

US Derivatives Regulation Commercial End-User Exception Corporate Governance Checklist USA (National/Federal)

Related Content

A checklist of conditions to be satisfied and corporate governance items to be considered by companies looking to take advantage of the commercial end-user exception from Dodd-Frank swap clearing and exchange trading under Title VII.

Title VII of the [Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010](#) (Dodd-Frank Act), and [Commodity Futures Trading Commission](#) (CFTC) rules promulgated thereunder, require that swap counterparties clear certain swaps at a clearinghouse and execute them on a registered facility or exchange ([7 U.S.C. § 2\(h\)\(1\), \(8\)](#); [17 C.F.R § 50.2](#); see [Practice Note, Summary of the Dodd-Frank Act: Swaps and Derivatives: Swap Clearing and Exchange Trading Under Title VII](#)).

However, in recognition of the important role that swaps play in mitigating commercial risk, Congress provided, and the CFTC implemented, an end-user exception to these requirements ([7 U.S.C. § 2\(h\)\(7\)](#); [17 C.F.R § 50.50](#)). The end-user exception permits eligible non-financial entities to continue using uncleared swaps to hedge risks associated with their business activities (see [Practice Note, Derivatives Regulation: The Commercial End-User Exception to the Mandatory Swap Clearing Requirement](#)).

There are several requirements that these entities must meet in order to rely on the end-user exception. Public companies must take certain governance steps that involve:

- Board-level approval of the company's use of uncleared swaps.
- Review of company policies on swaps.

To take advantage of the end-user exception, non-financial public companies should complete the steps outlined below, and then repeat these steps annually thereafter.

Non-Financial Commercial End-User Clearing Exception

- Mandatory clearing of most [interest rate swaps](#) and most index [credit default swaps](#) (CDS) began for non-financial entities on September 9, 2013 ([17 C.F.R §§ 50.2 and 50.4](#); see [Swaps and Derivatives Compliance Calendar: September 9, 2013](#) and [Legal Update, Final Clearing Determination for CDS and Interest Rate Swaps Issued by CFTC](#)).
- Before requiring clearing for a category of swaps, the CFTC must propose the determination for public comment and consider any comments. In determining whether to require clearing, the CFTC must consider certain factors, including:
 - trading liquidity;
 - the effect on systemic risk; and
 - the effect on competition.

([7 U.S.C. § 2\(h\)\(2\)](#).)

- Swaps subject to mandatory clearing may also be required to be executed on a facility or exchange ([7 U.S.C. § 2\(h\)\(8\)](#)).
- Swaps that fall under an exception from the mandatory clearing requirement (like the end-user exception) are not subject to Title VII mandatory exchange-trading requirements ([17 C.F.R. § 50.5](#)).
- Non-financial entities generally can rely on the end-user exception for swaps with any counterparty, including external swaps with unaffiliated third parties and internal swaps between affiliates.
- In addition, the CFTC has issued a rule that provides an exemption from mandatory clearing for swaps between eligible affiliates (inter-affiliate swaps) if several conditions are met ([17 C.F.R. § 50.52](#); see [Legal Update, Inter-Affiliate and Certain Other Swaps Exempted from Mandatory Clearing Requirements by CFTC](#)). Specifically:
 - the inter-affiliate swaps exemption is available for swaps with or between counterparties that are majority-owned where the financial statements of both counterparties are filed on a consolidated basis;
 - for public companies, the inter-affiliate clearing exemption includes a requirement of board-level approval that mirrors the approval required for use of the end-user exception (see [Criteria for Relying on the End-User Exception](#)); and
 - non-financial entities generally do not need to rely on the inter-affiliate exemption because they may use the end-user exception, for which it is easier to qualify.

Relief for Swaps Executed Through a Centralized Treasury Unit (CTU)

- The CFTC issued no-action relief to address concerns that non-financial entities that execute swaps through a centralized treasury unit (CTU) such as a treasury subsidiary may not be able to rely on the end-user exception for their external swaps. This is because:
 - a CTU that is a separate legal entity may be treated as a financial entity and, therefore, would not meet one of the key eligibility criteria for a company to rely on the end-user exception -- namely, that a non-financial entity must be a party to the swap (see [Criteria for Relying on the End-User Exception](#)); and
 - the inter-affiliate exemption is not available because it is limited to internal swaps (between affiliates) and therefore would not extend to swaps between a CTU and a third party.
- To address these concerns, on June 4, 2013 the CFTC issued [No-Action Letter 13-22](#), which was superseded on November 26, 2014 by [CFTC No-Action Letter 14-144](#). These letters permit CTUs at non-financial entities to avoid the mandatory swap-clearing requirement if several conditions are met (see [Legal Updates, Certain Affiliate Financial Entity Transactions Exempted from Mandatory Clearing by CFTC](#) and [CFTC Expands Dodd-Frank Clearing Exemption for Treasury Affiliates](#)).
- Among other things, to qualify for the no-action relief:
 - the CTU must be wholly owned directly by a non-financial entity or another eligible treasury affiliate;
 - the CTU's ultimate parent company must be a non-financial entity; and
 - the CTU cannot trade on behalf of any financial affiliates.
- Entities executing swaps through a CTU that are not eligible to take advantage of this relief are subject to the clearing requirements applicable to financial entities, which took effect June 10, 2013.

Criteria for Relying on the End-User Exception

In order to rely on the end-user exception for a swap, a company must meet all of the following criteria as set out in CFTC Regulation 50.50:

- It is not a financial entity, as defined in Section 2(h)(7)(C)(i) of the [Commodity Exchange Act](#) ([7 U.S.C. § 2\(h\)\(7\)\(C\)\(i\)](#)).
- It is using a swap to hedge or mitigate commercial risk, as defined in CFTC Regulation 50.50(c) ([17 C.F.R. § 50.50\(c\)](#)).
- It generally meets its financial obligations associated with entering into uncleared swaps.
- It takes certain governance steps if it is a public company—specifically, if it is a reporting issuer, which is:
 - an issuer of securities registered under Section 12 of the [Securities Exchange Act of 1934](#) (Exchange Act) ([15 U.S.C. § 78l](#)); or

- required to file reports under Section 15(d) of the Exchange Act ([15 U.S.C. § 78o\(d\)](#)).
- It reports the information described above to a swap data repository (SDR), or to the CFTC if no SDR is available, through an annual filing that would cover swap transactions taking place over the upcoming year. While most companies are expected to make the annual filing, CFTC rules offer the option of reporting the required information on a swap-by-swap basis, along with other information that must be reported in connection with every swap transaction. In that situation, typically the swap dealer (not the end user) will report the information.

([17 C.F.R. § 50.50](#).)

Governance Steps

For companies that are otherwise eligible to rely on the end-user exception and that are reporting issuers (see [Criteria for Relying on the End-User Exception](#)), the governance steps that are a pre-requisite for relying on the exception are:

- The board (or an appropriate committee of the board) must review and approve the company's use of uncleared swaps. The approval must authorize the company to enter into swaps that will not be cleared and will not be executed on a facility or exchange, due to the company's intention to rely on the end-user exception. In its commentary accompanying the release of the rules governing the end-user exception ([77 Fed. Reg. 42560](#)), the CFTC indicated that:
 - a committee is appropriate only if it is "specifically authorized to review and approve the ... decision to enter into swaps";
 - board or committee approval can be effected on a general basis, and if done on a general basis, it must occur at least annually because public companies must include confirmation of the approval each year as part of the annual filing (see [Criteria for Relying on the End-User Exception](#));
 - approval also can be obtained on a swap-by-swap basis and reported to an SDR in connection with each swap transaction;
 - the review/approval requirement applies to the reporting issuer and to any entities controlled by the issuer; and
 - the reporting issuer's board "would have reasonable discretion to determine the appropriate committee for approving decisions on swaps for its subsidiaries or affiliates."

([77 Fed. Reg. at 42569](#).)

- The board or committee must set appropriate policies governing the use of swaps subject to the end-user exception and review these policies at least annually or more often if there is a significant change in the policies (such as implementing a new hedging strategy that was not contemplated in the original board or committee approval).

Companies can comply with this requirement by having the board or committee review and discuss with management policies that management has developed on the use of swaps. This review and discussion can occur as part of the process of approving the company's use of uncleared swaps. The review and discussion regarding policies should include:

- verifying the company has written policies in place on the use of swaps and if not, it should review its existing practices and document them; and
- the company's policies should address the types of swaps for which the company may rely on the end-user exception, although companies may wish to adopt broader policies that address their use of swaps more generally.

While the CFTC has not issued guidance on what should be addressed in these policies, it is anticipated that these policies will vary based on a company's circumstances, including the type of company and the reasons it uses swaps.

How Reporting Issuers May Take Advantage of the End-User Exception

Reporting issuers that intend to rely on the end-user exception should:

- Make the annual filing to the SDR prior to entering into any swaps for which it would like to invoke the end-user exception (see [Criteria for Relying on the End-User Exception](#)).
- When making the annual filing, include information about the board or committee approval (the approval should be done before the filing).

Such reporting issuers should also consider taking the following steps:

- Confirm whether the company:
 - intends to rely on the end-user exception;
 - has, or is in the process of developing, written policies on the use of swaps; if the company does not have written policies, it should prepare a policy that documents how it uses swaps, with a particular focus on swaps subject to the end-user exception.
- Brief the board of directors on the end-user exception, including developing and discussing recommendations on how the board should:
 - oversee this area; and
 - grant required approvals.

These recommendations should involve consideration of whether to perform the oversight function at the board level or through a board committee. For example, this oversight function could be undertaken by the audit committee or the finance committee if the board has one.

- Decide whether the board or committee approvals will occur on a general basis at least annually or on a swap-by-swap basis. This decision depends primarily on the nature of the company's swaps activities. Annual approval will likely be the preferred course of action for companies doing multiple transactions each year in swaps that are subject to the clearing requirements.
- If the company conducts swaps activities through subsidiaries or affiliates, or both, consider whether to conduct the necessary review/approval at:
 - the parent company level (that is, through the board or a board committee of the reporting issuer); or
 - at the subsidiary/affiliate level.

Depending on a company's swaps activities, corporate structure, and governance practices, a company may determine that parent company approval on behalf of any subsidiaries is appropriate.

- If a committee of the board will oversee matters relating to the end-user exception, grant the necessary authority to the committee. Accordingly, the board should consider:
 - amending the committee charter to delegate this authority to the committee along with the authority to review and discuss policies on the company's use of swaps (there is no requirement to cover this in the charter, but doing so would confirm the committee's authority); or
 - adopting resolutions giving the committee this authority.
- Brief the board or responsible committee on company policies on:
 - the use of swaps (and, in particular, swaps subject to the end-user exception); and
 - the categories of swaps for which the company plans to rely on the end-user exception.

Ideally, this briefing should occur before or in connection with the first approval to enter into uncleared swaps so that directors have sufficient information to make an informed decision.

- Update board or committee calendars and agendas to include an annual review of company policies on the use of swaps and approval to enter into uncleared swaps if that approval will be done annually.
- The board or responsible committee should develop an understanding with management about the types of significant changes and the use of swaps that would trigger board or committee review of the company's swaps policies outside the annual cycle.

For further details on the end-user clearing exception, see [Practice Note, US Derivatives Regulation: The Commercial End-User Exception to the Mandatory Swap Clearing Requirement](#).

For further information on the obligations of commercial end users electing the clearing exception, see also [Standard Document, The ISDA Master Agreement: Dodd-Frank Amendment for End-User Swaps, Drafting Notes, Commercial End-User Clearing Exception, Reporting in Connection with the End-User Clearing Exception](#), and [End-User Exception Annual Report](#).

PRODUCTS

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