

US Derivatives Regulation: The Commercial End-User Exception to the Mandatory Swap Clearing Requirement

by Practical Law Finance

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A Practice Note explaining the final CFTC rules on the end-user exception to the mandatory swap clearing and exchange-trading requirements of Title VII of the Dodd-Frank Act.

On July 10, 2012, the [Commodity Futures Trading Commission](#) (CFTC) issued final rules ([77 Fed. Reg. 42560 \(July 19, 2012\)](#)), originally codified as former CFTC Rule 39.6) governing the end-user exception to the mandatory swap clearing and exchange-trading requirements under Title VII of the [Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010](#) (Dodd-Frank Act). As part of later rulemaking ([77 Fed. Reg. 74284 \(Dec. 13, 2012\)](#)), the CFTC recodified the end-user exception as CFTC Rule 50.50, effective February 11, 2013 ([17 C.F.R. § 50.50](#)).

Under Section 2(h)(7)(A) of the [Commodity Exchange Act](#) (CEA), as amended by Section 723(h)(7)(A) of the Dodd-Frank Act, and Part 50 of the CFTC's Regulations, Dodd-Frank mandatory swap clearing and exchange-trading requirements do not apply to a swap if one counterparty to the swap satisfies all of the following conditions:

- It is either:
 - not a "financial entity"; or
 - an exempt financial entity.
- It is using the swap to "hedge or mitigate commercial risk."
- It notifies the CFTC how it generally meets its financial obligations associated with entering into uncleared swaps.

([7 U.S.C. § 2\(h\)\(7\)\(A\)](#); [17 C.F.R. § 50.50\(a\), \(d\)](#).)

Note that as long as one of the counterparties to the swap qualifies for the end-user exception, the swap need not be cleared or exchange traded. Clearing and exchange trading for these swaps is optional, at the election of the end user ([7 U.S.C. § 2\(h\)\(7\)\(B\)](#); [17 C.F.R. § 50.50\(a\)\(1\)](#)).

For information on which swaps are subject to the mandatory clearing requirements under Section 723(h)(1) of the Dodd-Frank Act, codified in CEA Section 2(h)(1) ([7 U.S.C. § 2\(h\)\(1\)](#)), see [Practice Note, US Derivatives Regulation: Swap Clearing and Exchange Trading: CFTC Swap Clearing Determinations](#).

For information on which swaps are subject to mandatory exchange trading under Section 723(h)(8) of the Dodd-Frank Act, codified in CEA Section 2(h)(8) ([7 U.S.C. § 2\(h\)\(8\)](#)), see [Practice Note, US Derivatives Regulation: Swap Clearing and Exchange Trading: CFTC Made-Available-to-Trade \(MAT\) Determinations](#).

Note that these essentially overlap in their entirety.

Financial Entities

The final rules explicitly decline to give a hard definition to the term "financial entity." However, Section 2(h)(7)(C)(i) of the CEA provides a definition that includes the following types of entities, which may not make use of the end-user exception:

- [Swap dealers](#) (SDs) and [security-based swap dealers](#) (SBSDs).
- [Major swap participants](#) (MSPs) and [major security-based swap participants](#) (MSBSPs).
- Commodity pools.
- Private funds, as defined in Section 202(a) of the [Investment Advisers Act of 1940](#) (15 U.S.C.A. § 80b-2(a)(29)).
- Employee benefit plans, as defined in the [Employee Retirement Income Security Act of 1974](#) (ERISA) (29 U.S.C.A. § 1002(3), (32)).
- Any person 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](#) (BHCA) (12 U.S.C.A. § 1843(k)).

(7 U.S.C. § 2(h)(7)(C)(i).)

The CFTC noted in the adopting release for the end-user exception that when an entity's financial activities are incidental and not primary activities, the entity is not "predominantly" engaged in financial activities. However, the CFTC has not provided a clear rule for what constitutes being "predominantly" engaged. (77 Fed. Reg. at 42563.)

Exempt Financial Entities

The following entities are specifically excluded from the definition of "financial entity" and may therefore take advantage of the commercial end-user exception to the Dodd-Frank swap-clearing and exchange-trading requirement:

- **De minimis exception.** Banks, savings associations, farm credit institutions and credit unions with total assets of \$10 billion or less (7 U.S.C. § 2(h)(7)(C)(ii); 17 C.F.R. § 50.50(d)).
- **Treasury affiliates.** An affiliate of a non-financial entity acting on behalf of the non-financial affiliate where the swap is being used to hedge the commercial risk of the non-financial affiliate or another affiliated non-financial entity. This exception, known as the treasury affiliate exception, excludes certain entities, including SDs and MSPs (7 U.S.C. § 2(h)(7)(D); see [Legal Update, Treasury Affiliate Clearing Exception Codified as Part of Consolidated Appropriations Act](#)).
- **CFCs.** Certain entities, referred to as "captive financial companies" (CFCs), whose primary business is providing financing, and which use derivatives for the purposes of hedging underlying commercial risks related to their interest rate and foreign currency exposure, provided that:
 - 90% or more of the interest rate and currency exposures for which the CFC is using derivatives to hedge the related underlying commercial risks arises from financing that facilitates the purchase or lease of products; and
 - 90% or more of the products, the purchase or sale of which are being facilitated by the financing, are manufactured by the parent company or its subsidiary.

(7 U.S.C. § 2(h)(7)(C)(iii).)

The CFTC has clarified, for example, that a securitization [special purpose vehicle](#) (SPV) that is wholly owned by, and consolidated with, an entity that qualifies for the non-financial commercial end-user exception qualifies as a CFC and is therefore eligible to elect the end-user exception (CFTC Letter 15-27; see [Legal Update, CFTC Staff Letter to Ford Motor Credit Exempts Certain Auto ABS Swaps from Mandatory Clearing](#)).

In adopting the final rules, the CFTC also clarified that foreign governments, foreign central banks, and international financial institutions (IFIs) are not subject to Dodd-Frank clearing requirements under CEA Section 2(h)(1) (7 U.S.C. § 2(h)(1)). IFIs include development banks, such as the International Monetary Fund (IMF), but do not include large investment banks. However, a US state or local government entity's swap activity may be commercial in nature and such entity may also meet the "financial entity" definition under Section 2(h)(7)(C) of the CEA. Under such circumstances, the entity would be subject to compliance with the clearing requirement under CEA Section 2(h)(1)(A) (7 U.S.C. § 2(h)(1)(A), (7)(C)). (77 Fed. Reg. at 42562.)

If a foreign government, foreign central bank, or IFI enters into an uncleared swap with a counterparty that is subject to CFTC regulations regarding that transaction, then the counterparty must still comply with all the CFTC regulations that apply to swaps that are not subject to Title VII's mandatory clearing requirement (for example, recordkeeping and reporting requirements under Parts 23 and 45 of the CFTC regulations). (77 Fed. Reg. at 42562.)

In adopting the final rules, the CFTC further stated that, except with respect to foreign governments, foreign central banks, IFIs, and state and local government entities, it was otherwise declining to determine 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. ([77 Fed. Reg. at 42561.](#))

Definition of "Hedging or Mitigating Commercial Risk"

The final rules establish the criteria for determining whether a swap hedges or mitigates commercial risk for purposes of the end-user exception ([17 C.F.R. § 50.50\(c\)](#)). These criteria are virtually identical to the criteria used in the definition of "major swap participant" that was adopted under final definitional rules by the CFTC in its final rulemaking on the definitions of the terms "swap dealer" and "major swap participant" ([17 C.F.R. § 1.3](#)); see [Practice Note, US Derivatives Regulation: Swap Dealer and MSP Threshold Calculations: Definitions of Major Swap Participant \(MSP\) and Major Security-Based Swap Participant \(MSBSP\)](#).

The determination of whether a swap is entered into to hedge or mitigate commercial risk:

- Is made by the facts and circumstances of the instance of alleged hedging.
- Takes into account a market participant's overall hedging and risk mitigation strategies.
- Is made by the parties to a swap at the time a position is first entered into.

([77 Fed. Reg. at 42571 to 42572.](#))

Under CFTC Regulation 50.50(c), a swap is used to hedge or mitigate commercial risk if the swap meets one of the following criteria:

- Is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where the risks arise from:
 - 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;
 - 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;
 - 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;
 - 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;
 - 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
 - any fluctuation in interest, currency, or foreign exchange rate exposures arising from a person's current or anticipated assets or liabilities.
- Qualifies as a bona fide hedge for purposes of an exemption from position limits under the Act (see [Practice Note: US Derivatives Regulation: Commodity Position Limits: Bona Fide Hedge Definition](#)).
- Qualifies for hedging treatment under:
 - Financial Accounting Standards Board Accounting Standards Codification Topic 815, Derivatives and Hedging (formerly known as Statement No. 133); or
 - Governmental Accounting Standards Board Statement 53, Accounting and Financial Reporting for Derivative Instruments.

([17 C.F.R. § 50.50\(c\)\(1\)](#).)

In addition, for a swap to be used to hedge or mitigate commercial risk within the meaning of CFTC Regulation 50.50(c), the swap cannot be used:

- For a purpose that is in the nature of speculation, investing, or trading.
- To hedge or mitigate the risk of another swap or [security-based swap](#) (SBS) position, unless that other position itself is used to hedge or mitigate commercial risk.

([17 C.F.R. § 50.50\(c\)\(2\)](#).)

How Parties to an Eligible Swap May Elect to Use the Exception

If at least one of the parties to the swap is eligible for the end-user exception, the parties to the swap elect to make use of the exception by reporting the following information to a [swap data repository](#) (SDR), or if no SDR is available, to the CFTC:

- Notice of election to use the end-user exception.
- The identity of the counterparty that is eligible to elect the end-user exception.

(17 C.F.R. § 50.50(b)(1)(i), (ii).)

This information must be reported by the reporting counterparty on a [swap-by-swap basis](#) (77 Fed. Reg. at 42565). The reporting counterparty for the swap must report this information electronically to a registered SDR or the CFTC (for details on which is the reporting party to a swap, see [US Derivatives Regulation: Practical Guide to Over-the-Counter \(OTC\) Swap Data Reporting: Box, Which Is the Reporting Party?](#)).

The election also requires the reporting of certain information that the CFTC uses to monitor compliance with, and prevent abuse or evasion of, the end-user exception. This information may be provided to the CFTC [either in an annual filing by the electing counterparty or on a swap-by-swap basis by the reporting counterparty](#) (17 C.F.R. § 50.50(b)(1)(iii), (2)). Specifically, the reporting counterparty must report:

- Whether the electing counterparty is:
 - a financial entity eligible for the exception as a captive financial company (7 U.S.C. § 2(h)(7)(C)(iii));
 - a financial entity eligible for the exception as an affiliate of a non-financial entity (7 U.S.C. § 2(h)(7)(D)); or
 - a small financial institution exempt from the definition of financial entity (17 C.F.R. § 50.50(d).)

(See [Exempt Financial Entities](#).)

- Whether the swap for which the exception is being elected is being used to hedge or mitigate commercial risk (see [Definition of "Hedging or Mitigating Commercial Risk"](#)).
- How the electing counterparty generally meets its financial obligations associated with entering into uncleared swaps, by identifying one or more specific categories listed in the regulations.
- Whether the electing counterparty is an [SEC Section 15\(d\) filer](#) and, if so:
 - the electing counterparty's relevant SEC Central Index Key number; and
 - whether its board of directors has approved generally the decision to enter into swaps that are excepted from Title VII clearing and exchange-trading requirements (see [US Derivatives Regulation Commercial End-User Exception Corporate Governance Checklist](#)).

(17 C.F.R. § 50.50(b)(1)(iii).)

The final rule requires that counterparties indicate through real-time public reporting under CFTC Regulations Part 43 to an SDR that the end-user exception has been elected (17 C.F.R. §§ 43.2 and 43.4(b); 77 Fed. Reg. at 42565 to 42566).

The final rules do not include a CFTC approval process for a counterparty's election of the end-user exception. However, a potential electing counterparty must meet the notification and reporting requirements specified in the rule in order to be eligible to elect the exception (77 Fed. Reg. at 42570).

End-User Exception Documentation

Note that, for any swap claimed to be excepted from mandatory clearing requirements, SDs and MSPs must obtain documentation sufficient to provide a reasonable basis on which to believe that its counterparty meets the statutory conditions required for an exception from the clearing requirement (17 C.F.R. § 23.505(a)). For more details, see [Practice Note, US Derivatives Regulation: Internal Business Conduct \(IBC\) Rules for Swap Dealers and MSPs: End-User Exception Documentation](#).

"Onboarding" for the End-User Exception

The final rules also do not specifically state how notification should be reported to an SDR. However, the [Depository Trust & Clearing Corporation](#) (DTCC) has developed a user-friendly, check-the-box online form (also referred to as "onboarding") allowing reporting counterparties to report election of the end-user exception, as well as the required information noted above. Electing counterparties may gain access to the onboarding system by e-mailing the DTCC at gtr-onboarding@dtcc.com.

DTCC provides two methods of onboarding for the end-user exception:

- The electing counterparty can complete a "light," read-only onboarding. This type of on-boarding allows the electing counterparty to review swap position reports and other swap information for which the electing counterparty is a counterparty; or
- The electing counterparty can complete a "full" onboarding, which allows the electing counterparty access to all reports and reporting connectivity.

Onboarding allows the annual submission of the end-user exception. Each electing counterparty should complete and return an Annual End-User Clearing Exception Form; otherwise, all required information must be reported by the reporting counterparty.

For a helpful link to the Annual End-User Clearing Exception Form and instructions for Dodd-Frank registered SDRs, see the [DTCC Data Repository Annual End-User Clearing Exception Form](#).

Exception Extends to Exchange Trading

The Title VII mandatory exchange-trading requirement requires that all swaps that have been made available to trade (MAT) and that are subject to the mandatory clearing requirement be traded on a [swap execution facility](#) (SEF) or [designated contract market](#) (DCM) ([7 U.S.C. §§ 7 and 7b-3](#)). Section 2(h)(7) of the CEA, which codifies the end-user exception, states that any eligible entity using swaps to hedge a legitimate business risk can ignore the mandatory clearing requirement of CEA Section 2(h)(1) ([7 U.S.C. § 2\(h\)\(1\), \(7\)](#)). Since the mandatory exchange-trading requirement under Section 2(h)(8) of the CEA only applies to swaps that are subject to mandatory clearing, if the end-user exception relieves the clearing requirement, it also must relieve the trade-execution requirement ([7 U.S.C. § 2\(h\)\(8\)](#)).

For information on which swaps are subject to mandatory Title VII clearing requirements under CEA Section 2(h)(1), see [Practice Note, US Derivatives Regulation: Swap Clearing and Exchange Trading: CFTC Swap Clearing Determinations](#).

For information on which swaps are subject to mandatory exchange trading under CEA Section 2(h)(8), see [Practice Note, US Derivatives Regulation: Swap Clearing and Exchange Trading: CFTC Made-Available-to-Trade \(MAT\) Determinations](#).

Note that these essentially overlap in their entirety.

Compliance Dates and Other Aspects of the Rules

In 2009, the [G-20](#) leaders made a commitment that all standardized derivatives would be cleared and traded on exchanges or electronic trading platforms, where appropriate, by the end of 2012. In the US, this commitment is reflected in Title VII of the Dodd-Frank Act. While US regulators (and all other global regulators) missed this deadline, mandatory clearing and exchange trading under Title VII is now underway in the US. Certain [interest rate swaps](#) (IRS) and [credit default swaps](#) (CDS), became subject to the mandatory Dodd-Frank Title VII clearing requirement on March 11, 2013 (see [Legal Update, Final Clearing Determination for CDS and Interest Rate Swaps Issued by CFTC](#)). This first date applied to swaps between two "Category 1 Entities": SDs, MSPs, and/or active funds (200 trades per month).

Mandatory clearing began on June 10, 2013 for these IRS and CDS when entered into between two Category 2 Entities or between a Category 1 Entity and a Category 2 Entity. Category 2 Entities are commodity pools, hedge funds (other than active funds), and persons predominantly engaged in activities that are in the business of banking or in "activities that are financial in nature," excluding accounts managed by third-party investment managers.

Mandatory clearing began on September 9, 2013 for these IRS and CDS when entered into by a Category 3 Entity. Category 3 Entities are ERISA plans, accounts managed by third-party investment managers, and non-financial commercial end users.

The final rules clarify that once a swap is entered into, any decision to change the clearing status of the swap is a contractual matter between the two parties to the transaction ([77 Fed. Reg. at 42581](#)).

The commercial end-user exception applies only to the clearing of [non-security-based swaps](#). The [Securities and Exchange Commission](#) (SEC) has proposed a corollary exemption for end users of SBS ([75 Fed. Reg. 79992 \(Dec. 21, 2010\)](#)); see [Legal Update, SEC Proposes Corollary End-User Exemption from Mandatory Swap Clearing Under Dodd-Frank](#)), but it is not yet effective as no SBS are yet subject to mandatory clearing under Title VII.

Title VII makes it a criminal offense to "abuse" the end-user exception ([17 C.F.R. § 50.10](#)).

Considerations for End Users

Clearing provides certain protections for end-user counterparties because the clearinghouse eliminates counterparty risk. While banks and broker-dealers with which end users are likely to enter into swaps are generally creditworthy, the financial crisis showed that no counterparty is immune from default in times of financial distress.

However, as a practical matter, cleared swaps are often comparatively more expensive for the bank or dealer, and therefore for the end-user counterparty to which this expense is passed on, than non-cleared swaps. The end user will therefore need to make a commercial determination as to the added value to it of clearing the swap against the added cost.

For more information on commercial end users of derivatives under the Dodd-Frank Act, see [Practice Note, Summary of the Dodd-Frank Act: Swaps and Derivatives: Non-Financial Commercial End Users](#).

Relief from Clearing Requirement for Banks and S&Ls with \$10 Billion or Less in Assets

On August 23, 2018, the CFTC issued a proposed rule (2018 Proposed Clearing Exemption) that would extend relief from mandatory swap clearing requirements under Part 50 of the CFTC's regulations to certain swap transactions entered into by:

- Bank holding companies (BHCs) with \$10 billion or less in consolidated assets.
- Savings and loan (S&L) holding companies with \$10 billion or less in consolidated assets.

([83 Fed. Reg. 44001 \(Aug. 29, 2018\)](#))

This limitation on asset size mirrors the limitation found in the end-user exception. This exception would be available only to swaps that are:

- Reported to a SDR under CFTC Regulations 45.3 and 45.4 ([17 C.F.R. §§ 45.3 and 45.4](#)); and
- Used to hedge or mitigate commercial risk.

([83 Fed. Reg. at 44005 to 44006](#).)

For more information, see [Legal Update, CFTC Approves Proposal to Relax Swap Clearing Requirement for Banks with \\$10 Billion or Less in Consolidated Assets and Certain Other Parties](#).

Relief for CDFIs

The 2018 Proposed Clearing Exemption would also extend relief from mandatory swap clearing requirements under Part 50 of the CFTC's regulations to swaps entered into by a community development financial institution (CDFI) provided that all of the following criteria are satisfied:

- The CDFI reports the swap to a SDR under swap data recordkeeping and reporting requirements (CFTC Regulations 45.3 and 45.4 ([17 C.F.R. §§ 45.3 and 45.4](#))) and reports all information regarding how the electing counterparty meets its financial obligations associated with swaps that are not subject to the clearing requirement to a swap data repository.
- The swap is a US dollar-denominated interest rate swap in either the fixed-to-floating class or the forward rate agreement (FRA) class of swaps that would otherwise be subject to the clearing requirement under CFTC Regulation 50.2 ([17 C.F.R. § 50.2](#)).
- The total aggregate notional value of the interest rate swaps and FRAs entered into during the 12-month calendar year is less than or equal to \$200 million.
- The swap is one of ten or fewer swap transactions that the CDFI enters into within a 12-month calendar year.

([83 Fed. Reg. at 44006 to 44007](#).)

For more information, see [Legal Update, CFTC Approves Proposal to Relax Swap Clearing Requirement for Banks with \\$10 Billion or Less in Consolidated Assets and Certain Other Parties](#).

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