DATE: June 15, 2016

MEMORANDUM TO: Board of Directors

FROM: Doreen R. Eberley, Director
Division of Risk Management Supervision

SUBJECT: Final Rule Addressing Public Comments Received on Interim Final Rule That Exempts Commercial End Users and Small Financial Institutions From Swap Margin Requirements

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Recommendation: Staff recommends that the FDIC Board of Directors ("Board") approve the attached notice of final rulemaking entitled "Margin and Capital Requirements for Covered Swap Entities" ("final rule") and authorize the document to be published in the Federal Register.

The final rule adopts exemptions from swap margin requirements for commercial end users and certain captive finance affiliates and treasury affiliates, as well as certain cooperatives and small financial institutions. The exemptions were first adopted by interim final rule published in the Federal Register in November 2015 with a request for public comment. The preamble of the attached document discusses the comments received, and the document adopts the earlier interim final rule as a final rule without change.

The final rule was developed jointly by staff from the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Farm Credit Administration, and the Federal Housing Finance Agency (collectively, the "Agencies").

Concur:

Charles Yi
General Counsel

DISCUSSION

I. Background

Title VII of the Dodd-Frank Act establishes a new regulatory regime for swaps and security-based swaps (collectively, "swaps").[1] Swaps that are sufficiently standardized are required to be cleared through a clearinghouse. Dealers and major participants in swaps that lack sufficient standardization for clearing are required to register with the Commodity Futures Trading Commission (CFTC) or Securities and Exchange Commission (SEC), as applicable, if their swap activities meet certain criteria and exceed certain thresholds. (Such a dealer or major participant is referred to in this memorandum as a "swap entity.")

Sections 731 and 764 of the Dodd-Frank Act charge the Agencies with establishing margin and capital requirements for a swap entity that is supervised by one of the Agencies. (Such an entity is referred to in this memorandum as a "covered swap entity.")[2] Similarly, the CFTC and SEC, as applicable, are charged with establishing margin and capital requirements for swap entities that are not supervised by one of the Agencies.

On January 12, 2015, President Obama signed into law the Terrorism Risk Insurance Program Reauthorization Act (TRIPRA).[3] Section 302 of TRIPRA amends sections 731 and 764 of the Dodd-Frank Act to provide that the initial and variation margin requirements do not apply to certain transactions of specified counterparties that would qualify for an exemption from clearing. Section 303 of TRIPRA requires the Agencies to implement section 302 by promulgating an interim final rule pursuant to which public comment is sought before a final rule is issued.

On November 30, 2015, the Federal Register published a joint final rule of the Agencies adopting margin and capital requirements for non-cleared swaps (swap margin requirements).[4] The swap margin requirements generally requires covered swap entities to exchange initial margin in swaps with other swap entities and with financial end users that have material swap

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1 Pub. L. 111-203, 124 Stat. 1376 (2010). "Swaps" are defined in the CEA to include interest rate swaps, foreign exchange swaps, commodity-based swaps, and broad-based credit swaps. "Security-based swaps" are defined in the Exchange Act to include single-name and narrow-based credit swaps and equity-based swaps.

2 7 U.S.C. 6s(e)(2)(A); 15 U.S.C. 78o-10(e)(2)(A).

3 Pub. L. 114-1, 129 Stat. 3 (2015).

4 80 FR 74840 (November 30, 2015).

exposure. The swap margin requirements also requires a covered swap entity to exchange variation margin in all swaps with other swap entities or with financial end users.

Also on November 30, 2015, the Agencies published and sought comment on an interim final rule to implement the TRIPRA exemption.[5] The interim final rule amended swap margin requirements to exclude from their coverage certain non-cleared swaps and non-cleared security-based swaps of counterparties covered by section 302 of TRIPRA.

II. Types of Entities Covered by the TRIPRA Exemption

Below is a discussion of each type of entity covered by the exemption provided by section 302 of TRIPRA.

A. Non-financial entities.

TRIPRA provides that the swap margin requirements shall not apply to a non-cleared swap in which a counterparty qualifies for an exception under section 2(h)(7)(A) of the Commodity Exchange Act or a non-cleared security-based swap in which a counterparty qualifies for an exception under section 3C(g)(1) of the Securities Exchange Act. Section 2(h)(7)(A) and section 3C(g)(1) except from clearing swaps or security-based swaps where one of the counterparties: (1) is not a financial entity; (2) is using the swap to hedge or mitigate commercial risk; and (3) notifies the CFTC or SEC how it generally meets its financial obligations associated with entering into non-cleared swaps. A number of different types of counterparties may qualify for an exception from clearing under section 2(h)(7)(A) and section 3C(g)(1), including non-financial end users and small banks, savings associations, Farm Credit System institutions, and credit unions. In addition, captive finance companies qualify for an exception from clearing swaps under section 2(h)(7)(A).

Commercial end users. A counterparty that is not a financial entity (sometimes referred to as "non-financial end users" or "commercial end users") and that is using swaps to hedge or mitigate commercial risk generally qualifies for an exception from clearing under section 2(h)(7)(A) or section 3C(g)(1) and thus, under section 302 of TRIPRA, from the swap margin requirements.

Small banks, savings associations, Farm Credit System institutions, and credit unions. The definition of "financial entity" in section 2(h)(7)(C)(ii) provides that the CFTC shall

[5] 80 FR 74916 (November 30, 2015).

consider whether to exempt small banks, savings associations, Farm Credit System institutions, and credit unions with total assets of $10 billion or less. Pursuant to this authority, the CFTC has exempted small banks, savings associations, Farm Credit System institutions, and credit unions with total assets of $10 billion or less from the definition of "financial entity," thereby permitting these institutions to avail themselves of the clearing exception when they are using swaps to hedge or mitigate risk. As a result, non-cleared swaps used by these small financial institutions to hedge or mitigate commercial risk would also qualify for an exemption from the swap margin requirements.

Similarly, section 3C(g) provides that the SEC shall consider whether to exempt small banks, savings associations, Farm Credit System institutions, and credit unions with total assets of $10 billion or less. If the SEC were to implement an exclusion for such entities from clearing, non-cleared security-based swaps with those entities would be eligible for the exemption from the swap margin requirements, provided they met the other requirements for the clearing exemption.

Captive finance companies. Section 2(h)(7)(C) also provides that the definition of "financial entity" does not include an entity whose primary business is providing financing and uses derivatives for the purposes of hedging underlying commercial risks relating to interest rate and foreign exchange 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 ("captive finance company"). These entities can qualify for a clearing exception when they are using swaps to hedge or mitigate commercial risk and thus non-cleared swaps of these entities would be eligible for the exemption from the swap margin requirements.

B. Treasury affiliates.

Section 302 of TRIPRA provides that the swap margin requirements shall not apply to a non-cleared swap or non-cleared security-based swap in which a counterparty satisfies the criteria in section 2(h)(7)(D) of the Commodity Exchange Act or section 3C(g)(4) of the Securities Exchange Act. At the time the interim final rule was published, these sections provided that, where a person qualifies for an exception from the clearing requirements, an affiliate of that person (including an affiliate predominantly engaged in providing financing for the purchase of the merchandise or manufactured goods of the person) may qualify for the

exception as well, but only if the affiliate is acting on behalf of the person and as an agent and 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 ("treasury affiliate acting as agent"). Under the interim final rule, non-cleared swaps and non-cleared security-based swaps of a treasury affiliate acting as agent that met the requirements for a clearing exemption would also be eligible for an exemption pursuant to § __.1(d) from the joint final rule.

The Consolidated Appropriations Act, 2016 ("Appropriations Act of 2016"), which was enacted on December 18, 2015, amended section 2(h)(7)(D) of the Commodity Exchange Act and section 3C(g)(4) of the Securities Exchange Act. Specifically, section 705 of the Appropriations Act of 2016 removed the requirement that treasury affiliates must act on behalf of a person and as an agent in order to avail themselves of the clearing exception. The Appropriations Act of 2016 also included certain conditions on the application of the treasury affiliate exception and imposed certain limitations on the types of entities that can qualify for the exception.

Because the exemption in the final rule incorporates the treasury affiliate exception by reference to section 2(h)(7)(D) of the Commodity Exchange Act and section 3C(g)(4) of the Securities Exchange Act, the exemption will by operation of law apply to qualifying non-cleared swaps and non-cleared security-based swaps of treasury affiliates, acting as either principal or agent. No changes to the regulatory text were necessary to reflect these changes to the underlying statutes.

C. Certain cooperative entities.

Section 302 of TRIPRA provides that the initial and variation margin requirements shall not apply to a non-cleared swap in which a counterparty qualifies for an exemption issued under section 4(c)(1) of the Commodity Exchange Act from the clearing requirements of section 2(h)(1)(A) of the Commodity Exchange Act for cooperative entities as defined in such exemption. The CFTC, pursuant to its authority under section 4(c)(1) of the Commodity Exchange Act, adopted a regulation that allows cooperatives that are financial entities to elect an exemption from mandatory clearing of swaps that: (1) they enter into in connection with originating loans for their members; or (2) hedge or mitigate commercial risk related to loans or swaps with their members, or arising from certain swaps with members. The swaps of these

cooperatives that would qualify for an exemption from clearing also would qualify for an exemption from the swap margin requirements.

III. Summary of Public Comments on Matters Raised in the Interim Final Rule.

Three banking organizations, two individuals, two trade associations, and one nonprofit finance cooperative submitted comments in response to the interim final rule. Four of the commenters expressed strong support for the approach taken in the interim final rule.

Comments were received from two public sector entities organized under foreign laws whose obligations are guaranteed by foreign governments. These commenters argued that, even though they are not included among the type of entities expressly covered by section 302 of TRIPRA, entities such as these should still not be subject to the joint final rule because the CFTC has determined that these types of entities are not subject to the mandate to clear swaps that are otherwise required to be cleared.

Staff recommends that the FDIC not provide the relief requested by these commenters. Section 731 and 764 require the Agencies to adopt margin requirements for all non-cleared swaps and non-cleared security-based swaps, and section 302 of TRIPRA narrows the scope with respect to certain transactions entered into by entities covered by section 302. Even though the CFTC has interpreted the CEA to exempt certain foreign public sector entities from the clearing mandate that the Dodd-Frank added to the CEA, such entities are not covered by section 302 of TRIPRA.[6]

One commenter asked for clarification that swap transaction documentation that contains "flip clauses" or "rating agency condition" ("RAC") provisions cannot qualify for an exemption from the Agencies' joint final rule or this final rule.[7] Specifically, the commenter stated that Title III of TRIPRA does not exempt a swap with a flip clause or RAC provision from the

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[6] Alternatively, each of these two foreign public sector entities sought clarification that it meets the definition of "sovereign entity" or "multilateral development bank" under the joint final rule. The joint final rule expressly excludes from the definition of "financial end user" an entity that meets the definition of "sovereign entity" or "multilateral development bank." Whether an entity meets the definition of "sovereign entity" or "multilateral development bank" depends on facts and circumstances that may vary from entity to entity and is outside the scope of this rule-making.

[7] The commenter has previously referred to a description of a "flip clause" as a contractual provision in a swap to which a structured finance vehicle (SPV) is a party and under which the payments owed by the SPV to a swap provider are at least *pari passu* with interest of the senior most class of debt issued by the structured finance vehicle. In the description that the commenter referred to, a "flip clause" was described as provision that provides that should the swap provider be the defaulting party to a swap, such default causes the swap provider to "flip" to a more junior position in the priority of payments.

margin requirements of the joint final rule. The commenter further requested that an entity covered by section 302 of TRIPRA that seeks an exemption from the swap margin requirements be required to file with the CFTC a signed affidavit stating that all swaps that not being subject to the swap margin requirements because of section 302 of TRIPRA do not have a flip clause or any other clause that can be reasonably classified as a walk-away provision or RAC provision. Finally, the commenter recommended that the prudential regulators should obligate a covered swap entity to post initial margin and variation margin to its guarantor or hedging affiliate against a swap that contains a "flip clause" or any other clause that can be reasonably classified as a walk-away provision. Staff recommends that the FDIC decline to make the requested changes, since the purpose of the final rule is to incorporate the terms of section 302 of TRIPRA, and the treatment of flip clauses is not specified by section 302.

The Agencies received one request for clarification with respect to paragraph (1)(xi) of the definition of "financial end user" set forth in the joint final rule. Specifically, the commenter asked the Agencies to clarify and consider the use of certain terms and phrases (*i.e.*, "investing or trading," "other assets" and "primarily") in this prong of the financial end user definition. While § __.1(d), as adopted in this final rule works in conjunction with the joint final rule, staff view that this comment does not relate to § __.1(d) and thus is outside of the scope of the interim final rule, which implements section 302 of TRIPRA.

The Agencies also received four comments in support of the treatment of certain cooperative entities under the interim final rule. One comment was received from an individual expressing his support for the approach taken in the interim final rule.

IV. Compliance With Eligibility Requirements

The attached document contains guidance on how covered swap entities can document that a counterparty's coverage with the substantive requirements related to the TRIPRA exemptions.

Section 302 of TRIPRA identifies the types of non-cleared swaps or non-cleared security-based swaps with counterparties that are excluded from the margin requirements of the joint final rule by referring to specific sections of the Commodity Exchange Act and the Securities Exchange Act. These provisions, in turn, set forth clearing exemptions and exceptions for these counterparties. To qualify for such exemptions and exceptions, the counterparty must, in

addition to falling within the class or type of entity exempted or excepted by the respective statutory provisions, also be entering into the swap or security-based swap to hedge or mitigate commercial risk, and must report to the applicable Commission how it generally meets its financial obligations associated with entering into non-cleared swaps or non-cleared security-based swaps.[8]

Swaps and Security-Based Swaps Required to be Cleared

For swaps that the CFTC has determined are required to be cleared, the Commission has adopted regulations that establish requirements by which an eligible entity may elect its option not to clear that type of swap and comply with the related substantive hedging and reporting requirements.[9] For such a swap, compliance with the CFTC regulatory requirements for a swap subject to clearing will provide the covered swap entity with sufficient information about the eligible entity and the swap to establish the swap is also exempt from the margin requirements of the joint final rule.[10] The Agencies believe that, whenever a covered swap entity that transacts in a swap subject to a clearing requirement for an entity on an uncleared basis, in compliance with these CFTC requirements, the covered swap entity needs no additional information from the eligible entity to proceed with that swap pursuant to the final rule's exemption from the margin requirements of the joint final rule.

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[8] 7 U.S.C. 2(h)(7)(A); 17 CFR 50.50(b); 15 U.S.C. 3C(g)(4). Other provisions of the Commodity Exchange Act and the Securities Exchange Act separately impose additional governance requirements on an entity that elects a clearing exemption and that is an issuer of securities registered under section 12 of, or that is required to file reports under section 15(d) of, the Securities Exchange Act of 1934. 7 U.S.C. 2(j); 15 U.S.C. 3C(i).

[9] 17 CFR 50.50(b), 50.51(c), 50.51. In addition to providing reporting requirements, these CFTC rules further define the entities that are eligible for exceptions and exemptions from the clearing requirements and define when a swap is used to hedge or mitigate commercial risk.

[10] Whenever a qualifying non-clearing entity has elected its option to not clear a swap that the CFTC has determined should be cleared, the entity's eligibility as well as its compliance with the associated hedging and reporting requirements must be demonstrated either: (1) in an annual filing by the entity reporting to an appropriate Swap Data Repository (SDR) or, if no registered SDR is available to receive the information, to the CFTC, which will be applicable to all such swaps entered into by the entity for 365 days following the date of such filing; or (2) on a swap-by-swap basis through a report filed by the eligible entity or the covered swap entity with the applicable SDR or, if no registered SDR is available to receive the information, the CFTC. The rule requires that the reporting counterparty have a reasonable basis to believe that the electing counterparty is an eligible entity that meets the associated hedging and reporting requirements. *See* 17 CFR 50.50(b)(2)-(3) and 50.51(c).

With respect to security-based swaps, the SEC has not yet made determinations requiring any security-based swap to be cleared, and has not yet adopted final rules related to how eligibility and compliance with the associated substantive requirements can be documented. [11] For such a security-based swap, compliance with the SEC regulatory requirements for a security-based swap subject to clearing, once finalized, will provide the covered swap entity with sufficient information about the eligible entity and the security-based swap to establish the security-based swap is also exempt from the margin requirements of the joint final rule. Until such time as determinations are finalized by the SEC, the Agencies expect that covered swap entities will take appropriate steps to establish a reasonable belief that the entity is of a type eligible for the exemption and is using the swap to hedge or mitigate commercial risk, as described below for other non-cleared swaps.

Swaps and Security-Based Swaps Not Required to be Cleared

There are also cases where an entity may enter into a non-cleared swap or non-cleared security based swap that the CFTC or SEC, respectively, does not require to be cleared. For swaps that are not subject to a CFTC or SEC clearing requirement, the Agencies expect that covered swap entities will take appropriate steps to establish a reasonable belief that the entity is of a type eligible for the exemption and is using the swap to hedge or mitigate commercial risk.[12] The final rule does not prescribe any specific procedure or standard in this regard, and instead leaves covered swap entities the flexibility to collect information specifically on these points, take cognizance of information they already have about their counterparties and their non-cleared swap transactions, or a combination of both. Without specifying any standard, the Agencies

[11] In December 2010, the SEC proposed reporting requirements for a counterparty exercising an exception from clearing, which would require the entity to report to a security-based swap data repository that it is an eligible entity and: that the swap is being used to hedge or mitigate commercial risk; how it generally meets its financial obligations associated with entering into non-cleared security-based swaps, and, if a registered issuer of securities, whether a committee of the board has reviewed and approved the decision to enter into security-based swaps subject to the clearing exception. 75 FR 79992 (December 21, 2010).

[12] As noted above, this category of non-cleared swaps includes all non-cleared security-based swaps during the interim until the SEC adopts final regulations requiring clearing of security-based swaps and associated exemptions from clearing.

believe it would be reasonable for a covered swap entity to rely in good faith on reasonable representations of its counterparty in making these assessments.[13]

In addition to the entity type requirements and the hedging requirements specified in the statutory clearing exemptions and exceptions referenced under section 302 of TRIPRA, there are requirements for reporting to the relevant Commission, in the manner set forth by the Commission, when the clearing exemptions and exceptions are elected. The Agencies expect covered swap entities subject to the joint final rule to comply with reporting requirements that the relevant Commission imposes on covered swap entities in association with the use of the margin exemptions pursuant to section 302 of TRIPRA.

Conclusion:

Staff recommends that the Board approve publication of the attached Notice of Final Rulemaking in the *Federal Register*.

Staff contacts:

Mike Spencer, ext. 87041 Tom Hearn, ext. 86967

Jacob Doyle, ext. 83920

[13] *See* the Agencies notice of final rulemaking for the non-cleared swap and non-cleared security-based swap margin requirements at 80 FR 74858 (November 30, 2015), discussing covered swap entities' reliance in good faith on reasonable representations of a counterparty as to whether the counterparty is a financial end user with a material swaps exposure; *see also* 17 CFR 50.50(b)(2)-(3) and 50.51(c).