

Dodd-Frank Update: How to Qualify for the End-User Exception to the Mandatory Clearing Requirement

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On September 9, 2013, many interest rate swaps and credit default swaps entered into by non-financial commercial end-users became subject to the mandatory clearing requirement imposed by Title VII of the Dodd-Frank Act. However, if you are a non-financial company that utilizes swaps to hedge and mitigate commercial risk, there is an exception to the mandatory clearing requirement called the "end-user exception." Virtually every entity that qualifies has elected the exception since the process of clearing swaps can be complicated and very expensive. Electing the exception can therefore save a lot of time and resources. This article outlines 1) the criteria necessary to determine whether you qualify as an "end-user," and 2) the steps necessary to elect the end-user exception.

I. Is Your Company an End-User?

In order to qualify as an end-user, your company must meet the following conditions.

1. It is not a "financial entity" as defined in Section 2(h)(7)(C)(i) of the Commodity Exchange Act. The term "financial entity" includes swap dealers, major swap participants, commodity pools, employee benefit plans, and banks that have total assets greater than \$10 billion. Banks that have total assets under that amount qualify for the end-user exception, even if their larger parent bank holding company may not. Captive finance companies meeting certain thresholds may qualify, as well.
2. It uses a swap to hedge or mitigate commercial risk, as defined under CFTC Regulation 50.50(c). In order to constitute "hedging," the swap must be a) used to reduce the overall risk of market fluctuation, b) consistent with the company's overall hedging and risk mitigation strategies, and c) entered into by the company at the time a position is first executed.
3. It generally meets its financial obligations associated with entering into uncleared swaps.
4. It takes certain governance steps if it is a public company (see Part II).
5. It reports the information described in steps 1-4 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. See Part II for more information about this filing.

II. How Does Your Company Elect the Exception?

1. If you are a public, SEC reporting company, there are certain corporate governance requirements that you must first follow.

(a) The board, or an "appropriate committee" of the board, must review and approve the company's use of uncleared swaps. The approval, which may be in the form of a resolution, must authorize the company to enter into swaps that will not be cleared and will not be executed on a facility or exchange. A committee is "appropriate" only if it is specifically authorized to review and approve the decision to enter into swaps. Therefore, if the committee does not currently have that authority, then it must be authorized either by amending the committee charter or adopting resolutions to give the committee the authority.

(b) Board or committee approval can be affected on an annual basis because public companies must include confirmation of the approval each year as part of the annual filing. Approval also can be obtained on a swap-by-swap basis and reported to an SDR in connection with each swap transaction.

(c) The review/approval requirement applies to the reporting issuer and to any entities controlled by the issuer, including non-reporting subsidiaries. The reporting company's board has reasonable discretion to determine the appropriate committee for approving decisions on swaps for its subsidiaries or affiliates.

(d) The board or committee must "set appropriate policies" governing the use of swaps subject to the end-user exception and review the policies annually, or more often if there is a significant change in management's policy towards its swap trading strategy. Companies can comply with this requirement by having the board or committee review and discuss with management its swap policies.

(e) The board should 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 applicable. Additionally, the board or responsible committee should stay in contact with management regarding any significant changes that occur in its trading strategy which might alter its hedging strategy.

2. Complete and file the "Annual End-User Clearing Exception Form" with the Depository Trust & Clearing Corporation (DTCC). This form requires you to make several representations that are necessary to confirm your status as an end-user. First, you must confirm that your company is not a "financial entity." Second, you must state that your company enters into swaps in order to hedge or mitigate commercial risk. Third, you must state how your company meets its financial obligations associated with entering into uncleared swaps. Options include written credit support agreements, pledged assets, guarantees from other parties, as well as your own company's available financial resources. Finally, if you are a public reporting company, you must represent that an appropriate committee of your board of directors, or the board itself, has reviewed and approved the decision to enter into uncleared swaps. An authorized signatory of your company must then sign and certify the accuracy of the foregoing information.

III. What To Do Next

If you have not already done so, it is not too late to elect the end-user exception for future swaps. Barley Snyder has completed this process for several clients, including publicly traded companies and small banks that qualify, and has drafted sample resolutions that your board may tailor to its specific needs. If you plan on executing a swap in the future and have not already taken the steps necessary to elect the end-user exception, please feel free to contact us.

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