reporting requirements.[4]

Defined in section 2(h)(7)(C) of the CEA, the term "financial entity" includes, among other entity categories, persons predominantly engaged in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956.[5] An exception from the clearing mandate is available, however, to certain "financial entities" that meet the requirements outlined in section 2(h)(7)(D)(i) of the CEA, which provides that an affiliate of a person who qualifies for the end-user exception may also qualify for the exception, but only if the affiliate, acting on behalf of the person and as an agent, uses the swap to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity. In the adopting release for the end-user exception, the CFTC took the view that treasury affiliates that are separate legal entities and whose sole or primary function is to undertake activities that are primarily financial in nature are financial entities because they are "predominately engaged" in such activities and, therefore, are not eligible for the end-user exception, except as provided in CEA section 2(h)(7)(D). Because treasury affiliates often enter into swaps on behalf of their non-financial affiliates as principal to the swap and not as agent, under CEA section 2(h)(7)(D)(i), treasury affiliates are unable to take advantage of the statutory exception to the clearing mandate. However, in response to a number of inquiries from market participants and in recognition of "the benefits that arise from the use of treasury affiliates within corporate groups," the Division issued No-Action Letter 13-22, which grants conditional relief from clearing requirements for

1. CFTC No-Action Letter 14-144 (Nov. 24, 2014), *available at* http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-144.pdf.

2. Pub. L. No. 111-203, 124 Stat. 1376 (2010).

3. *See* Clearing Exemption for Swaps Between Certain Affiliated Entities, 78 Fed. Reg. 21,749 (Apr. 11, 2013) (codified at 17 C.F.R. § 50.52).

4. *See* End-User Exception to the Clearing Requirement for Swaps, 77 Fed. Reg 42,559 (July 19, 2012) (codified at 17 C.F.R. § 50.50).

5. 12 U.S.C. §§ 1841 et seq.

such treasury affiliates.[6] Nonetheless, market participants have found that several conditions in No-Action Letter 13-22 have rendered the relief impractical.

Review of No-Action Letter 13-22

No-Action Letter 13-22 provides relief from the clearing mandate to "eligible treasury affiliates" that meet a number of qualifications, including (a) the person is directly wholly owned by a non-financial entity or another eligible treasury affiliate and not indirectly majority-owned by a financial entity; (b) the person's ultimate parent is not a financial entity and is able to identify all of its wholly and majority-owned affiliates and ensure that a majority qualifies for the exception; (c) the person is a financial entity 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; (d) the person is not and is not affiliated with a swap dealer, major swap participant, systematically important nonbank financial company, or certain other types of entities; and (e) the person is not a private fund, commodity pool, ERISA plan, or certain other types of entities. Additionally, No-Action Letter 13-22 specifies several general conditions relating to exempted swaps, which, in summary, require that

- the sole purpose of the exempted swap is to hedge or mitigate the commercial risk of related affiliates that were transferred to the eligible treasury affiliate by operation of one or more swaps with such related affiliates;
- the eligible treasury affiliate does not enter into swaps other than for hedging or mitigating the commercial risk of related affiliates;
- neither any related affiliate that enters into swaps with the eligible treasury affiliate nor the eligible treasury affiliate enters into swaps with or on behalf of—or otherwise assumes, nets, combines, or consolidates the risk of swaps entered into by—any financial affiliate that does not qualify as an eligible treasury affiliate;
- each swap is subject to a centralized risk management program; and
- the payment obligations of the eligible treasury affiliate are guaranteed by its non-financial parent.

The relief also imposes certain reporting obligations that require a reporting counterparty to provide information to a registered swap data repository.

Overview of No-Action Letter 14-144

No-Action Letter 14-144 is an attempt to rectify some of the issues faced by treasury affiliates under the requirements of No-Action Letter 13-22. However, for an eligible treasury affiliate that seeks to elect the exception, the swap activity must still meet a number of conditions, as described below.

Conditions for the Relief

As a general matter, the relief granted in No-Action Letter 14-144 is only available to "eligible treasury affiliates" and their "related affiliates," as such terms are defined in the letter, that meet the following conditions:

- An eligible treasury affiliate must enter into the 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.
- An eligible treasury affiliate must not enter into swaps with its related affiliates or unaffiliated counterparties other than for the purpose of hedging or mitigating its own commercial risk or the commercial risk of one or more related affiliates.
- Eligible treasury affiliates and related affiliates that enter into swaps with the eligible treasury affiliates must not enter into swaps with or on behalf of any "financial affiliate" (an affiliate that is a financial entity) or otherwise assume, net, combine, or consolidate the risk of swaps entered into by any financial affiliate, except in the case of financial affiliates that qualify as eligible treasury affiliates.
- Each swap entered into by the eligible treasury affiliate must be subject to a centralized risk management program that is reasonably designed to (a) monitor and manage the risks associated with the swap and (b)

6. CFTC No-Action Letter 13-22 (June 4, 2013), *available at* http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-22.pdf.

identify the related affiliate or affiliates on whose behalf each exempted swap has been entered into by the eligible treasury affiliate.

Furthermore, as with prior relief granted under No-Action Letter 13-22, with respect to each swap that an eligible treasury affiliate elects not to clear in reliance on the relief, the reporting counterparty must provide certain information to a registered swap data repository. The requirements and conditions for the relief are described more fully in No-Action Letter 14-144.

Improvements Contained in No-Action Letter 14-144

The following are material improvements contained in No-Action Letter 14-144:

- Removal of the requirement that the ultimate parent of a treasury affiliate must identify all wholly and majority-owned affiliates and ensure that a majority qualify for the end-user exception.
- Amendment to the requirement that the treasury affiliate is not itself or is not affiliated with a systemically important nonbank financial company. The Division substituted the requirement on non-affiliation with a restriction on the affiliate from (i) entering into transactions with, or on behalf of, a systemically important nonbank financial company, and (ii) providing any services, financial or otherwise, to such a designated entity.
- Relaxation of the requirement that treasury affiliates act only on behalf of certain types of "related affiliates" by amending the definition of "related affiliates" to allow entities that provide financial services on behalf of a financial entity to nonetheless qualify as an eligible treasury affiliate.
- Removal of the requirement that treasury affiliates transfer the risk of related affiliates through the use of swaps, recognizing that the method by which the risk is transferred can depend on the type of risk being hedged. However, as the transfer of risk from the related affiliate to the treasury affiliate will no longer be evidenced by back-to-back swaps, the Division added a requirement that the treasury affiliate identify the related affiliate on whose behalf the swap was entered into.
- Amendment to the requirement that treasury affiliates not enter into swaps other than for hedging or mitigating the commercial risk of one or more related affiliates. The latest relief allows a treasury affiliate to enter into its own hedging transaction without losing its eligible treasury affiliate status. The Division notes, however, that such transactions would not be "exempted swaps" and may be required to be cleared.
- Amendment to the requirement that related affiliates entering into swaps with the treasury affiliate, or the treasury affiliate itself, not enter into swaps with or on behalf of any affiliate that is a financial entity. The Division clarified that the restriction does not preclude the circumstance where the financial entity affiliate is an eligible treasury affiliate.
- Removal of the condition for the payment obligations of the treasury affiliate to be guaranteed.

Final Notes

In light of the expanded relief provided in No-Action Letter 14-144, corporate groups that use treasury affiliates to hedge or mitigate commercial risk across their enterprise should review their activities to determine whether they may qualify for the treasury affiliate exception. Additionally, all affected parties should review and update relevant documentation as may be necessary to elect the end-user exception from clearing.

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