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Division of Clearing and Risk

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Director

CFTC Letter No. 13-02
No-Action
March 20, 2013
Division of Clearing and Risk

Mr. Robert G. Pickel
Chief Executive Officer
International Swaps and Derivatives Association, Inc.
1001 Pennsylvania Avenue, NW, Suite 600
Washington, D.C. 20004

Re: No-Action Relief from Required Clearing for Partial Novation and Partial Termination of Swaps

Dear Mr. Pickel:

This letter is in response to a request dated March 10, 2013, from The International Swaps and Derivatives Association, Inc. (ISDA), on behalf of its members and other similarly situated persons, to the Division of Clearing and Risk (Division) of the Commodity Futures Trading Commission (Commission), in which ISDA requested an interpretative letter regarding whether the remaining portion of a swap between the original counterparties that is partially novated or partially terminated is subject to the clearing requirement under section 2(h)(1)(A) of the Commodity Exchange Act (CEA) and part 50 of the Commission's regulations. The request is limited to the partial novation or partial termination of swaps that were executed prior to the date on which counterparties must begin complying with the clearing requirement (and therefore, not required to be cleared).¹

¹ The Commission set forth a specific compliance schedule for market participants to bring their swaps into compliance with the clearing requirement. *See* Clearing Requirement Determination Under Section 2(h) of the Commodity Exchange Act, 77 FR 74284, 74319-20 (Dec. 13, 2012) (hereinafter the "Clearing Requirement Determination"). Swap dealers (SDs), major swap participants (MSPs), and private funds active in the swap market (active funds) were required to comply beginning on March 11, 2013, for swaps they enter into on or after that date. All other financial entities are required to clear swaps beginning on June 10, 2013, for swaps entered into on or after that date, except for accounts managed by third-party investment managers, as well as ERISA pension plans, which have until September 9, 2013, to begin clearing swaps entered into on or after that date. With regard to the credit default swap indices on European corporate names, iTraxx, the Clearing Requirement Determination provided that, if no derivatives clearing organization (DCO) offers iTraxx for client clearing by February 11, 2013, the Commission will delay compliance for those swaps until 60 days after an eligible DCO offers iTraxx indices for client clearing. The Commission recently announced that iTraxx clearing will commence on April 26, 2013, for SDs, MSPs, and active funds. Financial entities other than accounts managed by third-party investment managers and ERISA plans are required to begin clearing iTraxx index swaps entered into on or after July 25, 2013, and all

Factual Background and Request for Relief

ISDA represents that when the two counterparties to an uncleared swap (the “original counterparties” to an “original swap”) agree to novate or terminate an original swap in full, that swap no longer exists between the original counterparties and so there is nothing between them (with respect to that original swap) that could be subject to the clearing requirement. The original swap was not required to be cleared when it was executed because the original swap was executed prior to the date on which the counterparties were required to comply with the clearing requirement.

ISDA further explains that when the original counterparties wish to novate or terminate an original swap in part (a “partial novation” or “partial termination,” respectively), they may agree to an amendment that reduces the notional amount of the original swap. The remaining portion of the original swap between the original counterparties after such reduction by a partial novation or partial termination is referred to in ISDA’s letter as the “stub swap.” ISDA represents that the terms of the original swap, including the terms that define the remaining cash flows, continue to govern the stub swap (apart from the reduction in the notional amount of that swap).

Under a partial termination, all terms of the stub swap, apart from the reduction of the notional amount, remain the same. The original counterparties remain the same and no third parties are involved in the transaction. Under a partial novation, one of the two original counterparties novates² part of the original swap to a third party (the “novated swap”). As with partial terminations, for the remainder of the original swap (*i.e.*, the stub swap), all terms, apart from the reduction of the notional amount, remain the same.

According to ISDA, imposing required clearing on the stub swap, under either a partial novation or a partial termination, would create distorted incentives for risk and investment management decisions.

ISDA states that it does not request relief from required clearing for circumstances where the original counterparties enter into and book a new swap that fully or partially offsets the risk of an existing uncleared swap and thereby achieve a similar economic result to a full termination, a partial novation, or a partial termination. ISDA further acknowledges that in the context of partial novations, the novated swap, which was executed between one of the original counterparties and a third party, may be subject to required clearing.³

other entities are required to begin clearing iTraxx index swaps on October 23, 2013, for swaps entered into on or after that date. See <http://www.cftc.gov/PressRoom/PressReleases/pr6521-13>.

² For purposes of this letter, novation means a change in ownership of the swap or portion of the notional amount of the swap.

³ The novated portion of the original swap may be subject to required clearing depending on whether (1) it is a swap that falls into one of the classes of swaps set forth under Commission regulation 50.4(a) or (b), and (2) the date of partial novation occurs on or after the applicable compliance date for both counterparties to the novated swap.

ISDA represents that its proposed interpretation is consistent with the goal of required clearing, namely reducing counterparty credit risk. According to ISDA, a partial termination by its nature reduces the counterparty credit risk posed by a swap, because it reduces the notional size of that swap, and a partial novation reduces the notional size of the swap as between the original counterparties.

Applicable Regulatory Requirements and Analysis

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010,⁴ in relevant part, amended section 2(h)(1)(A) of the CEA, which states that “it shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing to a derivatives clearing organization [(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.”⁵

On November 29, 2012, the Commission adopted final rules implementing its first Clearing Requirement Determination. Under these rules, market participants are required to clear swaps meeting the specifications of two classes of credit default swaps based on North American and European corporate entities and four classes of interest rate swaps.⁶ As described above, the Commission set forth a series of compliance dates to phase in compliance with the clearing requirement. Commission regulation 50.5(b) provides that swaps entered into before the relevant compliance date for a particular swap are not subject to the clearing requirement.⁷

In the final rulemaking, the Commission clarified that the clearing requirement applies to all new swaps, as well as changes in the ownership of a swap, including assignment, novation, exchange, transfer, or conveyance.⁸ Commission regulation 50.2 provides that swaps subject to a clearing requirement need to be submitted for clearing no later than the day of execution.⁹ Under Commission regulation 23.506(b), SDs and MSPs executing swaps subject to the clearing requirement must submit such swaps to a DCO as soon as technologically practicable after execution, but no later than the close of business on the day of execution.¹⁰ In addition, SDs and MSPs that are clearing members of a DCO must accept or reject each trade submitted by or for it

⁴ Pub. L. No. 111-203, 124 Stat. 1376 (2010).

⁵ 7 U.S.C. § 2(h)(1)(A).

⁶ See Clearing Requirement Determination, 77 FR at 74336-37 (establishing Commission regulation 50.4, which sets forth the classes of swaps that are required to be cleared).

⁷ *Id.* at 74337.

⁸ *Id.* at 74316.

⁹ *Id.* at 74336.

¹⁰ See 17 CFR § 23.506(b), 77 FR 21278, 21307 (Apr. 9, 2012); see also Clearing Requirement Determination, 77 FR at 74314 n.138 (discussing the application of Commission regulations 50.2 and 23.506(b)).

“as quickly as would be technologically practicable if fully automated systems were used.”¹¹ Likewise, futures commission merchants (FCMs) that are clearing members of a DCO must accept or reject each trade submitted by or for it or its customers “as quickly as would be technologically practicable if fully automated systems were used.”¹²

For purposes of the following analysis in this letter, the Division assumes that each swap, other than an original swap, discussed herein is subject to the clearing requirement under section 2(h) of the CEA and part 50 of the Commission’s regulations because (1) the swap is within a class of swaps with the specifications set forth in Commission regulations 50.4(a) and (b), and (2) the swap was executed or subject to an ownership change, including by assignment, novation, exchange, transfer, or conveyance, after an applicable compliance date. When both conditions are met, this letter will refer to the swap as “subject to required clearing.”

This no-action letter applies to partial terminations and partial novations, as those terms are defined in this letter. After an applicable compliance date, market participants that enter into new swaps that are in one of the classes of swaps that is required to be cleared must submit those newly-executed swaps to a DCO for clearing pursuant to section 2(h) of the CEA and part 50 of the Commission’s regulations. This requirement applies to all new swaps that are subject to required clearing, even if those swaps fully or partially offset the risks of swaps that were executed prior to an applicable compliance date for required clearing. All new swaps, including those that offset the risk of original swaps, are subject to required clearing, unless an exception or exemption under part 50 of the Commission’s regulations applies.¹³

As noted above, ISDA has represented that an original swap that is executed prior to an applicable compliance date and is fully terminated (after an applicable compliance date) such that the original swap no longer exists between the original counterparties, is not subject to required clearing. Consistent with the Commission’s statements in the Clearing Requirement Determination with regard to which swaps are required to be cleared, the Division confirms that if the original swap is fully terminated (meaning the terms are fully extinguished with no remaining obligations for either counterparty), the original swap is not subject to required clearing because it has ceased to exist.¹⁴ From an operational standpoint, the two records of the

¹¹ See 17 CFR § 23.610(b), 77 FR at 21308 (establishing the rule for SDs and MSPs). Under Commission regulation 39.12(b)(7)(iii), a DCO must have rules providing that the DCO will accept or reject all swaps listed for clearing as quickly as would be technologically practicable if fully automated systems were used. See 77 FR at 21310.

¹² See 17 CFR § 1.74(b), 77 FR at 21307 (establishing the rule for FCMs).

¹³ For purposes of this letter, the term “offset” means that the risks of one or more swaps compensate for the risks of another swap or swaps.

¹⁴ For purposes of this letter a swap that is “fully terminated” means that the rights and obligations under the original swap are extinguished, other than the right to receive, or obligation to pay, a single termination payment with respect to the termination of such rights and obligations, provided that such payment shall be due and payable promptly following the termination.

original swap that exist in the trading and/or recordkeeping systems¹⁵ of the original counterparties must be changed to reflect the full termination.¹⁶

With regard to an original swap that is fully novated from one of the original counterparties to a third party, the Division confirms that if the ownership interest of one of the original counterparties to the original swap is fully transferred to a third party (meaning the rights and obligations of one of the original counterparties to the swap are fully extinguished), the original swap is not subject to required clearing because it no longer exists as between the original counterparties. Again, from an operational standpoint, the record of the original swap that exists in the trading and/or recordkeeping system of the original counterparty that is transferring its ownership interest to a third party must be changed to reflect the full termination of its rights and responsibilities.¹⁷ The novated swap between the remaining original counterparty to the original swap and a third party is a new swap based on a change of ownership and is subject to required clearing.¹⁸

With regard to partial terminations and partial novations, for purposes of this letter, the following definitions shall apply to the relief provided below:

Original swap means a swap that was executed between two original counterparties prior to an applicable compliance date that would, but for execution prior to the applicable compliance date, be subject to required clearing.

Stub swap means the portion of an original swap that remains after two counterparties have agreed to reduce the notional amount of their original swap on or after an applicable compliance date, but all other terms of the swap remain the same as the original swap.

Novated swap means the portion of an original swap that is transferred from one of the original counterparties to a third party on or after an applicable compliance date. Such novated swap is subject to required clearing.

Fully terminate means that the rights and obligations under the original swap are extinguished, other than the right to receive, or obligation to pay, a single termination payment

¹⁵ To the extent that an original counterparty has both trading and recordkeeping systems, both systems must be changed.

¹⁶ The termination of the original swap must be reported, as applicable, under parts 43, 45, and/or 46 of the Commission's regulations. SDs and MSPs executing terminations must confirm such swap transactions under Commission regulation 23.501.

¹⁷ The termination of the original swap must be reported, as applicable, under parts 43, 45, and/or 46 of the Commission's regulations. SDs and MSPs executing terminations must confirm such swap transactions under Commission regulation 23.501.

¹⁸ See 17 CFR § 50.2, Clearing Requirement Determination, 77 FR at 74336 (establishing the treatment of swaps subject to a clearing requirement). The novated swap also is subject to applicable reporting requirements under parts 43, 45, and/or 46 of the Commission's regulations, and SDs and MSPs executing novated swaps must confirm such swap transactions under Commission regulation 23.501.

with respect to the termination of such rights and obligations, provided that such payment is due and payable promptly following the termination.

Partially terminate means to extinguish all rights and obligations for a stated portion of the notional amount of an original swap, other than the right to receive, or obligation to pay, a single termination payment with respect to the termination of such rights and obligations, provided that such payment is due and payable promptly following the termination.

Partially novate means to transfer the ownership of a stated portion of the notional amount of an original swap from one of the original counterparties to an original swap to a third party.

Division No-Action Position

Based on the foregoing, the Division believes that granting relief is warranted. Accordingly, the Division will not recommend that the Commission take an enforcement action against any person for failure to clear a stub swap as required under section 2(h)(1)(A) of the CEA and part 50 of the Commission's regulations, provided that the following conditions are met:

1. The original swap that is partially novated or partially terminated was not cleared by a DCO.
2. The original swap was executed prior to the compliance date for required clearing applicable to such a swap.
3. With respect to partially terminating an original swap:
 - a. the records of the original swap that exist in the trading and/or recordkeeping systems of the original counterparties are amended solely to reflect the reduced notional amount of the original swap;
 - b. the stated portion of the original swap that is terminated is fully terminated, apart from the stated portion that is the stub swap; and
 - c. all other terms of the stub swap remain the same as the terms of the original swap.
4. With respect to partially novating an original swap:
 - a. the records of the original swap that exist in the trading and/or recordkeeping systems of the original counterparties are amended solely to reflect the reduced notional amount of the original swap;
 - b. all other terms of the stub swap remain the same as the terms of the original swap; and
 - c. the novated swap is submitted for clearing pursuant to section 2(h)(1)(A) of the CEA and part 50 of Commission regulations.

This letter, and the positions taken herein, represent the view of this Division only, and do not necessarily represent the position or view of the Commission or of any other office or division of the Commission. The relief issued by this letter does not excuse persons relying on it from compliance with any other applicable requirements contained in the CEA or in the Commission regulations issued thereunder.¹⁹ It does not create or confer any rights for or obligations on any person or persons subject to compliance with the CEA that bind the Commission or any of its other offices or divisions.

Further, this letter, and the relief contained herein, is based upon the representations made to the Division. Any different, changed or omitted material facts or circumstances might render this no-action relief void.

Should you have any questions, please do not hesitate to contact Sarah Josephson, Deputy Director, at (202) 418-5684, or Brian O'Keefe, Associate Director, at (202) 418-5658.

Sincerely,

Ananda Radhakrishnan

¹⁹ For example, the relief provided herein does not excuse persons from any applicable swap reporting requirements, any requirement under section 2(h)(8) of the CEA, or, for SDs and MSPs, any requirement under part 23 of the Commission's regulations, including the confirmation requirement under 17 CFR § 23.501.