

COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 39

RIN 3038-AD10

End-User Exception to the Clearing Requirement for Swaps

AGENCY: Commodity Futures Trading Commission.

ACTION: Final rule.

SUMMARY: The Commodity Futures Trading Commission (Commission or CFTC) is adopting final regulations to implement certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). These regulations govern the exception to the clearing requirement available to swap counterparties meeting certain conditions under Section 2(h)(7) of the Commodity Exchange Act (CEA), as amended by the Dodd-Frank Act.

DATES: Effective [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

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SUPPLEMENTARY INFORMATION

I. Background

The CEA, as amended by Title VII of the Dodd-Frank Act, establishes a comprehensive new regulatory framework for swaps. The CEA requires a swap: (1) to

be cleared through a derivatives clearing organization (DCO) if the Commission has determined that the swap is required to be cleared, unless an exception to the clearing requirement applies; (2) to be reported to a swap data repository (SDR) or the Commission; and (3) if the swap is subject to a clearing requirement, to be executed on a designated contract market (DCM) or swap execution facility (SEF), unless no DCM or SEF has made the swap available to trade.

Section 2(h)(1)(A) of the CEA establishes a clearing requirement for swaps, providing that “it shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing to a [DCO] that is registered under [the CEA] or a [DCO] that is exempt from registration under [the CEA] if the swap is required to be cleared.”<sup>1</sup> However, Section 2(h)(7)(A) of the CEA provides that the clearing requirement of Section 2(h)(1)(A) shall not apply to a swap if one of the counterparties to the swap: “(i) is not a financial entity; (ii) is using swaps to hedge or mitigate commercial risk; and (iii) notifies the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations associated with entering into non-cleared swaps” (referred to hereinafter as the “end-user exception”).<sup>2</sup> The Commission is adopting § 39.6 herein to implement certain provisions of Section 2(h)(7). Accordingly, any swap that is required to be cleared by the Commission pursuant to Section 2(h)(2) of the CEA must be submitted to a DCO for clearing by the parties thereto unless the conditions of Section 2(h)(7)(A) and § 39.6 are satisfied.

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<sup>1</sup> See Section 2(h)(1)(A) of the CEA, 7 U.S.C. 2(h)(1)(A).

<sup>2</sup> See Section 2(h)(7)(A) of the CEA, 7 U.S.C. 2(h)(7)(A).

Congress promulgated the end-user exception in Section 2(h)(7) of the CEA to permit non-financial companies to continue using non-cleared swaps to hedge risks associated with their underlying business, such as manufacturing, energy exploration, farming, transportation, or other commercial activities. Additionally, Section 2(h)(7)(F) gives the Commission the authority to prescribe rules (or interpretations of such rules) that may be necessary to prevent abuse of the end-user exception, and Section 2(h)(4)(A) requires the Commission to prescribe rules as determined by the Commission to be necessary to prevent evasions of the clearing requirement.<sup>3</sup>

Regulation 39.6 implements Section 2(h)(7) of the CEA by: (1) establishing the criteria for determining whether a swap hedges or mitigates commercial risk for purposes of Section 2(h)(7)(A)(ii); (2) specifying the information that counterparties must report to satisfy the notification requirement of Section 2(h)(7)(A)(iii); and (3) establishing an exemption for small financial institutions pursuant to Section 2(h)(7)(C)(ii) of the CEA. The rule also requires reporting of certain information that the Commission will use to monitor compliance with, and prevent abuse or evasion of, the end-user exception.

On December 23, 2010, the Commission published for public comment a notice of proposed rulemaking (NPRM) for § 39.6.<sup>4</sup> The Commission received approximately 2,000 comment letters, approximately 1,650 of which were form letters (cited herein as “Form Letters”), and Commission staff participated in approximately 30 ex parte

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<sup>3</sup> 7 U.S.C. 2(h)(7)(F) and 7 U.S.C. 2(h)(4)(A).

<sup>4</sup> See 75 FR 80747 (Dec. 23, 2010).

meetings and teleconferences concerning the rulemaking.<sup>5</sup> The Commission considered each of these comments in formulating the final regulations, as discussed below.<sup>6</sup>

## II. Comments on the Notice of Proposed Rulemaking

### A. Scope of the End-User Exception

As proposed, § 39.6(a) would provide that a counterparty to a swap (an “electing counterparty”) may elect the end-user exception to the clearing requirement provided in Section 2(h)(7)(A) of the CEA (i.e., the end-user exception) if the electing counterparty: (1) is not a “financial entity” as defined in Section 2(h)(7)(C)(i) of the CEA; (2) is using the swap to hedge or mitigate commercial risk as defined in § 39.6(c); and (3) provides or causes to be provided to a SDR or, if no SDR is available, the Commission, the information specified in proposed § 39.6(b).

#### 1. General Scope of Regulation 39.6(a)

The Commission received a number of comments regarding the general scope of § 39.6(a). Commodity Markets Council (CMC) and Riverside Risk Advisors, LLC (Riverside) recommended that the end-user exception should be available to a wide variety of entities. According to CMC, many market participants rely on customized over-the-counter swaps because they have small volume transactions or there are no standardized contracts available to hedge their specific commercial risks. Riverside requested that the Commission allow all potential counterparties other than swap dealers or major swap participants (MSPs) to elect the end-user exception.

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<sup>5</sup> The comment file for the proposed rulemaking can be found on the Commission Web site, [www.cftc.gov](http://www.cftc.gov).

<sup>6</sup> The Commission notes that the Securities and Exchange Commission has proposed regulations concerning an exception for end-users from clearing requirements applicable to security-based swaps. See 75 FR 79992 (Dec. 21, 2010). The Commission has reviewed the SEC’s proposal and consulted with SEC staff regarding the SEC’s proposal and this final rulemaking.

In contrast, Idaho Petroleum Marketers & Convenience Store Association (IPM&CSA) stated that the end-user exception should be narrowly tailored to businesses that produce, refine, process, market, or consume underlying commodities and to counterparties transacting with non-financial counterparties. The Form Letters generally agreed with the scope of the proposed rule's exception from clearing for non-financial companies engaging in commercial hedging and expressed concern with broadening the rule to include financial institutions or non-commercial hedges.<sup>7</sup>

In response to the comments from CMC and Riverside seeking a broader end-user exception, the Commission notes that the exception to the clearing requirement provided by Section 2(h)(7)(A) is based on the type of counterparty (e.g., the electing counterparty must not be a financial entity) and the type of risk hedged or mitigated (commercial risk). The Commission believes the general scope of the rule provides an appropriately flexible exception to the clearing requirement for commercial entities within the limits of these two parameters established in the CEA. In response to Riverside's other comment, the Commission notes that Congress specifically required all financial entities as defined in Section 2(h)(7)(C) (with certain exceptions specifically identified in that section) to submit for clearing swaps that are subject to the clearing requirement. Therefore, the Commission is adopting § 39.6(a) largely as proposed, except for changes to clarify the rule language and to make it consistent with other provisions of the rule as finalized.

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<sup>7</sup> The Form Letters stated:

"The big banks and their allies . . . are calling for exemptions for a very broad array of companies from the clearing and margin requirements of the act. Dodd-Frank already contains an exception for legitimate end-users, such as airlines and farmers, who are doing commercial hedging as part of their business from clearing and exchange trading requirements. We must not broaden this narrow, commonsense exception to include financial and commercial institutions that want to gamble in the derivatives markets. Doing so would allow systemically important companies to enter into risky trades in a market with zero transparency and accountability."

## 2. Application of the End-user Exception to Certain Entities

The Commission received a number of specific requests from commenters that the Commission determine that certain entities, or types of entities, are able to elect the end-user exception.<sup>8</sup> The commenters asked for relief in one of two ways: (i) that the Commission provide an express exemption from the clearing requirement for such entity; or (ii) that the Commission determine that the specific entity in question is not a financial entity and is hedging commercial risk.

Regulation 39.6(a), as adopted, sets forth the basic conditions that an entity must satisfy to elect the end-user exception. Except with respect to foreign governments, foreign central banks, international financial institutions, and state and local government entities as discussed below, the Commission is declining to determine at this time whether certain specific entities, or types of entities, are exempt from the clearing requirement or would qualify for the end-user exception based on their specific circumstances.<sup>9</sup> This release addresses comments and questions that are generally applicable to the rule. Any exemptive or interpretive determinations based on the specific nature or circumstances of a particular entity can better be addressed on a case-by-case basis, with the benefit of all relevant facts and circumstances, through the

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<sup>8</sup> See, e.g., American Securitization Forum (ASF), American Public Gas Association (APGA), National Rural Utilities Cooperative Finance Corp. (CFC), Coalition of Physical Energy Companies (COPE), Dairy Farmers of America (DFA), EDF Trading North America, LLC (EDF Trading), Farm Credit Council (FCC), Garkane Energy Cooperative (Garkane), Government Finance Officers Association (GFOA), Kraft Foods, Inc. (Kraft), National Association of Regulatory Utility Commissioners (NARUC), National Council of State Housing Agencies (NCSHA), Not for Profit Electricity End-Users (NFPPEU), National Milk Producers Foundation (NMPF), and Pacific Gas and Electric Co. (PG&E).

<sup>9</sup> An exemption for small financial institutions from the definition of “financial entity,” which Congress directed the Commission to consider in Section 2(h)(7)(C)(ii) of the CEA, is addressed in section II.D hereof.

interpretive or exemptive relief processes available for such purposes under the CEA and the Commission's regulations.

### 3. Definition of "Financial Entity" and "Financial Institution" for purposes of FDICIA

The International Energy Credit Association (IECA) requested that the Commission clarify the meaning of "financial entity" in the regulation. According to IECA, because of the implications of being labeled a "financial entity" under the Dodd-Frank Act, an entity may be reluctant to represent that it is a "financial institution" for purposes of the Federal Deposit Insurance Corporation Improvement Act (FDICIA).<sup>10</sup> IECA recommended that proposed § 39.6(a) be revised in part to state that a counterparty may elect the end-user exception if the electing counterparty (new language emphasized):

"is not a 'financial entity' as defined in section 2(h)(7)(C)(i) of the Act (determined without regard to whether such entity believes itself to be, or in fact constitutes, a 'financial institution' within the meaning of FDICIA)."

The Commission declines to revise proposed § 39.6(a) as requested by IECA because "financial entity" and "financial institution" are different terms referenced in different statutes. Interpreting the meaning and use of "financial institution" under FDICIA is within the jurisdiction of the Federal Deposit Insurance Corporation. Accordingly, the Commission is not inclined to render a view on the meaning of that term.

### 4. Status of Foreign Governments, Foreign Central Banks, and International Financial Institutions as "Financial Entities"

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<sup>10</sup> Public Law 102-242, 105 Stat. 2236 (1991).

The Commission received a comment from Milbank, Tweed, Hadley & McCloy LLP (Milbank) recommending that foreign governments and their agencies be excluded from the definition of “financial entity.” Milbank cited central banks, treasury ministries, export agencies, and housing finance authorities as examples of agencies of foreign governments that could be affected. Milbank expressed concern that these entities might be treated as “financial entities” that would not be permitted to use the end-user exception if, for example, they are viewed as “predominately engaged in ... activities that are financial in nature, as defined by Section 4(k) of the Bank Holding Company Act of 1956.”<sup>11</sup> In a separate letter, the World Bank commented that it should not be subject to the clearing requirement under Section 2(h)(1) of the CEA.

The Commission recognizes that there are important public policy implications related to the application of the end-user exception, and the clearing requirement generally, to foreign governments,<sup>12</sup> foreign central banks,<sup>13</sup> and international financial institutions.<sup>14</sup> The Commission expects that if any of the Federal Government, Federal

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<sup>11</sup> 12 U.S.C. 1841 *et seq.*

<sup>12</sup> For this purpose, the Commission considers that the term “foreign government” includes KfW, which is a non-profit, public sector entity responsible to and owned by the federal and state authorities in Germany, mandated to serve a public purpose, and backed by an explicit, full statutory guarantee provided by the German federal government.

<sup>13</sup> For this purpose, the Commission considers the Bank for International Settlements, in which the Federal Reserve and foreign central banks are members, to be a foreign central bank. *See* <http://www.bis.org/about/orggov.htm>.

<sup>14</sup> For this purpose, the Commission considers the “international financial institutions” to be those institutions defined as such in 22 U.S.C. 262r(c)(2) and the institutions defined as “multilateral development banks” in the Proposal for the Regulation of the European Parliament and of the Council on OTC Derivative Transactions, Central Counterparties and Trade Repositories, Council of the European Union Final Compromise Text, Article 1(4a(a)) (March 19, 2012). There is overlap between the two definitions, but together they include the following institutions: the International Monetary Fund, International Bank for Reconstruction and Development, European Bank for Reconstruction and Development, International Development Association, International Finance Corporation, Multilateral Investment Guarantee Agency, African Development Bank, African Development Fund, Asian Development Bank, Inter-American Development Bank, Bank for Economic Cooperation and

Reserve Banks, or international financial institutions of which the United States is a member were to engage in swap transactions in foreign jurisdictions, the actions of those entities with respect to those transactions would not be subject to foreign regulation. However, if foreign governments, foreign central banks, or international financial institutions were subjected to regulation by the Commission in connection with their swap transactions, foreign regulators could treat the Federal Government, Federal Reserve Banks, or international financial institutions of which the United States is a member in a similar manner. The Commission notes that the Federal Reserve Banks and the Federal Government are not subject to the clearing requirement under the Dodd-Frank Act.

Canons of statutory construction “assume that legislators take account of the legitimate sovereign interests of other nations when they write American laws.”<sup>15</sup> In addition, international financial institutions operate with the benefit of certain privileges and immunities under U.S. law indicating that such entities may be viewed similarly under certain circumstances.<sup>16</sup> There is nothing in the text or history of the swap-related

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Development in the Middle East and North Africa, Inter-American Investment Corporation, Council of Europe Development Bank, Nordic Investment Bank, Caribbean Development Bank, European Investment Bank and European Investment Fund. (The International Bank for Reconstruction and Development, the International Finance Corporation and the Multilateral Investment Guarantee Agency are parts of the World Bank Group.)

<sup>15</sup> See F. Hoffman-LaRoche, Ltd. v. Empagran S.A., 542 U.S. 155, 164 (2004), citing Murray v. Schooner Charming Betsy, 2 Cranch 64, 118, 2 L.Ed. 208 (1804) (“[A]n act of congress ought never to be construed to violate the law of nations if any other possible construction remains”); Hartford Fire Insurance Co. v. California, 509 U.S. 764 (1993) (Scalia, J., dissenting). See also Restatement (Third) Foreign Relations Law § 403 (scope of a statutory grant of authority must be construed in the context of international law and comity including, as appropriate, the extent to which regulation is consistent with the traditions of the international system).

<sup>16</sup> See, e.g., the International Organization and Immunities Act (22 U.S.C. §288) and the Foreign Sovereign Immunities Act (28 U.S.C. § 1602). The United States has taken appropriate actions to implement international obligations with respect to such immunities and privileges. See, e.g., International Bank for Reconstruction and Development (the “World Bank”) and International Monetary Fund (22 U.S.C. §286g

provisions of Title VII of the Dodd-Frank Act to establish that Congress intended to deviate from these traditions of the international system by subjecting foreign governments, foreign central banks, or international financial institutions to the clearing requirement set forth in Section 2(h)(1) of the CEA.<sup>17</sup>

Given these considerations of comity and in keeping with the traditions of the international system, the Commission believes that foreign governments, foreign central banks, and international financial institutions should not be subject to Section 2(h)(1) of the CEA.<sup>18</sup> Accordingly, it is not necessary to determine whether these entities are “financial entities” under Section 2(h)(7) of the CEA.

The Commission notes, however, that if a foreign government, foreign central bank, or international financial institution enters into a non-cleared swap with a counterparty who is subject to the CEA and Commission regulations with regard to that transaction, then the counterparty still must comply with the CEA and Commission regulations as they pertain to non-cleared swaps. For example, the party must comply

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and 22 U.S.C. §286h), the European Bank for Reconstruction and Development (22 U.S.C. §290l-6), the Multilateral Investment Guarantee Agency (22 U.S.C. §290k-10), the Africa Development Bank (22 U.S.C. §290i-8), the African Development Fund (22 U.S.C. §290g-7), the Asian Development Bank (22 U.S.C. §285g), the Inter-American Development Bank (22 U.S.C. §283g), the Bank for Economic Cooperation and Development in the Middle East and North Africa (22 U.S.C. §290o), and the Inter-American Investment Corporation (22 U.S.C. §283hh). See, e.g., CFTC Interpretative Letter regarding World Bank Group, dated October 30, 1991. “Based on the unique attributes and status of the World Bank Group as a multinational member agency, . . . the CFTC believes that the World Bank Group need not be treated as a U.S. person for purposes of application of the CFTC’s Part 30 rules.” See, also e.g., Board of Governors of the Federal Reserve approval of the application of BCI to acquire LITCO Bancorporation of New York, Inc., 68 Federal Reserve Bulletin 423 (1982) (the Bank Holding Company Act does not apply to foreign governments because they are not “companies” as such term is defined in the Bank Holding Company Act).

<sup>17</sup> To the contrary, Section 752(a) of the Dodd-Frank Act directs the Commission to consult and coordinate with other regulators “on the establishment of consistent international standards with respect to the regulation (including fees) of swaps [and] swap entities . . . .”

<sup>18</sup> The foregoing rationale and considerations do not, however, extend to sovereign wealth funds or similar entities due to the predominantly commercial nature of their activities. Accordingly, the Commission clarifies that sovereign wealth funds and similar entities are subject to Section 2(h)(1) of the CEA.

with the recordkeeping and reporting requirements under Parts 23 and 45 of the Commission's regulations.

#### 5. Status of State and Local Government Entities as "Financial Entities"

NCSHA recommended that the Commission explicitly provide that state and local governmental entities, specifically housing finance agencies, are not "financial entities" as defined in Section 2(h)(7) of CEA. In particular, NCSHA expressed concern regarding the applicability of Section 2(h)(7)(C)(VIII), which provides that a person is a financial entity if the person is "predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956."

As an initial matter, the Commission notes that Congress did not expressly exclude state and local government entities from the "financial entity" definition. On the contrary, in Section 2(h)(7)(C)(VII), Congress expressly included employee benefit plans of state and local governments in the "financial entity" definition, thereby prohibiting them from using the end-user exception.<sup>19</sup> A per se exclusion for state and local government entities from the "financial entity" definition is inappropriate. A state or local government entity's swap activity may be commercial in nature and such entity may also meet the definition of a "financial entity" in Section 2(h)(7)(C) of the CEA. Under such circumstances, the entity would be subject to compliance with the clearing

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<sup>19</sup> The Commission is not convinced by NCHSA's suggestion that Congress would have expressly included in the definition housing finance entities and other state and local government entities if it had intended for them to be "financial entities." Congress did not list every type of entity that is a financial entity, but provided a catch-all definition in Section 2(h)(7)(C)(VIII) to capture various types of entities it did not specifically list. The reference to government employee benefit plans is part of Section 2(h)(7)(C)(VII), which includes various types of employee benefit plans specifically in the definition of "financial entity," does not appear to have been intended as a singular identification of the only type of governmental entity that could be captured by the definition of "financial entity."

requirement of Section 2(h)(1)(A). As an example, much like state and local government employee benefit plans that are expressly identified in Section 2(h)(7)(C) as financial entities, other state or local government entities that act in the market in the same manner as private asset managers, such as local government investment pools, would need to comply.

The “business of banking” is a term of art found in the National Bank Act<sup>20</sup> and is within the jurisdiction of, and therefore subject to interpretation by, the Office of the Comptroller of the Currency.<sup>21</sup> Similarly, Section 4(k) of the Bank Holding Company Act is within the jurisdiction of, and therefore subject to interpretation by, the Board of Governors of the Federal Reserve System. Accordingly, the Commission is not inclined to interpret these provisions. However, even assuming that many state and local government entities may engage in some limited activities that are in the business of banking or are financial in nature as defined by Section 4(k), such activities are likely to be incidental, not primary, activities of those entities. Therefore, most state and local government entities are not likely to be “financial entities” under Section 2(h)(7)(C)(VIII), because they are not predominantly engaged in activities that are in the business of banking, or are financial in nature, as defined by Section 4(k) of the Bank Holding Company Act of 1956. Instead, most state and local government entities are “predominantly engaged” in other, non-banking and non-financial, activities related to their core public purposes and functions. Such entities therefore would not be “financial entities” by virtue of Section 2(h)(7)(C)(VIII) of the CEA.

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<sup>20</sup> 12 U.S.C. 24(Seventh).

<sup>21</sup> Nationsbank of N.C., N.A. v. Variable Annuity Life Ins. Co., 513 U.S. 251, 258 & n.2 (1995).

Regarding NCHSA's request for a specific determination for housing finance agencies, the Commission is not inclined to make such a determination without the opportunity to consider all relevant facts and circumstances.

#### 6. Affiliates

Section 2(h)(7)(D)(i) of the CEA provides that an affiliate of a person that qualifies for the end-user exception (including affiliate entities predominantly engaged in providing financing for the purchase of the merchandise or manufactured goods of the person) may qualify for the exception 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. The clear implication of this provision is that such an affiliate may elect the end-user exception, even if it is a financial entity, if the swap and the affiliate relationship otherwise comply with the requirements of Section 2(h)(7) and in particular, Section 2(h)(7)(D). Section 2(h)(7)(D)(ii), however, provides that this affiliate exception shall not apply to certain types of entities including, among others, swap dealers or MSPs.

Shell Energy North America (US), L.P. (Shell) commented that, absent clear guidance by the Commission, potential electing counterparties that centralize their risk management through a hedging affiliate that is designated as a swap dealer or MSP may be unable to benefit from the end-user exception. As a result, many potential electing counterparties may need to restructure their businesses and risk management techniques, thereby losing the many benefits of centralized hedging. According to Shell, such a loss might require potential electing counterparties to take on additional risk or to transact with third parties.

In response, the Commission notes that it lacks discretion in this regard because Congress specifically defined financial entities (which cannot use the end-user exception) to include swap dealers and MSPs, and Section 2(h)(7)(D) specifically prohibits swap dealers or MSPs acting on behalf of affiliates from using that provision to elect the end-user exception.<sup>22</sup>

Similarly, Kraft, Philip Morris International, Inc. (Philip Morris), and Siemens Corp. (Siemens) commented that the Commission should exclude wholly-owned treasury subsidiaries of non-financial companies from the “financial entity” definition, to the extent that they solely engage in swap transactions to hedge or mitigate the commercial risks of an entire corporate group. These commenters noted in particular that the treasury subsidiaries may be, or are likely to be, “financial entities” under Section 2(h)(7)(C)(VIII), because they are predominantly engaged in activities of a financial nature as defined in Section 4(k) of the Bank Holding Company Act. Siemens believes the Commission should amend the proposed rule to clarify that a financial entity acting as a “Treasury Affiliate” satisfies the statutory criteria for “acting on behalf of the person and as an agent,” as required by section 2(h)(7)(D)(i) of the CEA.

Here too, the Commission notes that Congress specifically defined “financial entity” for purposes of Section 2(h)(7) of the CEA, and proposed § 39.6(b)(2) (renumbered as § 39.6(a)(1)(i) in the final rule) simply adopts that definition. Likewise,

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<sup>22</sup> The Commission notes that the definition of “major swap participant” in Section 1a(33) of the CEA, in which the term “financial entity” is also used, does not include a provision that is similar to Section 2(h)(7)(D). In the absence of such a provision, the Commission has defined the term “financial entity” in § 1.3(mmm)(1) for purposes of the “major swap participant” definition in Section 1a(33) of the CEA and § 1.3(hhh), to exclude certain centralized hedging and treasury entities. *See* 77 FR 30596 at 30750 (May 23, 2012). The Commission does not believe it would be appropriate to take a similar approach with respect to the end-user exception, however, because Section 2(h)(7)(D) specifically addresses when affiliates may be eligible for the end-user exception.

Congress specifically set out in Section 2(h)(7)(D) who may qualify as an affiliate eligible for the end-user exception. The specificity with which Congress defines “financial entity” and sets out when affiliates, including affiliates that may be financial entities, may elect the end-user exception on behalf of an affiliate that is not a financial entity (i.e., the treasury affiliate would need to be “acting on behalf of the [other affiliate] and as agent”), constrains the Commission’s discretion in this area.

However, the Commission notes that it is important to distinguish where the treasury function operates in the corporate structure. Treasury affiliates that are separate legal entities and whose sole or primary function is to undertake activities that are financial in nature as defined under Section 4(k) of the Bank Holding Company Act are financial entities as defined in Section 2(h)(7)(C)(VIII) of the CEA because they are “predominantly engaged” in such activities. If, on the other hand, the treasury function through which hedging or mitigating the commercial risks of an entire corporate group is undertaken by the parent or another corporate entity, and that parent or other entity is entering into swaps in its own name, then the application of the end-user exception to those swaps would be analyzed from the perspective of the parent or other corporate entity directly.

For example, consider a parent company or other corporate entity predominantly engaged in manufacturing, agriculture, retailing, energy, or other non-“financial entity” businesses and which is not one of the types of financial entities described in Sections 2(h)(7)(C)(I) through (VII). If that parent or other corporate entity enters into swaps with an affiliate that hedge or mitigate commercial risk of the affiliate, the affiliate may elect the end-user exception for those inter-affiliate swaps if the affiliate is not a financial

entity. If the parent or other corporate entity then aggregates the commercial risks of those swaps with other risks of the commercial enterprise and hedges the aggregated commercial risk using a swap with a swap dealer, that entity may, in its own right, elect the end-user exception for that hedging swap. The parent or other corporate entity in the example is not a “financial entity” as defined in Section 2(h)(7)(C)(VIII) of the CEA, because that entity is “predominantly engaged” in other, non-financial activities undertaken to fulfill its core commercial enterprise purpose. However, if the parent or other corporate entity, including, for example, a separately incorporated treasury affiliate, is a “financial entity,” then that entity cannot elect the end-user exception unless one of the specific affiliate provisions of the statute, Section 2(h)(7)(C)(iii) or Section 2(h)(7)(D), apply.

CFC recommended that the Commission clarify that the definition of “an affiliate of a person” includes a nonprofit, tax-exempt cooperative of which the person is a member and which is not a depository institution. Section 2(h)(7)(D)(ii) of the CEA lists certain types of entities that do not qualify as affiliates able to elect the end-user exception. The Commission declines to determine at this time whether specific types of entities would qualify as affiliates able to elect the end-user exception because such determinations are best made on a case-by-case basis with the benefit of all relevant facts and circumstances.

Cravath, Swaine, and Moore, LLP (Cravath), EDF Trading, The Prudential Insurance Company of America (Prudential), and Working Group of Commercial Energy Firms (WGCEF) commented that the Commission should provide an explicit exemption from clearing and notification requirements for inter-affiliate swaps, *i.e.*, swaps between

companies that are part of a single group of affiliated companies. EEI & EPSA recommended that the Commission clarify in the regulatory text that “acting on behalf of the person and as an agent” to hedge or mitigate commercial risk includes inter-affiliate transactions.

As a general matter, the Commission notes that Congress did not treat inter-affiliate swaps differently from other swaps in Section 2(h)(7) of the CEA. Accordingly, the fact that a swap is between two affiliates would not change the analysis of whether one of the parties to the swap can elect the end-user exception. If one of the affiliates is not a financial entity and is using the swap to hedge or mitigate commercial risk, even if the other affiliate is a financial entity, the non-financial entity affiliate may elect the end-user exception and neither affiliate needs to clear the swap. However, whether the Commission should provide general clearing relief for inter-affiliate swaps for which the statutory requirements of the end-user exception are not satisfied is outside the scope of this rulemaking. Notwithstanding the foregoing, the Commission acknowledges that commenters have raised issues regarding inter-affiliate swaps that warrant further review and the Commission is considering other options regarding these issues.

#### 7. Captive Finance Companies

Section 2(h)(7)(C)(iii) of the CEA provides that the definition of “financial entity” in Section 2(h)(7)(C)(i) of the CEA “shall not include an entity whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or

another subsidiary of the parent company.” In connection with this “captive finance company” exception, the U.S. Chamber of Commerce and the Coalition for Derivatives End Users (CDEU) requested that the Commission interpret the phrase “90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company” to include component parts, attachments, systems, and other products that may be manufactured by others, but sold together with the company’s products as well as attachments and labor costs that are incidental to the primary purchase.

The Commission believes that the captive finance company exception must be interpreted in a manner consistent with the plain language of the statute. As a result, a person that seeks to fall within the captive finance company exception must be in the “primary business” of providing financing of purchases or leases from its parent company or subsidiaries thereof. Consistent with this requirement, the Commission states that the captive finance company exception can be applied when this financing activity finances the purchase or lease of products sold by the parent company or its subsidiaries in a broad sense, including service, labor, component parts, and attachments that are related to the products.

A group of captive finance companies or affiliates of captive finance companies (the “Captive Finance Companies”)<sup>23</sup> asked the Commission to create a simple test to determine whether an entity qualifies for the captive finance company exception and to clarify whether the two “90 percent” prongs should be read separately or together. The Commission believes the test is set out plainly in the statute and only allows for limited

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<sup>23</sup> American Honda Finance Corp., John Deere Financial Services, Inc., Nissan North America, Inc., Toyota Financial Services, and Caterpillar Financial Services Corp.

interpretation. As to the two prongs, the Commission interprets them separately. That is, 90 percent or more of the interest rate and currency exposures for which the captive finance company is using derivatives to hedge the related underlying commercial risks must arise from financing that facilitates the purchase or lease of products. Ninety percent or more of the products, the purchase or sale of which are being facilitated by the financing, must be manufactured by the parent company or its subsidiary. An entity must satisfy both prongs in order to be eligible for the captive finance company exception.

The Captive Finance Companies expressed concern that the Commission would require a product, in order to qualify as “manufactured” by the parent company or a subsidiary, to have 90 percent or more of its components manufactured by the parent company or subsidiary. The Commission requires only that the final product being purchased or sold, regardless of its components, be manufactured by the parent company or subsidiary in order to qualify.

The Captive Finance Companies also asked the Commission whether the “financing that facilitates the purchase or lease of products” should be measured on a single-entity or consolidated basis that includes the entity’s consolidated subsidiaries. They recommended that it be measured on a consolidated basis to prevent an entity that is a part of a larger group of entities from using corporate structures to manipulate the outcome and because most entities manage the reporting of their finance and leasing portfolios on that basis. The Commission agrees that the financing should be measured on a consolidated basis.

Further, the Captive Finance Companies discussed the ways in which a captive finance company might “facilitate” the purchase or lease of the parent company’s and

subsidiaries' products. For example, a captive finance company for an engine manufacturer may finance the sale of a boat that includes the manufacturer's engine in order to facilitate the sale of the engine, even if the boat itself were manufactured by a different company. As a second example, a captive finance company may provide working capital and related financing to a dealer that sells the parent company's products, even though such financing is not directly related to the sale of products. The Commission agrees that the word "facilitates" as used in Section 2(h)(7)(C)(iii) should be interpreted broadly to include financing that may indirectly help to facilitate the purchase or lease of products.

CFC commented that it should be viewed as a captive finance subsidiary of the entities that own it in a cooperative structure. CFC also discussed whether the captive finance company exception should be available when it provides financing to its member-owners to support their general business activities, rather than to finance purchases from its member-owners. The Commission is declining to determine at this time whether specific entities would qualify for the captive finance company exception because such determinations are best made on a case-by-case basis with the benefit of all relevant facts and circumstances.

#### B. Reporting Requirements

Section 2(h)(7)(A)(iii) of the CEA requires that, for the end-user exception to apply, one of the counterparties to the swap must notify "the Commission in a manner set forth by the Commission how it generally meets its financial obligations associated with entering into non-cleared swaps." Section 2(h)(7)(F) of the CEA allows the Commission to "prescribe such rules or issue interpretations of the rules as the Commission

determines to be necessary to prevent abuse” of the end-user exception and to “request information from those persons claiming the clearing exception as necessary to prevent abuse.”<sup>24</sup>

Proposed § 39.6(b) would implement Section 2(h)(7)(A)(iii) by requiring one of the counterparties (the “reporting counterparty”) to provide, or cause to be provided, to a registered SDR, or if no registered SDR is available, to the Commission, information about how the electing counterparty generally expects to meet its financial obligations associated with the non-cleared swap. In addition, proposed § 39.6(b) would require the reporting counterparty to provide certain information that the Commission will use to monitor compliance with, and prevent abuse of, the end-user exception. The reporting counterparty would be required to provide the information at the time the electing counterparty elects the end-user exception.

#### 1. Frequency of Reporting

The Commission received numerous comments suggesting that reporting of the information specified under proposed § 39.6(b) for each swap transaction would be burdensome.<sup>25</sup> A number of commenters recommended that the Commission permit entities to report some or all of the required items on an annual or periodic basis with

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<sup>24</sup> In addition, Section 2(h)(4)(A) requires the Commission to prescribe rules as determined by the Commission to be necessary to prevent evasion of the clearing requirements.

<sup>25</sup> See, e.g., American Bankers Association (ABA), American Gas Association (AGA), APGA, American Petroleum Institute (API), Air Transport Association (ATA), CDEU, COPE, Cravath, EDF Trading, Edison Electric Institute (EEI), EEI and Electric Power Supply Association (EEI & EPSA), Encana Marketing (USA) Inc. (EMUS), IECA, Independent Petroleum Association (IPA), National Council of Farmer Cooperatives (NCFC), NCSHA, National Energy Marketers Association (NEMA), Natural Gas Supply Association (NGSA), NMPF, Noble Energy, Inc. (Noble), National Rural Electric Cooperative Association (NRECA), Peabody Energy Corp. (Peabody), Retail Energy Supply Association (RESA), San Diego Gas and Electric Co. (SDG&E), Shell, Swap Financial Group, LLC (SFG), WGCEF, and WSPP, Inc. (WSPP).

updates for any material changes.<sup>26</sup> According to these commenters, an annual or periodic filing would provide sufficient notice to the Commission because the reasons for which each entity enters into hedge transactions, and the manner in which each entity generally meets its financial obligations associated with those transactions, do not change materially on a frequent basis.<sup>27</sup> Several commenters believe that a one-time filing of some or all of the required items should suffice.<sup>28</sup>

Hess suggested that, instead of imposing additional reporting requirements, the Commission could prevent abuse of the end-user exception by requiring electing counterparties to represent that they satisfy the requirements of Sections 2(h)(7) and 2(j) of the CEA in swap contracts that they elect not to clear. EEI & EPSA also recommended that if the Commission were to require swap-by-swap reporting, it should adopt a flexible requirement that establishes reasonable time frames for reporting. ATA recommended that the Commission streamline the notice requirement by providing that notice may be satisfied on a one-time basis as part of the ISDA master agreement.

IECA recommended that the rule be revised to state that if more than one, but less than all, parties to a swap are electing counterparties, the information specified in proposed § 39.6(b) shall be provided with respect to each of the electing counterparties. According to IECA, if all parties to a swap are electing counterparties, no report should be required.

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<sup>26</sup> See, e.g., ABA, AGA, API, ATA, CDEU, CFI Industries, Inc. (CFI), Hess Corp. (Hess), NCFE, NCSHA, NFPEEU, Noble, Peabody, SDG&E, Shell, and WGCEF.

<sup>27</sup> Id.

<sup>28</sup> See, e.g., APGA, COPE, Cravath, EDF Trading, EEI & EPSA, EMUS, Hess, IECA, IPA, NCSHA, NMPF, Petroleum Marketers Association of America and New England Fuel Institute (PMAA & NEFI), RESA, and SFG.

NMPF requested that the Commission simplify the reporting requirements, especially for those smaller hedgers for whom the typical reporting requirements would be burdensome, and exempt agricultural swaps between non-financial counterparties from all or most reporting requirements. Federal Home Loan Banks (FHL Banks) commented that certain non-financial entities should have no reporting obligation.

As proposed, the swap-by-swap reporting frequency for all information to be reported may impose unnecessary burdens, and therefore the Commission is revising proposed § 39.6(b) to require only swap-by-swap reporting of the election of the end-user exception and the identity of the electing counterparty to the swap. The other information for which proposed § 39.6(b) would have required reporting on a swap-by-swap basis does not have to be reported for each swap if the electing counterparty has previously provided the information in an annual filing.

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. The Commission is requiring certain information on a swap-by-swap basis so it can verify that the end-user exception is being elected in compliance with the CEA and Commission regulations.<sup>29</sup> In addition, if a counterparty is eligible to claim the end-user exception for one asset class but not

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<sup>29</sup> The Commission’s Part 43 rules on real-time public reporting of swap transaction data also require the reporting counterparty to indicate election of the end-user exception on a swap-by-swap basis. See 77 FR 1182 at 1250 (Jan. 9, 2012). Indication of the election of the end-user exception will be publicly disseminated as required in Part 43, but the additional information required under § 39.6(b) will not be.

another (for example, if the counterparty is a swap dealer granted limited designation by the Commission pursuant to § 1.3(ggg)(3)), the Commission must be able to distinguish those swaps for which the counterparty may legitimately claim the end-user exception from those for which it cannot. The Commission does not believe this reporting requirement will impose a significant burden on parties because other detailed information for every swap must be reported under other provisions of the CEA and Commission regulations.<sup>30</sup>

The Commission agrees with commenters that an annual filing for the remaining information will provide sufficient notice to the Commission because the general reasons for which electing counterparties enter into hedge transactions, and the manner in which they generally meet their financial obligations for those transactions, do not change frequently. While this approach may impose additional costs on SDRs and the Commission because each will have to establish and maintain two reporting alternatives,<sup>31</sup> the Commission believes that this approach will impose lower costs on the swap parties than they would incur if all information were required to be reported on a swap-by-swap basis. Accordingly, § 39.6(b) is being revised to permit the following information to be reported on a swap-by-swap or an annual basis: 1) whether the electing counterparty is a financial entity or a finance affiliate (i.e., is a financial entity electing the end-user exception by virtue of Sections 2(h)(7)(C)(ii) or (iii) or 2(h)(7)(D) of the CEA); 2) whether the swap hedges or mitigates commercial risk (the annual filing will

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<sup>30</sup> See, e.g., Sections 4(g) and 4(r) of the CEA; and Part 45 of the Commission's regulations.

<sup>31</sup> The Commission believes that the cost of establishing an additional reporting alternative is unlikely to be significant because the SDR and the Commission may do so in conjunction with establishing numerous other reporting processes, such as those required by the Commission's Part 43 rules on real-time public reporting of swap transaction data (77 FR 1182 (Jan. 9, 2012)).

state that the electing counterparty will only elect the end-user exception for swaps that hedge or mitigate commercial risk); 3) how the electing counterparty generally expects to meet its financial obligations; and 4) information related to whether the electing counterparty is an issuer of securities with board approval to not clear the swaps for which the end-user exception is elected.

The Commission has determined not to grant any exemptions to the § 39.6(b) reporting requirements at this time because any such determinations require a consideration of all relevant facts and circumstances. The modified reporting requirements should reduce some of the burdens cited by the commenters and given the low reporting burden under the rule and the general swap-by-swap reporting requirements in other regulations (e.g., Part 45), the Commission does not believe that a special, lesser reporting requirement for smaller parties or certain types of swaps is consistent with the statute. The Commission believes it would not be appropriate to require contract representations instead of reporting, or eliminate all or some reporting requirements for certain types of electing counterparties, because Section 2(h)(7)(A)(iii) of the CEA specifically requires notification to the Commission. Finally, the information required under § 39.6(b) will help to prevent abuse of the end-user exception by allowing the Commission to track when the exception is elected and who is electing it.

## 2. Identifying the Reporting Counterparty

As noted above, proposed § 39.6(b) would require one of the counterparties to the swap to act as the “reporting counterparty.” WSPP requested that the Commission clarify who the reporting counterparty is. WSPP noted that the Commission indicated in the NPRM that the reporting counterparty would be determined in accordance with the swap

data recordkeeping and reporting rules and that if one of the counterparties is an MSP or swap dealer, then that entity would be the reporting counterparty. WSPP further noted that proposed § 39.6 itself would not impose such a requirement, and recommended that the Commission either cross-reference the relevant swap reporting rules in § 39.6 or define “reporting counterparty” for purposes of § 39.6. WSPP also requested clarification as to how two electing counterparties in an electing counterparty-to-electing counterparty transaction would determine which counterparty is the reporting counterparty, and whether the reporting counterparty would provide information on both electing counterparties at the same time.

The Commission notes that § 45.8 of its swap data recordkeeping and reporting rules sets out how the determination of which counterparty is the reporting counterparty for a swap is to be made.<sup>32</sup> The Commission is revising § 39.6(b) to include a reference to § 45.8.

### 3. Reporting Methods

As noted above, proposed § 39.6(b) would require the reporting counterparty to provide or cause to be provided to a registered SDR, or if no registered SDR is available, to the Commission, the information set forth in that paragraph. CFI recommended that the Commission revise the proposed rule to permit an electing counterparty to summarize or submit copies of ISDA agreements and credit support agreements to the Commission to demonstrate how the electing counterparty generally meets its financial obligations related to non-cleared swaps. Similarly, EDF Trading stated that for transactions where

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<sup>32</sup> See 77 FR 2136 at 2207 (Jan. 13, 2012) (Swap Data Recordkeeping and Reporting Requirements; final rule).

neither party is a swap dealer or MSP, the Commission should provide an alternative to SDR reporting, such as the opportunity to submit hard copy records.

Better Markets, Inc. (Better Markets) recommended that the Commission require electing counterparties to report directly to the Commission, in addition to an SDR. According to Better Markets, this would ensure that the Commission receives complete and timely information regarding reliance upon the end-user exception. Hess requested that the Commission permit electing counterparties who are not swap dealers or MSPs to report directly to an SDR or the Commission, rather than rely on a swap dealer or MSP counterparty to report. Hess commented that such a requirement would be more efficient and reliable.

The Commission has determined not to revise § 39.6(b) in response to these comments. As discussed further in the considerations of costs and benefits in Section III hereof, the Commission believes that adopting alternative approaches to reporting is unnecessary, unduly burdensome, and may complicate data management and review. In response to Hess' comment, the Commission notes that, as previously discussed, the final rule has been revised to permit electing counterparties to report much of the information required by the rule directly to an SDR or the Commission on an annual basis. For the information required to be reported on a swap-by-swap basis, the reporting counterparty must be determined in accordance with § 45.8.

In the NPRM, the Commission stated that a reporting counterparty would provide the information required by proposed § 39.6(b) via a "check-the-box" approach and asked whether such an approach would be appropriate.

EMUS, IECA, National Grain and Feed Association (NGFA), and WSPP commented that a check-the-box approach is sufficient to collect the information required. IECA recommended that the Commission specify the check-the-box system in the rule text.

In contrast, Professor Michael Greenberger commented that a check-the-box approach is inadequate. According to Professor Greenberger, this approach will almost certainly be unreliable because the Commission will not have the necessary information to monitor and prevent potential abuse of the end-user exception.

EMUS expressed concern that different reporting counterparties could provide the same information to a registered SDR in different formats. It recommended that the Commission adopt a yes-or-no schema for each of the items set forth in proposed §§ 39.6(b)(1)-(6). According to EMUS, such a system would standardize reporting, which would provide more useful information. EMUS also commented that a standardized submission format would reduce costs and facilitate reporting for electing counterparties.

The Commission is satisfied that a check-the-box approach is an appropriate method to collect the information that the Commission requires to exercise regulatory oversight and that it mitigates the costs of compliance for the electing and reporting counterparties. In addition, a check-the-box approach provides a standardized data collection method for voluminous amounts of data, which will facilitate effective review by the Commission. It would be inefficient for the Commission to monitor and analyze a large volume of unique data points from a potentially wide range of electing counterparties.

The final rule itself does not specify the exact format for reporting purposes because the Commission's Part 45 rules establish the reporting requirements for all swap data, including the information required under § 39.6.

#### 4. Reporting of Inter-affiliate or Cooperative-to-Member Swaps

A few commenters raised issues regarding reporting of swaps between particular types of counterparties. Shell requested that the Commission clarify that swaps between affiliates need not be reported because such reporting for inter-affiliate swaps provides no useful information to the Commission and would be burdensome.

NCFC requested clarification regarding who provides the financial obligation information in a transaction between a cooperative and its members (such as producers or elevators) or customers (e.g., an electing counterparty-to-electing counterparty transaction). NCFC also questioned whether an SDR or the Commission will accept the data for transactions that cooperatives enter into with their members and customers and whether the Commission has the resources to accept such data.

In response to Shell's comment, the Commission notes that, although Congress expressly addressed in Section 2(h)(7)(D) of the CEA when an affiliate executing a swap on behalf of another affiliate may qualify for the end-user exception, Congress did not exempt such inter-affiliate swaps from the reporting requirements. Because inter-affiliate swaps must be reported, the parties also must provide the information required under § 39.6(b) so that the Commission will know why a swap that would otherwise be subject to clearing is not being cleared. In response to NCFC's request for clarification as to who provides the financial obligation information for cooperative-to-member swaps, the Commission notes that the reporting counterparty in such electing counterparty-to-

electing counterparty transactions is to be determined in accordance with § 45.8, as previously discussed.

#### 5. Finance Affiliates

As previously noted, Section 2(h)(7)(C)(iii) of the CEA provides that the definition of “financial entity” “shall not include an entity whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company.” Section 2(h)(7)(D)(i) of the CEA provides that an affiliate of a person that qualifies for the end-user exception also may 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. Section 2(h)(7)(D)(ii) identifies certain types of financial entities that cannot act as an affiliate electing counterparty on behalf of another person under Section 2(h)(7)(D)(i), indicating that financial entities that are not identified in Section 2(h)(7)(D)(ii) may do so. Proposed § 39.6(b)(3) would implement these provisions and require the reporting counterparty to report, or cause to be reported, whether the electing counterparty is a “finance affiliate”, i.e., a financial entity electing the end-user exception by virtue of Section 2(h)(7)(C)(iii) or 2(h)(7)(D) of the CEA.

EMUS requested that the Commission clarify whether the reporting counterparty must report that the electing counterparty is an affiliate of another person qualifying for the end-user exception under Section 2(h)(7)(D)(i) of the CEA or a finance affiliate of

such a person. According to EMUS, the NPRM indicated that the notification requirement would apply to all affiliates, while the rule text indicated a notification requirement would apply only to finance affiliates.

In response to EMUS, the Commission is revising § 39.6(b)(3) (renumbered in the final rule as § 39.6(b)(1)(iii)(A)(1)) to clarify that the notification requirement only applies to financial entities acting as affiliates. While identification of financial entities acting as affiliates is important because they are an exception to the prohibition on financial entities electing the end-user exception, the Commission does not believe that identification of non-financial entities acting as agents for affiliated entities is necessary. Similarly, the Commission is further revising this provision to add a requirement for electing counterparties to report whether they are “financial entities” as defined in Section 2(h)(7)(C)(i) of the CEA that are nevertheless exempt from the definition of “financial entity” as described in § 39.6(d). But for the exemption provided in § 39.6(d), such entities would be prohibited from electing the end-user exception (the exemption in § 39.6(d) is discussed in Section D below).

#### 6. Reporting How an Electing Counterparty Generally Meets Financial Obligations Associated with Non-cleared Swaps

As noted above, Section 2(h)(7)(A)(iii) of the CEA requires that the Commission be notified as to how an electing counterparty generally meets its financial obligations associated with entering into non-cleared swaps. Proposed § 39.6(b)(5) would implement this provision.

NGSA recommended that the Commission modify the language of its proposed rule to be identical to the statutory language — namely, that the words “expects to meet”

and “swap” in proposed § 39.6(b)(5) should be replaced with the words “meets” and “swaps,” respectively.

CFC recommended that the information contained in the notice should be general enough to encompass all transactions of an electing counterparty, and the notice should contain information as to how entities meet the obligations of multiple types of non-cleared swaps, not individual swaps.

CDEU and EMUS commented that the information the Commission proposed to collect is sufficient. According to CDEU, any additional information on meeting obligations would be non-standardized information that is not easily captured and reportable in a systematic fashion. CDEU commented that non-financial counterparties do not pose systemic risk and it is not clear how the reporting of more information on meeting financial obligations comports with the legislative intent of the Dodd-Frank Act.

Several commenters recommended that the Commission collect substantially more information, including specific information such as the types of collateral the electing counterparty will use to satisfy its financial obligations, the exact collateral terms and arrangements, and the contractual terms and provisions.<sup>33</sup>

The Commission is modifying proposed § 39.6(b)(5) (renumbered in the final rule as § 39.6(b)(1)(iii)(C)) to read as follows: “How the electing counterparty generally meets its financial obligations associated with entering into non-cleared swaps by identifying one or more of the following categories, as applicable. . . .” The Commission believes this revision more accurately reflects the Dodd-Frank Act’s intent that an

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<sup>33</sup> See, e.g., Americans for Financial Reform (AFR), American Federation of State, County and Municipal Employees (AFSCME), Better Markets, PMAA & NEFI, and Professor Greenberger.

electing counterparty must demonstrate how it “generally meets its financial obligations” (emphasis added) with respect to non-cleared swaps. Furthermore, the Commission is declining to modify proposed § 39.6(b)(5) to require reporting of additional, specific information because the statute only requires the electing counterparty to provide notice of how it “generally meets its financial obligations.” The Commission believes that the information required by the regulation will enable the Commission to exercise its regulatory oversight in an efficient and effective manner given the wide variety of different types of swaps and swap hedging strategies used by commercial entities.

#### 7. How a Counterparty Meets its Financial Obligations

Proposed §§ 39.6(b)(5)(i)-(v) would set forth categories of means by which an electing counterparty could generally meet its financial obligations associated with non-cleared swaps.

The National Rural Electric Cooperative Association (NRECA) asked the Commission to confirm that, in representing which swaps are secured by collateral, the counterparty should check the box under proposed § 39.6(b)(5)(ii) only if all or any portion of the financial obligations associated with the reported swap are secured by collateral that has been pledged to the swap counterparty at the time the swap is entered into. NRECA also asked whether that counterparty should check the box under proposed § 39.6(b)(5)(i) only if the obligations associated with the reported swap are to be secured in the future by collateral that is to be, or may in the future be, pledged to the swap counterparty pursuant to a master agreement or other credit support agreement applicable to the swap. NRECA also asked whether proposed § 39.6(b)(5)(i) is the appropriate box

to check when the counterparties have in place collateralization arrangements subject to agreed-upon unsecured credit thresholds.

NRECA asked how a reporting counterparty may satisfy proposed § 39.6(b)(5) where the financial obligations are not satisfied by any of the collateral set forth under proposed §§ 39.6(b)(5)(i) through (iii) and the electing counterparty “intends to generally meet its financial obligations associated with non-cleared swaps” by managing its commercial risks prudently, offsetting its obligations under its non-cleared swaps against those commercial risks and, for a not-for-profit electricity provider, passing through its costs and benefits of hedging to its retail energy customers during the time period(s) for which a swap hedges or mitigates commercial risk. NRECA asked the Commission to clarify whether such a reporting counterparty should check the box for proposed §§ 39.6(b)(iv) or (v). NRECA also asked whether the financial resources must be “available” for purposes of proposed § 39.6(b) at the time the swap is executed or by the time the swap is expected to settle and hedge or mitigate the commercial risk.

In response to NRECA’s comments, the Commission is modifying the text of proposed §§ 39.6(b)(5)(i)-(v) (renumbered in the final rule as §§ 39.6(b)(1)(iii)(C)(1)-(5)) to provide greater clarity as follows (new language emphasized): “(1) A written credit support agreement; (2) Pledged or segregated assets (including posting or receiving margin pursuant to a credit support agreement or otherwise); (3) A written third-party guarantee; (4) The electing counterparty’s available financial resources; or (5) Means other than those described in paragraphs (b)(1)(iii)(C)(1), (2), (3) or (4) of this section....”

In response to the comment regarding reporting of multiple sources, the Commission believes the word “solely” in proposed § 39.6(b)(5)(iv) may have created

some uncertainty and has deleted this word from the final rule text. The NPRM stated that parties are required to check multiple boxes if multiple sources of financial resources may be used. For clarity, the Commission is modifying the text of proposed § 39.6(b)(5) (renumbered as § 39.6(b)(1)(iii)(C)) to expressly require the checking of all applicable categories. In the example provided by NRECA, where the parties have a credit support arrangement subject to a threshold, the reporting counterparty would check one or more of the following: (1) proposed § 39.6(b)(5)(i) if the credit support arrangement is subject to a credit support agreement; (2) proposed § 39.6(b)(5)(ii) if the credit support arrangement provided for pledging or segregating assets; and (3) proposed § 39.6(b)(5)(iv) if the electing counterparty will use available financial resources to cover any amount up to the threshold listed in the credit support agreement.

Finally, the Commission believes that NRECA's example, where no collateral is used to satisfy obligations, falls squarely in proposed § 39.6(b)(5)(iv). The rule only requires that the electing counterparty identify how it generally meets its financial obligations with regard to uncleared swaps.

#### 8. Board Approval for SEC Filers

Under Section 2(j) of the CEA, exemptions from the requirements of Section 2(h)(1) to clear a swap and Section 2(h)(8) to execute a swap through a board of trade or SEF are available to a counterparty that is an issuer of securities that are registered under Section 12 of the Securities Exchange Act of 1934 or that is required to file reports pursuant to Section 15(d) of the Securities Exchange Act of 1934 (an "SEC Filer"), but only if an appropriate committee of the issuer's board or governing body has reviewed and approved the decision to enter into swaps that are subject to such exemptions.

Proposed § 39.6(b)(6) would implement this provision and require an SEC Filer to report, on a swap-by-swap basis, whether an appropriate committee of its board of directors (or equivalent body) has reviewed and approved the decision not to clear the swap subject to the clearing requirement.

A number of commenters interpreted proposed § 39.6(b)(6) as requiring an SEC Filer's board of directors to approve each decision to not clear a swap (*i.e.*, to grant approval on a swap-by-swap basis) and commented that Section 2(j) of the Dodd-Frank Act does not impose such a requirement.<sup>34</sup> COPE noted that companies generally do not engage in transaction-specific board actions.

According to most of these commenters, swap-by-swap board approval would impose excessive costs and burdens on companies.<sup>35</sup> AGA stated that a requirement that a board convene, review, and approve each and every decision to enter into a non-cleared swap transaction would be so administratively burdensome as to preclude its use.

Several commenters remarked that boards should be given broad discretion over their hedging strategies and how they choose to authorize entering into non-cleared swaps.<sup>36</sup> Commenters also recommended that companies should be able to delegate board approval to the appropriate board, committee, or corporate official on a general or "blanket" basis for either all swaps or various categories of swaps.<sup>37</sup> For example, COPE recommended that the Commission revise proposed § 39.6(b)(6)(ii) to state that a board

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<sup>34</sup> See, e.g., AGA, API, CDEU, COPE, Cravath, EEI & EPSA, EMUS, EPSA, IECA, NFPEEU, NGSA, NRECA, Mr. Steve Quinlivan, RESA, SDG&E, WGCEF, and WSPP.

<sup>35</sup> See, e.g., AGA, COPE, Cravath, EEI, EMUS, Hess, IECA, NGSA, NREC, NYCBA, Mr. Quinlivan, SDG&E, and WSPP.

<sup>36</sup> See, e.g., ATA, COPE, EMUS, SDG&E, and WGCEF.

<sup>37</sup> See, e.g., AGA, API, ATA, Cope, Cravath, EEI, EEI & EPSA, Hess, NFPEEU, NRECA, NYCBA, NGSA, Mr. Quinlivan, SDG&E, and WGCEF.

or committee may authorize the company to adopt a policy which grants general and continuing authority to enter into one or more swaps which are not cleared, and that specific approval is not required before entering into each and every swap. NGSa and the Committee on Futures and Derivatives Regulation of the New York City Bar Association (NYCBA) commented that the Commission should clarify footnote 18<sup>38</sup> of the NPRM and revise proposed § 39.6(b)(6)(ii) by replacing the words “the decision not to clear the swap” with the words “the decision not to clear such swaps.”

Cravath commented that the requirements should be flexible enough such that companies are able to manage and supervise their non-cleared swaps in a manner that is consistent with their existing governance policies.

On the other hand, Better Markets suggested imposing additional disclosure requirements on the companies, including specific justification for why each swap is not cleared. Better Markets also recommended that the SEC Filer’s CEO and CFO be required to certify that they have conducted a substantive review of the board committee’s action and decision not to clear the swaps.

The Commission believes that Section 2(j) of the Dodd-Frank Act does not require board approval of each decision by an SEC Filer to enter into a swap that is exempt from the clearing requirement. As noted above, Section 2(j) of the CEA states that exemptions from Sections 2(h)(1) and 2(h)(8) (i.e., the clearing and trade execution requirements) shall be available to an SEC Filer “only if an appropriate committee of the

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<sup>38</sup> Footnote 18 of the NPRM stated: “For example, a board resolution or an amendment to a board committee’s charter could expressly authorize such committee to review and approve decisions of the electing person not to clear the swap being reported. In turn, such board committee could adopt policies and procedures to review and approve decisions not to clear swaps, on a periodic basis or subject to other conditions determined to be satisfactory to the board committee.” 75 FR at 80750.

[SEC Filer]’s board or governing body has reviewed and approved its decision to enter into swaps that are subject to such exemptions.” The Commission interprets this language to allow board approval on a general basis. To remove any ambiguity, the Commission is modifying proposed § 39.6(b)(6)(ii) (renumbered as § 39.6(b)(1)(iii)(D)(2)) to read as follows: “Whether an appropriate committee of that counterparty’s board of directors (or equivalent body) has reviewed and approved the decision to enter into swaps that are exempt from the requirements of sections 2(h)(1) and 2(h)(8) of the Act.” This change allows for board approval on a general, as opposed to swap-by-swap, basis. Also, the reference to both Sections 2(h)(1) and 2(h)(8) makes clear that the board must have approved the decision to enter into swaps that are neither cleared nor executed on a DCM or SEF, as required by Section 2(j).

Commenters also discussed how frequently the counterparty should be required to provide notice that the board has approved use of the end-user exception and how frequently the board must renew its approval. A number of commenters suggested that an annual certification of board approval of a general hedging policy would be sufficient.<sup>39</sup> NRECA stated that annual certification should be sufficient unless there is an intervening material change in the board approval information previously submitted. AGA commented that the Commission should be satisfied if the company’s officers and/or risk committee annually reports to the board to ensure that the board remains informed of hedging activities. Hess, NRECA, and Shell commented that boards or board-appointed committees should be able to approve swaps on a periodic basis for

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<sup>39</sup> See, e.g., AGA, EEI, EMUS, Hess, NEMA, and SDG&E.

either several months or years. IECA recommended that board approval be required whenever a company enters into a new ISDA agreement for swap transactions.

EEI and RESA recommended a one-time notice that the board has approved the use of the end-user exception. WGCEF commented that companies should be able to adopt a single continuing resolution approving any decision to use the end-user exception. Peabody agreed that a single determination by a committee, which would only be revisited as the committee deems necessary, is appropriate.

As noted above, the Commission has revised proposed § 39.6(b)(6) so that entities have the option to report board approval information annually or on a swap-by-swap basis. The Commission would expect an SEC Filer's board 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 (e.g., a new hedging strategy is to be implemented that was not contemplated in the original board approval).

A number of commenters requested that the Commission clarify some of the terms used in proposed § 39.6(b)(6)(ii). NYCBA requested clarification as to what constitutes an "appropriate committee" for purposes of reviewing and approving the decision not to clear a swap. AGA asked the Commission to confirm that if a utility is a subsidiary of an SEC Filer, then the subsidiary's board committee would authorize the swap, not the board of the SEC Filer. IECA recommended that the rule be revised to expressly provide that approval must be given by the board of the transacting entity, not the board of an affiliate. Finally, EMUS requested clarification as to the meaning of "issuer of securities."

The Commission considers a committee to be appropriate if it is specifically authorized to review and approve the SEC Filer's decision to enter into swaps.<sup>40</sup> The SEC Filer's board would have reasonable discretion to determine the appropriate committee for approving decisions on swaps for its subsidiaries or affiliates.

In response to the comment regarding the meaning of "issuer of securities," the Commission notes that Section 2(j) of the CEA refers to an "an issuer of securities that are registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l) or that is required to file reports pursuant to section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o)." The SEC has stated that, for purposes of its proposed rule governing the end-user exception to mandatory clearing of security-based swaps, "a counterparty invoking the end-user clearing exception is considered by the [SEC] to be an issuer of securities registered under Exchange Act Section 12 or required to file reports pursuant to Exchange Act Section 15(d) if it is controlled by a person that is an issuer of securities registered under Exchange Act Section 12 or required to file reports pursuant to Exchange Act Section 15(d)."<sup>41</sup> The Commission is interpreting this term in the same manner as the SEC.

## 9. Liability for Reporting

Several commenters recommended that the Commission provide a safe harbor from liability for firms who report on behalf of other firms.<sup>42</sup> These commenters expressed concern that the proposed regulations may not protect the electing counterparty

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<sup>40</sup> See 75 FR at 80750 n. 16.

<sup>41</sup> See 75 FR 79992 at 79996 n. 34 (Dec. 21, 2010) (End-User Exception to Mandatory Clearing of Security-Based Swaps).

<sup>42</sup> See, e.g., Cravath, EMUS, IECA, NCFC, NGSA & NCGA, NRECA, and Peabody.

from potential liability if the reporting counterparty misreports information regarding the electing counterparty. These commenters also expressed concern that a swap dealer or MSP may be liable if the electing counterparty provides the swap dealer or MSP with false information and the swap dealer or MSP then provides the false information to an SDR or the Commission. NGSAs, CDEU, and RESA commented that the Commission should authorize a reporting entity to rely on the written representations or affirmations of the electing counterparty. NCFCA stated that the Commission should not require a reporting firm to verify the information provided by the electing counterparty. In the event that a reporting counterparty incorrectly reports a swap, CDEU recommended that the Commission provide a procedure to cure a notice failure.

The Commission notes that proposed § 23.505 addresses obtaining and reporting end-user exception information by swap dealers and MSPs.<sup>43</sup> Under that proposed rule, “[e]ach swap dealer and major swap participant shall obtain documentation sufficient to provide a reasonable basis on which to believe that its counterparty meets the statutory conditions required for an exception from a mandatory clearing requirement, as defined in section 2(h)(7) of the Act and § 39.6 of this chapter.”

To provide greater clarification for the end-user exception, the Commission is modifying § 39.6 to add § 39.6(b)(3), which states: “Each reporting counterparty shall have a reasonable basis to believe that the electing counterparty meets the requirements for an exception to the clearing requirement under section 2(h)(7) of the Act and this

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<sup>43</sup> See 76 FR 6715 at 6726 (Feb. 8, 2011) (Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants).

section.”<sup>44</sup> The Commission believes that establishing this explicit standard will give reporting counterparties greater clarity as to how to comply with the requirements of the rule and will help prevent abuse of the end-user exception. What constitutes a “reasonable basis to believe” will depend on the applicable facts and circumstances. For example, a reporting counterparty that has a long-standing business relationship with the electing counterparty and knows that the electing counterparty is doing the same repetitive swap trades for the same commercial risk hedging purposes may be able to rely on its due diligence for the initial swap in the series and not need to re-establish the due diligence for every subsequent swap trade. As a further example, it may be reasonable in many circumstances for the reporting counterparty to rely on appropriate representations from the electing counterparty. On the other hand, if the reporting counterparty has a reasonable basis to believe that the representations of the electing counterparty are not accurate for a particular swap being considered, then the reporting counterparty may not reasonably rely on those representations for that swap.

In response to comments concerning the liability of electing counterparties that are dependent on reporting counterparties to fulfill the reporting requirements of the rule, the electing counterparty is entitled to rely on reasonable representations by the reporting counterparty that the notification information has been properly transmitted. In such circumstances, the electing counterparty would not be subject to adverse consequences

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<sup>44</sup> Unlike proposed § 23.505, this provision does not include a requirement to “obtain documentation.” This is because proposed § 23.505 applies only to swap dealers and MSPs, whereas the reporting counterparty under § 39.6 may be a non-swap dealer/MSP. Such entities are less likely to have standardized documentation compliance systems in place and therefore obtaining documentation may be burdensome. To reduce this burden, the Commission has determined to provide greater flexibility in this rule.

and the swap will not be deemed ineligible for the end-user exception for failure of the reporting counterparty to properly report the information.

Regarding CDEU's comment on correcting information later determined to have been reported incorrectly, the Commission notes that its swap data recordkeeping and reporting rules address this issue for reported information generally in § 45.14.<sup>45</sup>

#### 10. Commission Approval for Use of the End-User Exception

NCSHA requested that the Commission clarify how the notification and reporting requirements of § 39.6 will affect the approval process for eligible counterparties electing the end-user exception. According to NCSHA, it is unclear whether the Commission will deny a counterparty the right to elect the end-user exception on the basis of

“insufficiently meeting the Commission’s notification and reporting requirements.”

NCSHA does not believe the Commission has the authority to reject eligible counterparties from electing the end-user exception on the basis of a failure to meet the Commission reporting or notification standards. However, if the Commission determines that it has that authority, NCSHA requested that the Commission provide a detailed list of the criteria it deems as necessary for a counterparty to sufficiently meet the CEA’s notification and reporting requirements.

The Commission notes that § 39.6 does not include a process for approving a counterparty’s election of the end-user exception, but a potential electing counterparty must meet the notification and reporting requirements in order to be eligible to elect the exception.

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<sup>45</sup> See 77 FR 2136 at 2210 (Jan. 13, 2012) (Swap Data Recordkeeping and Reporting Requirements; final rule).

### C. Hedging or Mitigating Commercial Risk

Section 2(h)(7)(A)(2) of the CEA provides that a swap shall not be subject to the clearing requirement if, among other things, one of the counterparties to the swap “is using swaps to hedge or mitigate commercial risk....” Proposed § 39.6(c) provides potential electing counterparties with criteria for determining whether a swap hedges or mitigates commercial risk.<sup>46</sup>

#### 1. Breadth of the Criteria

As noted in the NPRM, the criteria for what constitutes hedging or mitigating commercial risk in proposed § 39.6(c) are generally designed to allow a wide variety of potential electing counterparties to structure their swaps in a manner that fits their particular businesses while also providing guidance and a measure of certainty in discerning the line between swaps used for hedging or mitigating commercial risk and swaps used for other purposes.

Many commenters supported a broad set of criteria that would provide entities with sufficient flexibility to accommodate different risk mitigation strategies.<sup>47</sup> EEI & EPSA stated that a limited set of criteria (particularly with regard to hedging financial risks, as discussed in Section II.C.2 below) would prevent non-financial entities from effectively hedging risks associated with significant parts of their commercial businesses and could conflict with Section 737 of the Dodd-Frank Act (which concerns position limits). CDEU recommended that commercial risk be construed more broadly to

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<sup>46</sup> The phrase “hedge or mitigate commercial risk” was also the subject of joint rulemaking by the Commission and the SEC for purposes of the “major swap participant” definition under Section 1a(33) of the CEA. The overlap of that joint rulemaking and § 39.6(c) is addressed in Section II.C.11 below.

<sup>47</sup> See, e.g., CDEU, API, APGA, EEI & EPSA, Kraft, CMC, Milbank, and Philip Morris.

incorporate all risks associated with an entity's operations, including, but not limited to, interest rate risk, currency risk, credit risk, equity price risk, and risks arising from the purchase, ownership, production, storage, sale, financing, or transportation of commodities.

Conversely, other commenters suggested that the Commission should construe commercial risk more narrowly.<sup>48</sup> A number of commenters recommended that the definition of "commercial risk" be narrowly tailored to apply only to those entities whose business activities expose them to risk from physical commodity price fluctuations.<sup>49</sup> According to these commenters, "commercial risk" should not include risks that are purely financial in nature. AFR expressed concern that the proposed rule construes commercial risk too broadly and would provide little direction as to whether a swap position is hedging or mitigating commercial risk. In AFR's view, any business risks might qualify under the proposed regulations. AFR recommended that the Commission provide a narrower, prescriptive definition.

The Commission has determined that the criteria described in proposed § 39.6(c) should not change except for certain limited changes specifically discussed below. The Commission believes that by limiting the end-user exception to swaps that hedge or mitigate commercial risk, Congress made clear that it did not intend the exception to be applicable for all types of risk. Given the wide variety of potential electing counterparties, swaps, and hedging scenarios, the Commission believes that the rule

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<sup>48</sup> See, e.g., AFR, AFSCME, WDM, IPM&CSA, East Coast Petroleum (ECP), Pennsylvania Petroleum Marketers and Convenience Store Association (PPMCSA), Commodity Markets Oversight Coalition (CMOC), Fuel Merchants of New Jersey (FMNJ), Georgia Oilmen's Association (GOA), Skylands Energy Service, Inc. (Skylands), Weiss, Edward M. Minicozzi, Medford Heating (Medford), Tobin, Sullivan, Fay & Grunebaum, and Form Letters.

<sup>49</sup> See, e.g., CMOC, ECP, FMNJ, IPM&CSA, Medford, General Utilities, Inc., PPMCSA, and Skylands.

strikes an appropriate balance between providing flexibility for entities to qualify for the end-user exception and clarity on the limits of the exception.

## 2. Treatment of Commodity Risks and Financial Risks

Proposed § 39.6(c) sets out criteria for hedging certain financial risks such as interest, currency, or foreign exchange rate risks. The Commission asked in the NPRM whether the rule should only apply to swaps involving non-financial commodities.

Several commenters noted that non-financial entities regularly hedge financial risks related to their business operations and that limiting the rule to risks related to non-financial commodities would be unduly restrictive.<sup>50</sup> In contrast, other commenters stated that the rule should be limited to risks related to physical commodity price fluctuations and the principal business of the electing counterparty and should not include purely financial risks.<sup>51</sup> Some commenters expressed the view that the end-user exception should be limited so that it can only be used in direct proportion to the electing counterparty's physical holdings.<sup>52</sup> These commenters believe this approach would prevent an entity that is engaged in commercial activity from claiming the end-user exception for risks that are not commercial. AFSCME expressed concern about including foreign exchange hedging because foreign exchange transactions are alleged to be regularly abused and manipulated.

The Commission declines to revise proposed § 39.6 to exclude hedging of commercial "financial" risks from the end-user exception. The Commission believes that

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<sup>50</sup> See, e.g., Independent Community Bankers of America (ICBA), COPE, Peabody, WSPP, and SIFMA.

<sup>51</sup> See, e.g., WDM, IPM&CSA, ECP, PPMCSA, CMOC, FMNJ, GOA, Skylands, General Utilities, Inc., Medford, and Ms. Roselyn Devlin.

<sup>52</sup> See, e.g., Skylands, FMNJ, General Utilities, Inc., Cochran's, ECP, and Medford.

an entity that may elect the end-user exception can be subject to financial risks related to its commercial activities and that these risks can constitute commercial risks. For example, a change in interest rate risk on a non-financial entity's debt incurred for commercial business operations (e.g., to fund the purchase of inputs or to build a factory for the entity) can constitute commercial risk. As a further example, § 39.6(c)(1)(i)(F) addresses the risk of a change in interest, currency or foreign exchange risk exposures arising from a person's current or anticipated assets or liabilities in the ordinary course of business.<sup>53</sup>

Furthermore, the Commission does not believe the end-user exception was intended to apply only to physical commodity hedging. The Commission notes that the Dodd-Frank Act did not limit the end-user exception to physical position hedging. However, the Commission acknowledges the concern of commenters that allowing the end-user exception to be used for financial risk hedging might increase the potential for abuse of the exception. The Commission emphasizes that the use by non-financial entities of the end-user exception for financial risk hedging or mitigation must be an incidental part of (i.e., not central to) the electing counterparty's business and must fully qualify under all other applicable provisions of the CEA and § 39.6. The Commission will monitor the use of the end-user exception, particularly when it is used for hedging financial risks. If the Commission finds that the end-user exception is being abused in this regard, it will take appropriate action.

### 3. Facts and Circumstances Test

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<sup>53</sup> Proposed § 39.6(c)(1)(i)(E) addressed similar financial risks arising from rate "movements" rather than "exposures." However, the text of proposed § 39.6(c)(1)(i)(E) inadvertently referred only to foreign exchange rates. Accordingly, the final rule text has been revised to include interest and currency rates to be consistent with § 39.6(c)(1)(i)(F).

The Commission noted in the NPRM that it preliminarily believed that whether a position is used to hedge or mitigate commercial risk should be determined by the facts and circumstances existing at the time the swap is entered into, and should take into account the person's overall hedging and risk mitigation strategies.

A number of commenters generally agreed with the Commission's preliminary view.<sup>54</sup> EDF Trading suggested that such an approach is the only commercially practical way to implement the rule. NRECA commented that the Commission should make clear in its rules that it will not second-guess the decision of an electing counterparty to enter into the swap and the decisions related to the terms of the swap for which the end-user exception is elected, and should not provide for review of such commercial risk management decisions with the benefit of hindsight.

The Commission confirms that counterparties should look to the facts and circumstances that exist at the time the swap is executed to determine whether a swap satisfies the criteria for hedging or mitigating commercial risk as set forth in the final rule. In response to NRECA's comment, the Commission does not believe it is necessary to expressly set forth the facts and circumstances test in § 39.6. The Commission notes that nothing in § 39.6 would require ongoing reporting or testing of a swap's hedge effectiveness.<sup>55</sup> The Commission further notes, however, that it may review whether the election of the end-user exception was made in compliance with the CEA and the Commission's regulations at the time such election was made.

#### 4. Commercial Status of the Electing Counterparty

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<sup>54</sup> See, e.g., CDEU, Peabody, Philip Morris, EDF Trading, Kraft, NRECA, and AFSCME.

<sup>55</sup> Hedge effectiveness testing is discussed in further detail below in section II.C.9.

The Commission received a number of comments on whether “commercial” refers to (i) the underlying activity being hedged or (ii) the nature of the general activities of the entity claiming the end-user exception. CDEU, ICBA, WSPP, and the Securities Industry and Financial Markets Association (SIFMA) agreed with the Commission’s general view expressed in the NPRM that the determinant of whether a risk is “commercial” should be based on the underlying activity to which the swap relates and not the general nature of the electing counterparty’s activities. A number of commenters requested that, to avoid any uncertainty, the rule language clarify that governmental and non-profit entities can incur commercial risks (such as interest rate risk associated with debt).<sup>56</sup> Similarly, Norges Bank Investment Management asked the Commission to confirm that use of the word “commercial” does not preclude foreign central banks and other sovereign entities from relying on the end-user exception.<sup>57</sup>

In response to a question asked in the NPRM, ICBA commented that agricultural cooperatives and non-profit, governmental, or municipal entities should not receive any special considerations. ICBA reasoned that adding further gradations or special considerations could create competitive disadvantages for other entities. ICBA further noted that the Dodd-Frank Act contemplates special treatment under the end-user exception only for small financial institutions and accordingly, special treatment for other types of entities might contravene Congressional intent.

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<sup>56</sup> See, e.g., SIFMA, SIFMA MFP, SFG, Milbank, NCHSA, and WSPP.

<sup>57</sup> Based on the language of some of the comments, it appears that part of this concern may arise from the use of the phrase “commercial enterprise” in the proposed rule. That phrase is used to be consistent with existing § 1.3(z) of the Commission’s regulations, which identifies activities that qualify as hedging in the futures markets.

In response to these comments, the Commission confirms that the determination of whether the risk being hedged or mitigated is “commercial” will be based on the underlying activity to which the risk relates, not on the type of entity claiming the end-user exception.<sup>58</sup> The Commission confirms that this distinction applies to all potential electing counterparties including governmental entities, both domestic and foreign, and non-profit entities. Their status as governmental or non-profit entities does not control the determination of whether they are hedging or mitigating “commercial” risk. Rather, that determination will depend on the nature of the underlying activity to which the risk being hedged or mitigated relates.

Finally, the Commission believes that any additional language adding further gradations or special considerations in this regard could create confusion or unintended distinctions among different types of entities.

#### 5. “Economically Appropriate” Standard

Under proposed § 39.6(c)(1)(i), a swap is used to hedge or mitigate commercial risk if the swap is “economically appropriate” to the reduction of any of six different categories of commercial risk listed in that section.<sup>59</sup> Kraft commented that the

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<sup>58</sup> The exception to this approach is with respect to financial entities, which are defined in Section 2(h)(7)(C) of the CEA based on who they are or what they do generally. Financial entities are prohibited from electing the end-user exception under Section 2(h)(7)(A)(i) of the CEA.

<sup>59</sup> In the alternative to meeting the requirements of § 39.6(c)(1)(i), a swap executed by an electing counterparty may also be eligible for the end-user exception if the swap qualifies as a bona fide hedge for purposes of an exception from position limits under the CEA as provided in § 39.6(c)(1)(ii), or if it qualifies for hedging treatment under FASB Accounting Standards Codification Topic 815 or under GASB Statement 53 as provided in § 39.6(c)(1)(iii). Consequently, the universe of swaps that can qualify for the exception is broader than the universe of swaps that qualify as bona fide hedges for purposes of an exception from position limits under the CEA as provided in § 39.6(c)(1)(ii).

“economically appropriate” standard should not be further defined because “bright-line” definitions or limitations will result in less effective hedges and increased costs.

Better Markets expressed concern that the proposed “economically appropriate” standard may allow the end-user exception to be elected for swaps that do not hedge commercial risk precisely. Better Markets recommended that the Commission adopt a “congruence” standard that Better Markets believes fits the statutory language better. The “congruence” standard would require each risk in the swap to be congruent with a corresponding commercial risk being hedged.

On the other hand, SFG believes the “economically appropriate” standard is too narrow and should be replaced with a “management or reduction of risks” standard.

The Commission is adopting the “economically appropriate” standard as proposed. The Commission believes that this standard will help interested parties distinguish those swaps that hedge or mitigate commercial risks from those that do not, thereby reducing regulatory uncertainty and helping prevent abuse of Section 2(h)(7) of the CEA. The facts and circumstances will determine whether the swap is economically appropriate to hedge or mitigate commercial risks. While the Commission acknowledges that this standard leaves room for judgment in its application, the Commission believes this flexible approach is needed given the wide variety of swaps, potential electing counterparties, and hedging strategies to which the rule applies. The Commission believes the “economically appropriate” standard, together with the identification of the six different categories of permissible commercial risks listed in proposed § 39.6(c)(1)(i), is specific enough, when reasonably applied, to determine whether a swap is being used to hedge or mitigate commercial risk.

The Commission is not adopting a “congruence” standard because it believes the standard, which would require that each component risk of the swap be congruent with each risk being hedged, may be too restrictive and difficult to apply given the range of potential electing counterparties, types of swaps, and hedging strategies. Nor is the Commission adopting a “management or reduction of risks” standard. SFG’s recommendation does not explain what risk “management” means. Furthermore, the Commission is concerned that a standard based on “management” of risks may be overly inclusive and could apply to any swap that changes risk levels, including swaps that increase risk contrary to the goals of the Dodd-Frank Act.

#### 6. Hedging Treatment under Accounting Standards

Under proposed § 39.6(c)(1)(iii), a swap may be deemed to hedge or mitigate commercial risk if the swap qualifies for hedging treatment under Financial Accounting Standards Board (FASB) Accounting Standards Codification Topic 815. Professor Greenberger commented that transactions that meet the definition of hedging under accounting standards should qualify as commercial hedges.

SIFMA, SIFMA’s Municipal Financial Products Committee (SIFMA MFP), and GFOA asked that the Commission revise the proposed rule to include swaps that qualify for hedging treatment under the Governmental Accounting Standards Board (GASB) Statement 53, Accounting and Financial Reporting for Derivative Instruments (Statement 53). Statement 53 is the accounting standard for establishing a bona fide hedge under the GASB accounting standards used by many local government entities in the United States. Although different from the FASB accounting standard for hedging treatment, Statement 53 is similar in effect.

The Commission agrees that entities that use GASB accounting standards should be able to use Statement 53 to demonstrate that a swap hedges or mitigates commercial risk in the same way that the FASB hedging standard is used. Accordingly, the Commission is revising proposed § 39.6(c)(1)(iii) to include swaps that qualify for hedging treatment under Statement 53.

#### 7. Speculation, Investing, or Trading

Under proposed § 39.6(c)(2)(i), a swap does not hedge or mitigate commercial risk if it is used for a purpose that is in the nature of “speculation, investing, or trading.” Commenters expressed different views on whether swaps held for speculative, investing, or trading purposes should qualify as hedging or mitigating commercial risk and whether it is practical for the Commission to include the limitation in the rule. The Commission also received a number of comments that addressed application of the proposed limitation specifically to physical commodity swaps.

A number of commenters agreed that swaps which are used for one or more of the purposes of speculation, trading or investing should not qualify for the end-user exception.<sup>60</sup> Philip Morris commented that the proposed criteria for hedging or mitigating commercial risk sufficiently encompass swaps legitimately used to hedge commercial risks, while excluding those used for speculation, trading, or other non-hedging purposes. The Form Letters supported the general concept of this limitation, noting that the “common sense” exception for end users should not be broadened to allow institutions to “gamble” in the derivatives markets. AFR agreed with the Commission’s approach as explained in footnote 23 of the NPRM, but also expressed concern that the

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<sup>60</sup> See, e.g., BG Americas & Global LNG (BG LNG), Peabody, Philip Morris, Form Letters, and Cravath.

proposed rule may be too flexible and could create a loophole for speculators claiming to be hedging commercial risk when in fact they are not.

Several commenters suggested revising the proposed rule to limit the possibility that the provision would be applied in an overly restrictive manner. IECA recommended that the words “investing or trading” be eliminated from § 39.6(c)(2)(i). IECA believes that, because swaps are “traded” and can appear on an entity’s balance sheet, it is inappropriate to prohibit swaps used for investing or trading purposes. Vitol, Inc. (Vitol) expressed concern that excluding speculative or trading activities might preclude commercial firms that merchandise commodities or act as intermediaries in the supply chain from treating such positions as hedging or mitigating their commercial risk.

Commenters expressed particular concern that the term “trading” could be interpreted to include entering and exiting swap positions used to hedge or mitigate commercial risk and therefore such swaps would be ineligible for the end-user exception.<sup>61</sup> For example, WGCEF commented that a “trading” position held in anticipation of a potential price increase should qualify as hedging commercial risk, but under the proposed rule it could be interpreted as a “trading” position and not qualify for the end-user exception.

Similarly, BG LNG, API, and WGCEF believe, based on their reading of footnote 23 of the NPRM, that certain swaps entered into for the purpose of hedging physical market positions could be excluded. According to BG LNG and EPSA, any rule that prohibits the end-user exception from being applied generally to swaps that hedge physical market positions because they are classified as “trading” positions or

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<sup>61</sup>See, e.g., Hess, WGCEF, EPSA, and Peabody.

“speculative” positions would have serious, adverse consequences to physical markets for energy and other commodities. Also in reference to footnote 23 in the NPRM, WGCEF and BG LNG commented that many swaps that represent “arbitrage” positions are themselves hedges of commercial risk and not the type of speculative swaps that should be denied the end-user exception. BG LNG further commented that the unwinding or offsetting of such swaps should not change their characterization as “hedging or mitigating commercial risk.”

API, EPSA, and WGCEF recommended that the Commission clarify that swap positions that hedge other speculative or trading swap positions are also speculative or trading positions, unless such swap positions hedge physical commodity positions.

Cravath and Riverside commented that “investments” should be deleted from the limitation, noting that certain swaps that hedge or mitigate commercial risks specified in the rule may be treated as investments for accounting or other purposes.

Finally, WGCEF noted that “trading,” “speculation,” and “investing” were not defined in the proposed rule or the CEA.

The Commission is adopting § 39.6(c)(2)(i) as proposed. While the line between hedging or mitigating commercial risk and other uses of swaps can be difficult to discern at times, the Dodd-Frank Act nonetheless requires such determinations to be made. The Commission believes that explicitly prohibiting the end-user exception for swaps entered into for the purpose of speculating, investing, or trading, as opposed to swaps used for the purpose of hedging or mitigating commercial risk, will help entities to understand the limits of hedging or mitigating commercial risk for purposes of § 39.6 and will help prevent abuse of the exception.

The Commission believes that the meaning of § 39.6(c)(2)(i) is apparent when read in the overall context of § 39.6(c), which addresses the requirement in Section 2(h)(7)(A)(ii) of the CEA that the electing counterparty be using the swap to hedge or mitigate commercial risk. This requirement focuses on the purpose for which the potential electing counterparty is using the swap. Swaps executed for the purpose of speculating, investing, or trading are not being used to hedge or mitigate commercial risk. Such positions are, generally speaking, being executed primarily for the purpose of taking an outright view on market direction or to obtain an appreciation in value of the swap position itself and not primarily for hedging or mitigating underlying commercial risks. For example, swap positions held primarily for the purpose of generating profits directly upon closeout of the swap, and not to hedge or mitigate underlying commercial risk, are speculative or serve as investments. Further, as an alternative example, swaps executed for the purpose of offsetting potential future increases in the price of inputs that the entity reasonably expects to purchase for its commercial activities serve to hedge a commercial risk.

As noted above, several commenters expressed concern regarding the inclusion of “trading” in § 39.6(c)(2)(i). In the context of the rule, “trading” is not used to mean simply buying and selling. Rather, a party is using a swap for the purpose of trading under the rule in this context when the party is entering and exiting swap positions for purposes that have little or no connection to hedging or mitigating commercial risks incurred in the ordinary course of business. “Trading,” as used in § 39.6(c)(2)(i), therefore would not include simply the act of entering into or exiting swaps if the swaps

are used for the purpose of hedging or mitigating commercial risks incurred in the ordinary course of business.<sup>62</sup>

The Commission acknowledges that some swaps that may be characterized as “arbitrage” transactions in certain contexts may also reduce commercial risks enumerated in § 39.6(c)(1). The discussion in footnote 23 of the NPRM was intended to clarify that swaps are speculative for purposes of the rule if entered into principally and directly for profit and not principally to hedge or mitigate commercial risk. The reference to “arbitrage profits” in footnote 23 was intended to provide an example of what is commonly a speculative swap, not to characterize all arbitrage swaps as speculative.

The Commission is not revising § 39.6(c)(2)(i) to provide an express exception for swaps related to physical commodity positions. Swaps related to physical positions are not always hedging or mitigating commercial risk. For example, a swap related to physical positions may be a speculative position taking an outright view of the underlying commodity market. In limiting the end-user exception to swaps that hedge or mitigate commercial risk, Congress did not provide an exception from that limitation for swaps related to physical positions.

The Commission also notes that some commenters may have interpreted the proposed rule as prohibiting an entity that claims the end-user exception with respect to certain swaps from entering into other swaps for the purpose of speculation, investing, or trading. The Commission reiterates that a party’s ability to elect the end-user exception for a particular swap is a function of the purpose of the particular swap in question. The

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<sup>62</sup> The Commission further clarifies that merchandising activity in the physical marketing channel qualifies as commercial activity, consistent with the Commission’s longstanding bona fide hedging exemption to speculative position limits. See § 1.3(tt)(1)(ii).

fact that a party enters into other unrelated swaps for the purpose of speculating, investing, or trading will have no effect on the counterparty's assessment of whether its other swaps meet the requirements of the rule.

#### 8. Swaps Hedging Other Swaps

Under proposed § 39.6(c)(2)(ii), a swap that hedges or mitigates the risk of another swap or security-based swap may qualify as hedging or mitigating commercial risk only if the underlying swap or security-based swap itself is used to hedge or mitigate commercial risk.

Professor Greenberger generally agreed with the limitation in the proposed rule and recommended that the limitation be extended to all swaps hedging other swaps. In his view, hedges of other hedging swaps are inherently speculative and should not be allowed under the end-user exception.

Reval.com, Inc. (Reval) suggested that swap transactions that are executed on a “matched book” basis with swaps that are excepted from the clearing requirement should also be eligible for the clearing end-user exception. Several small or regional financial entities commented that swaps executed on a matched book or back-to-back basis with swap dealers, which hedge swaps executed with non-financial entities who themselves are using the swaps to hedge commercial risks, should get the benefit of the end-user exception.<sup>63</sup>

The Commission considered whether a swap that hedges another swap that itself is used to hedge or mitigate commercial risk could qualify for the end-user exception.

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<sup>63</sup>See, e.g., Susquehanna Bancshares, Inc., The Private Bank and Trust Company, Commerce Bank, Atlantic Capital Bank, Trustmark, Webster Bank, UMB Bank, Chatham Financial, and Wintrust.

The Commission determined that such a swap could qualify if it in fact hedges or mitigates commercial risk for a party entering into the swap. In connection therewith, the Commission has determined that “matched book” or “back-to-back” swaps that hedge or mitigate risks of other swaps may qualify for the end-user exception if the swap is used to reduce risks in the conduct and management of a commercial enterprise as set forth in § 39.6(c)(1) and the “other swap” itself qualifies for the end-user exception. This is why § 39.6(c)(2)(ii) provides that a swap that hedges or mitigates the risk of another swap or security-based swap may qualify as hedging or mitigating commercial risk, so long as the underlying swap or security-based swap itself is used to hedge or mitigate commercial risk. This provision allows successive swaps in a chain of back-to-back swaps to qualify for the end-user exception if the first underlying swap qualifies for the exception, and each such successive swap is used by a party to that successive swap that qualifies for the end-user exception to hedge or mitigate commercial risk. This result is only applicable to entities that could otherwise qualify for the end-user exception. Accordingly, in a chain of qualifying swaps involving only qualifying entities, if the “last” qualifying entity in the chain hedges its qualifying swap (its “underlying swap”) by entering into a qualifying swap with a non-qualifying financial entity (its “hedging swap”), then although the qualifying entity can elect to use the end-user exception with respect to its hedging swap, that financial entity cannot elect the end-user exception for any further swap used by that financial entity to hedge or mitigate its position. In effect, the chain is then broken.

Reval’s comment indicates that the text of proposed § 39.6(c)(2) may be unclear. When the wording of proposed § 39.6(c) is read as a whole, the proposed rule provides that a swap qualifies for the end-user exception if it meets one of the conditions stated in

proposed § 39.6(c)(1) and if, as stated in proposed § 39.6(c)(2), the swap is (i) not held for a speculative, investing, or trading purpose, or (ii) not hedging another swap unless that swap itself is held for hedging purposes. Accordingly, the literal text of proposed § 39.6(c)(2) could be interpreted to permit a swap to qualify for the end-user exception if the swap is not hedging another swap (i.e., if the second clause is satisfied), even if the swap is itself held for a speculative, investing, or trading purpose (i.e., if the first clause is not satisfied).

The NPRM stated that “[p]roposed § 39.6(c)(2) further provides, however, that a swap is disqualified from the end-user exception if it is held for a speculative, investing, or trading purpose, or if it hedges another swap unless that swap itself is held for hedging purposes.”<sup>64</sup> In other words, proposed § 39.6(c)(2) provides that a swap would be disqualified from the end-user exception if either of two conditions were true: if the swap is held for a speculative, investing, or trading purpose, or if the swap hedges another swap unless that swap itself is held for hedging or mitigating purposes.

Accordingly, the Commission is revising the text of § 39.6(c)(2) to clarify the rule text in accordance with the intended purpose by replacing the conjunction “or” between clauses (i) and (ii) in § 39.6(c)(2) with the conjunction “and.”<sup>65</sup> This clarifies that, in order to qualify for the end-user exception, the swap must not be used for the purposes

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<sup>64</sup> 75 FR at 80752 (footnote omitted).

<sup>65</sup> The Commission notes that in the definition of “hedge or mitigate commercial risk” proposed by the Commission for purposes of defining “major swap participant” under Section 1a(33) of the CEA, there was no conjunction between clauses (i) and (ii). See Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant,” 75 FR 80174, 80214, 80217 (Dec. 21, 2010) (proposed § 1.3(tt)(2)). However, the Commission added the conjunction in the final definition. See 77 FR 30596 at 30750 (May 23, 2012) (final § 1.3 (kkk)(2)).

stated in § 39.6(c)(2)(i), and it must not be used for the purposes stated in § 39.6(c)(2)(ii). The final rule adopted by the Commission includes this change.

In response to Professor Greenberger's comment, the Commission does not believe that a swap that hedges an existing hedge is always speculative. The CEA does not require that the end-user exception be available only if the swap is a perfect or exact hedge. A swap originally designed to hedge commercial risk in compliance with the criteria of the rule may, over time, no longer fully serve its original hedging purpose. For example, if the underlying commercial risk hedged by the original swap or security-based swap no longer exists or changes as a result of changing market conditions or changes in the business needs of the electing counterparty, the risk now posed by the original swap or security-based swap itself is like other commercial risks that arose in the ordinary course of business because that swap originated as a hedge of commercial risk. Accordingly, as the Commission has stated that the entities shall evaluate the facts and circumstances existing at the time a hedge position is initiated<sup>66</sup> when electing the end-user exception, the entity should have the option to elect the end-user exception for swaps that hedge or mitigate risks created by the original swap or security-based swap, even if the original risk hedged no longer exists or has changed.

#### 9. Portfolio and Dynamic Hedging, and Hedge Effectiveness Testing

In the NPRM, the Commission asked whether the end-user exception should apply to swaps that hedge or mitigate commercial risk on a single-risk basis or an aggregate-risk basis or to swaps that facilitate dynamic hedging. The Commission also asked whether hedge effectiveness should be addressed.

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<sup>66</sup> See section II.C.9 herein.

A number of commenters stated that portfolio hedging and dynamic hedging may hedge or mitigate commercial risk, and are commonly used by certain potential electing counterparties, and therefore the hedging techniques should be eligible for the end-user exception.<sup>67</sup> WGCEF, Shell, and ATA noted that commercial firms in the physical energy and other markets often hedge underlying physical assets and related positions on a portfolio or aggregate basis and also may dynamically hedge. WGCEF stated that in such cases it would be impracticable to have one-to-one matching of each swap to a specific physical transaction or asset for purposes of complying with the end-user exception. EEI & EPSA and WGCEF commented that excluding hedging of commercial risks on a portfolio basis or dynamic hedging could introduce uncertainty and limit the ability of non-financial entities to effectively manage their commercial risks.

Regarding hedge effectiveness, a number of commenters stated that it is important for entities to know at the time a transaction is executed whether the end-user exception applies. According to these commenters, an effectiveness test should not be used because it can only determine whether the swap appropriately hedges or mitigates commercial risk at the time of the test and not at the time of swap execution.<sup>68</sup> EDF Trading suggested that “reasonable efforts to hedge commercial risks” should be considered hedging. EDF Trading noted that tracking and analyzing the hedging or mitigating characteristics of a swap after its inception would be difficult because the hedging value of a swap fluctuates over time and is subject to market forces. EDF Trading further noted that such uncertain market fluctuations are the principal reason for entering into hedging

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<sup>67</sup> See, e.g., EEI & EPSA, ATA, WGCEF, RESA, Peabody, Kraft, and American Public Power Association & Large Public Power Council.

<sup>68</sup> See, e.g., ATA, APGA, Cravath, EDF Trading, and Kraft.

transactions in the first place. EDF Trading believes that requiring an ongoing, periodic assessment of a hedge's effectiveness or purpose would be burdensome for commercial entities and would do little to reduce systemic risk.

CFI suggested that a requirement to report the related risk being hedged, which would be necessary to test hedge effectiveness, would impose an unnecessary burden on electing counterparties. In contrast, Better Markets and PMAA & NEFI commented that entities should be required to disclose what specific risks they are hedging and how the swap hedges those risks so that regulators can police the end-user exception. Furthermore, Better Markets stated that entities should have to certify that excepted swaps are not entered into for speculation either in whole or in part.

The Commission has determined that a swap that facilitates portfolio hedging or dynamic hedging may be eligible for the end-user exception if that swap hedges or mitigates commercial risk. The Commission acknowledges that portfolio hedging and dynamic hedging<sup>69</sup> can be economically appropriate to hedge or mitigate commercial risk, depending on the relevant facts and circumstances.

The Commission has also determined that parties will not be required to demonstrate hedge effectiveness or engage in periodic hedge effectiveness testing. The Commission agrees with commenters that entities need to know whether the swap is eligible for the end-user exception at the time it is executed and should not be subject to second guessing if subsequent hedge effectiveness testing finds that the swap does not,

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<sup>69</sup> Regarding commenters' queries about dynamic hedging, which WGCEF described as the ability to modify the hedging structure related to physical assets or positions when relevant pricing relationships applicable to that asset change, the Commission notes that qualification as bona fide hedging does not require that hedges, once entered into, must remain static. The Commission recognizes that entities may update their hedges periodically when pricing relationships or other market factors applicable to the hedges change.

over time, hedge the intended risk as such ineffectiveness may be beyond the control of the electing counterparty. Furthermore, the Commission believes that such a requirement could potentially add costs and burdens with potentially limited added benefit.

Finally, the Commission has determined not to require entities to document and report the risk being hedged. The Commission believes that such a requirement would create a large volume of unique data that would be difficult to meaningfully review. Although the Commission has determined not to modify § 39.6 to address portfolio hedging or dynamic hedging at this time, the Commission recognizes that the end-user exception could be more easily abused in these contexts. The Commission intends to monitor use of the end-user exception and if such abuse becomes prevalent, it may impose appropriate hedge identification and/or hedge effectiveness testing or reporting requirements.

#### 10. Swap-by-Swap or Swap Portfolio Approach

In a comment submitted prior to publication of the NPRM, NYCBA requested clarification as to whether all swaps entered into by a party, or only a certain percentage of the party's swap portfolio, must hedge or mitigate commercial risk for the party to qualify for the end-user exception. In proposed § 39.6, whether a commercial risk is being hedged or mitigated would be determined for each swap, not for all or a portion of a party's swap portfolio.

As noted above, Section 2(h)(7)(A)(ii) of the CEA provides that a swap shall not be subject to the clearing requirement if, among other things, one of the counterparties to the swap "is using swaps to hedge or mitigate commercial risk...." The Commission does not believe that Congress intended this language to automatically apply to all swaps

— no matter how numerous and no matter what their purpose — used by an entity that uses some swaps to hedge or mitigate commercial risk. Such an interpretation would extend the end-user exception beyond its purpose of facilitating the use of swaps for hedging or mitigating commercial risk. Conversely, the statutory language does not clearly limit the end-user exception to entities that use swaps solely to hedge or mitigate commercial risk. Implementation of Section 2(h)(7)(A)(ii) thus requires the Commission to determine how the provision should be applied to entities that use swaps to hedge or mitigate commercial risk but also for other purposes.

Broadly speaking, there are two possible ways to do this: either on a swap-by-swap basis or based on an entity's overall portfolio of swaps. The former approach has a number of important advantages and the Commission therefore is adopting the swap-by-swap approach as proposed. This approach is consistent with the swap-by-swap clearing requirement in Section 2(h)(1) of the CEA. The portfolio approach would present numerous issues that would be difficult to overcome or would render the end-user exception less effective for achieving the stated goals of the Dodd-Frank Act. For example, if the Commission required that a certain minimum percentage of a party's swaps must hedge or mitigate commercial risk, the end-user exception would be unavailable to parties who do not reach the minimum threshold. This could prevent a large number of non-financial entities from using the end-user exception at all. It is unlikely that Congress intended such a result. In addition, if the Commission required a high percentage of a party's swap portfolio to hedge or mitigate commercial risk, potential electing counterparties could be more inclined to abuse the end-user exception and evade clearing by classifying non-hedging swaps as hedges to meet the threshold set

forth in the rule. Another concern is that, if a party's swap portfolio satisfied the percentage requirement, the party could elect the end-user exception for all swaps, including swaps that do not hedge or mitigate commercial risk, thereby undermining the systemic risk reduction benefits of the clearing requirement. A swap-by swap approach is thus consistent with Section 2(h)(7)(F), which authorizes the Commission to prescribe rules to prevent abuse of the end-user exception to the clearing requirement, and Section 2(h)(4)(A), which directs the Commission to prescribe rules as determined by the Commission to be necessary to prevent evasions of the clearing requirement.

The Commission also believes the percentage approach would be difficult to apply as a rule. In addition to determining whether each swap hedges or mitigates commercial risk to calculate a swap portfolio percentage, each such entity would need to repeatedly measure and report portfolio hedging percentages to maintain compliance. A percentage-of-portfolio test could lead to significant regulatory uncertainty given the difficulty of measuring the percentage of swaps that hedge or mitigate commercial risk over time as the portfolio changes.

#### 11. Consistency across Commission Regulations

The Commission asked in the NPRM whether the criteria for hedging or mitigating commercial risk should be consistent across all Commission regulations. Section 1a(33) of the CEA, which defines "major swap participant," provides for an exclusion of certain swap positions held for "hedging or mitigating commercial risk" from the determination of whether an entity maintains a substantial position in swaps. For purposes of Section 1a(33) and the Commission's definition of "major swap

participant” in §1.3(hhh), the Commission has adopted § 1.3(kkk) to provide criteria for what constitutes “hedging or mitigating commercial risk.”<sup>70</sup>

A number of commenters recommended that the criteria for hedging or mitigating commercial risk be consistent across all Commission regulations. These commenters do not believe it is appropriate to have different hedging criteria under the “major swap participant” definition and end-user exception.<sup>71</sup> The ABA recommended that the Commission cross-reference the hedging criteria used in the “major swap participant” definition rather than include separate but identical criteria in the end-user exception to avoid the possibility of inadvertent or inconsistent amendments and interpretations.

The “hedging or mitigating commercial risk” criteria set forth in § 1.3(kkk) and § 39.6(c) are consistent. The Commission has determined that the criteria will remain as consistent as possible to facilitate consistent interpretation across the CEA and Commission regulations. However, application of the phrase “hedging or mitigating commercial risk” serves similar, but different purposes in the two rules. In addition, while the “major swap participant” definition allows for application of the criteria to financial entities, pursuant to the limitations in Section 3(h)(7)(C) of the CEA, the end-user exception does not. Accordingly, there is a reasonable possibility that the Commission may determine that the two criteria should be modified in different ways in the future. Therefore, the Commission has determined to publish the criteria in separate rules rather than incorporate them by reference.

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<sup>70</sup> 77 FR 30596 at 30750 (May 23, 2012).

<sup>71</sup> See, e.g., ABA, COPE, EMUS, ICBA, Reval, FHL Banks, Philip Morris, and EDF Trading.

D. Exemption of Small Banks, Savings Associations, Farm Credit System Institutions, and Credit Unions from the Definition of “Financial Entity”

Section 2(h)(7)(C)(ii) of the CEA provides that the Commission “shall consider whether to exempt from the definition of ‘financial entity’ small banks, savings associations, farm credit system institutions and credit unions including:

- (I) depository institutions with total assets of \$10,000,000,000 or less;
- (II) farm credit system institutions with total assets of \$10,000,000,000 or less; or
- (III) credit unions with total assets of \$10,000,000,000 or less.”

For purposes of this discussion, all banks, savings associations, farm credit system institutions, and credit unions, regardless of size, are referred to as “Section 2(h)(7)(C)(ii) institutions” and the subgroup of Section 2(h)(7)(C)(ii) institutions that are eligible for exemption from the “financial entity” definition are collectively referred to as “small financial institutions” or “SFIs.”

In the NPRM, the Commission requested comment regarding the appropriateness, breadth, risk issues, and limits of an exemption for Section 2(h)(7)(C)(ii) institutions. The Commission also asked whether there are appropriate measures for determining whether a Section 2(h)(7)(C)(ii) institution qualifies as a small financial institution other than the \$10 billion or less total assets test referenced in the CEA.

A number of commenters supported defining SFIs broadly,<sup>72</sup> but AFR stated that only those small banks that engage in de minimis swap activity should be exempted. CII opposed extending the end-user exception to small Section 2(h)(7)(C)(ii) institutions

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<sup>72</sup> See, e.g., CUNA, FHL Banks, 19 Small Banks, MBCA, Frost, FTNF, ICBA, PCBB, and Reval.

because doing so “would help preserve a hole in the oversight and regulation of derivatives that would likely be exploited to the detriment of the capital markets.”

A number of commenters<sup>73</sup> recommended that the Commission provide an exemption for SFIs because most small Section 2(h)(7)(C)(ii) institutions only offer swaps to customers in connection with loans for the customers’ commercial business activities, and the related swaps hedge interest rate risk. These commenters noted that such swaps are not speculative in nature and are generally low risk. The small Section 2(h)(7)(C)(ii) institutions then enter into swaps with other financial institutions, often on a matched or back-to-back swap basis, to hedge the underlying risk of those customer swaps. According to these commenters, such matched or back-to-back swaps pose less risk to the small Section 2(h)(7)(C)(ii) institutions. For example, MBCA commented that “[small Section 2(h)(7)(C)(ii) institutions] participate in the swaps markets for purposes of hedging interest rate risk on their balance sheets and offering swaps in connection with loans as a means to deliver long-term fixed rate financing to commercial borrowers.” Also, these commenters noted that the swaps are often secured by assets funded by the loans and those assets are not liquid. The lack of liquidity of the security means that the small Section 2(h)(7)(C)(ii) institutions cannot simply pass on the security to a DCO as collateral for the matched swaps and must fund the collateral posted to DCOs in other ways.

Commenters also claimed that requiring small Section 2(h)(7)(C)(ii) institutions to clear swaps would impose inordinate costs on them. Chatham and Webster Bank

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<sup>73</sup> See, e.g., ICBA, 19 Small Banks, MBCA, FCC, Chatham, FTNF, Trustmark, UMB, Webster Bank, and Wintrust.

noted that the fees charged by futures commission merchants to clear swaps could be significant for Section 2(h)(7)(C)(ii) institutions that are ineligible for the end-user exception and did not previously clear their swaps, especially those institutions that transact only a small number of swaps. They indicated that these fees generally take the form of a fixed minimum monthly fee, plus a "ticket" fee that varies with the volume of swap transactions processed.<sup>74</sup> ABA and ICBA commented that if small Section 2(h)(7)(C)(ii) institutions have to incur high fixed costs for clearing, they might refrain from entering into swaps to avoid having to incur such costs.

ABA and 19 Small Banks commented that Section 2(h)(7)(C)(ii) institutions should be exempted because applicable banking regulations and guidance require banks to establish internal risk management policies and procedures for all operations and activities, including, in some cases, for swap transactions. ABA also noted that banks are limited by the banking regulations applicable to them as to the amount of credit they can extend to each individual or entity to a specified percentage of capital and reserves.

FCC recommended that the Commission adopt rules that would permit farm credit system (FCS) associations and banks to exercise the end-user exception. FCC noted that FCS associations have, on average, total assets under \$10 billion, and that FCS banks may have total assets exceeding \$10 billion. According to FCC, these FCS institutions are cooperatives owned by their members, and a major function of each cooperative is to act on behalf of its members in the financial markets. FCC further noted

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<sup>74</sup> Chatham indicated that Section 2(h)(7)(C)(ii) institutions will spend between \$2,500 and \$25,000 in legal fees related to reviewing and negotiating clearing-related documentation, and a Section 2(h)(7)(C)(ii) institution will spend a minimum of between \$75,000 and \$125,000 per year on fees paid to each FCM with which it maintains a relationship. Webster Bank corroborated these numbers and also noted that a Section 2(h)(7)(C)(ii) institution will incur additional costs from DCO fees, which vary based on collateral delivered.

that the members of these cooperatives are generally either non-financial entities or small financial institutions. FCC reasoned that, because an FCS cooperative essentially is taking the place of its members to face the larger financial markets on behalf of the members, the end-user exception that would be available to the cooperative's members should pass through to the cooperative. In addition, FCC noted that the Farm Credit Administration effectively regulates FCS institutions; FCS institutions only enter into safe, non-speculative swaps primarily related to member loans backed by collateral; and, unlike large banks, the FCS institutions are not as interconnected with other financial entities.

Regarding the criteria for determining whether a Section 2(h)(7)(C)(ii) institution is eligible for the exemption, a number of commenters recommended that the Commission allow institutions with more than \$10 billion in assets to qualify for the exemption.<sup>75</sup> FCC commented that Congress provided the Commission with the authority to exempt financial institutions with more than \$10 billion in assets. A number of commenters<sup>76</sup> suggested raising the threshold to \$30 billion or higher. Frost, FTN, and MBCA recommended a \$50 billion threshold. 19 Small Banks recommended that institutions with assets less than \$50 billion and with uncollateralized exposure less than \$1 billion should qualify for the exemption. These commenters suggested that historically, the swap activity of financial institutions with these higher asset levels is

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<sup>75</sup> See, e.g., ABA, FCC, Frost, FTNF, MBCA, Devlin, FHL Banks, 19 Small Banks, Susquehanna Bancshares, Inc., The Private Bank and Trust Company, Commerce Bank, Atlantic Capital Bank, Trustmark, Webster Bank, UMB Bank, Chatham Financial, and Wintrust.

<sup>76</sup> ABA, Susquehanna Bancshares, Inc., The Private Bank and Trust Company, Commerce Bank, Atlantic Capital Bank, Trustmark, Webster Bank, UMB Bank, Chatham Financial, and Wintrust.

only a small percentage of the total swaps market and therefore exempting them would not pose risk to the market or the financial system.

FHL Banks commented that the \$10 billion asset level should be the baseline for the exemption. For Section 2(h)(7)(C)(ii) institutions with more assets, FHL Banks recommended that the Commission establish objective criteria for the exemption based on the risk that the institution poses to the U.S. financial system. For example, FHL Banks suggested that the Commission could look to the institution's current uncollateralized exposure as well as its potential future exposure.

Similarly, FCC commented that the systemic risk created by derivatives is not a function of an institution's asset size, but a function of the type and amount of derivative activity after netting offsetting positions and collateral. According to FCC, small institutions that enter into many risky trades pose greater risk to the financial system than larger institutions that carefully manage their derivatives portfolios. Accordingly, FCC recommended that the Commission focus on risk instead of asset size and recommended defining "financial entity" to mean entities with current uncollateralized exposure and potential future exposure of \$3 billion in rate swaps and \$1 billion in other major swap categories. FCC noted that such entities could be required to report compliance with the risk-based exposure test when electing the end-user exception. Similarly, CUNA recommended that the Commission should only allow entities with at least \$10 billion in assets and that engage in a "significant volume" of swaps to qualify for the exemption.

The Commission is adopting § 39.6(d) to provide an exemption from the definition of "financial entity" for small Section 2(h)(7)(C)(ii) institutions. The Commission acknowledges that small Section 2(h)(7)(C)(ii) institutions, which tend to

serve smaller, local markets, are well situated to provide swaps to the customers in their markets for the purpose of hedging commercial risk. The Commission also acknowledges that historically, as indicated by commenters, a large portion of the swaps executed by small Section 2(h)(7)(C)(ii) institutions with customers likely hedge interest rate risk associated with commercial loans. Many of these loans and the related swaps are not secured by cash or other highly liquid collateral, but by less liquid assets of the customer such as the property or inventory purchased with the loan proceeds. Based on the comments received, it appears that small Section 2(h)(7)(C)(ii) institutions typically hedge customer swaps by entering into matching swaps in the swap market, and if those matched swaps had to be cleared, the small Section 2(h)(7)(C)(ii) institutions would have to post margin to satisfy the requirements of the DCOs.<sup>77</sup> This arrangement could raise the costs for small Section 2(h)(7)(C)(ii) institutions of hedging the risks related to these types of customer swaps to the extent they need to fund the cost of the margin posted. In addition, the Commission acknowledges that some small Section 2(h)(7)(C)(ii) institutions may incur initial and annual fixed clearing fees and other expenses that may be incrementally higher relative to the small number of swaps they execute over a given period of time. Lastly, given the relatively low notional volume swap books held by small Section 2(h)(7)(C)(ii) institutions<sup>78</sup> and the commercial customer purposes these swaps satisfy, the Commission believes that swaps executed by small Section 2(h)(7)(C)(ii) institutions are what Congress was considering when it directed the

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<sup>77</sup> The Commission notes that if a Section 2(h)(7)(C)(ii) institution, regardless of its size, executes a swap with a customer/counterparty who properly elects the end-user exception for that swap, then neither the customer/counterparty nor the Section 2(h)(7)(C)(ii) institution needs to clear its position in that swap.

<sup>78</sup> See Section III.E hereof for information on the volume of swaps executed by Section 2(h)(7)(C)(ii) institutions.

Commission to consider an exemption from the “financial entity” definition for small financial institutions in Section 2(h)(7)(C)(ii) of the CEA. Accordingly, the Commission believes that it is appropriate to exempt small Section 2(h)(7)(C)(ii) institutions from the definition of “financial entity” in Section 2(h)(7)(C), thereby permitting small Section 2(h)(7)(C)(ii) institutions to elect not to clear swaps that are otherwise eligible for the end-user exception.<sup>79</sup>

Having determined that an exemption for small Section 2(h)(7)(C)(ii) institutions is appropriate, the Commission considered the comments received regarding whether to use the \$10 billion total assets threshold identified in Section 2(h)(7)(C)(ii) of the CEA for determining what is a “small” Section 2(h)(7)(C)(ii) institution, or whether to use another test. The Commission has determined to limit the exemption to Section 2(h)(7)(C)(ii) institutions with \$10 billion in total assets or less.<sup>80</sup> The Commission acknowledges that the \$10 billion level is not required by the CEA. However, the Commission also believes that by specifically identifying that asset level three times, once for each type of Section 2(h)(7)(C)(ii) institution, Congress expressed its clear intent that the Commission should base its consideration of what is a “small” institution on the \$10 billion asset level. The Commission therefore believes that it is appropriate to use the \$10 billion level absent strong and convincing facts or circumstances supporting alternative measures.

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<sup>79</sup> As noted by the 19 Small Banks in their comment letter, “it is important to note that an SFI would not be exempt from clearing and trading for any speculative trades. Indeed, SFIs would have to meet the same conditions required for the end-user exception to mandatory clearing of swaps under Proposed Rule 39.6.”

<sup>80</sup> The Commission’s \$10 billion threshold is in harmony with the SEC’s proposed approach to exempt SFIs from clearing security-based swaps that are subject to mandatory clearing. 75 FR 79992 at 80011 (Dec. 21, 2010).

The Commission believes that it would be inappropriate to exempt Section 2(h)(7)(C)(ii) institutions with substantially higher total asset amounts, such as the \$30 billion, \$50 billion, or higher levels recommended by several commenters. Congress has identified large financial institutions as more likely to cause systemic risk and has directed prudential regulators to consider prudential standards for “large” institutions having assets of \$50 billion or more.<sup>81</sup> Although \$30 billion in assets is less than the \$50 billion level identified by Congress as being indicative of “large” financial institutions, \$30 billion is three times greater than the \$10 billion level identified by Congress in Section 2(h)(7)(C)(ii) as indicative of a “small” financial institution that should have the benefit of the exemption. While some commenters asserted that Section 2(h)(7)(C)(ii) institutions with assets in excess of \$10 billion have commonly executed swaps with customers for the same purposes that smaller institutions do, and that these institutions pose less risk to the financial system than much larger institutions, these commenters did not provide specific data applicable to institutions with \$10 billion or more of assets that would confirm these assertions.<sup>82</sup> Accordingly, commenters did not provide strong and convincing evidence that an asset level higher than \$10 billion would be more

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<sup>81</sup> See, e.g., Section 165 of the Dodd-Frank Act. (“In order to prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected financial institutions, the Board of Governors shall, on its own or pursuant to recommendations by the Council under section 115, establish prudential standards for nonbank financial companies supervised by the Board of Governors and bank holding companies with total consolidated assets equal to or greater than \$50,000,000,000.”)

<sup>82</sup> Furthermore, although not determinative as to what is “small,” the Commission is concerned that if Section 2(h)(7)(C)(ii) institutions with assets greater than \$10 billion can avail themselves of the exemption, these larger institutions, which have greater capabilities than institutions with less than \$10 billion of assets, are more likely to increase their swap activities at the regional or national level using the commercial advantage that the exemption will provide. Accordingly, it is possible that the amount of swap activity of these larger institutions could increase significantly over time if the exemption were available to them.

appropriate than the \$10 billion or less test for distinguishing “small” Section 2(h)(7)(C)(ii) institutions from others.

As a basic check on how many institutions could use the exemption at the \$10 billion total assets level, the Commission looked at how many Section 2(h)(7)(C)(ii) institutions had total assets less than \$10 billion and how many had more. Approximately 14,700 Section 2(h)(7)(C)(ii) institutions were operating in the United States as of December 31, 2011. Of those, approximately 120 had total assets greater than \$10 billion.<sup>83</sup> The remaining 14,580 institutions had less than \$10 billion in total assets. In other words, about 99 percent of banks, savings associations, farm credit system institutions, and credit unions will qualify as SFIs using the \$10 billion or less test.<sup>84</sup> While this data did not influence the Commission’s consideration of what constitutes a “small” Section 2(h)(7)(C)(ii) institution, it indicates that a high number of Section 2(h)(7)(C)(ii) institutions would be able to use the exemption for their hedging swap activities.

The Commission also considered whether it should adopt an alternative or additional uncollateralized exposure test, as recommended by some commenters. As noted above, several commenters recommended defining financial institutions that can use the exemption based on whether an institution’s current and potential future uncollateralized swap exposure exceeds a certain threshold. Commenters suggested \$1 billion or \$3 billion as acceptable levels of uncollateralized exposure.

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<sup>83</sup> Asset level data for banks and savings associations is available at [fdic.gov](http://fdic.gov), and for credit unions at [ncua.gov](http://ncua.gov). Data for farm credit system institutions was provided to the Commission by the Farm Credit Administration.

<sup>84</sup> In mid-2010, the most recent period for which Section 2(h)(7)(C)(ii) institution swap data could be obtained, approximately 1,015 Section 2(h)(7)(C)(ii) institutions had outstanding swap exposure. Of those institutions, 138 had total assets over \$10 billion and 876 had total assets below \$10 billion.

The Commission determined that an uncollateralized exposure test is not consistent with the statutory language of Section 2(h)(7)(C) of the CEA or the reasons for including a central clearing requirement in the Dodd-Frank Act. The Commission takes particular note of the fact that in Section 2(h)(7)(C)(ii), Congress focused exclusively on the size of the entity, based on total amount of assets, for measuring whether a financial institution should be exempt from the “financial entity” definition. Congress did not direct the Commission to consider whether uncollateralized risk exposure should be used for this purpose. Furthermore, it is not readily apparent how even full collateralization of exposure on a bilateral basis is an effective substitute for required clearing in the event of a severe financial shock such as occurred in 2008.

Commenters did not establish how an uncollateralized exposure test would be consistent with a definition of "small" financial institutions. An uncollateralized exposure test based on an entity's current and potential future exposure from swaps is not linked to the size of the financial institution or its significance to the financial system. For example, an uncollateralized exposure test allowing up to \$1 billion in uncollateralized exposure could allow institutions with over \$100 billion in assets to qualify as "small." The Commission does not believe such a definition would be consistent with the intent of allowing an exemption for "small" Section 2(h)(7)(C)(ii) institutions from the clearing requirement. Had Congress intended such a result, it would have directed the Commission to consider exempting “low-risk” institutions.

In addition, the entity-by-entity uncollateralized exposure tests proposed by commenters may not capture the different risks non-cleared swaps may pose to the financial system. Any such test would need to carefully consider risk factors that the

clearing requirement under the Dodd-Frank Act addresses, including opaque, non-public risk transference among market participants; buildup of risks in individual entities (such as the swap dealers with whom Section 2(h)(7)(C)(ii) institutions generally hedge swap exposure); effective measurement of risk in ever changing markets; and effective risk management frameworks for extreme market conditions. In this regard, the Commission does not believe that an entity-by-entity uncollateralized exposure test would account for: systemic risks that could arise if many Section 2(h)(7)(C)(ii) institutions are executing non-cleared swaps with only one swap dealer that fails, thereby concentrating uncleared counterparty risk; whether the Section 2(h)(7)(C)(ii) institutions hedging trades are creating other risks because they cannot perfectly match the risks being hedged;<sup>85</sup> rapidly changing market conditions; or a systemic liquidity freeze.

These risks are mitigated through central clearing. DCOs set margin levels and recalculate and collect margin amounts daily (sometimes intra-daily) based on changing market conditions. DCOs also use established and tested processes to swiftly calculate and cover losses resulting from a counterparty default, rapidly closing out or transferring the defaulted positions, and using the liquid collateral posted as margin by the defaulting party (plus other liquid assets available to the DCO, if necessary) to satisfy any losses incurred by the DCO in connection with the default. In this way, DCOs are able to make whole the market participants using its clearing services, notwithstanding a default by a member that may otherwise have been a counterparty to many of those market participants on a bilateral trading basis. As such, a swap clearing requirement protects

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<sup>85</sup> For example, if the SFIs internally net large numbers of customer trades and then partially hedge the aggregate risk, or use hedging swaps based on interest rates or durations that do not match the customer swaps precisely, basis risk could be created that could become significant in another financial crisis.

the financial system from the risks that attend to the interconnectedness of the financial system. The interconnectedness of financial institutions, particularly large institutions, means that severe shocks to the financial system, such as occurred in late 2008, can cause liquidity to dry up in a matter of days or change the perceived credit quality of institutions overnight, vastly increasing their capital requirements. Such rapid changes can cause entities, particularly in the banking system, to fail with little or no forewarning. Notably, these risks are not necessarily ameliorated by a test that looks at uncollateralized exposure, because in the event of a severe financial shock, even swaps that are fully collateralized at the mark-to-market value on one day can fall into default the next as credit conditions change rapidly. In such event, the non-defaulting counterparties become exposed to losses that accumulate rapidly, which in turn can lead to their default.

Because the comments have not demonstrated why the Commission should interpret "small" to mean "low-risk" based upon an uncollateralized exposure calculus, and why such a calculus is an adequate substitute for the benefits provided by required clearing, the Commission declines to adopt an uncollateralized exposure test at this time.

With regard to FCC's comments regarding FCS institutions, the Commission notes that if any such institution has total assets equal to or less than \$10 billion, then it is a small financial institution that can elect the end-user exception. However, for those FCS institutions with assets greater than \$10 billion, Section 2(h)(7)(C)(ii) of the CEA does not provide special consideration for cooperatives that meet the definition of "financial entity" and therefore the asset size limit applies to them.

The Commission recognizes that cooperatives exist to serve their member owners. The Commission further recognizes that, as described above, some cooperatives represent their members in the financial markets, and the members of some of these cooperatives are entities that could elect the end-user exception if acting alone. Accordingly, the Commission may consider providing exemptive relief for financial cooperatives through a separate action under its authority in Section 4(c) of the CEA.

E. Additional Considerations

1. Consultation with Other Regulatory Agencies; Jurisdictional Issues

Staff of the Federal Energy Regulatory Commission (FERC Staff) commented that “the CFTC should interpret and apply the CEA as amended by Dodd-Frank to ensure that CFTC jurisdiction and FERC jurisdiction do not overlap.” FERC Staff believes that, due to FERC’s existing comprehensive regulation, “Dodd-Frank terms should be interpreted as not applying to any contract or instrument traded in an RTO/ISO market pursuant to a FERC accepted or approved rate schedule or tariff. Applying Dodd-Frank swaps regulation to RTOs/ISOs is not only unnecessary but also potentially harmful.”

PG&E and SDG&E recommended that the Commission consult and coordinate with other regulatory agencies and state commissions (such as FERC and the California Public Utilities Commission (CPUC)) to assure regulatory consistency and comparability to the extent that hedging activities are already regulated. They noted that the costs and burdens associated with duplicative or inconsistent regulation would be passed through to ratepayers. As an example, PG&E noted that in certain instances, the CPUC may direct PG&E, as part of their obligation to serve customer load, to perform hedging on behalf of third parties, or assist municipalities in making decisions about hedging transactions. In

such cases where the utility is directed to engage in certain derivative transactions by the CPUC, PG&E commented that these activities should be exempt from Commission regulation.

Finally, NRECA stated that the Commission should create a “Commission-lite” regime for non-financial entities that are already subject to regulation by energy or environmental federal agencies and do not have the infrastructure/personnel of financial entities.

The Commission has determined not to revise § 39.6 in response to these comments. The Commission does not believe the commenters have identified a conflict between § 39.6 and other regulations. Regulation 39.6 would not prevent entities from entering into swaps that do not hedge commercial risk; it would only identify when a swap may be excepted from the clearing requirement in accordance with the CEA. Accordingly, if other regulators require an entity to enter into swaps that do not hedge commercial risk, these entities can still execute those swaps and clear them as required under the CEA. However, the Commission recognizes that conflict between regulatory regimes may arise and the Commission plans to consult with other regulators as appropriate.

Regarding the FERC comment, the Commission notes that Section 722(f) of the Dodd-Frank Act<sup>86</sup> provides that the Commission may exempt transactions entered into pursuant to, inter alia, a tariff approved by FERC or the Public Utility Commission of Texas (which would include RTO/ISO transactions) if the Commission determines that such an exemption would be consistent with the public interest and the purposes of the

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<sup>86</sup> 7 U.S.C. 4(c)(6).

CEA. Six RTO/ISOs<sup>87</sup> have submitted a petition for an order of exemption pursuant to Section 722(f) of the Dodd-Frank Act. The Commission intends to act on this petition expeditiously.

Regarding FCC's comment, Section 2(h)(7)(C)(ii) of the CEA expressly provides the Commission with the authority to exempt certain farm credit system institutions from the definition of "financial entity" along with other SFIs. Such exemptive authority would be unnecessary if the clearing requirement was not intended to apply to farm credit system institutions.

## 2. Implementation and Compliance

The Committee on Capital Markets Regulation (CCMR) and CME Group, Inc. (CME) recommended that the end-user exception be finalized early in the establishment of the clearing requirement process. CME commented that the end-user exception should be finalized early so companies know who will be subject to the clearing requirement.

Other commenters, including EEI & EPSA, Shell, EDF Trading, EEI, and CDEU, recommended that the implementation deadline for the Dodd-Frank Act be extended. EDF Trading and EEI recommended that the Commission allow a one-year "transition period" following the effective date of the Dodd-Frank Act to allow entities to comply with the new end-user exception regulations.

Finally, a number of commenters recommended that the Commission delay the § 39.6 reporting requirements. ATA recommended that the Commission key implementation of the end-user notification regime to the time when SDRs become

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<sup>87</sup> The six RTO/ISOs are California Independent System Operator Corporation, Electric Reliability Council of Texas, Inc., ISO New England Inc., Midwest Independent Transmission System Operator, Inc., New York Independent System Operator, Inc., and PJM Interconnection, L.L.C.

operational. COPE suggested that the reporting requirement not be enforced until reporting systems have been largely standardized to avoid the development of multiple, bespoke software programs or systems for compliance. NEMA noted that significant terms have not been defined and that an overly aggressive compliance schedule could force many of its members out of the market for financial products because of their concern of being treated as a financial entity. NEMA also commented that parties must have sufficient time to make the requisite investment in information technology systems and to develop compliance plans.

The Commission has determined that § 39.6 will become effective 60 days after publication in the Federal Register. However, the Commission notes that compliance with § 39.6 will not be necessary or possible until swaps become subject to the clearing requirement. The Commission's proposed compliance and implementation schedule for the clearing requirement gives non-financial entities a minimum of 270 days to comply after the Commission issues a clearing requirement determination for a swap or group, category, type or class of swaps.<sup>88</sup> Moreover, the Commission has stated that no such clearing requirement determinations will become effective until the Commission adopts certain related rules.

### 3. Revocation of Election of the End-User Exception

IECA recommended that the Commission establish regulations that would make an election not to clear a swap irrevocable without the consent of both parties.

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<sup>88</sup> See 76 FR 58186 (Sept. 20, 2011) (Swap Transaction Compliance and Implementation Schedule: Clearing and Trade Execution Requirements under Section 2(h) of the CEA).

The Commission notes that Section 2(h)(7)(B) of the CEA provides that the application of the end-user exception is solely at the discretion of the counterparty to the swap that meets the conditions set forth in Section 2(h)(7)(A). Section 2(h)(7) does not address, however, whether the electing counterparty may revoke its election and choose to clear the swap. The Commission believes that any decision to change the clearing status of the swap after it is entered into is a contractual matter between the two parties.

### III. Consideration of Costs and Benefits

#### A. Introduction

The regulations being adopted herein interpret and establish qualifying criteria for the end-user exception provided in Section 2(h)(7) of the CEA from the clearing requirement established in Section 2(h)(1)(A) of the CEA, as amended by the Dodd-Frank Act. An understanding of the costs and benefits of the end-user exception requires background understanding of the Section 2(h)(1)(A) clearing requirement.<sup>89</sup>

Prior to the passage of the Dodd-Frank Act, swap transactions were not required to be cleared. In the wake of the financial crisis of 2008, Congress adopted the Dodd-Frank Act, which, among other things, requires the Commission to determine whether a particular swap, or group, category, type or class of swaps, shall be required to be cleared.<sup>90</sup> Specifically, Section 723(a)(3) of the Dodd-Frank Act amended Section 2(h)(1)(A) of the CEA to make it “unlawful for any person to engage in a swap unless that person submits such swap for clearing to a derivatives clearing organization that is

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<sup>89</sup> As previously noted, this section states: “It shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing to a [DCO] that is registered under this Act or a [DCO] that is exempt from registration under [the CEA] if the swap is required to be cleared.”

<sup>90</sup> See Section 2(h)(2) of the CEA, 7 U.S.C. 2(h)(2).

registered under [the CEA] or a derivatives clearing organization that is exempt from registration under [the CEA] if the swap is required to be cleared.” This clearing requirement is designed to reduce counterparty risk associated with swaps and, in turn, mitigate the potential systemic impact of such risk and reduce the likelihood for swaps to cause or exacerbate instability in the financial system.<sup>91</sup> It reflects a fundamental premise of the Dodd-Frank Act: the use of properly regulated and functioning central clearing can reduce systemic risk.

Notwithstanding the benefits of clearing, Section 2(h)(7) of the CEA provides for the end-user exception if one of the swap counterparties: “(i) is not a financial entity; (ii) is using swaps to hedge or mitigate commercial risk; and (iii) notifies the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations associated with entering into non-cleared swaps.” Section 2(h)(7)(C)(ii) directs the Commission to consider making the end-user exception available to small banks, savings associations, credit unions, and farm credit institutions, including those institutions with total assets of \$10 billion or less, through an exemption from the statutory definition of “financial entity.”<sup>92</sup> As noted above in section D hereof, for purposes of this final release, all banks, savings associations, farm credit system institutions, and credit unions, regardless of size, are referred to as “Section 2(h)(7)(C)(ii) institutions” and the subgroup

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<sup>91</sup> When a bilateral swap is moved into clearing, the clearinghouse becomes the counterparty to each of the original participants in the swap. This standardizes counterparty risk for the original swap participants in that they each bear the same risk attributable to facing the clearinghouse as counterparty. In addition, clearing mitigates counterparty risk to the extent that the clearinghouse is a more creditworthy counterparty relative to those that each participant in the trade might have otherwise faced. Clearinghouses have demonstrated resilience in the face of past market stress. Most recently, they remained financially sound and effectively settled positions in the midst of turbulent events in 2007-2008 that threatened the financial health and stability of many other types of entities.

<sup>92</sup> See CEA 2(h)(7)(C)(ii).

of Section 2(h)(7)(C)(ii) institutions that are eligible for exemption from the “financial entity” definition are collectively referred to as “small financial institutions” or “SFIs.”

In this final rulemaking, the Commission is adopting rules implementing the end-user exception. More specifically, the final rules: (1) specify the content and manner to effect the required Commission notification (i.e., the reporting requirements); (2) establish the criteria for determining whether a swap is “hedging or mitigating commercial risk”; and (3) exclude SFIs from the definition of “financial entity” for purposes of Section 2(h)(7)(A)(i) of the CEA, making it possible for them to avail themselves of the end-user exception. It is the costs and benefits of this rulemaking that the Commission considers in the discussion that follows.

Important to the Commission’s consideration of costs and benefits is that this rulemaking is permissive – that is, the election of the end-user exception is at the discretion of the counterparty to the swap that meets the requisite conditions set forth in the statute and the final rule. In addition, except for the reporting required for those electing the end-user exception set forth in §39.6(b), the final rule imposes no substantive obligations on the electing parties. Rather, the final rule largely clarifies the statute it implements and provides specific criteria for certain key terms in the statute including “financial entity” and “hedging or mitigating commercial risk.”

This notice also provides statutory interpretation and guidance to potential electing counterparties as to whether they are, for example, a “financial entity.” Although that term is defined in statute, the Commission’s response to comments regarding application of the definition to certain types of entities should yield a substantial, if unquantifiable, benefit by providing clarity and reducing uncertainty about

a market participant's status for purposes of determining the availability of the end-user exception. The added clarity provided by the Commission's statutory interpretation and guidance, although beyond the scope of the Commission's obligation to consider the costs and benefits of its regulations or orders under Section 15(a) of the CEA, should nevertheless promote greater confidence and integrity in the market.

In the NPRM, the Commission asked for public comment on the costs and benefits of the proposed regulations, and specifically invited comments on whether: (1) it would be difficult or prohibitively expensive for persons to report the information required under the proposed rule; (2) there are more feasible and cost effective ways for the Commission to receive notification regarding the use of the end-user exception; (3) the Commission should consider requiring electing counterparties to report additional types of information; (4) collecting notice information regarding use of the end-user exception through SDRs would create significantly greater burdens for some parties to swaps compared to others; and (5) the Commission should extend the end-user exception to SFIs.<sup>93</sup> The Commission also asked for commenters to provide an explanation for any preferred alternative and data to support their comments.<sup>94</sup>

The Commission received numerous comments addressing various cost and benefit considerations of the proposed rule and sought to promulgate a final rule that will help swap market participants apply the end-user exception in a uniform and accurate manner, balance the tradeoff of costs and benefits associated with the exemption, and minimize reporting burdens on market participants who elect the exception while still

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<sup>93</sup> See 75 FR at 80750-80751.

<sup>94</sup> Id. at 80754.

providing the Commission the information that it needs to monitor the markets and use of the exception by market participants. The Commission adopted a number of the alternatives posed by commenters, particularly with regard to the final rule's reporting requirements.<sup>95</sup>

Informed by commenters, the discussion below considers the rule's costs and benefits as well as alternatives to the rule. The discussion concludes with a consideration of the rule's costs and benefits in light of the five factors specified in Section 15(a) of the CEA.

B. Requirement to Consider the Costs and Benefits of the Commission's Action under Section 15(a) of the CEA

Section 15(a) of the CEA<sup>96</sup> requires the Commission to consider the costs and benefits of its actions before promulgating a regulation under the CEA or issuing certain orders. Section 15(a) further specifies that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (1) protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. The Commission considers the costs and benefits resulting from its discretionary determinations with respect to the Section 15(a) factors.

In the sections that follow, the Commission considers the costs and benefits of final § 39.6, namely: (1) the costs and benefits of the reporting requirements; and (2) the costs and benefits of the established criteria for determining whether a swap hedges or

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<sup>95</sup> See, e.g., sections II.B.1, 6, 7, 8, and 9 and II.C.6.

<sup>96</sup> 7 U.S.C. 19(a).

mitigates commercial risk for purposes of Section 2(h)(7)(A)(ii). The former is in large part amenable to quantification, but the latter is not due to a lack of data about the manner in which swaps are currently being used to hedge or mitigate commercial risk and the economic terms thereof. Nevertheless, the Commission provides qualitative consideration of the costs and benefits of its approach to establishing criteria for determining whether a swap hedges or mitigates commercial risk. Finally, as required by Sections 2(h)(7)(C)(ii) and 15(a) of the CEA, the Commission considers the costs and benefits of exempting SFIs with total assets of \$10 billion or less from the definition of "financial entity."

The costs and benefits of the Commission's action in this rulemaking are measured against the level of costs and benefits that would exist absent this rulemaking. With respect to each of this rulemaking's three elements this is as follows:

- Establishing the reporting requirements. The requirement that counterparties availing themselves of the end-user exception provide notification to the Commission remains a statutory requisite to invoke the exemption, albeit one that is not self-executing.<sup>97</sup> Thus, the foundation against which this rulemaking's costs and benefits are measured is the minimum notification that the Commission could prescribe to meet the statutory requirement.
- The "hedge or mitigate commercial risk" element. Absent this rulemaking, "hedging or mitigating commercial risk" remains a statutory requisite to invoke the end-user exception.<sup>98</sup> This rulemaking clarifies the Commission's

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<sup>97</sup> See Section 2(h)(7)(A)(iii) of the CEA.

<sup>98</sup> See Section 2(h)(7)(A)(ii) of the CEA.

interpretation of the term for purposes of implementing and enforcing the CEA's statutory requirements. Thus, the foundation against which this rulemaking's costs and benefits are measured is the statutory requirement standing alone without the clarification that the rulemaking provides.

- Excluding qualifying SFIs from the definition of "financial entity." Absent this rulemaking, all financial entities as defined in Section 2(h)(7)(C) of the CEA, including all SFIs, are statutorily disqualified from the end-user exception pursuant to Section 2(h)(7)(A)(i) of the CEA, which specifies that to qualify for the end-user exception the counterparty must not be a financial entity. Thus, the foundation against which this rulemaking's costs and benefits are measured is the statutory requirement that SFIs, as financial entities, remain subject to the clearing requirement of Section 2(h)(1)(A) of the CEA.

Additionally, with respect to the second and third elements, the Commission considers the rulemaking's costs and benefits relative to alternatives besides that of abstaining from action. In the case of articulating reporting requirements, which is statutorily required, the Commission considers the rulemaking's costs and benefits relative to prescribing the minimum obligation.

As discussed in more detail below, the Commission is able to estimate certain reporting costs. The dollar estimates are offered as ranges with upper and lower bounds, which is necessary to accommodate the uncertainty that surrounds them. The Commission notes that the most likely outcome with respect to each estimate is a cost above the lower bound and below the upper bound. The costs and benefits associated with compliance with the Commission's interpretation of the term "hedging or mitigating

commercial risk,” as well as those that result from the exemption for SFIs, however, are not readily susceptible to meaningful quantification because the requisite data is not available.

For example, to reasonably estimate quantifiable costs and benefits of compliance with this rule’s interpretation of “hedging or mitigating commercial risk,” relative to alternatives, the Commission would need sufficient information to determine what swaps would be or would not be eligible for the end-user exception under different approaches considered by the Commission. This would require the Commission to identify a representative sample of market participants and collect detailed proprietary information regarding each swap position currently on their books, as well as the economic terms of the swap transactions entered into by those entities over a certain period of time. The Commission would also need detailed information regarding each sample member’s business practices, current assets, anticipated acquisition or disposition of assets, and other financial positions related to their commercial operations to determine what swaps are “hedging or mitigating commercial risk” under various approaches considered by the Commission.

To estimate the costs and benefits related to the exemption for SFIs, the Commission would need similar information regarding SFIs, including detailed information regarding the swap positions and activities of those entities and sufficient knowledge of their business models, as well as their current and future assets, to determine what swaps constitute “hedging or mitigating commercial risk.” Again, the data necessary to calculate such estimates is largely proprietary, not available to the Commission, and was not provided by commenters. Notwithstanding these limitations,

the Commission identifies and considers the costs and benefits of these aspects of the rule in qualitative terms.

### C. Reporting Requirements

#### 1. Introduction

Under Section 2(h)(7)(A)(iii) of the CEA, a condition to electing the end-user exception is that the electing counterparty “notifies the Commission in a manner set forth by the Commission how it generally meets its financial obligations associated with entering into non-cleared swaps.” Regulation 39.6(b) provides a mechanism for such reporting to the Commission and also requires the reporting counterparty to report that the end-user exception is being elected, who the electing counterparty is, and that the swap hedges or mitigates commercial risk. In addition, Section 2(j) of the CEA provides that any exception to the clearing requirement of Section 2(h)(1) of the CEA and the trading requirement of Section 2(h)(8) of the CEA are only available to an SEC Filer if the decision to enter into swaps subject to such exceptions has been reviewed by an appropriate committee of the governing body of the SEC Filer. Regulation 39.6(b)(1)(iii)(D)(2) would require reporting of confirmation by the SEC Filer that such review has occurred. The information reported under § 39.6(b) is needed for the Commission to be able to determine when the end-user exception is being used and to monitor compliance with the exception.

In the NPRM, the Commission contemplated swap-by-swap reporting of all the information required. As described below, the Commission received comments in response suggesting that the reporting requirements were burdensome and that less costly options may be available. In response to those comments, the Commission has made

changes to the final rule that allow an electing counterparty to report certain information on an annual basis and to clarify that SEC Filers can obtain general approval of the end-user exception. The Commission believes that these changes will create significant cost reductions and benefits for electing and reporting counterparties, as described below. In addition, as described in more detail in Section II.B.3 above, the Commission has confirmed that the simple “check-the-box” reporting mechanism proposed in the NPRM may be used. A number of commenters agreed that this mechanism would greatly minimize the reporting burden and would provide standardized information that will be easily reviewable for regulatory purposes.

The discussion below of the rule’s reporting requirements is divided into three parts. The first part covers the reporting requirements under the rule generally, the second addresses the SEC Filer reporting requirements, and the third provides specific cost estimates. Consideration of alternatives is incorporated within the first two parts.

## 2. Reporting Generally

In the NPRM, the Commission contemplated requiring the reporting counterparty to provide all information required under the rule on a swap-by-swap basis. The Commission received comments that swap-by-swap reporting of all information required to be reported under the rule could be more burdensome than necessary and that other alternatives are available, such as annual or other periodic reporting, submission of contracts or contract summaries, separate reduced reporting requirements for certain

small entities, or reliance on contract representations by electing counterparties instead of reporting.<sup>99</sup>

After consideration of these comments, the Commission believes that certain information required to be reported by § 39.6(b) could be reported on an annual basis without significantly compromising its value to the Commission and the public, and that such an approach is likely to be more cost-effective. Therefore, in response to these comments, the Commission revised the rule to require reporting of the following for each swap for which the end-user exception is elected: (1) that the election of the exception is being made; (2) which party is the electing counterparty; and (3) certain information specific to the electing counterparty unless that information has already been provided by the electing counterparty through an annual filing. The third set of information comprises data that is likely to remain relatively constant for many electing counterparties and therefore can be reported less frequently.

In making this change in the final rule, the Commission believes that allowing the third set of information to be reported on either a swap-by-swap basis or on an annual basis is likely to mitigate reporting costs from the solely swap-by-swap approach proposed in the NPRM because entities will be able to select the most cost-effective option.

As an estimate of cost savings, the Commission expects that the annual report will take approximately 30 minutes to 90 minutes to complete, but then that information will not have to be reported on a swap-by-swap basis, generating incremental savings of one

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<sup>99</sup> See, e.g., Cravath, AGA, APGA, SFG, Noble, NCHSA, API, CDEU, Shell, SDG&E, Peabody, FHL Banks, NRECA, WSPP, IPA, COPE, WGCEF, EDF Trading, Hess, EEI & EPSA, API, IECA, and NMPP.

to five minutes per transaction. The Commission does not have adequate data to estimate these costs in the aggregate. However, the Commission believes that the number of swap transactions subject to this rule is likely to be quite large, and therefore, the aggregate savings of one to five minutes per transaction could be significant. Also, the approach has benefits for market participants generally in that the form of data provided to the Commission will enable it to exercise its regulatory oversight in an efficient and effective manner given the wide variety of different types of swaps and swap hedging strategies used by potential electing counterparties. Lastly, standardized reports make it more feasible for the Commission to conduct periodic auditing, which will be less costly to regulators than examining on a case-by-case basis possibly unstructured financial data or different contract security provisions submitted by electing counterparties.

The Commission considered the other reporting frequency and mechanism alternatives proposed in the comments, but other than the annual reporting option provided in § 39.6(b)(2) of the rule, determined not to adopt them for several reasons. First, as mentioned above, Section 2(h)(7)(A) of the CEA requires an electing counterparty to notify the Commission how the counterparty meets its financial obligations associated with entering into non-cleared swaps as a condition to electing the end-user exception. Accordingly, the requirement to report some information is statutory and beyond the discretion of the Commission. Second, for swaps that are subject to the clearing requirement but are not being cleared, the Commission needs notice that the end-user exception is being elected and certain other information to assess compliance with Sections 2(h)(1) and (2)(h)(7) of the CEA and § 39.6. Third, delivery of agreements to the Commission would be almost as burdensome as the check-the-box approach (and in

some cases more so) and would provide information in non-standard formats that would be difficult to review for regulatory purposes. Standardized data, on the other hand, will facilitate effective review by the Commission. Fourth, given the low reporting burden under these rules and the general swap-by-swap reporting requirements in other regulations (e.g., Part 45), the Commission does not believe that a special, lesser reporting requirement for smaller parties would result in a materially lower burden while still maintaining compliance with the CEA. And last, the Commission believes that the check-the-box reporting method, and addition of the annual reporting option described above (together with the fact that various other information will already be reported for each swap pursuant to other provisions of the CEA and other regulations promulgated thereunder), minimize the reporting burden.

EDF Trading, API, MarkitSERV, and COPE raised another concern about the costs of reporting. They commented that some potential electing counterparties may bear costs in order to implement new reporting systems to comply with the reporting requirements. The Commission notes that electing counterparties will only incur such costs if they engage in swaps with other electing counterparties. If the electing counterparty enters into swaps with a swap dealer or a major swap participant, the swap dealer or major swap participant will be the reporting counterparty.<sup>100</sup> Based on historical experience, the Commission believes that electing counterparties will generally enter into swaps with swap dealers and major swap participants, and therefore will not be responsible for reporting the swap-by-swap information required in this rule. Moreover,

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<sup>100</sup> See 77 FR 2136 at 2207 (Jan. 13, 2012) (Swap Data Recordkeeping and Reporting Requirements; final rule).

even in the absence of this rule, if electing counterparties entered into swaps with one another they would be required to implement reporting systems in order to meet other swap-by-swap reporting requirements in the CEA and Commission regulations promulgated thereunder. Therefore, the Commission believes that the large majority of costs to implement reporting systems are properly recognized as the result of swap-by-swap reporting requirements that are beyond the scope of this rule. Accordingly, this rule will only result in costs to modify those reporting systems in order to provide the additional information required by this rule.

NGSA, NRECA, IECA, and EEI recommended that the Commission provide a safe harbor from liability for firms who report on behalf of the electing counterparty. The Commission expects that if the electing counterparty has not filed an annual report to provide the information required in § 39.6(b)(1)(iii), the reporting counterparty may choose to conduct some measure of due diligence in order to develop a reasonable basis for believing that the information it reports on behalf of the electing counterparty is accurate and the swap is eligible for the end-user exception. These costs are likely to vary depending on the number of electing counterparties with whom each reporting counterparty transacts, and the amount of due diligence that they choose to conduct, which can vary substantially depending on whether the electing counterparty has done an annual filing, the number of swaps the reporting counterparty executes within a year, and how well the reporting party already knows the electing counterparty's financial strategies and policies. The Commission does not believe that there is sufficient data to estimate the burden hours that will result from this requirement, but believes that: (1) the cost is likely to be relatively low; and (2) such information will frequently be collected

along with other information the reporting counterparty will gather from the electing counterparty as part of the process of executing the swap and reporting other details required by the CEA and Commission regulations. Moreover, it is important to consider these costs in light of the benefits achieved by the requirement. The Commission believes that the “reasonable basis” standard is likely to deter abuse of the end-user exception, which could mitigate risks and costs that market participants and the public might otherwise face. If the end-user exception were abused, it would lead to reduced clearing and counterparty protection. If such abuse became widespread, it could also reduce the ability of clearinghouses to mitigate the transfer of financial instability among counterparties, thereby increasing risks to the public.

Some commenters favored requiring more information regarding the types of collateral, exact collateral terms and arrangements, and swap contractual terms and provisions.<sup>101</sup> The Commission determined not to require additional information because, on the one hand, the information would be costly for counterparties to provide and on the other, any such requirement would provide little benefit because it would be difficult to capture much of this information in a parameterized form, making it challenging to review the information in a systematic way.

According to EMUS, the NPRM indicated that the notification requirement would apply to all affiliates, while the rule text indicated a notification requirement would apply only to finance affiliates. In response to EMUS, the Commission is revising proposed §39.6(b)(3) to clarify that the notification requirement only applies to financial entities acting as affiliates. The Commission is also adding a requirement that electing

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<sup>101</sup> See, e.g., AFR, AFSCME, Better Markets, PMAA & NEFI, and Professor Greenberger.

counterparties report whether they are “financial entities” as defined in Section 2(h)(7)(C)(i) of the CEA that are nevertheless exempt from the definition of “financial entity” as described in §39.6(d). For entities affected by these provisions, the total impact is the removal or addition of one check-box when reporting.

### 3. SEC Filers

In accordance with Section 2(j) of the CEA, the proposed rule required a committee of the board of directors (or equivalent body) of an SEC Filer to approve the decision not to clear the swap for which the end-user exception would be elected. The Commission received comments that requiring swap-by-swap board approval would impose excess costs and burdens on SEC Filers.<sup>102</sup> The Commission determined that any additional benefit of a swap-by-swap approval, as compared to a more general approval, was insufficient to justify such an approach and accordingly, has revised the final rule to only require reporting (in the annual or swap-by-swap filing) whether such committee has generally approved entering into swaps subject to an exception to the clearing and trading requirements. The Commission believes this change will mitigate the potential burdens commenters raised by allowing such committees to provide blanket or more limited approvals for the end-user exception on a periodic basis as they deem appropriate for such approval and in a manner that may be consistent with general corporate practice. At the same time, the reporting requirement, while limited, still confirms that a committee of the governing board of the SEC Filer using the end-user exception has considered such exceptions as required by Section 2(j) of the CEA.

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<sup>102</sup> See, e.g., Hess, EEI & EPSA, NGSA, CDEU, EMUS, SDG&E, WGCEF, Mr. Quinlivan, Cravath, AGA, EMUS, COPE, NYCBA, Shell, ATA, Noble, WSPP, IPA, Hess, IECA, EEI, PMAA & NEFI, CDEU, and NYCBA.

#### 4. Cost Estimates<sup>103</sup>

The Commission lacks data to estimate the precise number of non-financial entities that may be eligible for the end-user exception, and therefore cannot estimate total reporting costs with great accuracy. However, for informational purposes, the Commission has endeavored, where feasible, to estimate quantifiable costs. It has done so by using assumptions to define what it believes to be reasonable parameters for various uncertainties. At times, as noted with more specificity in the discussion that follows, the uncertainties are such that costs are reasonably estimable only within a wide range. For the purposes of these estimates, the Commission assumes a total of 30,000 electing counterparties (which includes SFIs), and that approximately 1,000 of them will function as reporting counterparties in any given year. The Commission further estimates that approximately 125 swap dealers and major swap participants will function as reporting counterparties for swaps for which the end-use exception is elected each year. All of these reporting counterparties likely will need to modify their reporting systems in order to accommodate the additional data fields required by this rule. The Commission estimates that those modifications will create a one-time expense of approximately one to ten burden hours per entity, for a total of approximately 1,125 to 11,250 burden hours. The hourly wage for a senior programmer is \$292, which means that the aggregate one-

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<sup>103</sup> As discussed above, the statute itself requires some level of reporting. Absent an ability to demarcate between the minimum reporting that the statute would require and that resulting from this rule, the Commission has estimated the costs attributable to this rule from a base of zero, recognizing that the costs attributable to its discretion in this action must necessarily start from some higher base. Accordingly the costs attributable to the Commission's action in this rulemaking are necessarily something below the estimates provided. Also, because the statute requires some reporting, the Commission has not articulated separate benefits attributable to this rulemaking. However, to the extent benefits distinguish this rule from considered alternatives, they are considered in the preceding discussion.

time cost for modifying reporting systems is likely to be between \$328,811 and \$3,288,110.<sup>104</sup>

Furthermore, the 29,000 electing counterparties who do not function as reporting counterparties may, at certain times, need to communicate information to their respective reporting counterparties in order to facilitate reporting. That information may include, among other things, whether the electing counterparty has filed an annual report pursuant to § 39.6(b)(2) and information to facilitate any due diligence that the reporting counterparty may conduct. These costs will likely vary substantially depending on the number of different reporting counterparties with whom an electing counterparty conducts transactions, how frequently the electing counterparty enters into swaps, whether the electing counterparty undertakes an annual filing, and the due diligence that the reporting counterparty chooses to conduct. Therefore, the Commission believes that it is very difficult to estimate these costs reliably at this time. However, the Commission has endeavored to do so given the concerns commenters expressed about relying on other parties to provide information and to report the information. Accordingly, the Commission estimates that non-reporting electing counterparties will incur between five minutes and ten hours of annual burden hours. The hourly wage for a compliance

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<sup>104</sup> All salaries in these calculations are taken from the 2010 SIFMA Report on Management and Professional Earnings in the Securities Industry. Annual wages were converted to hourly wages assuming 2,000 work hours per year (40 hours per week for 50 weeks), and then multiplying by 5.35 to account for bonuses, firm size, employee benefits and overhead. The remaining calculations used in these cost-benefit considerations are also derived from this source and modified in the same manner.

In addition, for each range of aggregate costs presented in this discussion, the lower bound would be the aggregate cost if every relevant entity experienced the minimum per entity cost, and the upper bound would be the aggregate cost if every relevant entity experienced the maximum per entity cost. It is highly improbable that every entity would experience either the minimum or the maximum per entity cost, and as a consequence, the actual aggregate cost to market participants is likely to lie somewhere in the midst of each range that has been estimated in this section.

attorney is \$320, which means that the annual per entity cost for communicating information to the reporting counterparty is likely to be between \$27 and \$3,210. Given the unknowns associated with this cost estimate noted above, the Commission does not believe this wide range can be narrowed at this time.

Also, the Commission estimates that approximately two-thirds of electing counterparties (or 20,000 electing counterparties) will choose to file an annual report pursuant to § 39.6(b)(2). The annual filing option was added in the final rule and therefore an estimate of costs related thereto was not included in the NPRM. The annual filing option will reduce reporting costs overall because it is less costly than swap-by-swap reporting. The Commission estimates that it will take an average of 30 minutes to 90 minutes to complete and submit this filing, for an aggregate total of 10,000 to 30,000 burden hours. The average hourly wage for a compliance attorney is \$320, which means that the aggregate annual cost for submitting the annual report is likely to be approximately \$3,200,000 to \$9,600,000. Other costs and benefits associated with the rule's reporting requirements cannot be monetized at this time because the Commission lacks adequate information to do so.

The rule requires reporting of the following for each swap for which the end-user exception is elected: (1) that the election of the exception is being made; (2) which party is the electing counterparty; and (3) certain information specific to the electing counterparty unless that information has already been provided by the electing counterparty through an annual filing. The third set of information comprises data that is likely to remain relatively constant for many electing counterparties and therefore can be

reported either on a transaction-by-transaction basis or through an annual report that is updated as necessary.

As a recurring expense, the reporting counterparty will have to report the information required in §§ 39.6(b)(1)(i) and (ii) for each swap and the information required in § 39.6(b)(1)(iii) for each swap only if the electing counterparty has not filed an annual report. To comply with §§ 39.6(b)(1)(i) and (ii), the reporting counterparty will be required to check one box indicating the end-user exception is being elected and complete one field identifying the electing counterparty. The Commission expects that this information will be entered into the appropriate reporting system concurrently with additional information that is required under the CEA and other Commission regulations promulgated thereunder. Therefore, each reporting counterparty is likely to spend 15 seconds to two minutes per transaction in incremental time entering the swap-by-swap information that is required in §§ 39.6(b)(1)(i) and(ii) into the reporting system. Regarding the § 39.6(b)(1)(iii) information, the Commission expects that, for the first swap conducted involving a particular electing counterparty, it will take approximately 30 minutes to 90 minutes to collect and submit the information required and then approximately one to five minutes to collect and submit this information for subsequent transactions with that same counterparty. The Commission does not have sufficient data to estimate the number of swaps that will be subject to this rule, so it is not possible to estimate these costs in the aggregate.

#### D. Hedging or Mitigating Commercial Risk

##### 1. Introduction

Regulation 39.6(c) provides a broad set of criteria for determining what constitutes hedging or mitigating commercial risk for the end-user exception to apply. The Commission's flexible set of criteria allows counterparties to use the end-user exception when appropriate given their specific circumstances. At the same time, the criteria are designed to prevent abuse of the end-user exception, which would hinder one of the primary goals of the Dodd-Frank Act: moving swaps into central clearing, thereby reducing counterparty risk and its potential to create instability in the financial system.

Congress prescribed "hedging or mitigating commercial risk" as a condition for applying the end-user exception, without providing further statutory definition of its meaning. The Commission is exercising its discretion to do so. Thus, relative to the statutory requirement, the costs and benefits of the rule are those attributable to clarifying the Commission's understanding of the term for implementation and enforcement purposes rather than implementing and enforcing the condition without clarifying its interpretation. Relative to other alternatives that the Commission could have selected, the costs or benefits of the rule are generally a function of whether the Commission adopts a more- or less-inclusive approach in articulating what constitutes hedging or mitigating commercial risk for purposes of the end-user exception relative to the theoretically optimal level that Congress presumably intended the statutory language to effect.<sup>105</sup> In addition, a potential electing counterparty will incur some costs in applying the standard set forth in the rule to determine whether a specific swap qualifies as hedging or

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<sup>105</sup> In either case, costs and benefits are not readily quantifiable. Such quantification would require data and information that the Commission does not possess nor have at its disposal. This includes data regarding the number, characteristics, and notional value of swaps that are impacted by these decisions, as well as information about the required margin for the swaps if they are cleared or not cleared, the type and amount of collateral that counterparties require for the swaps, estimates for the affected firms of the cost of capital used to post margin, and pricing for cleared swaps and non-cleared swaps.

mitigating commercial risk. Each category — clarification costs and benefits, inclusion costs and benefits, and determination costs — is discussed below.

## 2. Clarification Costs and Benefits

As stated above, even in the absence of this rulemaking, “hedging or mitigating commercial risk” is a necessary condition for being eligible to claim the end-user exception with respect to a particular swap. By clarifying the Commission’s interpretation of this term, this rule provides market participants with the benefit of greater regulatory certainty, which will reduce costs associated with, for example, legal opinions to interpret the term or the costs of foregoing the end-user exception to which market participants might otherwise be entitled.

## 3. Inclusion Costs and Benefits

Regulation 39.6(c)(1)(i) identifies six possible sources of commercial risk and sets forth an “economically appropriate” standard for assessing the correspondence between a given swap and the commercial risk that it hedges or mitigates.<sup>106</sup>

As noted above, the Commission has determined not to provide a bright-line definition of “economically appropriate” to allow greater flexibility in application of the standard. The Commission cannot anticipate and account for all of the types of potential electing counterparties, swaps, and strategies that might be used to hedge or mitigate commercial risk, so a bright-line approach not allowing for judgment and consideration

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<sup>106</sup> In the alternative to meeting the requirements of § 39.6(c)(1)(i), a swap executed by an electing counterparty may also be eligible for the end-user exception if the swap qualifies as a bona fide hedge for purposes of an exception from position limits under the CEA as provided in § 39.6(c)(1)(ii), or if it qualifies for hedging treatment under FASB Accounting Standards Codification Topic 815 or under GASB Statement 53 as provided in § 39.6(c)(1)(iii). No comments raised cost/benefit issues regarding these two bases for electing the end-user exception other than supporting the benefits offered by including these additional alternatives.

of all relevant facts and circumstances would likely lead to outcomes in some circumstances that inappropriately include or exclude certain swaps from the end-user exception, particularly with respect to custom swaps and unique hedging strategies.<sup>107</sup> Therefore, the Commission did not adopt alternatives that relied on a bright-line approach.

In addition, the Commission described the six categories of commercial risk in a way that it believes are inclusive of the many different types of commercial risk that can be hedged or mitigated. At the same time, by delineating specific types of commercial risk that can be hedged or mitigated for the end-user exception to apply, the Commission has created boundaries that provide greater clarity for application of the exception and prevent abuse or evasion of the exception thereby reducing the costs that can result from uncertainty or abuse or evasion.

The Commission has determined that alternative approaches proposed by commenters that are significantly more or less inclusive assign undue weight to various costs and benefits that increase or decrease with varying degrees of inclusiveness. The “management or reduction of risks” standard proposed by SFG would create the possibility that swaps could be excepted from clearing when they are merely being used to “manage” risks. That approach would be contrary to the statute because it could include swaps that are used to increase risk rather than to hedge or mitigate commercial risks. On the other hand, as explained above in Section II.C.5, the “congruence” standard proposed by Better Markets would require “an exact match” between each component of

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<sup>107</sup> The Commission agrees with Kraft that “[a]ny bright-line definition or exclusion, such as those previously discussed, would infringe on a swap counterparty's ability to effectively hedge or mitigate its commercial risk....”

commercial risk being hedged and the swap that hedges it. However, a hedge does not have to be economically perfect in order to reduce rather than increase risk. Moreover, commenters emphasized the prevalence and necessity of dynamic hedging strategies, which continually rebalance hedges in light of changes or anticipated changes in underlying positions and their alignment with the hedges that offset their risk.<sup>108</sup> In light of this, the Commission believes that the additional costs created by a “congruence standard” would not be justified by its benefits and therefore has not adopted that alternative.<sup>109</sup>

Several commenters suggested that excluding swaps that hedge or mitigate financial risks would prevent abuse of the end-user exception by making the exception unavailable for speculative swaps.<sup>110</sup> However, as stated above, the Commission acknowledges that there are various financial risks that may be commercial risks for potential electing counterparties. Section 2(h)(7) of the CEA clearly allows swaps used by qualifying entities to hedge or mitigate commercial risks to be excepted out of the clearing requirement. The Commission believes that imposing such a limitation on using the end-user exception for financial swaps without consideration of whether they in fact do hedge or mitigate commercial risk would be inconsistent with the statute, and therefore has not adopted that alternative and accordingly, this alternative is beyond the reach of consideration under Section 15(a) of the CEA.

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<sup>108</sup> See, e.g., Kraft, RESA, WGCEF, Peabody, NRECA, American Public Power Association & Large Public Power Council, and EEI & EPSA.

<sup>109</sup> See section II.C.5 above.

<sup>110</sup> See, e.g., Tobin, Sullivan, Fay & Grunebaum, CMOC, Skylands, IPM&CSA, and FMNJ.

Various commenters suggested that § 39.6(c)(2)(i), which prohibits use of the end-user exception for swaps used for the purpose of speculation, trading, and investing, would prevent use of the exception for swaps that hedge or mitigate commercial risk.<sup>111</sup> Some of these comments also indicate that the meaning of “speculation, trading or investing” is unclear, which could cause some regulatory uncertainty, leading participants to refrain from electing the end-user exception in appropriate circumstances or to avoid entering into some swaps that hedge or mitigate commercial risk altogether.

The Commission has addressed these concerns by clarifying how § 39.6(c)(2)(i) is to be applied in the context of the entire rule. As explained in greater detail in section II.C.7 above, the focus of the limitation is on the purpose of the swap for the potential electing counterparty, *i.e.*, if it is principally used for hedging or mitigating commercial risk as characterized in the rule, then the end-user exception may be elected notwithstanding how the swap may otherwise be characterized, but if it is used for speculative, trading or investing purposes with little or no intent to hedge or mitigate commercial risk, then the end-user exception is not available. Accordingly, the Commission believes that this provision, if applied as intended, provides a benefit to market participants by clarifying the circumstances under which they may claim the end-user exception in accordance with the general requirement in Section 2(h)(7)(A)(ii) of the CEA that the swap must “hedge or mitigate commercial risk”.

#### 4. Determination Costs

To avail themselves of the end-user exception, potential electing counterparties must determine whether the specific swap in question is being used to “hedge or mitigate

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<sup>111</sup> See section II.C.7 above.

commercial risk” under the rule.<sup>112</sup> The Commission expects that entities will incur direct costs in the form of personnel hours devoted to analyzing this question. The cost of determining whether a specific swap is being used to “hedge or mitigate commercial risk” will depend on the nature of the entity’s hedging activities in the relevant situation. Some entities will incur relatively few costs in confirming that they are hedging or mitigating commercial risk. Others will incur little or no cost confirming that they are not covered by the definition. However, for some entities, especially those that use swaps to hedge in a variety of ways and circumstances, the determination could be more complex and may require that personnel with financial and legal expertise review the circumstances of the entity’s swap activities to make the determination of whether the swap in question is being used to hedge or mitigate commercial risk.

Notably, entities would incur determination costs regardless of the terms of the rule, because they must in any event interpret the statutory definition to determine whether they, and the swap in question, are eligible. Thus, at a minimum, a significant portion of the costs discussed here are attributable to the inclusion in the Dodd-Frank Act of a restriction on eligible swaps to those that “hedge or mitigate commercial risk,” and not from any aspect of this rule. Indeed, the final rule mitigates these costs by providing guidance about the application of the statutory requirements.

The time and resources that must be expended by an entity on this exercise will vary considerably depending on a number of factors, including (1) whether the entity in question must determine whether it is a financial entity; (2) the number and diversity of

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<sup>112</sup> Entities will also have to determine whether or not they are financial entities according to Section 2(h)(7)(C) of the CEA. Such costs result from the requirements of the Dodd-Frank Act and therefore do not arise as a result of the exercise of discretion by the Commission.

swaps executed by the entity; and (3) the complexity of the swap strategies being used by the entity. The Commission did not receive any comments quantifying the costs that an entity may incur in making these determinations. The Commission believes that, for most entities and swaps, making the determinations necessary will involve little or no cost because the nature of the electing counterparty and the use of the swaps in the context of the rule will be readily apparent. The Commission also recognizes that for some swaps and entities that have mixed purposes or that have unique characteristics, there will be determination costs; and in limited cases, such costs could be significant. However, it is not possible to estimate such costs for the entire market because the Commission does not have available to it detailed data for the swap market that would be needed to make such an estimate and also because such determinations are highly fact specific and can vary substantially from one swap to the next.

#### E. Exemption for Small Financial Institutions

Section 2(h)(7)(C)(ii) of the CEA directs the Commission to consider exempting small banks, savings associations, farm credit institutions, and credit unions with \$10 billion or less in total assets from the definition of “financial entity.” As discussed above, the Commission is adopting such an exemption in § 39.6(d).<sup>113</sup> The Commission notes that as of December 31, 2011, there were approximately 14,700 Section 2(h)(7)(C)(ii) institutions operating in the United States. Of those institutions, approximately 120 of them had total assets greater than \$10 billion, while the remaining 14,580 institutions had less than \$10 billion in total assets making them SFIs that could elect the end-user

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<sup>113</sup> See Section II.D.

exception when using swaps to hedge or mitigate commercial risk.<sup>114</sup> In other words, about 99 percent of banks, savings associations, farm credit system institutions, and credit unions will qualify as SFIs using the \$10 billion level.<sup>115</sup> In addition, analysis conducted by the Commission suggests that 99 percent of Section 2(h)(7)(C)(ii) institutions with less than \$10 billion in total assets that had open swap positions had gross notional swap books of \$2 billion or less. While this data did not influence the Commission's consideration of what constitutes a "small" Section 2(h)(7)(C)(ii) institution, it does indicate how many institutions may benefit from the exemption as adopted by the Commission.

Commenters suggested alternative approaches to the exemption for SFIs, such as asset test thresholds above \$10 billion, or a test that focuses on uncollateralized exposure. However, commenters did not provide sufficient quantitative or qualitative evidence to persuade the Commission that a threshold greater than \$10 billion in assets would provide benefits that justify any corresponding costs. In the absence of compelling evidence for a threshold other than that which was suggested by Congress, the Commission has adopted the threshold identified in the statute.

#### F. Consideration of Section 15(a) Factors

##### 1. Protection of Market Participants and the Public

The reporting requirements help to discourage abuse of the end-user exception by requiring electing counterparties to provide, or cause to be provided, information to the

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<sup>114</sup> Asset level data for banks and savings associations is available at [fdic.gov](http://fdic.gov), and credit unions at [ncua.gov](http://ncua.gov). Data for farm credit system institutions was provided to the Commission by the Farm Credit Administration.

<sup>115</sup> In mid-2010, the most recent period for which Section 2(h)(7)(C)(ii) institution swap data could be obtained, approximately 1,015 Section 2(h)(7)(C)(ii) institutions had outstanding swap exposure. Of those institutions, 138 had total assets over \$10 billion and 876 had total assets below \$10 billion.

Commission that demonstrates compliance with the legal conditions for using the exception. This helps protect market participants and the public. If the end-user exception were abused or evaded (i.e., if entities wrongfully avoided clearing and trading on an exchange swaps that were required to be cleared and traded), market participants would be exposed to additional counterparty risk. Moreover, the public could be exposed to systemic risk, and the costs associated with large-scale financial system failure, if large aggregate positions of non-cleared, speculative swaps were to accumulate in systemically important institutions.

Although reporting counterparties will incur reporting costs, the rule seeks to minimize these costs and provide flexibility as to the frequency at which the information is reported. The Commission has promulgated rules that require electing counterparties to provide, or cause to be provided, the limited information needed to effectively regulate the end-user exception and meet the statutory requirements. In addition, certain reporting requirements may be satisfied by submitting the required information on a swap-by-swap or annual basis. This enables entities to adopt reporting practices that reduce their reporting costs without compromising the Commission's ability to regulate the market.

The rules also help to protect market participants and the public because they permit boards of SEC Filers to approve swaps on a swap-by-swap or more general basis. The Commission believes that either basis is sufficient to ensure that members of the board are aware that the end-user exception may be elected and to ensure that such an election has been appropriately considered at the top of the corporate responsibility hierarchy. The Commission recognizes that swap-by-swap approval might reduce risk to market participants and the public to a somewhat greater degree than general approval,

but it agrees with commenters that any such incremental improvement does not warrant the additional burden.

The “reasonable basis” standard required of reporting counterparties is likely to create some costs for market participants who are reporting entities.<sup>116</sup> The Commission expects that if a reporting counterparty is not the electing counterparty and is reporting all information on a swap-by-swap basis, reporting counterparties may choose to conduct some due diligence in order to verify that their counterparty and the swap meet the requirements for eligibility. However, the Commission expects that most reporting entities are likely to know their customers, which will mitigate any costs associated with due diligence. Moreover, these costs must be considered in light of the benefits of such a requirement, namely enhanced compliance with clearing requirements, which serves to protect public interests, as well as the competitiveness and integrity of swap markets.

Finally, as described above, the “economically appropriate” hedging standard, together with the six types of commercial risk and specific safe harbors for hedging or mitigating risk that are recognized in the rule, mitigates the risk that market participants could abuse the exception or evade the clearing requirement, which could increase counterparty risk and potentially harm market participants and the public.

## 2. Efficiency, Competitiveness, and Financial Integrity of Swap Markets

Section 2(h)(8) of the CEA provides that swaps that are subject to the clearing requirement shall be executed on a board of trade or swap execution facility unless no such board or facility makes the swap available for trading. Preventing abuse of the end-user exception promotes exchange trading as intended by the Dodd-Frank Act by

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<sup>116</sup> See, e.g., NGSAs, Reval, RESAs, NRECAs, IECA, and EEI.

ensuring that more swaps that are supposed to be cleared are in fact cleared. This is likely to increase liquidity for these swaps, which should promote competitiveness by increasing the number of market participants that offer certain swaps in any one place. It should also enhance the efficiency of swap markets by reducing the amount of time that market participants must spend looking for willing counterparties and receiving actionable quotes for such swaps.

Certain provisions of this rule, such as the information required to be reported, the requirement for board approval, and the requirement that reporting entities gather sufficient information to have a reasonable basis for concluding that their counterparty is eligible for the end-user exception, will discourage abuse of the exception, thereby promoting the financial integrity of swap markets and financial markets as a whole. Market participants should have confidence that swaps that are not being used to hedge or mitigate commercial risk will be cleared.

### 3. Price Discovery

As described in greater detail above in Section III.C.1, the Commission believes that the rule reduces the potential for abuse or evasion (which could result in reduced exchange trading and therefore reduced price discovery) while also giving effect to the statutory requirement to create an exception from clearing for non-financial entities and SFIs using swaps to hedge or mitigate commercial risk. To the extent that reducing abuse or evasion results in greater liquidity on boards of trade and swap execution facilities, it promotes improved price discovery.

### 4. Sound Risk Management Practices

The Commission believes that the rule will lead to sound risk management practices. By requiring that swaps be “economically appropriate” to the reduction of the commercial risks that they hedge or mitigate, the rule helps to ensure that changes in the value of non-cleared swaps that otherwise would be subject to clearing are largely offset by changes in the value of assets or liabilities that electing counterparties have or reasonably expect to have (e.g., future changes in variable interest rates, foreign exchange rates, or the price of commodities). The offset should partially or fully ensure that the electing counterparty has sufficient resources to meet the financial commitments incumbent on them by virtue of their hedging positions.

Electing counterparties may be exposed to certain financial risks in the course of ordinary business, such as the risk of exchange rate fluctuations related to foreign transactions and interest rate risk that could impact a potential electing counterparty’s cost of debt incurred for commercial business purposes. The rule promotes sound risk management practices by mitigating the cost of collateral for entities to use swaps to hedge these types of financial risks related to their commercial activities.

For SEC Filers, the governing board or equivalent body is directly responsible to shareholders for the financial condition and performance of the firm, and also has access to information that would give them a comprehensive picture of the company’s financial condition and risk management strategies. Therefore, any oversight they provide to the firm’s risk management strategies is likely to encourage sound practices. However, the requirement contemplated in the NPRM that boards approve decisions to exempt swaps from clearing on a swap-by-swap basis could have been difficult for some firms to operationalize, and therefore could have undermined a firm’s ability to implement risk

management strategies that take advantage of the end-user exception. In other words, there is a tradeoff between the risk management benefits associated with more direct and intimate board oversight, and the risk management costs of the same. The Commission believes that the addition of the option to approve use of the end-user exception on a broad basis, rather than swap by swap, effectively balances these concerns, retaining direct board involvement in the firm's decision to exercise the exemption, but in a manner that does not hinder the firm's ability to operationalize their risk management strategies.

#### 5. Other Public Interest Considerations

For purposes of determining whether a swap hedges or mitigates commercial risk, the rule includes swaps that qualify for hedging treatment under Statement 53, Accounting and Financial Reporting for Derivative Instruments, issued by GASB. This change in the final rule expands the range of swaps that state and local government entities can except from the clearing requirement to provide a safe harbor for swaps that are bona fide hedges under Statement 53. As a consequence, the change helps to ensure that U.S. local governmental entities who use what are definitively hedging swaps under accounting standards are able to take advantage of the end-user exception for such purposes.

In addition, the Commission provides guidance in Section II.A.4 that foreign governments, foreign central banks and certain international financial institutions will not be subject to the clearing requirements of Section 2(h)(1) of the CEA as a matter of comity. This guidance is in the public interest because it is premised on the expectation that foreign regulators will reciprocate and provide similar relief to the Federal

Government, the Federal Reserve Banks of the United States and the international financial institutions of which the United States is a member.

#### IV. Related Matters

##### A. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) requires federal agencies, in promulgating regulations, to consider whether those regulations will have a significant economic impact on a substantial number of small entities and, if so, provide a regulatory flexibility analysis respecting the impact.<sup>117</sup> As noted in the NPRM, the regulations adopted herein would affect eligible contract participants (ECPs) and SDRs. The Commission has previously determined that neither ECPs nor SDRs are small entities for purposes of the RFA.<sup>118</sup> Accordingly, the Chairman, on behalf of the Commission, certified in the NPRM pursuant to 5 U.S.C. 605(b) that these regulations will not have a significant economic impact on a substantial number of small entities.

##### B. Paperwork Reduction Act

The Paperwork Reduction Act (PRA)<sup>119</sup> imposes certain requirements on Federal agencies (including the Commission) in connection with conducting or sponsoring any collection of information as defined by the PRA. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. This rulemaking imposes new collection of information requirements within the meaning of the PRA. Accordingly, the Commission requested

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<sup>117</sup> 5 U.S.C. 601 *et seq.*

<sup>118</sup> See 66 FR 20740 at 20743 (Apr. 25, 2001) (regarding ECPs) and 75 FR 80898 at 80926 (Dec. 23, 2010) (regarding SDRs).

<sup>119</sup> 44 U.S.C. 3501 *et seq.*

and the Office of Management and Budget (OMB) assigned a control number for the new collection of information: OMB control number 3038-0085. The Commission has submitted this final rule along with supporting documentation for OMB's review. Responses to this collection of information will be mandatory.

The Commission will protect proprietary information according to the Freedom of Information Act and 17 CFR Part 145, "Commission Records and Information." In addition, section 8(a)(1) of the CEA strictly prohibits the Commission, unless specifically authorized by the CEA, from making public "data and information that would separately disclose the business transactions or market positions of any person and trade secrets or names of customers." The Commission is also required to protect certain information contained in a government system of records according to the Privacy Act of 1974, 5 U.S.C. 552a.

#### 1. Information Provided by Reporting Entities/Persons

Regulation 39.6 will require an electing counterparty to provide or cause to be provided certain information about the swap to a registered SDR or, if no registered SDR is available to receive the information, the Commission in the form and manner specified by the Commission. The reporting will occur only once at the beginning of the swap life cycle. If one of the counterparties to the swap is a swap dealer or a major swap participant, the electing counterparty would cause such information to be reported by that swap dealer or major swap participant. The electing counterparty would act as the reporting counterparty only if its counterparty is not a swap dealer or a major swap participant.

As noted in the NPRM, the Commission estimates that there are approximately 30,000 non-financial entities that are counterparties to a swap in a given year. Of those entities, the Commission estimates that the majority will not be required to report under Regulation 39.6 because their counterparty will be a swap dealer or major swap participant. In that case, as described above, the swap dealer or major swap participant will be required to report on behalf of the electing counterparty. Also, the reporting under Regulation 39.6 is only required to be made one time for each swap, with no further notifications or other reporting required in subsequent years. Reducing the number of annual potential electing counterparties by these factors, the Commission estimates that there are approximately 1,000 electing counterparties who will be required to report in a given year. The Commission estimates that the report will require between 10 minutes and one hour of burden, per electing counterparty per year. The number of burden hours per electing counterparty may vary depending on various factors, such as the number of swaps entered into by that electing counterparty in the given year. Therefore, the number of estimated aggregate annual burden hours is between 167 and 1,000 hours.

## 2. Information Collection Comments

The Commission received a comment from the Electric Trade Associations stating that the Commission rulemakings under the Dodd-Frank Act constitute an accumulation of interrelated regulatory burdens and costs on nonfinancial small entities and the Commission should conduct a comprehensive analysis under the PRA and other statutes. However, the comment did not specifically address this rulemaking.

### List of Subjects in 17 CFR Part 39

Business and industry, Reporting requirements, Swaps.

For the reasons stated in the preamble, amend 17 CFR part 39 as follows:

## PART 39 – DERIVATIVES CLEARING ORGANIZATIONS

1. The table of contents for part 39 is revised to read as follows:

### **Subpart A – General Provisions Applicable to Derivatives Clearing Organizations**

Sec.

39.1 Scope.

39.2 Definitions.

39.3 Procedures for registration.

39.4 Procedures for implementing derivatives clearing organization rules and clearing new products.

39.5 Review of swaps for Commission determination on clearing requirement.

39.6 Exceptions to the clearing requirement.

39.7 Enforceability.

39.8 Fraud in connection with the clearing of transactions on a derivatives clearing organization.

### **Subpart B – Compliance with Core Principles**

Sec.

39.9 Scope.

39.10 Compliance with core principles.

39.11 Financial resources.

39.12 Participant and product eligibility.

39.13 Risk management.

39.14 Settlement procedures.

- 39.15 Treatment of funds.
- 39.16 Default rules and procedures.
- 39.17 Rule enforcement.
- 39.18 System safeguards.
- 39.19 Reporting.
- 39.20 Recordkeeping.
- 39.21 Public information.
- 39.22 Information sharing.
- 39.23 Antitrust considerations.
- 39.24 [Reserved]
- 39.25 [Reserved]
- 39.26 [Reserved]
- 39.27 Legal risk considerations.

Appendix A to Part 39 — FORM DCO DERIVATIVES CLEARING ORGANIZATION  
APPLICATION FOR REGISTRATION

2. The authority citation for part 39 is revised to read as follows:

Authority: 7 U.S.C. 2 and 7a-1 as amended by Pub. L. 111-203, 124 Stat. 1376.

3. Add § 39.6 to read as follows:

**§ 39.6 Exceptions to the clearing requirement.**

(a) Non-financial entities. (1) A counterparty to a swap may elect the exception to the clearing requirement under section 2(h)(7)(A) of the Act if the counterparty:

(i) Is not a “financial entity” as defined in section 2(h)(7)(C)(i) of the Act;

(ii) Is using the swap to hedge or mitigate commercial risk as provided in paragraph (c) of this section; and

(iii) Provides, or causes to be provided, the information specified in paragraph (b) of this section to a registered swap data repository or, if no registered swap data repository is available to receive the information from the reporting counterparty, to the Commission. A counterparty that satisfies the criteria in this paragraph (a)(1) and elects the exception is an “electing counterparty.”

(2) If there is more than one electing counterparty to a swap, the information specified in paragraph (b) of this section shall be provided with respect to each of the electing counterparties.

(b) Reporting. (1) When a counterparty elects the exception to the clearing requirement under section 2(h)(7)(A) of the Act, one of the counterparties to the swap (the “reporting counterparty,” as determined in accordance with § 45.8 of this part) shall provide, or cause to be provided, the following information to a registered swap data repository or, if no registered swap data repository is available to receive the information from the reporting counterparty, to the Commission, in the form and manner specified by the Commission:

(i) Notice of the election of the exception;

(ii) The identity of the electing counterparty to the swap; and

(iii) The following information, unless such information has previously been provided by the electing counterparty in a current annual filing pursuant to paragraph (b)(2) of this section:

(A) Whether the electing counterparty is a “financial entity” as defined in section 2(h)(7)(C)(i) of the Act, and if the electing counterparty is a financial entity, whether it is:

(1) Electing the exception in accordance with section 2(h)(7)(C)(iii) or section 2(h)(7)(D) of the Act; or

(2) Exempt from the definition of “financial entity” as described in paragraph (d) of this section;

(B) Whether the swap or swaps for which the electing counterparty is electing the exception are used by the electing counterparty to hedge or mitigate commercial risk as provided in paragraph (c) of this section;

(C) How the electing counterparty generally meets its financial obligations associated with entering into non-cleared swaps by identifying one or more of the following categories, as applicable:

(1) A written credit support agreement;

(2) Pledged or segregated assets (including posting or receiving margin pursuant to a credit support agreement or otherwise);

(3) A written third-party guarantee;

(4) The electing counterparty's available financial resources; or

(5) Means other than those described in paragraphs (b)(1)(iii)(C)(1), (2), (3) or (4) of this section; and

(D) Whether the electing counterparty is an entity that is an issuer of securities registered under section 12 of, or is required to file reports under section 15(d) of, the Securities Exchange Act of 1934, and if so:

(1) The relevant SEC Central Index Key number for that counterparty; and

(2) Whether an appropriate committee of that counterparty's board of directors (or equivalent body) has reviewed and approved the decision to enter into swaps that are exempt from the requirements of sections 2(h)(1) and 2(h)(8) of the Act.

(2) An entity that qualifies for an exception to the clearing requirement under this section may report the information listed in paragraph (b)(1)(iii) of this section annually in anticipation of electing the exception for one or more swaps. Any such reporting under this paragraph shall be effective for purposes of paragraph (b)(1)(iii) of this section for swaps entered into by the entity for 365 days following the date of such reporting. During such period, the entity shall amend such information as necessary to reflect any material changes to the information reported.

(3) Each reporting counterparty shall have a reasonable basis to believe that the electing counterparty meets the requirements for an exception to the clearing requirement under this section.

(c) Hedging or mitigating commercial risk. For purposes of section 2(h)(7)(A)(ii) of the Act and paragraph (b)(1)(iii)(B) of this section, a swap is used to hedge or mitigate commercial risk if:

(1) Such swap:

(i) Is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where the risks arise from:

(A) The potential change in the value of assets that a person owns, produces, manufactures, processes, or merchandises or reasonably anticipates owning, producing, manufacturing, processing, or merchandising in the ordinary course of business of the enterprise;

(B) The potential change in the value of liabilities that a person has incurred or reasonably anticipates incurring in the ordinary course of business of the enterprise;

(C) The potential change in the value of services that a person provides, purchases, or reasonably anticipates providing or purchasing in the ordinary course of business of the enterprise;

(D) The potential change in the value of assets, services, inputs, products, or commodities that a person owns, produces, manufactures, processes, merchandises, leases, or sells, or reasonably anticipates owning, producing, manufacturing, processing, merchandising, leasing, or selling in the ordinary course of business of the enterprise;

(E) Any potential change in value related to any of the foregoing arising from interest, currency, or foreign exchange rate movements associated with such assets, liabilities, services, inputs, products, or commodities; or

(F) Any fluctuation in interest, currency, or foreign exchange rate exposures arising from a person's current or anticipated assets or liabilities; or

(ii) Qualifies as bona fide hedging for purposes of an exemption from position limits under the Act; or

(iii) Qualifies for hedging treatment under:

(A) Financial Accounting Standards Board Accounting Standards Codification Topic 815, Derivatives and Hedging (formerly known as Statement No. 133); or

(B) Governmental Accounting Standards Board Statement 53, Accounting and Financial Reporting for Derivative Instruments; and

(2) Such swap is:

(i) Not used for a purpose that is in the nature of speculation, investing, or trading;  
and

(ii) Not 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 as defined by this rule or § 240.3a67-4 of this title.

(d) For purposes of section 2(h)(7)(A) of the Act, a person that is a “financial entity” solely because of section 2(h)(7)(C)(i)(VIII) shall be exempt from the definition of “financial entity” if such person:

(i) Is organized as a bank, as defined in section 3(a) of the Federal Deposit Insurance Act, the deposits of which are insured by the Federal Deposit Insurance Corporation; a savings association, as defined in section 3(b) of the Federal Deposit Insurance Act, the deposits of which are insured by the Federal Deposit Insurance Corporation; a farm credit system institution chartered under the Farm Credit Act of 1971; or an insured Federal credit union or State-chartered credit union under the Federal Credit Union Act; and

(ii) Has total assets of \$10,000,000,000 or less on the last day of such person’s most recent fiscal year.

Issued in Washington, DC, on July 10, 2012, by the Commission.



David A. Stawick,

Secretary of the Commission.

Appendices to End-User Exception to Mandatory Clearing of Swaps — Commission  
Voting Summary and Statements of Commissioners

NOTE: The following appendices will not appear in the Code of Federal Regulations.

Appendix 1—Commission Voting Summary

On this matter, Chairman Gensler and Commissioners Sommers, Chilton, O'Malia and  
Wetjen voted in the affirmative; no Commissioner voted in the negative.

Appendix 2—Statement of Chairman Gary Gensler

I support the final rule on the end-user exception to the clearing requirement for swaps.

One of the primary goals of the Dodd-Frank Wall Street Reform and Consumer  
Protection Act (Dodd-Frank Act) was to lower risk to the interconnected financial system  
by requiring standardized swaps between financial entities to be cleared.

Congress provided that non-financial entities, such as farmers, ranchers, manufacturers  
and other end-users, should be able to choose whether or not to clear those swaps that  
hedge or mitigate commercial risks. The Commission's final rule implements this  
exception for non-financial entities, establishing criteria for hedging or mitigating  
commercial risk and imposing minimal reporting requirements for those swaps that come  
under the end-user exception. The final rule benefited from significant public input,  
including requiring that most of the information be reported annually, rather than  
transaction by transaction as had been proposed.

In the Dodd-Frank Act, Congress also directed the Commission to consider exempting  
from the definition of "financial entity" small financial institutions with total assets of

\$10 billion or less, thus making them eligible for the end-user exception. After considering the comments received on the end-user exception proposal, the Commission is exempting small financial institutions, including small banks, savings associations, farm credit system institutions and credit unions, at the \$10 billion total asset level, as identified by Congress.