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COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 50

RIN 3038-AD47

Clearing Exemption for Swaps Between Certain Affiliated Entities

AGENCY: Commodity Futures Trading Commission.

ACTION: Final rule.

SUMMARY: The Commodity Futures Trading Commission (Commission or CFTC) is adopting regulations to exempt swaps between certain affiliated entities within a corporate group from the clearing requirement under new section 2(h)(1)(A) of the Commodity Exchange Act (CEA or Act), enacted under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The regulations include specific conditions, as well as reporting requirements, that affiliated entities must satisfy in order to elect the inter-affiliate exemption from required clearing.

DATES: The rules will become effective [60 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER].

FOR FURTHER INFORMATION CONTACT: Sarah E. Josephson, Deputy Director, 202-418-5684, sjosephson@cftc.gov; Nadia Zakir, Associate Director, 202-418-5720, nzakir@cftc.gov; Erik Remmler, Associate Director, 202-418-7630, eremmler@cftc.gov; Eric Lashner, Special Counsel, 202-418-5393, elashner@cftc.gov; Meghan Tente, Law Clerk, 202-418-5785, mtente@cftc.gov; Division of Clearing and Risk, Camden Nunery, Economist, 202-418-5723, cnunery@cftc.gov, Office of the Chief

Economist, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581.

SUPPLEMENTARY INFORMATION:

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I. BACKGROUND

On August 21, 2012, the Commission published a notice of proposed rulemaking proposing to exempt swaps between certain affiliated entities from the clearing

requirement under section 2(h)(1)(A) of the CEA (NPRM).[1] As proposed, § 39.6(g) provides that counterparties to a swap may elect an inter-affiliate exemption from the clearing requirement if: (1) the financial statements of both counterparties are reported on a consolidated basis, and either one counterparty directly or indirectly holds a majority ownership interest in the other, or a third party directly or indirectly holds a majority ownership interest in both counterparties; (2) both counterparties comply with the conditions set forth in the proposed rule; and (3) one of the counterparties provides certain information on behalf of both affiliated counterparties to either a registered swap data repository (SDR) or the Commission if a registered SDR does not accept the information. The Commission is hereby adopting proposed § 39.6(g), finalized as § 50.52,[2] subject to the changes discussed below.

Section 723(a)(3) of the Dodd-Frank Act amended the CEA to provide, under new section 2(h)(1)(A) of the CEA, 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.[3] Section 2(h)(2) of the CEA charges the Commission with the responsibility for determining whether a swap is required to be cleared, through one of two means: (1) pursuant to a Commission-initiated

[1] Clearing Exemption for Swaps Between Certain Affiliated Entities, 77 FR 50425 (Aug. 21, 2012).

[2] For ease of reference, the Commission is re-codifying proposed § 39.6(g) as § 50.52 so that market participants are able to locate all rules related to the clearing requirement in one part of the Code of Federal Regulations.

[3] Section 2(h)(7) of the CEA provides an exception to the clearing requirement when one of the counterparties to a swap (i) is not a financial entity, (ii) is using the swap to hedge or mitigate commercial risk, and (iii) notifies the Commission how it generally meets its financial obligations associated with entering into a non-cleared swap.

review; or (2) pursuant to a submission from a DCO of each swap, or any group, category, type, or class of swaps that the DCO "plans to accept for clearing." On November 29, 2012, the Commission adopted its first clearing requirement determination, requiring that swaps meeting the specifications outlined in four classes of interest rate swaps and two classes of credit default swaps (CDS) are required to be cleared.[4]

The Clearing Requirement Determination adopting release provided a specific compliance schedule for market participants to bring their swaps into compliance with the clearing requirement.[5] Swap dealers (SDs), major swap participants (MSPs), and private funds active in the swaps market were required to comply beginning on March 11, 2013, for swaps they enter into on or after that date.[6] Accounts managed by third-party investment managers, as well as ERISA pension plans, have until September 9, 2013, to begin clearing swaps entered 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. With regard to the CDS indices on European corporate names, iTraxx, the Clearing Requirement Determination provided that, if no DCO offered iTraxx for client clearing by February 11, 2013, the Commission would delay compliance for those

[4] Clearing Requirement Determination Under Section 2(h) of the CEA, 77 FR 74284 (Dec. 13, 2012) (hereinafter "Clearing Requirement Determination").

[5] See Clearing Requirement Determination at 74319-21.

[6] The first compliance date for required clearing applies to Category 1 Entities, as defined in § 50.25(a). Swap dealers, major swap participants, and private funds active in the swaps market are defined as Category 1 Entities. Security-based swap dealers and major security-based participants also are included in the definition. However, as the Commission has stated, if a security-based swap dealer or a major security-based swap participant is not yet required to register with the Securities and Exchange Commission (SEC) at such time as the Commission issues a clearing determination, then the security-based swap dealer or a major security-based swap participant would be treated as a Category 2 Entity, as defined in § 50.25(a). See Swap Transaction Compliance Implementation Schedule: Clearing and Trade Execution Requirements under Section 2(h) of the CEA, 76 FR 58186, 58190, n. 38 (Sept. 20, 2011).

swaps until 60 days after an eligible DCO offers iTraxx indices for client clearing. On February 25, 2013, the Commission received notice from ICE Clear Credit LLC that it had begun offering customer clearing of the iTraxx CDS indices that are subject to the clearing requirement under § 50.4(b). In accordance with the timeframe previously set forth by the Commission,[7] the following compliance dates shall apply to the clearing of iTraxx indices: Category 1 Entities: Friday, April 26, 2013; Category 2 Entities: Thursday, July 25, 2013; and all other entities: Wednesday, October 23, 2013.[8]

II. COMMENTS ON THE NOTICE OF PROPOSED RULEMAKING

The Commission received 13 comments during the 30-day public comment period following publication of the NPRM on August 21, 2012, and one additional comment after the comment period ended. The Commission considered each of these comments in formulating the final regulation, § 39.6(g) (finalized as § 50.52).

During the process of proposing and finalizing this rule, the Chairman and Commissioners, as well as Commission staff, participated in informational meetings with market participants, trade associations, public interest groups, and other interested parties. In addition, the Commission has consulted with other U.S. financial regulators including: (i) the SEC; (ii) the Board of Governors of the Federal Reserve System; (iii) the Office of the Comptroller of the Currency; and (iv) the Federal Deposit Insurance Corporation (FDIC). Staff from each of these agencies has had the opportunity to provide oral and/or

[7] Clearing Requirement Determination at 74319-21.

[8] See Press Release, CFTC's Division of Clearing and Risk Announces Revised Compliance Schedule for Required Clearing of iTraxx CDS Indices (Feb. 25, 2013) available at http://www.cftc.gov/PressRoom/PressReleases/pr6521-13.

written comments to this adopting release, and the final regulations incorporate elements of the comments provided.

The Commission is mindful of the benefits of harmonizing its regulatory framework with that of its counterparts in foreign countries. The Commission has therefore monitored global advisory, legislative, and regulatory proposals, and has consulted with foreign authorities in developing the final regulations.

A. Overview of Comments Received

Of the 14 comment letters received by the Commission in response to its NPRM, ten commenters expressed general support for the concept of an inter-affiliate exemption from the clearing requirement.[9] These commenters offered comments addressing the proposed rule generally and comments addressing specific provisions of the proposed rule. Comments addressing specific provisions of the proposed rule are discussed in detail below.

A number of commenters requested a broader exemption with few or no conditions. Cravath and DLA Piper requested that the Commission exempt swaps between affiliates from all clearing, margining, and reporting obligations. The Working Group, Cravath, CDEU, ISDA & SIFMA, DLA Piper, and EEI[10] recommended that the Commission eliminate, simplify or minimize the conditions imposed, or unconditionally

[9] Cravath, Swaine & Moore LLP (Cravath), the Coalition for Derivatives End-Users (CDEU), the Financial Services Roundtable (FSR), Chris Barnard, the Commercial Energy Working Group (The Working Group), the Edison Electric Institute (EEI), The Prudential Insurance Company of America (Prudential), Metropolitan Life Insurance Company (MetLife), the International Swaps and Derivatives Association and Securities Industry and Financial Markets Association, (together, ISDA & SIFMA), and DLA Piper.

[10] EEI commented that "corporate families typically face bankruptcy together" and that it is "unusual for only one member of a corporate group to go bankrupt." EEI also noted that a bankruptcy could cause increased risk to clearinghouses that would face multiple entities going into default at the same time if all affiliates of one corporate group were required to clear their inter-affiliate swaps.

exempt inter-affiliate swaps from clearing. These commenters stated that inter-affiliate swaps pose little or no risk to the U.S. financial system and do not increase the interconnectedness between major financial institutions, particularly if affiliates' financial statements are consolidated for accounting purposes. The Working Group commented that entities use inter-affiliate trades not only to net risk related to market-facing swaps, but also to transfer physical commodity or futures exposure between affiliates for compliance with international tax law, customs, or accounting laws. Similarly, MetLife and Prudential supported the proposed exemption and noted that transactions between affiliates do not present the same risks as market-facing swaps.

ISDA & SIFMA commented that inter-affiliate swaps provide important benefits to corporate groups by enabling centralized management of market, liquidity, capital, and other risks, and allowing affiliated groups to realize associated hedging efficiencies and netting benefits. Imposing mandatory clearing on inter-affiliate swaps, according to ISDA & SIFMA, could compromise the ability of affiliated groups to realize these benefits.[11] ISDA & SIFMA also commented that third parties face no increased risk from inter-affiliate swaps. In their view, the credit risks faced by a third party entering into an uncleared swap with a group member are a function of the group member's entire portfolio of assets and liabilities and other credit factors.

Along the same lines, CDEU commented that non-financial entities typically enter into external swaps with swap dealers and other large banks that typically evaluate the risks of entering into swaps based on the overall creditworthiness of their

[11] ISDA & SIFMA commented that inter-affiliate swaps do not introduce risk into a corporate group, stating, "[b]ecause capital, liquidity and risk allocation decisions, as well as the exercise of default remedies between group members are under unified management, group entities do not face default risk of other group entities, so long as the group as a whole is solvent."

counterparties. These financial entity counterparties, according to CDEU, have the opportunity to review financial statements, the creditworthiness of any guarantor, and a number of other credit-related items. After the credit review, according to CDEU, the counterparties may request credit risk mitigants such as corporate parent guarantees, collateral, and credit-based legal terms.

On the other hand, Americans for Financial Reform (AFR) commented that a wide-ranging exemption for inter-affiliate swaps could create systemic risk and threaten the U.S. financial system. AFR cited a number of reasons for its concern such as: the risk transfer between separate corporate entities; the possibility for financial contagion to be transferred from one part of a large financial institution to different groups within the institution; restrictions on access to affiliate assets across national boundaries; and reduction in volumes at DCOs that could hurt liquidity and risk management. AFR further noted that because the end-user exception is available for non-financial and small financial entities in connection with swaps that hedge or mitigate systemic risk, the inter-affiliate exemption is primarily available for large financial institutions and speculative trades by large commercial institutions with many affiliates.

Better Markets Inc. (Better Markets) also expressed concern that an inter-affiliate exemption could be contrary to Congressional intent, as expressed in the Dodd-Frank Act, if it is not a very narrow and strictly implemented exemption.

Two individual persons commented against the proposed exemption. Steve Wentz requested that the Commission not issue any exemptions because the exemptions "would just open the door to divert trades through that open door to avoid protective

oversight." Aaron D. Small commented that the "unregulated derivatives market has been a disaster for the US and world economy and must be reined in."

Having considered these comments, and the specific comments discussed below, the Commission is adopting the proposed inter-affiliate exemption rule, subject to several important modifications. The Commission recognizes the need for an exemption from clearing for inter-affiliate swaps, but believes it is important to establish certain conditions for entities electing the exemption. In reaching this conclusion, the Commission considered the benefits of clearing as recognized by the fact that Congress included a clearing requirement in the Dodd-Frank Act, against the benefit to market participants of being able to continue entering into inter-affiliate swaps on an uncleared basis. The Commission believes it has reached an appropriate balance by allowing an exemption from required clearing for certain inter-affiliate swaps while imposing necessary conditions on that exemption in order to ensure that all inter-affiliate swaps exempted from required clearing meet certain risk-mitigating conditions.

1. Benefits of clearing and its role in the Dodd-Frank Act.

As the Commission has previously stated,[12] in the fall of 2008, a series of large financial institution failures triggered a financial and economic crisis that led to unprecedented governmental intervention to ensure the stability of the U.S. financial

[12] See Clearing Requirement Determination at 74284-86; Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 FR 41214, 41215-17 (July 12, 2012) (hereinafter "Proposed Cross-Border Interpretive Guidance").

system. The financial crisis made clear that an uncleared, over-the-counter (OTC) derivatives market can pose significant risks to the U.S. financial system.[13]

One of the most significant examples of this risk was the accumulation of uncleared CDS entered into by an affiliate in the AIG corporate group providing default protection on more than $440 billion in bonds, leaving it with obligations that the AIG corporate family could not cover as a result of changed market conditions.[14] As a result of the CDS exposure of this one affiliate, the U.S. Federal government bailed out the AIG corporate group with over $180 billion of taxpayer money in order to prevent AIG's failure and a possible contagion event in the broader economy.[15] While the downfall of AIG was not caused by inter-affiliate swaps, the events surrounding AIG during the 2008 crisis demonstrate how the risks of uncleared swaps at one affiliate can have significant ramifications for the entire affiliated business group.

Recognizing the peril that the U.S. financial system faced during the financial crisis, Congress and the President came together to pass the Dodd-Frank Act in 2010. Title VII of the Dodd-Frank Act establishes a comprehensive new regulatory framework for swaps, and the requirement that certain swaps be cleared by DCOs is one of the cornerstones of that reform. The CEA, as amended by Title VII, now requires a swap to

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[13] See Financial Crisis Inquiry Commission, "The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States," Jan. 2011, at 386, available at http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf ("The scale and nature of the [OTC] derivatives market created significant systemic risk throughout the financial system and helped fuel the panic in the fall of 2008: millions of contracts in this opaque and deregulated market created interconnections among a vast web of financial institutions through counterparty credit risk, thus exposing the system to a contagion of spreading losses and defaults.").

[14] Adam Davidson, "How AIG fell apart," Reuters, Sept. 18, 2008, available at http://www.reuters.com/article/2008/09/18/us-how-aig-fell-apart-idUSMAR85972720080918.

[15] Hugh Son, "AIG's Trustees Shun 'Shadow Board,' Seek Directors," Bloomberg, May 13, 2009, available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aaog3i4yUopo&refer=us.

be cleared through a DCO if the Commission has determined that the swap, or group, category, type, or class of swaps, is required to be cleared, unless an exception to the clearing requirement applies. As noted above, the only exception to the clearing requirement provided by Congress was the end-user exception in section 2(h)(7) of the CEA.[16]

The benefits of clearing derivatives have been recognized internationally, as well. In September 2009, leaders of the Group of 20 (G-20)—whose membership includes the United States, the European Union, and 18 other countries—agreed that: (1) OTC derivatives contracts should be reported to trade repositories; (2) all standardized OTC derivatives contracts should be cleared through central counterparties by the end of 2012; and (3) non-centrally cleared contracts should be subject to higher capital requirements.

The Commission believes that required clearing through a DCO is the best means of mitigating counterparty credit risk and providing an organized mechanism for collateralizing the risk exposures posed by swaps. By clearing a swap, each counterparty no longer needs to rely on the individual creditworthiness of the other counterparty for payment. Both original counterparties now look to the DCO that has cleared their swap to ensure that the payment obligations associated with the swap are fulfilled. The DCO manages the risk of failure of a counterparty through appropriate margining, a mutualized approach to default management among clearinghouse members, and other risk management mechanisms that have been developed over the more than 100 years that modern clearinghouses have been in operation. Clearing can avert the development of

[16] Congress did not provide for an exception or exemption for inter-affiliate swaps in the Dodd-Frank Act. However, commenters have pointed to legislative history and statements made by members of Congress supporting such an exemption at the time the Dodd-Frank Act was enacted.

systemic risk by reducing the potential knock-on, or domino, effect resulting from counterparties with large outstanding exposures defaulting on their swap obligations and causing their counterparties—counterparties that would otherwise be financially sound if they had been paid—to default. Failure of those counterparties could lead to the failure of yet other counterparties, cascading through the economy and potentially causing systemic harm to the U.S. financial system. Required clearing reduces this risk by ensuring that uncollateralized risk does not accumulate in the financial system.

2. Risks and benefits posed by inter-affiliate swaps.

The Commission is not persuaded by comments suggesting that inter-affiliate swaps pose no risk to the financial system or that clearing would not mitigate those risks. Entities that are affiliated with each other are separate legal entities notwithstanding their affiliation. As separate legal entities, affiliates generally are not legally responsible for each other's contractual obligations. This legal reality becomes readily apparent when one or more affiliates become insolvent.[17] Affiliates, as separate legal entities, are managed in bankruptcy as separate estates and the trustee for each debtor estate has a duty to the creditors of the affiliate, not the corporate family, the parent of the affiliates, or the corporate family's creditors.[18] This potential for separate treatment in bankruptcy,

[17] Note, for example, that while the Rule 1015 of the Federal Rules of Bankruptcy Procedure (FRBP) permits a court to consolidate bankruptcy cases between a debtor and affiliates, FRBP Rule 2009 provides that, among other things, if the court orders a joint administration of two or more estates under FRBP Rule 1015, the trustee shall keep separate accounts of the property and distribution of each estate. See Federal Rules of Bankruptcy Procedure (2011).

[18] See In re L & S Indus., Inc., 122 B.R. 987, 993-994 (Bankr. N.D. Ill. 1991), aff'd 133 B.R. 119, aff'd 989 F.2d 929 (7th Cir. 1993) ("A trustee in bankruptcy represents the interests of the debtor's estate and its creditors, not interests of the debtor's principals, other than their interests as creditors of estate."); In re New Concept Housing, Inc., 951 F.2d 932, 938 (8th Cir. 1991) (quoting In re L & S Indus., Inc.). While the concept of "substantive consolidation" of affiliates in a business enterprise when they all enter into bankruptcy is sometimes used by a bankruptcy court, substantive consolidation is generally considered an

calls into question commenters' claims that third parties can rely on the creditworthiness of the entire corporate group when entering into swaps with affiliates.

On the other hand, inter-affiliate swaps offer certain risk-mitigating, hedging, and netting benefits as described by several commenters including ISDA & SIFMA, The Working Group, CDEU, and EEI. Furthermore, because affiliates in a corporate family generally internalize the risks of inter-affiliate transactions in the affiliated group, as described in the NPRM, the corporate family could face serious reputational harm if affiliates default on their swaps. Consequently, the entities within an affiliated group are incentivized to fulfill their inter-affiliate swap obligations to each other, to support each other to prevent outward-facing failures, and to resolve any disagreements about the terms of inter-affiliate swaps more quickly and amicably. As noted by ISDA & SIFMA, when an affiliated business group is fiscally sound, the capital, liquidity, and risk allocation decisions and default remedies between group members may be centrally managed thereby reducing the likelihood of group entities facing default risk of other group entities, "so long as the group as a whole is solvent."

While in many circumstances, these characteristics of inter-affiliate swaps may mitigate the risk of an affiliate defaulting on its obligations—particularly when the group as a whole is financially healthy—they do not constitute legally enforceable obligations pre-bankruptcy or in bankruptcy.[19] Accordingly, despite the existence of mutual support incentives, a corporate group facing insolvency risk may ultimately make the decision to

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extraordinary remedy to be used in limited circumstances. See Substantive Consolidation—A Post-Modern Trend, 14 Am. Bankr. Inst. L. Rev. 527 (Winter 2006).

[19] See Bankrupt Subsidiaries: The Challenges to the Parent of Legal Separation, 25 Emory Bankr. Dev. J. 65 (2008); Liability of a Parent Corporation for the Obligations of an Insolvent Subsidiary Under American Case Law and Argentine Law, 10 Am. Bankr. Inst. L. Rev. 217 (Spring 2002).

allow some affiliates to fail and default on their swap obligations so that other affiliates can survive without becoming insolvent.[20] In cases where an insolvent affiliate has multiple obligations to third parties (swap-related or otherwise), those third parties may be subject to a pro rata distribution along with other creditors if the trust estate of the defaulting affiliate does not have sufficient liquid assets to cover losses on its uncleared swaps. It is at such times of financial stress that central clearing serves as the most effective systemic risk mitigant.

3. The Commission's consideration of the risks and benefits.

In providing an inter-affiliate exemption from required clearing, the Commission has considered the benefits that inter-affiliate swaps offer corporate groups against the risk of allowing an exemption from required clearing for swaps entered into by separate, but affiliated, legal entities. In considering the risks and benefits, the Commission was guided, in part, by comments pointing to the risk-mitigating characteristics of inter-affiliate swaps and the sound risk management practices of corporate groups that rely on inter-affiliate swaps. In crafting the rule, the Commission sought to codify these characteristics as eligibility criteria, or conditions, for the exemption from required clearing. The conditions imposed are designed to increase the likelihood that affiliates will take into consideration their mutual interests when entering into, and fulfilling, their inter-affiliate swap obligations. For example, the inter-affiliate exemption may be

[20] See, e.g., the bankruptcy of Residential Capital (ResCap) and its subsidiaries. ResCap is a mortgage subsidiary of Ally Financial Inc. ResCap declared bankruptcy independent of Ally Financial Inc., which is not part of the bankruptcy proceeding and continues to operate as a legally separate, solvent entity. See In re Residential Capital, LLC, No. 12-12020 (MG) (Bankr. S.D.N.Y 2012), available at http://www.kccllc.net/rescap. While the bankruptcy of ResCap was not the direct result of inter-affiliate swaps, ResCap's bankruptcy demonstrates that an affiliate can be put into bankruptcy without forcing the affiliated parent to declare bankruptcy or to be legally responsible for the affiliate's debts.

elected only if the affiliates are majority owned and their financial statements are consolidated, thereby increasing the likelihood that entities will be mutually obligated to meet the group's swap obligations. Additionally, the affiliates must be subject to a centralized risk management program, the swaps and the trading relationship between affiliates must be documented, and outward-facing swaps must be cleared or subject to an exemption or exception from clearing.

Despite the conditions to the exemption adopted in this final rule, the Commission reminds market participants that the conditions included in the final rule do not mitigate potential losses between inter-affiliates to the extent that clearing would, particularly if one or more affiliated entities become insolvent.

B. Section 4(c) Authority

Section 4(c)(1) of the CEA grants the Commission the authority to exempt any transaction or class of transactions, including swaps, from certain provisions of the CEA, including the clearing requirement, in order to "promote responsible economic or financial innovation and fair competition." Section 4(c)(2) of the Act further provides that the Commission may not grant exemptive relief unless it determines that: (1) the exemption is appropriate for the transaction and consistent with the public interest; (2) the exemption is consistent with the purposes of the CEA; (3) the transaction will be entered into solely between "appropriate persons"; and (4) the exemption will not have a material adverse effect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory responsibilities under the CEA.[21] In enacting section 4(c), Congress noted that the purpose of the provision is to give the Commission a

[21] 7 U.S.C. 6(c)(2).

means of providing certainty and stability to existing and emerging markets so that financial innovation and market development can proceed in an effective and competitive manner.[22]

In the NPRM, the Commission requested comment as to whether exempting inter-affiliate swaps from the clearing requirement under certain terms and conditions would be an appropriate exercise of its section 4(c) authority.[23] A number of commenters supported the Commission's use of its section 4(c) authority to exempt inter-affiliate swaps from clearing. According to MetLife and Prudential, the inter-affiliate exemption as proposed promotes responsible economic or financial innovation and fair competition by allowing corporate groups to use inter-affiliate swaps to engage in effective and efficient risk management activities. As an example, MetLife and Prudential explained that corporate groups can use a single conduit in the market on behalf of multiple affiliates within the group, which permits the corporate group to net affiliates' trades. This netting effectively reduces the overall risk of the corporate group and the number of open positions with external market participants, which in turn reduces operational, market, counterparty credit, and settlement risk. MetLife and Prudential both expressed the view that inter-affiliate swaps do not pose risks to corporate groups and third parties, and both stated that inter-affiliate swaps may pose less risk to corporate groups given efficient netting across the corporate group. EEI also supported the Commission's use of its section 4(c) authority for similar reasons to those stated by MetLife and Prudential.

[22] House Conf. Report No. 102-978, 1992 U.S.C.C.A.N. 3179, 3213.

[23] See NPRM at 50428.

ISDA & SIFMA stated that the Commission's proposed exemption meets the requirements of section 4(c) of the CEA by promoting innovation and competition, and the exemption serves the public interest. ISDA & SIFMA noted that inter-affiliate swaps are integral to the strategies consolidated financial institutions rely upon to meet customer needs in an efficient, competitive, and sound manner. According to ISDA & SIFMA, inter-affiliate swaps maximize hedging efficiencies and allow customers to transact with a single client-facing entity in the customer's jurisdiction, which increases the scope of risk-reducing netting with individual customers as well as risk-reducing netting of offsetting positions within the financial group. This allows the institution to meet customer needs across jurisdictions and provide improved pricing or other risk management benefits to customers, thereby promoting financial innovation and competition. ISDA & SIFMA also commented that inter-affiliate swaps allocate and transfer risks among members of a corporate group rather than increasing risks.

CDEU also supported the Commission's use of its section 4(c) authority. CDEU stated that the inter-affiliate exemption would promote financial innovation, fair competition, and the public interest by preserving the ability of corporate entities to centrally hedge the risks of their affiliates. CDEU stated that without such an exemption firms that currently use a central hedging model will be disadvantaged as compared to direct competitors that do not use the same, efficient risk management model. CDEU also noted the additional costs that would be incurred from subjecting inter-affiliate swaps to clearing.

In the NPRM, the Commission requested comments on whether the inter-affiliate exemption would be in the public interest. In addition to responses noted above with

regard to the public interest,[24] the Commission received two comment letters questioning whether the proposed exemption serves the public interest.

According to AFR, there are serious doubts about whether the inter-affiliate exemption is in the public interest. AFR stated that any hedging and netting benefits gained from corporate groups engaging in inter-affiliate swaps must be weighed against the benefits of full novation to a central counterparty in the form of a clearinghouse, which is a more comprehensive level of risk management. Given the experience of the 2008 financial crisis, AFR noted that any risk-reducing benefit of corporate group risk management practices assumes that the corporate group actually implements and adheres to sufficient risk management procedures. AFR is concerned about relying on such an assumption in light of the fact that there was a large-scale failure of proper risk management prior to and during the 2008 financial crisis.

Better Markets similarly commented that only a very narrow and strict inter-affiliate exemption could be in the public interest. Better Markets suggested ways in which the Commission should strengthen the proposed exemption to satisfy the public interest standard, including requiring a 100% majority ownership interest standard, requiring that both initial and variation margin be exchanged, and banning rehypothecation of posted collateral.[25]

After considering the complete record in this matter, the Commission has

[24] As noted above, CDEU, MetLife, Prudential, and ISDA & SIFMA stated that an inter-affiliate exemption is consistent with the public interest.

[25] As discussed further below, both AFR and Better Markets contend that all the proposed conditions must be retained and the conditions must be strengthened in a number of ways.

determined that the requirements of section 4(c) of the Act have been met with respect to the exemptive relief described above. The Commission believes that the exemption, as modified in this release, is consistent with the public interest and with the purposes of the CEA. The Commission's determination is based, in large part, on the transactions that are covered under the exemption. Namely, as most commenters noted, inter-affiliate transactions provide an important risk management role within corporate groups. In addition, and as discussed in the NPRM, the Commission recognizes that swaps entered into between corporate affiliates, if properly risk-managed, may be beneficial to the entity as a whole. Accordingly, in promulgating this rule, the Commission concludes that an exemption subject to certain conditions is appropriate for the transactions at issue, promotes responsible financial innovation and fair competition, and is consistent with the public interest. As the Commission noted in the NPRM and as reiterated in AFR's comment, any benefits to the corporate entity have to be considered in light of the risks that uncleared swaps pose to corporate groups and market participants generally. For this reason, the Commission is adopting an inter-affiliate exemption that is narrowly tailored and subject to a number of important conditions, including that affiliates seeking eligibility for the exemption document and manage the risks associated with the swaps.

Further, the Commission finds that the exemption is only available to "appropriate persons." Section 4(c)(3) of the CEA includes within the term "appropriate persons" a number of specified categories of persons, including "such other persons that the Commission determines to be appropriate in light of their financial or other qualifications, or the applicability of appropriate regulatory protections."[26] Given that

[26] 7 U.S.C. 6(c)(3)(K).

only ECPs can enter into uncleared swaps and that the elements of the ECP definition (as set forth in section 1a(18)(A) of the CEA and Commission regulation 1.3(m)) generally are more restrictive than the comparable elements of the enumerated "appropriate person" definition, the Commission finds that ECPs are appropriate persons within the scope of section 4(c)(3)(K) for purposes of this final release and that in so doing, the class of persons eligible to rely on the exemption will be limited to "appropriate persons" within the scope of section 4(c)(3) of the CEA.

Finally, the Commission finds that this exemption will not have a material effect on the ability of the Commission to discharge its regulatory responsibilities. This exemption is limited in scope and, as described further below, the Commission will have access to information regarding the inter-affiliate swaps subject to this exemption because they will be reported to an SDR pursuant to the conditions of the exemption. In addition to the reporting conditions in the rule, the Commission retains its special call, anti-fraud, and anti-evasion authorities, which will enable it to adequately discharge its regulatory responsibilities under the CEA.

For the reasons described in this release, the Commission believes it is appropriate and consistent with the public interest to adopt such an exemption.

C. Definition of Affiliate Status

As proposed, § 39.6(g)(1) provides that counterparties to a swap may elect the inter-affiliate exemption to the clearing requirement if the financial statements of both counterparties are reported on a consolidated basis, and either one counterparty directly or indirectly holds a majority ownership interest in the other, or a third party directly or

indirectly holds a majority ownership interest in both counterparties. The proposed rule further specified that a counterparty or third party directly or indirectly holds a majority-ownership interest if it directly or indirectly holds a majority of the equity securities of an entity, or the right to receive upon dissolution, or the contribution of, a majority of the capital of a partnership.

1. Majority ownership interest.

Four commenters supported proposed § 39.6(g)(1), which set forth the requirements of an affiliate status. CDEU commented that the majority-ownership test strikes an appropriate balance between ensuring that the rule is not overly broad and providing companies with the flexibility to account for differences in corporate structures. EEI stated that majority ownership is sufficient to mitigate what EEI believes is "minimal" risk posed by uncleared inter-affiliate swaps. In addition, EEI noted that majority-owned affiliates will have strong incentives to internalize one another's risks because the failure of one affiliate impacts all affiliates within the corporate group. The Working Group generally supported the Commission's definition, but stated that inter-affiliate swaps should be unconditionally exempt from mandatory clearing when the affiliates are consolidated for accounting purposes.[27] MetLife stated that it would likely

[27] The Working Group also stated that it was unable to determine the scope of the proposed rule until the Commission provides further guidance on the definition of "financial entity" under section 2(h)(7) of the CEA. In particular, The Working Group asked that the Commission clarify the status of treasury affiliates acting on behalf of affiliates able to claim an exception or exemption from required clearing. The Working Group further requested that the Commission provide guidance regarding what constitutes being 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 of 1956, and clarify that trading physical commodities is not financial in nature. In response to The Working Group and other comments regarding the applicability of the end-user exception for certain inter-affiliate swaps, the Commission notes that it will address the use of treasury affiliates under a separate Commission action. With regard to the definition of financial entity, the Commission provided additional guidance in the end-user exception rulemaking, and declined to interpret statutory provisions within the jurisdiction of other U.S. authorities. See End-User Exception to the Clearing Requirement for Swaps, 77 FR 42560, 42567 (July 19, 2012)

limit inter-affiliate trading to "commonly-owned" affiliates, but agreed with the flexibility of including majority-owned affiliates.[28]

Two commenters objected to proposed § 39.6(g)(1) and requested the Commission require 100% ownership of affiliates. AFR stated that the systemic impact of swaps is based on ownership, not on corporate control. AFR also stated that permitting such a low level of joint ownership would lead to evasion of the clearing requirement through the creation of joint ventures set up to enable swap trading between banks without the need to clear the swaps. Similarly, Better Markets agreed that only 100% owned affiliates should be eligible for the exemption because allowing the exemption for the majority owner permits that owner to disregard the views of its minority partners[29] and creates an incentive to evade the clearing requirement by structuring subsidiary partnerships. Finally, Better Markets stated that the majority-ownership standard would result in corporate groups transferring price risk and credit risk to different locations, facilitating interconnectedness and potentially giving rise to systemic risk during times of market stress.

(explaining that "business of banking" is a term of art found in the National Bank Act and is within the jurisdiction of, and therefore subject to interpretation by, the Office of the Comptroller of the Currency and section 4(k) of the Bank Holding Company Act is within the jurisdiction of, and therefore subject to interpretation by, the Board of Governors of the Federal Reserve System). Accordingly, further guidance on this issue is beyond the scope of this rulemaking, except as provided in note 76 of this release.

[28] Prudential stated that its affiliates are all wholly-owned affiliates and expressed no view on the issue of majority-owned affiliates.

[29] Two other commenters also discussed the issue of minority investors. ISDA & SIFMA stated that any concerns about the protection of minority investors in group entities is "the province of corporate and securities laws." EEI noted that "to the extent minority owners have an opinion about electing the exemption, they may negotiate with majority-owners as they deem commercially appropriate for the right to participate in inter-affiliate clearing decisions."

Having considered these comments, the Commission is adopting proposed § 39.6(g)(1) (now § 50.52(a)) with the modifications discussed below. The Commission believes that the majority-owned standard is not overly broad and provides entities with flexibility to account for differences in corporate structure. In particular, requiring majority ownership serves to ensure that counterparty credit risk posed by inter-affiliate swaps is internalized by the corporate group.

In addition, as the NPRM noted, it is important for the inter-affiliate clearing exemption to be harmonized with foreign jurisdictions that have or are developing comparable clearing regimes consistent with the 2009 G-20 Leaders' Statement.[30] For example, the European Parliament and Council of the European Union have adopted the European Market Infrastructure Regulation (EMIR).[31] Subject to the relevant provisions, technical standards, and regulations under EMIR, certain OTC derivatives transactions between parent and subsidiary entities, could be exempt from its general clearing requirement. Generally speaking, it appears that the intragroup exemptions under EMIR will require majority-ownership rights and consolidated accounting and annual reporting.[32]

In response to the concerns of AFR and Better Markets regarding the need for the Commission to adopt a stricter requirement of 100% ownership, the Commission

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[30] At the G-20 meeting in Pittsburgh in 2009, as noted above, the G-20 Leaders declared that, "[a]ll standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest." G-20 Leaders' Final Statement at Pittsburgh Summit: Framework for Strong, Sustainable and Balanced Growth (Sept. 29, 2009).

[31] See Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC Derivatives, Central Counterparties and Trade Repositories, 2012 O.J. (L 201) (hereinafter "EMIR") available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF.

[32] Id. at Articles 3 and 4.

recognizes the potential for corporate entities to structure their affiliates in such a manner as to evade the clearing requirement. However, the Commission believes it has carefully crafted a narrow exemption based on the condition that the affiliate is majority-owned, along with the other conditions imposed under this exemption. In terms of the interests of minority shareholders, the Commission believes that the views of all shareholders should be taken into account when an entity decides whether to clear a swap, but ultimately, the decision is a matter for corporate and securities laws.

2. Consolidated financial statements.

In addition to the majority-ownership requirement, proposed § 39.6(g)(1) provided that counterparties to a swap may elect the inter-affiliate exemption to the clearing requirement if the financial statements of both counterparties are reported on a consolidated basis. The Commission received several comments on this provision. The FSR requested that the Commission clarify that alternative accounting standards can be used for purposes of meeting the requirement that the financial statements of both affiliates be reported on a consolidated basis. In response to a question in the NPRM regarding whether the exemption should be limited to the ownership threshold based on section 1504 of the Internal Revenue Code, MetLife and Prudential both explained that a U.S. taxpayer cannot file consolidated U.S. tax returns with its non-U.S. affiliate. Accordingly, both MetLife and Prudential stated that they did not support such a limitation on the exemption.

In an effort to clarify the consolidated financial reporting condition, the Commission is modifying the requirement that financial statements be reported on a consolidated basis in two ways. First, the Commission is clarifying which entities are

subject to the consolidated reporting condition. Under revised § 50.52(a)(1)(i), if one of the two affiliate counterparties claiming the exemption holds a majority interest in the other affiliate counterparty (the "majority-interest holder"), then the financial statements of the majority-interest holder must be reported on a consolidated basis and such statements must include the financial results of the majority-owned counterparty. On the other hand, under revised § 50.52(a)(1)(ii), if a third party is the majority-interest holder of both affiliate counterparties claiming the exemption (the "third-party majority-interest holder"), then the financial statements of the third-party majority-interest holder must be reported on a consolidated basis and such statements must include the financial results of both affiliate counterparties to the swap. In essence, the rule requires that the financial statements of the majority-owner (whether a third party or not) are subject to consolidation under accounting standards and must include either the other affiliate counterparty's or both majority-owned affiliate counterparties' financial results. The Commission is using the term "financial results" to refer to the financial statements, reports, or other material of the majority-owned counterparty or counterparties that must be consolidated with the majority owner's financial statements.

The second modification to the proposed rule responds to FSR's request that the Commission clarify that alternative accounting standards are permitted. Accordingly, the consolidated financial statements of the majority-interest holder or the third-party majority-interest holder, as appropriate, may be prepared under either Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS). The modification reflects the fact that entities claiming the exemption may be subject to different accounting standards.

The Commission is not modifying the rule to limit the exemption to an ownership threshold based on section 1504 of the Internal Revenue Code.

D. Inter-Affiliate Swap Documentation

As proposed, § 39.6(g)(2)(ii) provided that eligible affiliate counterparties that elect the inter-affiliate exemption must enter into swaps with a swap trading relationship document that is in writing and includes all the terms governing the relationship between the affiliates. These terms include, but are not limited to, payment obligations, netting of payments, transfer of rights and obligations, governing law, valuation, and dispute resolution. This requirement will be satisfied if an eligible affiliate counterparty is an SD or MSP that complies with the swap trading relationship documentation requirements of § 23.504. Regulation 23.504 includes all the proposed terms under proposed § 39.6(g)(2)(ii) plus a number of other specific requirements. The NPRM stated that the burden on affiliates would not be onerous because all affiliates should be able to use a master agreement to document their swaps, however, in the NPRM the Commission did not require the use of such a master agreement.

The Commission received a number of comments both supporting and opposing the swap documentation requirement. Better Markets, MetLife, and Prudential all supported the proposed documentation requirement. Specifically, MetLife and Prudential did not believe that the documentation requirement would be any more "burdensome or costly" for them because they already document all of their swaps. Additionally, MetLife and Prudential commented that the proposed documentation method is "preferable" to any other method and represents industry best practice. Better Markets agreed with the

conditions imposed on the exemption, including the documentation requirements, and stated that the conditions should not be weakened.[33]

Cravath, EEI, CDEU, and DLA Piper opposed the proposed documentation requirement. Cravath stated that the costs associated with the imposition of documentation requirements outweigh any benefits to the financial system, and that the Commission should leave the determination as to the appropriate level of documentation to boards of directors and management of companies, to determine based on the "reasonable exercise of their fiduciary responsibilities." DLA Piper commented that inter-affiliate swaps are typically documented by a simple intercompany agreement, trade ticket or accounting entry rather than ISDA Master Agreements, and that the documentation requirements would be burdensome.

CDEU expressed concern that proposed § 39.6(g)(2)(ii)(B) would require that full ISDA Master Agreements be used to document inter-affiliate swaps. CDEU explained that while many market participants use master agreements, some end users many not have full master agreements because inter-affiliate swaps are purely internal and do not increase systemic risk.[34] CDEU recommended that the proposed rule be revised to require that the swap documentation "include all terms necessary for compliance with its centralized risk management program" and eliminate the list of required terms. CDEU also requested that the Commission clarify that (1) market participants can continue to

[33] While it did not address the documentation requirements specifically, AFR stated that the proposed conditions on the exemption should be fully retained. Similarly, Chris Barnard generally expressed support for the proposed rules but did not specifically mention the documentation provisions.

[34] CDEU recognized that SDs and MSPs and their counterparties, including affiliates, will be subject to the requirements of § 23.504, but stated that it is not appropriate to apply the same requirements to non-registrant affiliates.

use documentation required by their risk management programs, and (2) the rule does not require market participants to use the ISDA Master Agreements.

EEI recommended that the Commission eliminate the documentation requirement because the requirement is duplicative of corporate accounting records that affiliates maintain as a matter of prudent business practice. According to EEI, current accounting practices will address the Commission's tracking and proof-of-claim concerns related to inter-affiliate swaps. EEI commented that a documentation requirement imposes "an additional, costly layer of ministerial process and documentation that is unnecessary to achieve the Commission's stated objectives."[35] EEI requested that the Commission allow market participants "to document their inter-affiliate risk transfers pursuant to standard commercial accounting and business records practices."

ISDA & SIFMA stated that the documentation requirements were overly prescriptive and would impose unnecessary costs on affiliates. Specifically, ISDA & SIFMA identified the valuation and dispute resolution requirements as serving little purpose. ISDA & SIFMA recommended a more flexible approach that would require adequate documentation of "all transaction terms under applicable law."

The Commission considered all of the comments relating to the proposed documentation requirement and is retaining the swap documentation requirement subject to certain modifications recommended by commenters. As discussed in the NPRM, the

[35] EEI commented on the NPRM's consideration of costs and benefits and stated that the costs of the proposed documentation requirement are unjustified. The NPRM included an estimate that there would be a one-time cost of $15,000 to develop appropriate documentation for use by an entity's affiliates. EEI objected to this estimate because, in its view, the legal costs associated with individually negotiating and amending standard agreements between individual affiliates would exceed the NPRM's estimates. In addition, EEI objected to the NPRM's estimate of 22 affiliated counterparties for each corporate group as "far too low" for U.S. energy companies. However, EEI did not provide specific, quantitative information in terms of either the legal costs of complying with the proposed documentation requirement or number of affiliates for a corporate group subject to this rule.

Commission is concerned that without adequate documentation entities will be unable to track and manage the risks arising from inter-affiliate swaps. Equally important, affiliates must be able to offer sufficient proof of claim in the event of insolvency. The Commission is adopting proposed § 39.6(g)(2)(ii)(A) (now § 50.52(b)(2)(i)), which essentially confirms the applicability of § 23.504 to swaps between affiliates where one of the affiliates is an SD or MSP. However, with regard to swaps between affiliates that are not SDs or MSPs, and in response to commenters' requests for a more flexible standard, the Commission is adopting ISDA & SIFMA's recommendation that the focus of the documentation requirement be on documenting all of an inter-affiliate transaction's terms. Accordingly, the Commission is modifying proposed § 39.6(g)(2)(ii)(B) (now § 50.52(b)(2)(ii)), to require that "the terms of the swap are documented in a swap trading relationship document that shall be in writing and shall include all terms governing the trading relationship between the eligible affiliate counterparties."

Under this modification, the Commission is eliminating the non-exclusive list of terms, which included payment obligations, netting of payments, transfer of rights and obligations, governing law, valuation, and dispute resolution. The change responds to commenters' requests for a more flexible approach that reflects current market best practices. While, in most instances, the Commission anticipates that documentation between affiliates will include all of the previously enumerated terms, the more general rule formulation signals that market participants retain the ability to craft appropriate documentation for their affiliated entities. This modification also serves to address concerns that the intent of the proposed rule was to require formal master agreements, such as the ISDA Master Agreement. As explained above, the proposed rule was not

intended to require affiliates to enter into formal master agreements. Rather, the Commission observed that parties that already use master agreements to document their inter-affiliate swaps would likely meet the requirements of the inter-affiliate exemption without additional costs.[36] This observation was supported by commenters such as MetLife and Prudential.

This modification also responds, in part, to CDEU's request that the documentation "include all terms necessary for compliance with its centralized risk management program." While the Commission is modifying the rule to delete the specific references to valuation and dispute resolution procedures, ensuring that affiliates entering into swaps have sound procedures in place to value their swaps and resolve any disputes is critical to risk management. Accordingly, as discussed further below, the Commission anticipates that affiliates will include rigorous valuation provisions and procedures for elevating and resolving disputes in their risk management programs.

In response to comments from Better Markets and AFR that the proposed regulations should be retained and not weakened, the Commission does not believe that eliminating the non-exclusive list of terms and replacing it with a simple requirement that all terms of the swap transaction and the relationship between the affiliates be documented will weaken the rule. Rather, eligible affiliates will have some discretion, but also have the obligation to ensure that their documentation contains an accurate and thorough written record of their swaps. The Commission clarifies, however, that book

[36] See Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 77 FR 55904, 55906 (Sept. 11, 2012) (recognizing that the ISDA Master Agreement, and other associated documents in their pre-printed form as published by ISDA are capable of compliance with the rules, but noting that such agreements are subject to customization by counterparties and such customization may or may not comply with Commission requirements).

entries would not suffice for purposes of complying with the swap documentation condition because such entries do not contain sufficient information to adequately document the swap or the trading relationship between affiliates.

EEI requested that, if the Commission retains the documentation requirement, the Commission clarify that swap confirmations are not required because executing confirmations would impose substantial costs. In response to this request, the Commission clarifies that for swaps between affiliates where one or both of the affiliates is an SD or MSP, the confirmation rules under § 23.501 are incorporated into § 23.504.[37] As a result, those affiliates must confirm all the terms of their transactions according to the applicable timeframes set forth under § 23.501.[38] By contrast, for swaps between affiliates that are not SDs or MSPs, the provisions of § 23.501 do not apply and formal confirmation pursuant to § 23.501 is not required. However, the Commission notes that the terms of the swap will be documented by the affiliates and confirmation of those terms will be reported to an SDR under the Commission's reporting rules.[39]

E. Centralized Risk Management Program

Proposed § 39.6(g)(2)(iii) requires the swap to be subject to a centralized risk management program that is "reasonably designed to monitor and manage the risks associated with the swap." If at least one of the eligible affiliate counterparties is an SD

[37] See 17 CFR 23.504(b)(2); 77 FR at 55907-08.

[38] See 17 CFR 23.501.

[39] See, e.g., § 45.3(c)(1)(iii) (requiring the reporting counterparty to report all confirmation data for the swap as soon as technologically practicable after confirmation, but no later than 30 minutes after confirmation if confirmation occurs electronically or 24 business hours after confirmation if confirmation does not occur electronically).

or MSP, the centralized risk management requirement is satisfied by complying with the requirements of § 23.600.[40]

Five commenters generally supported proposed § 39.6(g)(2)(iii). AFR supported the proposed risk management program requirement and stated that dispensing with or weakening this condition, or any of the conditions, would heighten systemic risk and call into question the Commission's exemptive authority. Better Markets agreed that requiring a centralized risk management program was wholly appropriate and should be maintained as a requirement.

Prudential and MetLife confirmed that both companies currently have centralized risk management programs and consider them to be consistent with current practice in the industry. Prudential noted that it structured its risk management system to allow only one affiliate to enter into swaps with third parties, which permits Prudential to impose a single credit limit on its market-facing counterparty relationships. MetLife's enterprise-wide risk management system provides all affiliates trading derivatives with affiliate-specific sets of guidelines and limits that are also included in enterprise-wide guidance and limits.

Finally, CDEU expressed support for the centralized risk management program requirement, but requested that the Commission clarify that the level of risk management for inter-affiliate swaps not be interpreted as requiring the same level of risk management that end-users maintain for external third-party swaps. CDEU noted that most end users that use inter-affiliate swaps currently have robust centralized risk management programs

[40] 17 CFR 23.600; Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflict of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants, 77 FR 20128 (Apr. 2, 2012).

in place to monitor all external swap risks and affiliates are required to follow group-wide risk polices. CDEU was supportive of the proposal so long as the requirement is interpreted reasonably and permits entities to "implement risk policies and procedures appropriate to the risks of a corporate group's inter-affiliate swaps."

Four commenters objected to the proposed requirement, suggested alternatives, and/or requested clarification. FSR stated that the condition should be eliminated because integrated risk management systems "are generally not established across international boundaries" and are not consistent with general risk practices in large, multinational organizations. FSR suggested that the requirement be dropped in favor of each entity making "its own evaluations of the risk associated with an inter-affiliate position."

Cravath stated that in many cases, for companies outside of the financial sector, the proposed rule will require a substantial change in the processes and procedures currently maintained by such companies, and the cost of complying with the risk management program requirements outweigh any benefits to the financial system. Cravath commented that rather than subject companies to a risk management rule, "[c]ompanies should have the flexibility to engage in prudent risk management for their corporate group in a manner consistent with the overall level of risks to their business."

EEI suggested that the Commission eliminate the centralized risk management program requirement on the grounds that it would be duplicative for corporate groups that already have risk management programs in place. According to EEI, it is standard industry practice for both private and public companies to have a risk management program. EEI accordingly does not see a "need to impose a separate, discrete regulatory

requirement to document with an SDR or the Commission the existence of a centralized risk management program." If the Commission decides to retain the requirement, EEI requested that the Commission require a program be "reasonably designed to monitor and manage the risks associated with the swap" and provide the flexibility to design risk management programs that address the unique risks of an entity's business.

The Working Group requested that the Commission clarify whether non-SDs and non-MSPs would be subject to the same enterprise-level risk management program as required for SDs and MSPs under § 23.600. If the Commission intended to require the same level of risk management, The Working Group commented that there are "a number of commercially and legally valid reasons" why a centralized risk management program in accordance with § 23.600 would be inconsistent with current industry practice. The Working Group cited cost as a reason companies do not provide for centralized risk management on different continents, in addition to antitrust and other regulatory reasons. The Working Group requested that the Commission clarify that the rule requires only that both counterparties be subject to a "robust risk management program."

In response to comments, the Commission observes a general consensus that market participants have risk management policies and procedures in place, at least with regard to affiliates located in the same jurisdiction. FSR and The Working Group questioned whether entities have centralized risk management programs for affiliates in different jurisdictions and whether such cross-border risk management systems are prohibitively costly. In response to these comments, the Commission points to comments stating that inter-affiliate swaps play a critical role in an entity's overall management of risk and provide netting benefits among affiliates. Consequently, it stands to reason that

inter-affiliate swaps between affiliates in different jurisdictions are as much a part of an entity's overall risk management framework as swaps between affiliates located in the same jurisdiction. The Commission does not believe that it would be prudent business practice for affiliates to enter into inter-affiliate swaps without risk management systems integrated across international boundaries to the extent that the entity permits affiliates across jurisdictions to enter into swaps with one another.

In response to comments asking that the Commission clarify the level of risk management required for non-SDs and non-MSPs, the Commission confirms that the requirements of proposed § 39.6(g)(2)(iii) (now § 50.52(b)(3)) are intended to be flexible and do not require the same level of policies and procedures as required under § 23.600 for SDs and MSPs. Under the rule, a company is free to structure its centralized risk management program according to its unique needs, provided that the program reasonably monitors and manages the risks associated with its uncleared inter-affiliate swaps. In all likelihood, if a corporate group has a centralized risk management program in place that reasonably monitors and manages the risk associated with its inter-affiliate swaps as part of current industry practice, it is likely that the program would fulfill the requirements of proposed § 39.6(g)(2)(iii) (now § 50.52(b)(3)).

The Commission did not receive comments regarding the requirement that SD and MSP affiliates must comply with § 23.600.[41] The Commission is adopting that provision of the rule as proposed.

[41] 17 CFR 23.600(c)(1)(ii) ("The Risk Management Program shall take into account risks posed by affiliates and the Risk Management Program shall be integrated into risk management at the consolidated entity level.").

Given that a number of commenters stated that it is common practice for market participants, including end users, to have risk management programs in place, the Commission is not persuaded by Cravath's comment that the rule will require a substantial change in the processes and procedures currently maintained by companies to manage risk. Accordingly, costs will be limited where an entity only needs to make modifications to existing risk management programs. Moreover, a corporate group may not have to incur any costs if it already has a risk management system that meets the requirements of the inter-affiliate exemption in place.

F. Variation Margin

Proposed § 39.6(g)(2)(iv) required that variation margin be collected for swaps between affiliates that are financial entities, in compliance with the proposed variation margin requirements in proposed § 39.6(g)(3).[42] The rule further proposed an exception to the variation margin requirement for 100% commonly-owned and commonly-guaranteed affiliates, provided that the common guarantor is under 100% common ownership.

Some commenters expressed support for the proposed variation margin requirement. Prudential commented that it did not take issue with the variation margin requirement, but noted that variation margin may not be appropriate or required in every circumstance.[43] Prudential also commented that the Commission should not impose

[42] The Commission also requested comments on, among other things, whether the Commission should promulgate regulations that set forth minimum standards for initial margin for inter-affiliate swaps.

[43] Prudential also commented that there is "no less costly risk-management tool" than variation margin.

initial margin requirements for the inter-affiliate exemption.[44] Chris Barnard agreed that the Commission should require the exchange of variation margin for financial entities and noted that the exchange of variation margin is consistent with the key principles proposed by the Basel Committee on Banking Supervision (BCBS) and the Board of the International Organization of Securities Commissions (IOSCO).[45] Better Markets expressed support for the variation margin requirement and commented that it should be expanded to non-financial entities.[46] AFR expressed support for the variation margin proposal. Both Better Markets and AFR also expressed support for the requirement that affiliates post initial margin for inter-affiliate swaps subject to the exemption.[47]

Several commenters stated that the proposed variation margin requirement for swaps between affiliates that are financial entities is not necessary and should not be a condition of the inter-affiliate exemption to clearing.[48] ISDA & SIFMA commented that the benefits of variation margin for inter-affiliate swaps are "tenuous" because the third party to a swap is exposed to the credit risk of the entire group not just the specific affiliate with which it enters into a swap. ISDA & SIFMA maintain that it is not

[44] MetLife also commented that the Commission should not impose initial margin requirements for the inter-affiliate exemption.

[45] See Margin Requirements for Non-Centrally-Cleared Derivatives, Consultative Report (July 2012), available at http://www.bis.org/publ/bcbs226.pdf.

[46] Better Markets also suggested that the Commission ban the rehypothecation of collateral.

[47] Better Markets commented that initial margin should be required because initial margin is the true "statistical estimate of the potential consequences of a default" and that variation margin is merely the "daily recalibration" of the risk estimation of initial margin.

[48] Cravath commented that variation margin requirements "tie up capital that could otherwise be used for investment purposes to create jobs and goods and services for the economy." MetLife commented that while it is subject to variation margin under state insurance law, MetLife believes that the Commission should eliminate the variation margin requirement for 100%-owned affiliates and should not require "inter-affiliate guarantees." DLA Piper also urged the Commission to provide corporate groups with legal certainty that no margin requirements will be imposed on any inter-company swaps.

necessary to protect group entities from the credit risk of other group entities because group management possesses the tools needed to resolve potential defaults within the group. According to ISDA & SIFMA, the Commission can fully achieve its regulatory mandate to protect third-party swap counterparties through the application of the clearing requirement to those outward-facing swaps that are subject to the Commission's regulation, as well as regulation of those group entities whose outward-facing swap activities are sufficiently large to subject them to SD and MSP registration.[49]

FSR commented that affiliates should be required to post margin only in instances where their primary regulator imposes such a requirement for affiliate transactions.[50] FSR states that requiring variation margin for inter-affiliate swaps involving non-bank financial entities will limit the ability of companies to efficiently allocate risk among affiliates and manage risk centrally.[51] FSR further commented that initial margin should not be required between affiliates, and requested that the Commission clarify that the exemption does not require the exchange of initial margin between affiliates.

[49] ISDA & SIFMA claimed that the additional liquidity demands resulting from variation margin will distort the group's risk management choices. ISDA & SIFMA further claimed that while they have previously stated that inter-affiliate margin occurs "routinely," this does not mean that it occurs "uniformly" or that imposing variation margin would not increase cost.

[50] Citing to sections 23A and 23B of the Federal Reserve Act and Regulation W as well as public utility, insurance, and investment company law, FSR commented that a number of regulated entities may be subject to various restrictions on affiliate transactions and that for purposes of the inter-affiliate exemption, margin requirements should only apply "to the extent other applicable law . . . imposes such restrictions on affiliate transactions." FSR also points out that subsidiaries of banks are "generally not treated as 'affiliates'" within the restrictions of sections 23A and 23B of the Federal Reserve Act.

[51] FSR further requested that the Commission clarify that to the extent that financial entities are required, through credit support arrangements with their affiliates, to have minimum transfer amounts, thresholds, and other similar arrangements in place, that such arrangements would be permitted in connection with inter-affiliate swaps relying on the inter-affiliate exemption.

CDEU commented that the Commission should not require variation margin, or initial margin, with respect to inter-affiliate swaps between end-user affiliates. According to CDEU, while margin requirements may serve as a risk-management tool for market-facing swaps, inter-affiliate swaps do not increase counterparty credit risk or contribute to interconnectedness among market participants. CDEU stated that a number of specific entities, including banks and insurance companies, already post variation margin for inter-affiliate swaps, largely because of prudential requirements, and that applying variation margin requirement to these entities is unnecessary.[52] CDEU requested that if the Commission retains the variation margin requirement, that it limit the exchange of variation margin to SDs and MSPs, and that the requirement should not apply to entities that are considered "financial entities."

With respect to the proposed common guarantor exception to the variation margin requirement, ISDA & SIFMA commented that the Commission has not provided adequate rationale for requiring a common guarantor as a condition for exempting group members from the proposed variation margin requirement, nor has the Commission made it clear which obligations must be guaranteed. ISDA & SIFMA requested that the Commission further clarify the guarantee exception in proposed § 39.6(g)(2)(iv),

[52] Moreover, CDEU claims that many inter-affiliate swaps between end-user corporate groups are not subject to variation margin requirements, and that these entities likely will not have the liquidity to exchange variation margin, and would likely be required to borrow the money from the centralized hedging unit with which it is entering the internal swap. Such an arrangement, according to CDEU, would transfer the loan back to the centralized hedging unit and effectively eliminate any perceived benefit from the exchange of variation margin.

including to clarify that it includes "direct or indirect" ownership, and that swaps between the common guarantor and its affiliates are eligible for the exception.[53]

CDEU commented that the Commission should not limit the guarantee exception to 100% commonly-owned affiliates and should allow the exception for majority-owned affiliates. CDEU requested that the Commission clarify that only the related market-facing swaps with third parties are required to be guaranteed by the common owner or parent. CDEU suggested that the Commission clarify that the parent company has the option to act as the guarantor of the transactions.

FSR commented that the variation margin requirement should not apply to 100% commonly–owned affiliates even if they do not have a common guarantor that is under 100% common ownership. According to FSR, the 100% common ownership requirement creates sufficient alignment of interests between swap counterparties and places the risk of the swap on the ultimate parent entity, and thus, the exchange of variation margin would do little to mitigate intercompany risk.

MetLife and Prudential commented that inter-affiliate swaps should not be commonly guaranteed by a 100% wholly-owned affiliate in order to be exempt from the variation margin requirement. Specifically, MetLife stated that the Commission should not require guarantees or explicit credit support as a condition for an exception from the variation margin requirement and should rely instead on the direct or indirect common ownership requirement. Both MetLife and Prudential stated that the corporate group of

[53] ISDA requested that the Commission clarify that the shareholders of a publicly-owned holding company are the common owners and that its 100% owned subsidiaries meet the definition of "100% commonly owned," and further stated that the Commission should address the consequences of a guarantee of a swap being considered a swap itself.

100% wholly owned affiliates should be able to decide whether internal swaps need to be guaranteed by an affiliate.

After considering the comments submitted in response to the proposed variation margin requirement, the Commission is determining not to require variation or initial margin as a condition for electing the inter-affiliate exemption. In so doing, the Commission was guided by comments expressing concern that a variation margin requirement will limit the ability of U.S. companies to efficiently allocate risk among affiliates and manage risk centrally. Notwithstanding the Commission's determination not to impose variation margin as a condition of the inter-affiliate exemption, the Commission is encouraged by comments noting that many companies already exchange variation margin, and agrees with commenters that collateralizing risk exposure with respect to any swaps, including inter-affiliate swaps, is critical, and encourages market participants to do so as a matter of sound business practice.

G. Treatment of Outward-Facing Swaps and Relief

Proposed § 39.6(g)(2)(v) provided that eligible affiliate counterparties to a swap may elect the inter-affiliate exemption from clearing provided that each affiliate counterparty either: (i) is located in the United States; (ii) is located in a jurisdiction with a clearing requirement that is comparable and comprehensive to the clearing requirement in the United States; (iii) is required to clear swaps with non-affiliated parties in compliance with U.S. law; or (iv) does not enter into swaps with non-affiliated parties.[54]

[54] In this release, the requirements of proposed § 39.6(g)(2)(v), which are now being adopted in new § 50.52(b)(4), are referred to as the "treatment of outward-facing swaps condition."

The Commission received several comments both in support of and in opposition to various aspects of the conditions related to the treatment of outward-facing swaps in proposed § 39.6(g)(2)(v). The Commission has considered each of the comments and has determined to adopt the treatment of outward-facing swaps conditions of the inter-affiliate exemption, with certain modifications described below, because such conditions are necessary to prevent evasion of the clearing requirement and to help protect the U.S. financial markets. The remainder of this Section II.G describes the comments received in response to proposed § 39.6(g)(2)(v) (now § 50.52(b)(4)), along with the Commission's responses and clarifications with respect to those comments.

1. Basis for the cross-border conditions.

While recognizing the benefits of exempting certain inter-affiliate transactions from the clearing requirement, in the NPRM, the Commission described two separate grounds for proposing the treatment of outward-facing swaps condition to the inter-affiliate exemption. First, the Commission explained that an inter-affiliate exemption from required clearing could enable entities to evade the clearing requirement through trades with affiliates that are located in foreign jurisdictions that do not have a comparable and comprehensive clearing regime. In addition, the Commission noted in the NPRM that uncleared inter-affiliate swaps may pose risk to other market participants, and therefore, the financial system if the affiliate enters into swaps with third parties that are related on a back-to-back or matched book basis with inter-affiliate swaps.

In support of the proposed treatment of outward-facing swaps conditions, AFR stated that inter-affiliate swaps could, without appropriate restrictions, bring risk back to the U.S. from foreign affiliates. AFR commented that an inter-affiliate swap might be

used to move parts of the U.S. swaps market outside of U.S. regulatory oversight by transferring risk to jurisdictions with little or no regulatory oversight, whereby a non-U.S. affiliate of a U.S. entity could enter into an outward-facing swap. AFR stated that an inter-affiliate swap could contribute to financial contagion across different groups within a complex financial institution, making it more difficult to "ring-fence" risks in one part of an organization. AFR further commented that laws and regulations of a foreign country might prevent U.S. counterparties to swaps from having access to the financial resources of an affiliate in the event of a bankruptcy or insolvency.[55] The inability of an affiliate to access resources in other jurisdictions, according to AFR, may threaten the ability of U.S. creditors to retrieve assets and may put U.S. taxpayers at risk.[56] Better Markets also supported the proposed treatment of outward-facing swaps condition.[57]

By contrast, ISDA & SIFMA, The Working Group, and CDEU all stated that the treatment of outward-facing swaps condition of the proposed rule is not necessary or

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[55] AFR suggested that the Commission consult with the U.S. banking agencies, such as the FDIC, regarding the potential issues relating to bankruptcy of non-U.S. affiliates. As noted above, the Commission has consulted with both U.S. and international authorities in preparing this adopting release. In response to AFR's comments pertaining to the limitations of foreign bankruptcy laws, the Commission notes that the specific bankruptcy limitations attendant to U.S. counterparties with respect to their non-U.S. affiliates are outside the scope of this rulemaking. The Commission further notes that the conditions imposed by the rules being adopted in this release, in large part, are aimed at ensuring that the benefits of central clearing, particularly with respect to counterparty and systemic risk mitigation, are maintained with respect to inter-affiliate swaps involving non-U.S. affiliates. Specifically, the Commission believes that the conditions imposed by the rules being adopted in this release will help to mitigate potential issues that could arise in uncleared inter-affiliate swaps when financial solvency is not an issue for the corporate enterprise. Furthermore, these conditions may, to some extent, diminish the impact of swaps in transmitting losses across affiliates, and in turn, to third-party creditors, following a default.

[56] AFR also noted restrictions under U.S. banking law with respect to the transfer of risk from non-depository to depository institutions, and stated that it may be necessary to require "ring-fencing" and separate capitalization of swaps affiliates. The Commission believes that these issues are outside of the scope of this rulemaking, and as AFR correctly noted, may be an issue that is more appropriate for the prudential regulators of such entities to consider.

[57] Prudential also commented that in relation to its own structure, it did not have concerns with the proposed cross-border conditions applicable to inter-affiliate swaps involving foreign affiliates.

appropriate and that the Commission should eliminate it altogether. FSR commented that the inter-affiliate exemption should extend to swaps between non-U.S. affiliates, such that the swaps should not be subject to mandatory clearing or margin requirements, even if the affiliated parties are financial entities.

Certain commenters stated that the proposed treatment of outward-facing swaps condition is not necessary to prevent evasion. ISDA & SIFMA noted that the Commission's existing anti-evasion authority[58] can address the anti-evasion objectives of the proposed condition, and the CDEU made a similar argument with respect to the Commission's new anti-evasion authority under section 721(c) of the Dodd-Frank Act. ISDA & SIFMA further noted that the Commission should limit application of its anti-evasion authority to instances where a foreign affiliate engages in a pattern of back-to-back swaps with the U.S. affiliate and where neither the affiliates nor the third-party counterparty are subject to capital regulation.[59]

Other commenters opposed the proposed treatment of outward-facing swaps condition based on their view that inter-affiliate swaps involving non-U.S. affiliates do not pose a risk to the U.S. financial markets. CDEU commented that the proposed "comparable and comprehensive" condition is not necessary or appropriate to reduce risk and prevent evasion because, according to CDEU, transactions between affiliates do not

[58] Section 2(i)(2) of the CEA (providing authority to promulgate rules addressing activities outside of the U.S. to prevent evasion of the Dodd-Frank Act); section 2(h)(4) of the CEA (requiring the Commission to issue rules to prevent evasion of the mandatory clearing requirement); section 721(c) of the Dodd-Frank Act (requiring the Commission to promulgate a rule defining certain terms to prevent evasion of the Dodd-Frank Act).

[59] Entities that are subject to capital regulations include SDs, MSPs, and banking entities subject to prudential regulation.

increase systemic risk, regardless of the location of the affiliate.[60] ISDA & SIFMA stated that the concern that foreign inter-affiliate swaps pose risk to the U.S. financial system is unfounded because internal swaps have no conclusive effect on systemic risk.[61]

The Commission has considered these comments, and for the reasons described below, has determined to retain the treatment of outward-facing swaps condition to the inter-affiliate exemption, with certain modifications and amendments, in order to address comments and provide greater clarity.

i. Prevention of evasion.

As an initial matter, as discussed above, the Commission believes that the benefits of inter-affiliate swaps for entities in affiliated groups warrant the Commission's use of its exemptive authority under section 4(c) of the Act to exclude certain inter-affiliate swaps from the clearing requirement. However, the Commission must exercise its exemptive authority in view of the Commission's charge under the CEA to prevent evasion of the clearing requirement.[62] The Commission remains concerned that absent the treatment of outward-facing swaps condition, the inter-affiliate exemption from clearing may create a ready means through which some U.S. entities may be able to evade the clearing requirement. Accordingly, the Commission believes that the treatment of outward-facing swaps condition to the inter-affiliate clearing exemption is necessary to address the potential for evasion.

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[60] CDEU further stated that inter-affiliate swaps do not create systemic risk.

[61] Prudential also stated that it does not believe that there are any additional risk implications of cross-border inter-affiliate swaps for the U.S. market, to the extent that the market-facing entity is located in the U.S.

[62] See sections 2(h)(4) and 2(i)(2) of the CEA.

Section 2(h)(4)(A) of the CEA requires that "the Commission shall prescribe rules…as determined by the Commission to be necessary to prevent evasions of the clearing requirement under this Act."[63] As the Commission explained in the NPRM, and as AFR also described in its comments, a broad inter-affiliate exemption from the clearing requirement could enable entities to evade the clearing requirement potentially through third-party trades with their foreign affiliates that are located in jurisdictions that do not have a clearing regime that is comparable to, or as comprehensive as, the Commission's clearing requirement. For example, rather than execute a swap opposite a U.S. counterparty, which would be subject to the clearing requirements of section 2(h) of the Act, a U.S. entity could execute an uncleared swap with its foreign affiliate or subsidiary, which could then execute a swap with a non-affiliated third-party in a jurisdiction that is either unregulated or does not have a clearing requirement that is comparable to or as comprehensive as the U.S. clearing requirement.

The Commission disagrees with commenters that suggest that the treatment of outward-facing swaps condition is not necessary to deter evasion because the Commission can rely on its general anti-evasion authority under the CEA or under section 721(c) of the Dodd-Frank Act to address the Commission's evasion concerns pertaining to the inter-affiliate exemption. The Commission notes that section 2(h)(4)(A) of the CEA specifically imposes an obligation on the part of the Commission to "prescribe rules" and "issue interpretations of rules" that are necessary to prevent evasions of the clearing requirement.[64] Furthermore, from an enforcement perspective, a

[63] 7 U.S.C. 2(h)(4).

[64] Under the authority of sections 2(h)(4)(A), 2(h)(7)(F), and 8a(5) of the CEA, the Commission recently adopted § 50.10 to prohibit evasions of the requirements of section 2(h) of the CEA, including the end-user

specific regulation provides more transparency to market participants with respect to the Commission's enforcement program. While the Commission has ample general authority to prevent evasion of the CEA and the swaps-related provisions of the Dodd-Frank Act, the Commission believes it is appropriate to impose the treatment of outward-facing swaps condition to the inter-affiliate exemption to prevent evasion of the clearing requirement.

In response to ISDA & SIFMA's claim that anti-evasion authority should only be applied in limited scenarios where there are back-to-back trades involving affiliates and non-affiliates who are not subject to capital requirements, the Commission declines to pre-judge the potential incentives or ways of evading, or complying with, the Commission's clearing requirement and the inter-affiliate exemption from clearing. To the extent that ISDA & SIFMA suggest that the treatment of outward-facing swaps condition should be limited to transactions involving back-to-back trades where the affiliates and the respective third-party are subject to capital requirements, the Commission is not persuaded that the rule should be so narrowly tailored to address only the scenario ISDA & SIFMA describe. In particular, the Commission notes that back-to-back transactions may not serve as the only potential means by which affiliates can evade the U.S. clearing mandate, and for that matter, transfer risk to one another. Accordingly, the Commission does not believe that the treatment of outward-facing swaps condition should be limited to the specific circumstances described by ISDA & SIFMA.

ii. Protection of financial markets.

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exception or any other exception or exemption that the Commission may provide by rule, regulation, or order. See Clearing Requirement Determination at 74317-19.

In addition to preventing evasion, the Commission believes that the treatment of outward-facing swaps condition will help to limit the potential transfer of risks to U.S. companies and financial markets that may result from third-party swaps between affiliates and non-affiliated entities domiciled in jurisdictions that do not regulate swaps or where the regulation is not comparable to, or as comprehensive as, the CEA and Commission regulations. As described in the preceding sections of this adopting release, there are numerous benefits associated with central clearing of swaps. In particular, clearing mitigates counterparty credit risk, provides an organized mechanism for collateralizing the risk exposures posed by swaps, and when applied on a market-wide scale, clearing reduces systemic risk. The counterparty and systemic risk mitigation benefits of central clearing are also realized from clearing transactions between affiliates.

The benefits of clearing notwithstanding, the Commission recognized in the NPRM commenters' assertions that there is less counterparty risk associated with inter-affiliate swaps than with swaps between third parties to the extent that the affiliated counterparties that are members of the same corporate group internalize each other's counterparty credit risk.[65] While the Commission recognizes, generally, the benefits of inter-affiliate swaps and the incentives for inter-affiliates to fulfill their inter-affiliate swap obligations to each other, these swaps are not immune from some of the risks that are associated with swaps between non-affiliated parties.

In particular, the Commission is not persuaded that inter-affiliate swaps, and swaps between affiliate counterparties outside the U.S. and non-affiliated counterparties, pose no risks to the U.S financial markets or that central clearing would not mitigate the

[65] See NPRM at 50427.

risks associated with such swaps. To the contrary, the counterparty and systemic risks associated with inter-affiliate swaps are heightened where, for example, the inter-affiliate transaction involves an uncleared swap with a foreign affiliate counterparty that is subsequently hedged with a third-party uncleared swap. Thus, the Commission disagrees with commenters that suggested that inter-affiliate swaps involving foreign affiliates do not have the potential to create systemic risk. As the Commission noted in the NPRM, systemic risk implications may be present where the foreign affiliate has large inter-affiliate swap positions and enters into related outward-facing swaps. If the foreign affiliate defaults on its obligations arising from the inter-affiliate swaps, it then increases the likelihood that the foreign affiliate could default on the outward-facing swaps, potentially jeopardizing the financial integrity of the third-party counterparty. Furthermore, to the extent that a foreign affiliate enters into both inter-affiliate swaps and related third-party swaps, any losses incurred by the foreign affiliate with respect to its inter-affiliate swaps may flow not only to the unaffiliated third-party counterparty, but conceivably, to the broader financial system.[66]

Moreover, the Commission notes AFR's comment that inter-affiliate swaps can, in some circumstances, contribute to financial contagion across different groups within a complex financial institution, making it more difficult to contain risks in one part of an organization. As evidenced by the events surrounding the 2008 financial crisis, many large financial institutions are interconnected and highly inter-dependent, with affiliated

[66] In the Proposed Cross-Border Interpretive Guidance, the Commission specifically discussed the flow of risk to the U.S. by entities that facilitate a U.S. person's ability to execute swaps outside the Dodd- Frank Act regulatory regime. 77 FR at 41228-29, 41234.

legal entities that are inextricably linked to each other.[67] The interconnected nature of corporate groups, therefore, increases the potential that risk in any part of a corporate group may spread throughout the organization, jeopardizing the financial integrity of not only the U.S affiliate, but depending on the scope of a potential default, the broader financial system.

For the aforementioned reasons, the Commission believes that the risk of evasion of U.S. laws and the potential systemic risk associated with uncleared inter-affiliate swaps involving foreign affiliates necessitates that the inter-affiliate exemption include the treatment of outward-facing swaps condition.

The treatment of outward-facing swaps condition that is being adopted as part of the inter-affiliate clearing exemption in this final release is aimed at addressing the potential risks associated with an eligible foreign affiliate's swaps with non-affiliated counterparties. As modified, the final rule requires that, as a condition to the inter-affiliate exemption, each eligible affiliate counterparty must clear all swaps that it enters into with an unaffiliated counterparty to the extent that the swap is included in the Commission's clearing requirement, i.e., in a class of swaps identified in § 50.4.[68] In order to satisfy this requirement, eligible affiliate counterparties must clear their third-party swaps pursuant to the Commission's clearing requirement or comply with the requirements for clearing the swap under a foreign jurisdiction's clearing mandate that is comparable, and comprehensive but not necessarily identical, to the clearing requirement of section 2(h) of the Act and part 50 of the Commission's regulations, as determined by

[67] For a discussion of specific institutional risks leading up to the 2008 financial crisis, see Proposed Cross-Border Interpretive Guidance at 41215-16.
[68] Currently, the scope of the Commission's clearing requirement is limited to four classes of interest rate swaps and two classes of CDS.

the Commission. In addition, the Commission is modifying the inter-affiliate exemption to allow for recognition of clearing exemptions and exceptions under the CEA and an exception or exemption under a foreign clearing mandate provided that the foreign jurisdiction's clearing mandate is comparable, and comprehensive but not necessarily identical, to the clearing requirement of section 2(h) of the Act and part 50 and the foreign jurisdiction's exception or exemption is comparable to an exception or exemption under the CEA or part 50, in each instance as determined by the Commission.

For eligible affiliate counterparties that are not located in the U.S. or in a comparable foreign jurisdiction, as determined by the Commission, the rule permits such eligible affiliates to clear any outward-facing swap that is required to be cleared under § 50.4 through a registered DCO or a clearing organization that is subject to supervision by appropriate government authorities in the home country of the clearing organization and has been assessed to be in compliance with the Principles for Financial Market Infrastructures (PFMIs). [69]

The Commission believes that this modified formulation of the treatment of outward-facing swaps condition being adopted as part of the final rule will more clearly establish the conditions to the exemption and alternative methods by which eligible affiliates may satisfy the requirements.

Moreover, in finalizing the requirement that eligible affiliate counterparties clear their swaps with unaffiliated counterparties, the Commission considered the approach adopted in EMIR. Articles 3, 4, and 13 of EMIR generally exempt from clearing OTC

[69] See Principles for Financial Market Infrastructures, April 2012, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD377.pdf.

derivatives transactions between intragroup counterparties, where one counterparty is located in the European Union and the other counterparty is located outside the European Union, provided that, among other things, the European Commission determines that the foreign counterparty is established in a country with "equivalent" requirements to EMIR.[70] By requiring that a foreign counterparty to an intragroup transaction be located in a country with equivalent requirements to EMIR, including clearing, any third-party swaps entered into by either the European Union counterparty or the non-European Union counterparty would be subject to a clearing requirement under EMIR or one that is equivalent to that required under EMIR, respectively.

In addition to the modifications to the treatment of outward-facing swaps condition described above, the Commission also is providing a transition period with alternative compliance frameworks, in response to concerns raised by commenters pertaining to the timing and sequencing of the implementation of the inter-affiliate exemption, which are discussed below.

2. Time-limited alternative compliance frameworks.

A number of commenters expressed concern with respect to the "comparable and comprehensive" requirement of the proposed rule. Several commenters expressed concern with respect to the timing and sequencing of the Commission's comparability

[70] See EMIR Article 13(1)-(3). The European Union has yet to make determinations as to whether third countries have equivalent requirements to EMIR. The European Commission (EC) has instructed the European Securities and Markets Authority (ESMA) to prepare possible implementing acts concerning the equivalence between the legal and supervisory frameworks of certain third countries and EMIR. Pursuant to the EC's instructions, ESMA must make its determination regarding the United States' clearing requirement by March 15, 2013. "Formal Request to ESMA for Technical Advice on Possible Implementing Acts Concerning Regulation 648/2012 on OTC Derivatives, Central Counterparties and Trade Repositories (EMIR)" available at http://www.esma.europa.eu/system/files/formal_request_for_technical_advice_on_equivalence.pdf.

determination in relation to the expected compliance date for the initial clearing requirement under section 2(h) of the Act.[71] These commenters noted that the comparability requirement is dependent upon the adoption of clearing regimes by other jurisdictions, and that because the U.S. clearing requirement is likely to take effect in advance of other jurisdictions adopting or finalizing their clearing regimes, non-U.S. affiliates effectively will not be able to rely on the inter-affiliate exemption from clearing when the Commission's initial clearing requirement takes effect. Significantly, ISDA & SIFMA commented that the cross-border condition may prove to be unnecessary because it is expected that the major financial jurisdictions will implement their own clearing regimes. However, ISDA & SIFMA and CDEU noted that questions of timing and criteria for comparability render the proposed treatment of outward-facing swaps condition problematic, and that unless the condition is satisfactorily resolved, the condition could hamper the ability of U.S.-based groups to compete in foreign markets. ISDA & SIFMA further commented that if the Commission retains the cross-border requirements, the Commission should provide an appropriate transition period in order to allow foreign jurisdictions to implement their own G-20 mandates.

The Working Group commented that because no other jurisdiction has a comparable clearing requirement,[72] the proposed rule would impose an obligation on almost all non-U.S. persons to comply with the U.S. clearing requirement in the event such entities wanted to engage in a non-hedge swap that was subject to mandatory

[71] See Clearing Requirement at 74319-21 (discussing the compliance dates for the first clearing requirement determination).

[72] This assertion is no longer accurate. As discussed below, Japan has adopted a clearing mandate for certain interest rate swaps and CDS.

clearing with a U.S. person affiliate. The Working Group claimed that this limitation would render the exemption unusable and questioned the public policy benefit of extending the clearing requirement in such instances. The Working Group further commented that the proposed rule represents a broad extension of U.S. law by, in effect, imposing the clearing requirement under 2(h)(1)(A) on non-U.S. persons that enter into swaps with U.S. person affiliates in order to satisfy the conditions of the inter-affiliate exemption. AFR supported the comparability condition and suggested that the Commission should grant the inter-affiliate exemption only with respect to foreign affiliate swaps once foreign jurisdictions finalize and implement their own clearing requirements.

The Commission recognizes commenters' concerns pertaining to the timing and sequencing of the inter-affiliate exemption in light of the Commission's clearing requirement, and in view of the ongoing progress of other jurisdictions to adopt and implement their respective clearing regimes. Accordingly, the Commission has determined to modify the proposed rule, as described in this release.

As an initial matter, and informed in large part by the reports of relevant international organizations and ongoing dialogue with international regulators, the Commission believes that many jurisdictions have made significant progress in implementing their clearing regimes. It is the Commission's understanding that the G-20 Leaders reaffirmed their commitment that all standardized OTC derivatives should be cleared through central counterparties by end-2012.[73] Importantly, the majority of G-20

[73] "G20 Leaders Declaration Los Cabos Mexico" (June 18-19, 2012) at paragraph 39. According to the October 2012 Report of the Financial Stability Board (FSB), 10 out of the 19 members of the G-20 group have either proposed or adopted legislation and/or regulations to implement their clearing framework, as of

members with major financial markets have been preparing for mandatory clearing, and significant steps towards further implementation have been taken by the United States, Japan, Singapore, and the European Union. In Japan, for example, the Japanese Financial Services Authority (JFSA) cabinet office ordinance regarding central counterparties and trade repositories which, among other things, subjects certain transactions to mandatory central clearing, became effective on November 1, 2012. The JFSA initially requires certain financial institutions to clear yen-denominated interest rate swaps that reference Yen-LIBOR, and CDS based on the Japanese iTraxx indices at a licensed CCP.

On November 15, 2012, the Singapore Parliament passed the Securities and Futures (Amendment) Bill 2012 to amend the Singapore Securities and Futures Act (SFA). This bill puts in place the regulatory regime for OTC derivatives in Singapore. This legislation institutes mandatory reporting and clearing requirements for financial entities and large non-financial entities. The Monetary Authority of Singapore is deliberating how to implement these legislative requirements and is expected to issue further consultation in 2013.

In the European Union, EMIR entered into force on August 16, 2012, and requires the clearing of all OTC derivatives subject to the clearing obligation. Clearing determinations are made at the initiative of the national authorities or the European Securities and Markets Authority (ESMA). Within six months of ESMA receiving notification by a national authority that a central counterparty has been authorized to clear a class of OTC derivatives, ESMA must determine whether that the class of OTC

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the date of that release. FSB, OTC Derivatives Market Reforms: Fourth Progress Report on Implementation, Oct. 31, 2012 at 74-77, available at https://www.financialstabilityboard.org/publications/r_121031a.pdf.

derivatives should be subject to the clearing obligation. At its own initiative, ESMA can also identify classes of OTC derivatives that should be subject to the clearing obligation. Additional details regarding the specific manner in which clearing determinations will be made have been set forth in implementing regulations adopted by the European Commission on December 19, 2012.[74]

As evidenced by the progress of these jurisdictions, and others that host major financial markets across the world in implementing their clearing frameworks, the Commission agrees with ISDA & SIFMA that the comparability requirement of the inter-affiliate exemption is unlikely to pose a significant impediment to the use of the inter-affiliate exemption by most foreign affiliates because it is expected that the major financial jurisdictions will implement their own mandatory clearing regimes. Notwithstanding the progress of other jurisdictions to implement their clearing regimes, as discussed above, the Commission is mindful of commenters' concerns that the compliance timeframe for the clearing requirement in the U.S. is likely to precede the adoption and/or implementation of the clearing regimes of most other jurisdictions.

Accordingly, the Commission believes that it is important to provide for a transition period for foreign regimes to implement their clearing mandates to bring swaps into clearing. For certain eligible affiliate counterparties located in jurisdictions that have adopted swap clearing regimes and are currently in the process of implementation, namely Japan, the European Union, and Singapore, the Commission is modifying the proposed rule to allow for a transition period of one year from the first compliance date of the U.S. clearing mandate, until March 11, 2014, for those foreign jurisdictions that are

[74] See http://ec.europa.eu/internal_market/financial-markets/derivatives/index_en.htm.

working to implement their mandatory clearing regimes.[75] The Commission believes that a transition period of 12 months after required clearing began in the U.S. is appropriate given its understanding of the progress being made on mandatory clearing in the specified foreign jurisdictions. Regulation 50.52(b)(4)(ii)(A) provides that during that one-year period, affiliates domiciled in such foreign jurisdictions can satisfy the requirements of § 50.52(b)(4)(i) through the following: (i) each eligible affiliate counterparty, or a majority-interest holder on behalf of both eligible affiliate counterparties, pays and collects full variation margin daily on all its swaps with unaffiliated counterparties; or (ii) each eligible affiliate counterparty, or a majority-interest holder on behalf of both eligible affiliate counterparties, pays and collects full variation margin daily on all its swaps with other eligible affiliate counterparties.

Moreover, the Commission has determined to provide further time-limited relief for certain eligible affiliated counterparties located in the European Union, Japan, or Singapore from complying with the requirements of § 50.52(b)(4)(i) (or (b)(4)(ii)(A)) as a condition of electing the inter-affiliate exemption. In particular,§ 50.52(b)(4)(ii)(B) provides that if one of the eligible affiliate counterparties is located in the European Union, Japan, or Singapore, the requirements of paragraph (b)(4)(i) will not apply to such eligible affiliate counterparty until March 11, 2014, provided that two conditions are met. The first condition provides that the one counterparty that directly or indirectly holds a majority ownership interest in the other counterparty or the third party that directly or

[75] While the time-limited alternative compliance framework of § 50.52(b)(4)(ii) is limited to jurisdictions that currently have the legal authority to adopt mandatory clearing regimes, any jurisdiction that later adopts a mandatory clearing regime will be eligible for a comparability determination for purposes of this rule.

indirectly holds a majority ownership interest in both counterparties is not a "financial entity" as defined in section 2(h)(7)(C)(i) of the Act.[76] The second condition requires that neither eligible affiliate counterparty is affiliated with an entity that is an SD or MSP, as defined in § 1.3. This condition essentially requires that the eligible affiliate counterparties are not part of a corporate group with a member affiliate that is an SD or MSP. Accordingly, eligible affiliate counterparties that are located in European Union, Japan, or Singapore and meet these two conditions, are exempt from the requirements of § 50.52(b)(4)(i) until March 11, 2014. The Commission believes that providing the time-limited exemption in § 50.52(b)(4)(ii)(B) to the specific entities described above is consistent with comments requesting that the exchange of variation margin requirement, to the extent retained, be limited to SDs and MSPs. Specifically, ISDA & SIFMA noted in their comments that the scope of the Commission's regulatory concern should be limited to SDs and MSPs, and that the regulatory regime applicable to SDs already contained applicable safeguards, including variation margin requirements. Similarly, CDEU commented that any variation margin requirements be limited to SDs and MSPs.

[76] For purposes of meeting the requirements of § 50.52(b)(4)(ii)(B)(1) until March 11, 2014, the holding company (i.e., the ultimate parent of the corporate group) may not be considered to be a "financial entity," as defined in section 2(h)(7)(C)(i) of the CEA, under certain circumstances. The holding company must be able to identify all affiliates that meet the requirements of § 50.52(a). Of those identified affiliates, a predominant number must qualify for the end-user exception under § 50.50. If a predominant number of the affiliates meeting the requirements of § 50.52(a) qualify for the end-user exception under § 50.50, then the holding company may treat the activities of all of its affiliates meeting the requirements of § 50.52(a) as if the holding company was engaged directly in such activities and consider such affiliates' activities on a cumulative basis with the holding company's other activities when assessing whether the holding company is "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 of 1956" under section 2(h)(7)(C)(i)(VIII) of the CEA. In effect, the holding company may "look through" its investment in affiliates to all of the activities of the affiliates meeting the requirements of § 50.52(a). Accordingly, the activities of affiliates meeting the requirements of § 50.52(a) that are not in the business of banking or financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956, would be attributed to the holding company. Conversely, if the affiliates meeting the requirements of § 50.52(a) are engaged in activities that are in the business of banking or of a financial nature, then those activities would be attributed to the holding company for purposes of determining whether the holding company is a financial entity for purposes of meeting the requirements of § 50.52(b)(4)(ii)(B)(1).

For eligible affiliate counterparties that are located in jurisdictions other than the European Union, Japan or Singapore, the Commission also is providing another time-limited alternative compliance framework for meeting the requirements of § 50.52(b)(4)(i). Specifically, § 50.52(b)(4)(iii) provides that if an eligible affiliate counterparty located in the United States enters into swaps (that are included in a class of swaps identified in § 50.4), with eligible affiliate counterparties located in jurisdictions other than the United States, the European Union, Japan, and Singapore, and the aggregate notional value of such swaps, which are included in a class of swaps identified in § 50.4 does not exceed five percent of the aggregate notional value of all swaps, which are included in a class of swaps identified in § 50.4, in each instance the notional value as measured in U.S. dollar equivalents and calculated for each calendar quarter, held by the eligible affiliate counterparty located in the United States, then such swaps shall be deemed to satisfy the requirements of paragraph (b)(4)(i) until March 11, 2014, provided that: (A) each eligible affiliate counterparty, or a third party that directly or indirectly holds a majority interest in both eligible affiliate counterparties, pays and collects full variation margin daily on all swaps entered into between the eligible affiliate counterparties located in jurisdictions other than the United States, the European Union, Japan, and Singapore and an unaffiliated counterparty; or (B) each eligible affiliate counterparty, or a third party that directly or indirectly holds a majority interest in both eligible affiliate counterparties, pays and collects full variation margin daily on all of the eligible affiliate counterparties' swaps with the other eligible affiliate counterparties.

The options provided under the two alternative compliance frameworks described above are intended to mitigate the risk associated with uncleared third-party swaps. The

payment and collection of variation margin is a vital component of the clearing process. As the Commission noted in the NPRM, variation margin is an essential risk-management tool that serves both as a check on risk-taking that might exceed a party's financial capacity and as a limitation on losses when there is a failure.[77] In addition to the risk-management benefits of variation margin, certain commenters expressed support for the inclusion of variation margin as a condition of the inter-affiliate exemption, and thus, the inclusion of variation margin within the alternative compliance frameworks is consistent with those comments. The Commission further clarifies that eligible affiliate counterparties that are eligible to comply with the alternative compliance frameworks in § 50.52(b)(4)(ii) or § 50.52(b)(4)(iii) and choose to pay and collect variation margin daily on either all of their inter-affiliate swaps or all of their third party swaps, will have flexibility in tailoring their daily variation margin arrangements, including with respect to establishing appropriate prices for purposes of marking to market and threshold levels at which margin will be settled.

Notwithstanding the alternative compliance frameworks, the Commission encourages all eligible affiliate counterparties to clear their outward-facing swaps on a voluntary basis in order to best mitigate the risks associated with those swaps. The Commission notes that in lieu of complying with the alternative compliance frameworks through March 11, 2014, eligible affiliate counterparties also may satisfy the outward-facing swap condition by complying with § 50.52(b)(4)(E) by clearing their third-party swaps through a registered DCO or a clearing organization that is subject to supervision

[77] As described in the NPRM, variation margin entails marking open positions to their current market value each day and transferring funds between the parties to reflect any change in value since the previous time the positions were marked. This process prevents uncollateralized exposures from accumulating over time and thereby reduces the size of any loss resulting from a default should one occur. NPRM at 50429.

by the appropriate government authorities in the home country of the clearing organization and has been assessed to be in compliance with the PFMIs.

The Commission believes that the alternative compliance framework adopted in this release addresses commenters' concerns pertaining to the timing and sequencing of the inter-affiliate exemption and the effective date of the Commission's initial clearing determination, and incorporates ISDA & SIFMA's recommendation to provide an appropriate transition period for foreign jurisdictions to implement their clearing regimes.

In response to The Working Group, the Commission notes that the treatment of outward-facing swaps condition is needed to protect U.S. financial markets and to prevent evasion of the clearing requirement. The modified condition requires that eligible affiliate counterparties, whether domiciled in the U.S. or in a foreign jurisdiction, that elect the inter-affiliate exemption must clear their outward-facing swaps, if such swaps fall within a class identified in § 50.4, or satisfy one the provisions in the alternative compliance frameworks, as applicable, until March 11, 2014. The alternative compliance frameworks are a direct response to concerns raised by The Working Group, and other commenters, regarding providing other jurisdictions with sufficient time to implement their clearing regimes. The alternative compliance framework provides eligible affiliates that elect the inter-affiliate exemption with other options, in addition to clearing, for managing the risks associated with their outward-facing swaps. In response to concerns that foreign-domiciled eligible affiliates would not be able to enter into uncleared non-hedge swaps with third parties that are foreign-domiciled end users, the Commission notes that it would take into consideration any comparable exceptions or exemptions granted under a comparable foreign jurisdiction's clearing regime.

In response to The Working Group's statement that the treatment of outward-facing swap condition expands the cross-border application of the clearing requirement to cover swaps between U.S. persons and non-U.S. persons, the Commission observes that U.S. persons are subject to the CEA's clearing requirement and part 50 of the Commission's regulations. Furthermore, the Commission notes that the final rule would permit eligible affiliate counterparties that are not located in the U.S. or in a comparable and comprehensive jurisdiction, to elect the inter-affiliate exemption provided that they clear any outward-facing swaps that are required to be cleared under § 50.4, through a registered DCO or a clearing organization that is subject to supervision by appropriate government authorities in the home country of the clearing organization and has been assessed to be in compliance with the PFMIs.[78]

Although the Commission believes that the alternative frameworks described above are necessary in the circumstances described, these alternatives are not equivalent to clearing and would not mitigate potential losses between swap counterparties in the same manner that clearing would. Thus, notwithstanding the alternative compliance frameworks, the Commission believes that the requirement that eligible affiliates clear swaps entered into with non-affiliated counterparties is the most appropriate method in which to prevent evasion of the clearing requirement and to help protect U.S. financial

[78] The Commission believes that the use of an international standard that is substantially similar, though not identical, to the requirements under part 39 imposed upon DCOs registered with the Commission is appropriate for purposes of the condition. The PFMIs were developed with broad participation and comment from entities from multiple nations and have been approved by both IOSCO's Technical Committee and the CPSS. The Commission further notes that eligible affiliate counterparties that are not located in the U.S. or in a comparable and comprehensive jurisdiction must comply with the requirements of § 50.52(b)(4)(i)(E). However, if such entities prefer to clear their swaps pursuant to the clearing requirement regime in the U.S. or in a jurisdiction that the Commission has determined to have a comparable clearing requirement, they also may comply with one of the conditions in § 50.52(b)(4)(i)(A) or (b)(4)(i)(B).

markets, and encourages market participants to do so. As noted above, incorporated within the requirement that eligible affiliate counterparties clear their outward-facing swaps is the option to comply with the requirements of a foreign jurisdiction's clearing mandate for the outward-facing swaps, including any comparable exception or exemption granted under the foreign clearing mandate, provided that such foreign jurisdiction's clearing mandate is determined by the Commission to be comparable, and comprehensive but not necessarily identical, to the clearing requirement established under the CEA, and the exception or exemption is determined by the Commission to be comparable to an exception or exemption provided under the CEA or part 50.

In the next section of the release, the Commission describes the specific comments raised with respect to the proposed "comparable and comprehensive" standard and provides a discussion of the its consideration of these comments, as well as an explanation of the Commission's anticipated process for reviewing and issuing comparability determinations in the context of the inter-affiliate exemption from clearing.

3. Application of the comparable and comprehensive standard to mandatory clearing.

Commenters raised questions as to the criteria the Commission would consider in rendering a comparability determination. ISDA & SIFMA requested that the Commission clarify that "comparability" does not mean that the host country must have the "same" requirement. CDEU questioned what specific criteria the Commission would consider in making a comparability finding. CDEU recommended that the Commission limit the applicability of the comparability requirement to SDs and MSPs, and claimed that extending the condition to end-users would disproportionately impact end-users that

have global operations, particularly in emerging markets.[79] CDEU further suggested that the Commission extend the inter-affiliate exemption to non-U.S. affiliates that enter into 20 or less third-party swaps per month. The Working Group noted that many commercial energy firms have operations in foreign jurisdictions that have less commercially robust financial markets than those in the U.S., and that the treatment of outward-facing swaps condition may place significant limitations on the ability of commercial enterprises to hedge risk associated with such operations, thereby resulting in higher cost of doing business in the foreign country or decreasing the business activity of the U.S. company in the foreign jurisdiction. The Working Group further commented that the proposed rule extends the reach of U.S. law on non-U.S. persons "far beyond" the immediate clearing requirement.[80]

AFR suggested that the final rule should specifically state that the "comparable and comprehensive" requirement must apply to each "specific type of swap" being considered for the exemption. AFR further stated that the Commission should provide a detailed comparability procedure, such as the procedure described in the proposed cross-border guidance. MetLife also suggested that rather than broadly prohibiting non-U.S. affiliates (that are not located in a comparable jurisdiction) from entering into any third-party swaps as a condition of the inter-affiliate exemption, the Commission should narrow the prohibition in the proposed rule to prohibit non-U.S. affiliates (that are not

[79] CDEU claimed that end users would be adversely impacted by the increased costs for risk-mitigating transactions between affiliates, and noted that the Dodd-Frank Act did not contemplate regulation of end-user transactions in the same manner as SD and MSP transactions.

[80] According to The Working Group, the proposed rule, for instance, would require certain non-U.S. persons to enter into an agreement with a futures commission merchant (FCM), and to enter into a commercial relationship in the U.S. including posting capital in U.S. markets that would subject such entities to U.S. bankruptcy law.

located in a comparable jurisdiction) from entering into "similar swaps of the same product type" with unaffiliated third parties.

As described above, a number of commenters requested further clarification on how the Commission will apply the "comparable and comprehensive" standard in the context of the mandatory clearing. The comparability requirement originally was discussed in the Commission's Proposed Cross-Border Interpretive Guidance. Drawing on its experience in exempting foreign brokers from certain registrations requirements under its rule 30.10 "comparability" determinations, the Commission proposed the "comparable and comprehensive" concept in the Proposed Cross-Border Interpretive Guidance[81] in order to permit certain classes of non-U.S. registrants to substitute compliance with the requirements of its home jurisdiction's law and regulations, in lieu of compliance with the CEA and the Commission's regulations, if the Commission finds that the relevant jurisdiction's laws and regulations are comparable to the relevant requirements of the CEA and Commission regulations.[82]

In the Proposed Cross-Border Interpretive Guidance, the Commission, in describing its intended approach to making comparability determinations, noted that similar to its policy with respect to rule 30.10, the Commission would retain broad discretion to determine that the objectives of any program elements are met,

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[81] Proposed Cross-Border Interpretive Guidance at 41232-35.

[82] The Proposed Cross-Border Interpretive Guidance identified transaction-level requirements to include mandatory clearing and swap processing, margining, segregation, trade execution, swap trading documentation, portfolio reconciliation and compression, real time public reporting, trade confirmation, and daily trading records requirements. The Proposed Cross-Border Interpretive Guidance proposed to allow substituted compliance with respect to transaction level requirements for swaps between a non-U.S. SD or non-U.S. MSP with a non-U.S. person that is guaranteed by a U.S. person, as well as swaps with non-U.S. affiliate conduits. See Proposed Cross-Border Interpretive Guidance at 41230.

notwithstanding the fact that the foreign requirements may not be identical to that of the Commission.

i. Comparability of foreign clearing mandate.

In response to comments seeking additional clarity around the Commission's comparability determination process, the Commission clarifies that it will review the comparability and comprehensiveness of a foreign jurisdiction's clearing mandate under § 50.52(b)(4)(i)(B) by reviewing: (i) the foreign jurisdiction's laws and regulations with respect to its mandatory clearing regime (i.e., jurisdiction-specific review), and (ii) the foreign jurisdiction's clearing determinations with respect to each class of swaps for which the Commission has issued a clearing determination under § 50.4 of the Commission's regulations (i.e., product-specific review).

As noted above, and in response to ISDA & SIFMA, the Commission reiterates that for purposes of the treatment of outward-facing swaps condition of the inter-affiliate exemption, comparability findings with respect to a foreign jurisdiction's clearing regime will not require an identical regime to the clearing framework established under the Act and Commission regulations. Rather, the Commission anticipates that it will make jurisdiction-specific comparability determinations by comparing the regulatory requirements of a foreign jurisdiction's clearing regime with the requirements and objectives of the Dodd-Frank Act. Notably, the Commission anticipates that the product-specific comparability determination will necessarily be made on the basis of whether the applicable swap is included in a class of swaps covered under § 50.4, and if so, whether such swap or class of swaps is covered under the foreign jurisdiction's clearing mandate.

ii. Comparability of exemption or exception under foreign clearing regime.

With respect to determining whether an exemption or exception under a comparable foreign clearing mandate is comparable to an exception or exemption under the CEA or part 50, as provided under § 50.52(b)(4)(i)(D), the Commission anticipates that it would review for comparability purposes the foreign jurisdiction's laws and regulations with respect to its mandatory clearing regime, as well as the relevant exception or exemption. In doing so, the Commission would exercise broad discretion to determine whether the requirements and objectives of such exemption or exception are consistent with those under the Dodd-Frank Act and that such objectives are being met, notwithstanding the fact that the exemption or exception from clearing under the comparable foreign clearing regime may not be identical to those established under the Act or the Commission's regulations. Accordingly, the Commission anticipates that comparability determinations with respect to a foreign jurisdiction's exemption or exception from mandatory clearing could be made at either the entity level, or the transaction type, as appropriate.

iii. Responses to additional comments.

In response to comments seeking clarification on what will trigger a Commission comparability determination, the Commission anticipates that it will render jurisdiction-specific and product-specific comparability determinations upon the adoption of clearing regimes by foreign jurisdictions for classes of swaps covered under § 50.4, upon the request of a counterparty that is located in a foreign jurisdiction, or upon receipt of a request from another appropriate party.

The Commission further anticipates that once a comparability determination is made with respect to the foreign jurisdiction's clearing regime, and with regard to a

particular class of swaps covered under § 50.4, eligible affiliates domiciled in such jurisdiction may rely on such determinations for swaps included within the applicable class, without further Commission action. To the extent that the Commission proposes a change to its regulations governing the clearing requirement generally or with respect to any particular product class, the Commission will reevaluate whether the proposed regulatory change would affect the basis upon which the Commission made the comparability determination. To the extent that there are discrepancies in the requirements between the foreign jurisdiction and the Commission's proposed regulatory change, the Commission anticipates that it would issue additional guidance or notifications to market participants to determine how affected entities can address any discrepancy in requirements.

The Commission declines to limit the condition that eligible affiliates clear their outward-facing swaps to SDs and MSPs, as suggested by CDEU. As explained throughout this release, the Commission believes that the requirements of § 50.52(b)(4) are necessary to prevent evasion of the clearing requirement and to protect U.S. financial markets. Moreover, the requirements of section 2(h)(1)(A) apply to all market participants not able to elect an exception under section 2(h)(7) of the CEA, not just to SDs and MSPs. The Commission believes that the modified rule and time-limited alternative compliance frameworks adopted in the final rule will provide end users, amongst others, with substantial flexibility to comply with the conditions of the exemption. Furthermore, the Commission notes that end users also may elect the end-user exception from clearing for hedging transactions that comply with the requirements of the CEA and § 50.50.

For the reasons described in this release, the Commission is adopting in § 50.52(b) the conditions to the inter-affiliate exemption, initially proposed in § 39.6(g)(2)(v), pertaining to swaps entered into with unaffiliated counterparties, with the modifications described above.

H. Reporting Requirement and Annual Election

In the NPRM, the Commission explained that general reporting requirements under sections 2(a)(13) and 4r of the CEA and part 45 apply to uncleared inter-affiliate swaps.[83] In addition, the proposed regulations require the reporting counterparty to provide, or cause to be provided, to a registered SDR, or if no registered SDR is available, to the Commission, certain additional information. Proposed § 39.6(g)(4)(i) requires the reporting counterparty to confirm that both counterparties to the inter-affiliate swap are electing not to clear the swap and that both counterparties meet the requirements in proposed § 39.6(g)(1)-(2). Proposed § 39.6(g)(4)(ii) requires the reporting counterparty to submit information regarding how the financial obligations of both counterparties are generally satisfied with respect to uncleared swaps. Proposed § 39.6(g)(4)(iii) implements section 2(j) of the CEA for purposes of the inter-affiliate exemption. Section 2(j) of the CEA applies to an issuer of securities registered under section 12 of the Securities Exchange Act of 1934 (Exchange Act)[84] or an entity required to file reports under Exchange Act section 15(g) ("electing SEC Filers") that elects an exemption from the CEA's clearing requirement under section 2(h)(1)(A) of the CEA. Section 2(j) requires that an appropriate committee of the electing SEC Filer's board or

[83] See NPRM at 50432.

[84] 15 U.S.C. 78l.

governing body review and approve its decision to enter into swaps subject to an exemption clearing. Proposed § 39.6(g)(4)(iii)(A) requires an electing SEC Filer to notify the Commission of its SEC Filer status by submitting its SEC Central Index Key number. In addition, proposed § 39.6(g)(4)(iii)(B) requires the counterparty to report whether an appropriate committee of its board of directors (or equivalent governing body) has reviewed and approved the decision to enter into the inter-affiliate swaps that are exempt from clearing.[85]

Lastly, proposed § 39.16(g)(5) permits a counterparty to provide information related to how it generally meets its financial obligations and information related to its status as an electing SEC Filer on an annual basis in anticipation of electing the inter-affiliate clearing exemption for one or more swaps. This election is effective for inter-affiliate swaps entered into within 365 days following the date of such reporting. During the 365-day period, the affiliate counterparty would be required to amend the information as necessary to reflect any material changes to the reported information. Under the proposal, confirmation that both counterparties are electing not to clear the swap and that they both satisfy the other requirements of the exemption would not be subject to an annual filing, but must be done on a swap-by-swap basis.

The Commission received several comments in response to the reporting obligations of affiliates. Prudential and MetLife both commented that the Commission should clarify that only one counterparty is required to report the swap to an SDR. In

[85] The proposed requirements under regulations implementing section 2(j) mirror the requirements that the Commission finalized in its end-user exception rulemaking, End-User Exception to the Clearing Requirement for Swaps, 77 FR at 42560.

addition, both Prudential and MetLife stated that annual reporting is more efficient than swap-by-swap reporting.

EEI stated that the Commission should eliminate the transaction-by-transaction reporting requirement under proposed § 39.6(g)(4)(i) for the election of the exemption and confirmation that the conditions have the exemption have been met. Instead, EEI recommended that one of the affiliates be permitted to file an annual notice on behalf of both affiliates to exempt all of their swaps from clearing for an entire year. EEI contended that it will increase costs if both affiliates have to communicate that they elect not to clear the swap and meet the conditions of the exemption for each swap. EEI also stated that the Commission should state that part 45 does not apply to inter-affiliate swaps because the Commission will be able to obtain information regarding an inter-affiliate transaction based on reporting of a corresponding market-facing swap.[86]

CDEU also objected to reporting any information to an SDR on a trade-by-trade basis for inter-affiliate swaps as such reporting would be costly and onerous for parties. Instead, CDEU recommended that all reporting be done on an annual basis through a board resolution.[87] CDEU also requested that part 45 data be reported on a quarterly basis for all inter-affiliate swaps between financial and non-financial end users, and that inter-affiliate swaps not be subject to historical swap reporting under part 46. Similarly,

[86] EEI cited to a statement in the NPRM's consideration of costs and benefits as support for an argument that the Commission did not intend for part 45 reporting to apply to inter-affiliate swaps. See NPRM at 50433. The statement in the cost-benefit consideration of the NPRM merely drew a comparison between the reporting requirements under the proposed exemption and the general reporting requirements under parts 45 and 46, and those reporting requirements applicable to SDs and MSPs under part 23. The statement should not be read as calling into question the applicability of part 45 to inter-affiliate swaps.

[87] Cravath stated that the Commission has determined that part 43 reporting does not apply to inter-affiliate swaps.

Cravath asked that the Commission "provide meaningful relief from the reporting requirements of Part 45 and Part 46."

DLA Piper commented that the regulatory reporting requirements are unnecessary for inter-affiliate swaps and should be eliminated.[88] DLA Piper claimed that the reporting of both the outward-facing swap and the inter-affiliate swap would increase systemic risk by distorting the risk to the financial system. DLA Piper also commented that the imposition of recordkeeping obligations with respect to inter-affiliate swaps would result in significant additional burdens on corporate groups. DLA Piper stated that inter-affiliate swaps should be expressly exempt from the part 45 and part 46 reporting requirements.

Under sections 2(a)(13) and 4r of the CEA, all swaps must be reported to an SDR (or the Commission if there is no available SDR) and are subject to comprehensive recordkeeping obligations.[89] Reporting and recordkeeping obligations apply to both historical swaps[90] and those swaps executed after the applicable compliance date listed in part 45 of the Commission's regulations.[91] As indicated in the preamble to the final end-

[88] According to its comment letter, DLA Piper's comments are limited to corporate end-users who enter into intercompany hedging transactions.

[89] See 17 CFR part 45; 17 CFR 45.2 (recordkeeping obligations); Swap Data Recordkeeping and Reporting Requirements, 77 FR 2136 (Jan. 13, 2012); 17 CFR part 46; Swap Data Recordkeeping and Reporting: Pre-Enactment and Transition Swaps, 77 FR 35200 (June 12, 2012).

[90] As described in the part 46 rules, historical swaps include pre-enactment swaps, that is, swaps still in existence after the date of enactment of the Dodd-Frank Act, and transition swaps, that is, swaps entered into on or after the date of enactment but before the compliance date specified in part 45 and other no-action or regulatory guidance issued by the Commission or one of the Commission's divisions or offices.

[91] These reporting obligations may be subject to no-action or other regulatory guidance issued by the Commission or any of the Commission's divisions or offices. See www.cftc.gov for a complete list of the staff no-action letters, Frequently Asked Questions, and other regulatory guidance.

user exception[92] and the NPRM,[93] parts 45 and 46 of the Commission's regulations apply to inter-affiliate swaps.[94] Whether an inter-affiliate swap is subject to the part 43 real-time reporting rules will depend on whether the transaction fits within the definition of a "publically reportable swap transaction."[95]

In response to commenters' requests, the Commission is clarifying that the reporting obligations under § 39.6(g)(2)(i) (now § 50.52(c)) can be fulfilled by one of the affiliate counterparties on behalf of both counterparties. The selection of which affiliate will be considered to be the reporting counterparty should be determined in accordance with the provisions of § 45.8 and, for part 43, the reporting party under § 43.3(a)(3).

As noted in the NPRM, the Commission believes that affiliates within a corporate group may make independent determinations on whether to submit an inter-affiliate swap for clearing. Given the possibility that each affiliate may reach different conclusions regarding clearing the swap, § 39.6(g)(2)(i) would require that both counterparties elect

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[92] See End-User Exception to the Clearing Requirement for Swaps, 77 FR at 42567 ("Congress did not exempt such inter-affiliate swaps from the reporting requirements" and "inter-affiliate swaps must be reported").

[93] NPRM at 50432 (noting that section 4r applies to uncleared swaps and that counterparties must comply with proposed rule 39.6(g)(4) "[i]n addition to any general reporting requirements applicable under other applicable rules").

[94] In addition, under part 45 non-SDs and MSPs must keep "full, complete, and systematic records, together with all pertinent data and memoranda, with respect to each swap in which they are a counterparty." 17 CFR 45.2(b). These recordkeeping obligations applied to inter-affiliate swaps as early as October 14, 2010. See Interim Final Rule for Reporting Pre-Enactment Swap Transactions, 75 FR 63090 (Oct. 14, 2010). Thus, as of the date of this release, swap counterparties already have an obligation to maintain swap records that has existed for more than two years.

[95] See 17 CFR 43.2 (defining "publicly reportable swap transaction" as an executed swap that is an arm's length transaction between two parties that results in a change in the market risk position between the two parties and citing "internal swaps between one-hundred percent owned subsidiaries of the same parent entity" as an example of a swap that does not meet the definition); see also Real-Time Public Reporting of Swap Transaction Data, 77 FR 1182, 1187 (Jan. 9, 2012) (discussing the real-time public reporting of inter-affiliate swaps).

the proposed inter-affiliate clearing exemption. The Commission is therefore adopting the electing requirement as proposed.

With regard to comments recommending that all reporting be done on an annual basis rather than a swap-by-swap basis, the Commission declines to modify the rule. The Commission believes it is appropriate to provide for annual reporting of certain information, including how affiliates generally meet their financial obligations and information related to its status as an electing SEC Filer.[96] However, it would not be appropriate to allow one annual report to cover both affiliate counterparties' election of the exemption from clearing and the confirmation that both affiliates meet the conditions of the exemption because each affiliate is under an ongoing obligation to demonstrate its eligibility to claim the exemption and because effective regulatory monitoring requires an indication of the election on a swap-by-swap basis.[97] Accordingly, the election of the exemption and the confirmation that the exemption's conditions are met must be made for each swap. The Commission does not believe that this reporting requirement will impose a significant burden on affiliate counterparties because, as discussed above, other

[96] The Commission is modifying the proposed reporting requirements relating to section 2(j) of the CEA to make them consistent with the approach adopted in the end-user exception to required clearing. As finalized, under § 50.52(c)(3)(ii), the committee of the board of directors (or equivalent body) of the eligible affiliate counterparty must have "reviewed and approved the decision to enter into swaps that are exempt from the requirements of sections 2(h)(1) and 2(h)(8) of the Act."

[97] If reports to the SDR were made on an annual basis, but included swap-by-swap information, regulators would not be able to monitor the transmission of risk through the market in a timely fashion. Regulators would have a one-year lag before such data could be used effectively for such purposes. If reports to the SDR were made on an annual basis and did not include swap-by-swap information, the regulators would be permanently hindered in their ability to monitor the swap markets. As noted above, inter-affiliate swaps and outward-facing swaps both transfer risk, but they do so in different ways and in differing degrees. Regulators must be able to distinguish between inter-affiliate swaps and outward-facing swaps in order to monitor markets effectively. If electing entities provided an annual statement that they are electing the exemption, and do not identify the individual swaps for which the exemption has been elected, the data would not allow regulators to distinguish between the two groups.

detailed information for every swap must be reported under sections 2(a)(13) and 4r of the CEA and Commission regulations. This approach comports with the approach adopted for market participants claiming the end-user exception under section 2(h)(7) of the CEA.[98]

The Commission does not agree with EEI's comment that the Commission will be able to obtain information on inter-affiliate swaps from the information reported on market-facing swaps, and disagrees with DLA Piper's comment that reporting and recordkeeping obligations are unnecessary or would increase systemic risk. The reporting and recordkeeping requirements promote accountability and transparency, and will aid the Commission in monitoring compliance with the inter-affiliate exemption. Moreover, the Commission does not believe that the information relating to inter-affiliate swaps will necessarily be identical to market-facing swaps. Also, the Commission does not believe that all inter-affiliate swaps will match up to market-facing swaps because, as The Working Group commented, entities use inter-affiliate trades to transfer physical commodity or futures exposure between affiliates for compliance with international tax law, customs, or accounting laws.

I. Implementation

The clearing requirement under section 2(h)(1)(A) of the CEA and part 50 of the Commission's regulations shall not apply to a swap executed between affiliated counterparties that have the status of eligible affiliate counterparties, as defined in § 50.52(a), and elect not to clear such swap until the effective date of this rulemaking.

[98] See End-User Exception to the Clearing Requirement for Swaps, 77 FR at 42565-66.

The effective date of this rulemaking shall be 60 days after publication in the Federal Register.

III. COST-BENEFIT CONSIDERATIONS

A. Statutory and Regulatory Background

Section 15(a) of the CEA[99] requires the Commission to consider the costs and benefits of its actions before promulgating a regulation under the CEA or issuing certain orders. Section 15(a) further specifies that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (1) protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. The Commission considers the costs and benefits resulting from its discretionary determinations with respect to the section 15(a) factors.

Prior to the passage of the Dodd-Frank Act, swaps were not required to be cleared. In the wake of the financial crisis of 2008, Congress adopted the Dodd-Frank Act, which, among other things, amends the CEA to impose a clearing requirement for swaps based on determinations by the Commission regarding which swaps are required to be cleared through a DCO.[100] This clearing requirement is designed to reduce counterparty risk associated with swaps and, in turn, mitigate the potential systemic impact of such risk and reduce the risk that swaps could cause or exacerbate instability in

[99] 7 U.S.C. 19(a).

[100] See section 2(h)(1) of the CEA, 7 U.S.C. 2(h)(1).

the financial system.[101] In amending the CEA, however, the Dodd-Frank Act preserved the Commission's authority to "promote responsible economic or financial innovation and fair competition" by exempting any transaction or class of transactions, including swaps, from select provisions of the CEA.[102] For reasons explained above,[103] the Commission proposes to exercise its authority under section 4(c)(1) of the CEA to exempt inter-affiliate swaps—that is, swaps between majority-owned affiliates with financial statements that are reported on a consolidated basis under GAAP or IFRS—from the clearing requirement under section 2(h)(1)(A) of the CEA, subject to certain conditions.

In the discussion that follows, the Commission considers the costs and benefits of the inter-affiliate exemption to the public and market participants generally. The Commission also separately considers the costs and benefits of the conditions placed on affiliates that would elect the exemption: (1) majority ownership and financial statements that are reported on a consolidated basis under GAAP or IFRS as conditions for status as an eligible affiliate counterparty; (2) swap trading relationship documentation, which would require affiliates to document in writing all terms governing the trading relationship; (3) centralized risk management requirement, which would require affiliates

[101] When a bilateral swap is moved into clearing, the clearinghouse becomes the counterparty to each of the original participants in the swap. This standardizes counterparty risk for the original swap participants in that they each bear the same risk attributable to facing the clearinghouse as counterparty. In addition, clearing mitigates counterparty risk to the extent that the clearinghouse is a more creditworthy counterparty relative to those that each participant in the trade might have otherwise faced. Clearinghouses have demonstrated resilience in the face of past market stress. Most recently, they remained financially sound and effectively settled positions in the midst of turbulent events in 2007-2008 that threatened the financial health and stability of many other types of entities.

[102] Section 4(c)(1) of the CEA, 7 U.S.C. 6(c)(1). Section 4(c)(1) is discussed in greater detail above in Section II.A.

[103] See Section II.A above.

to subject the swap to centralized risk management; and (4) reporting requirements, which would require counterparties to advise an SDR, or the Commission if no SDR is available, that both counterparties elect the inter-affiliate clearing exemption and to identify the types of collateral used to meet financial obligations. In addition to the foregoing reporting requirements, counterparties that are issuers of securities registered under section 12 of the Securities Exchange Act of 1934 or those that are required to file reports under section 15(d) of that Act, would be required to identify the SEC central index key number and confirm that an appropriate committee of board of directors has approved of the affiliates' decision not to clear a swap. The rule also would permit affiliates to report certain information on an annual basis, rather than swap-by-swap. Finally, the Commission considers the costs and benefits of the condition regarding the treatment of outward-facing swaps.

In the NPRM, where reasonably feasible, the Commission sought to estimate quantifiable dollar costs. In some instances, however, the Commission explained that certain costs were not susceptible to meaningful quantification, and in those instances, the Commission discussed proposed costs and benefits in qualitative terms. As stated above, the Commission received a total of 14 comment letters following the publication of the NPRM, many of which strongly supported the proposed regulations. Some commenters generally addressed the cost-and-benefit aspect of the current rule; none of them, however, provided any quantitative data in response to the Commission's requests for comment.[104]

[104] As discussed further below, EEI commented on the NPRM's consideration of costs and benefits and stated that the costs of the proposed documentation requirement are unjustified. The NPRM included an estimate that there would be a one-time cost of $15,000 to develop appropriate documentation for use by an

In the sections that follow the Commission considers: (1) costs and benefits of the exemption for eligible affiliate counterparties; (2) costs and benefits of the exemption for market participants and the public; (3) alternatives contemplated by the Commission and the costs and benefits relative to the approach adopted herein; (4) the impact of exemption in light of the 15(a) factors. The Commission also discusses the corresponding comments accordingly.

B. Costs and Benefits of Exemption for Eligible Affiliate Counterparties

Without the final rule exempting swaps between certain affiliated counterparties, those entities would have to clear their inter-affiliate swaps pursuant to section 2(h)(1)(A) of the CEA (unless one of the affiliates is able to claim an exception under section 2(h)(7) of the CEA and § 50.50).[105] This rule allows eligible affiliates to exempt inter-affiliate swaps from clearing, which creates both costs and benefits for those entities. Regarding costs, by allowing affiliates not to clear certain swaps that would otherwise be subject to required clearing, the rule may allow those affiliates to be exposed to greater measures of counterparty credit risk with respect to one another. On the other hand, the primary benefit of providing this exemption for inter-affiliate swaps between eligible affiliate counterparties is that each affiliate will not have to incur the costs of required clearing.

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entity's affiliates. EEI objected to this estimate because, in its view, the legal costs associated with individually negotiating and amending standard agreements between individual affiliates would exceed the NPRM's estimates. In addition, EEI objected to the NPRM's estimate of 22 affiliated counterparties for each corporate group as "far too low" for U.S. energy companies. However, EEI did not provide specific, quantitative information in terms of either the legal costs of complying with the proposed documentation requirement or number of affiliates for a corporate group subject to this rule.

[105] Under the § 50.50 exception, end users and small financial institutions that are hedging or mitigating commercial risk may elect not to clear their swaps, subject to certain conditions. Because of this exception, as explained in the NPRM, the Commission anticipates that the inter-affiliate exemption will be elected only when the two counterparties are financial entities that do not qualify for the end-user exception. See NPRM at 50426.

These costs include clearing fees, as well as costs associated with margin and capital requirements. The rule also facilitates affiliates' use of swaps to hedge various types of risk more efficiently.

1. Benefits of clearing inter-affiliate swaps.

The benefits of required clearing have been well-documented by the Commission.[106] As described in the preceding sections of this adopting release, there are numerous benefits associated with central clearing of swaps. In particular, clearing mitigates counterparty credit risk, provides an organized mechanism for collateralizing the risk exposures posed by swaps, and when applied to channels where systemic risk could be transmitted, clearing reduces systemic risk.

The counterparty and systemic risk mitigation benefits of central clearing also are realized from clearing transactions between affiliates. Central clearing would ensure that inter-affiliate swaps are fully documented and abide by valuation procedures set by the DCO, which would help to ensure that affiliates have current and accurate information regarding the value of their positions and would help prevent the possibility of valuation disputes.[107] In addition, when a bilateral swap is cleared, the clearinghouse becomes the counterparty to each of the original counterparties to the swap. This reduces and standardizes the counterparty risk borne by each of the original parties to the swap.[108]

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[106] See e.g., Clearing Requirement Determination at 74329.

[107] ISDA & SIFMA stated that valuation and dispute resolution procedures would appear to serve little purpose among majority-owned affiliates. This comment is discussed above in Section II.D, as well as in Section III.C.2. below.

[108] A clearinghouse is one of the most credit-worthy counterparties available in the market because of the panoply of risk management tools it has at its disposal. These tools include the contractual right to: (1) collect initial and variation margin associated with outstanding swap positions; (2) mark positions to market regularly (usually one or more times per day) and issue margin calls whenever the margin in a

Moreover, clearing mitigates the risk of financial contagion because the clearinghouse serves as a sort of "buffer" that protects each of the original counterparties from the credit risk of the other. This would also be true for inter-affiliate swaps. Novating the swap to a clearinghouse so that each affiliate faces the clearinghouse would ensure that each affiliate is facing minimal counterparty credit risk and would minimize the possibility of inter-affiliate swaps becoming a mechanism through which financial instability could pass from one affiliate to another.

This rule reduces these benefits by allowing affiliates to exempt swaps from required clearing. In the absence of clearing, affiliated entities will not be required to collect initial or variation margin, or to implement other measures that clearinghouses typically use to mitigate their own counterparty credit risk. As a consequence, the affiliates may accumulate large outstanding positions with one another as the value of their swap positions change value between payment dates. If an affiliate with large, out-of-the-money, inter-affiliate swap positions defaulted, it could cause financial instability in its affiliates, leading to a cascading series of defaults among them. As discussed

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customer's account has dropped below predetermined levels set by the DCO; (3) adjust the amount of margin that is required to be held against swap positions in light of changing market circumstances, such as increased volatility in the underlying; and (4) close out the swap positions of a customer that does not meet margin calls within a specified period of time.

Moreover, in the event that a clearing member defaults on their obligations to the DCO, the latter has a number of remedies to manage associated risks, including transferring the swap positions of the defaulted member, and covering any losses that may have accrued with the defaulting member's margin and other collateral on deposit. In order to transfer the swap positions of a defaulting member and manage the risk of those positions while doing so, the DCO has the ability to: (1) hedge the portfolio of positions of the defaulting member to limit future losses; (2) partition the portfolio into smaller pieces; (3) auction off the pieces of the portfolio, together with their corresponding hedges, to other members of the DCO; and (4) allocate any remaining positions to members of the DCO. In order to cover the losses associated with such a default, the DCO would typically draw from (in order): (1) the initial margin posted by the defaulting member; (2) the guaranty fund contribution of the defaulting member; (3) the DCO's own capital contribution; (4) the guaranty fund contribution of non-defaulting members; and (5) an assessment on the non-defaulting members. These mutualized risk mitigation capabilities are largely unique to clearinghouses, and help to ensure that they remain solvent and creditworthy swap counterparties even when dealing with defaults by their members or other challenging market circumstances.

below, the Commission expects that internalization of costs and risks among affiliated entities, as well as the conditions for electing the exemption will mitigate this cost, but will not eliminate it entirely.

2. Reduced clearing costs.

As stated above, by exempting qualified affiliates from clearing inter-affiliate swaps that would otherwise be subject to the clearing requirement, the rule ensures that each affiliate will not incur the costs of required clearing for those swaps. These costs include clearing fees as well as costs associated with margin and capital requirements. Regarding clearing fees, assuming that the affiliated counterparties cannot clear on their own behalves or through an affiliated clearing member of a DCO, the affiliated counterparties would have to arrange to clear their swaps through a futures commission merchant (FCM) that is a member of a DCO. Regardless of whether the affiliated counterparties clear on their own behalf or contract with an FCM, they will incur fees from the DCO.

For customer clearing, DCOs typically charge FCMs an initial transaction fee for each customer swap that is cleared, as well as an annual maintenance fee for each of the customers' open positions. For example, not including customer-specific and volume discounts, the transaction fees for interest rate swaps at CME range from $1 to $24 per million notional amount and the maintenance fees are $2 per year per million notional amount for open positions.[109] LCH transaction fees for interest rate swaps range from $1 to $20 per million notional amount, and the maintenance fee ranges from $5 to $20 per

[109] See CME pricing charts at: http://www.cmegroup.com/trading/cds/files/CDS-Fees.pdf; http://www.cmegroup.com/trading/interest-rates/files/CME-IRS-Customer-Fee.pdf; and http://www.cmegroup.com/trading/interest-rates/files/CME-IRS-Self-Clearing-Fee.pdf.

swap per month, depending on the number of outstanding swap positions that an entity has with the DCO.[110] It is within the FCM's discretion to determine whether or how to pass these fees on to their customers.[111] Accordingly, allowing affiliates to elect not to clear swaps that meet the requirements of the final rule will result in the affiliates not having to pay clearing-related fees, either directly or indirectly, with respect to those swaps.

Second, permitting an exemption from clearing for swaps between affiliates, the final rule will reduce the amount of initial margin that such entities are required to post or pay for those swaps. In the clearing requirement determination, the Commission estimated that if every interest rate swap and CDS that is not currently cleared were moved into clearing, the additional initial margin that would need to be posted is approximately $19.2 billion for interest rate swaps and $53 billion for CDS.[112] While the estimates provided by the Commission in its clearing requirement determination adopting release did not include data related to inter-affiliate swaps,[113] the estimates do support a conclusion that the exemption will reduce the amount of margin that affiliates would be obligated to allocate to initial margin in order to clear inter-affiliate swaps that are subject

[110] See LCH pricing for clearing services related to OTC interest rate swaps at: http://www.lchclearnet.com/swaps/swapclear_for_clearing_members/fees.asp.

[111] See discussion of clearing fees in the Clearing Requirement Determination, 77 FR at 74324-25.

[112] See Clearing Requirement Determination at 74326 (explaining how this estimate was reached and noting that the estimate may either over-estimate or under-estimate the amount of additional initial margin that would need to be posted).

[113] For example, swap data collected by the Bank of International Settlements (BIS) does not contain information regarding transactions between affiliates (i.e., branches and subsidiaries) of the same institution. See, e.g., Statistical release: OTC derivatives statistics at end-June 2012, Monetary and Economic Department, Bank of International Settlements (Nov. 2012), available at http://www.bis.org/publ/otc_hy1211.pdf. The Commission relied on BIS data in calculating its additional initial margin requirements for required clearing of certain interest rate swaps and credit default swaps.

to the clearing requirement. As a consequence, the exemption is likely to increase the amount of capital that affiliates may distribute to their owners or put to other uses.

Third, by exempting inter-affiliate swaps from required clearing, inter-affiliate swaps would not be subject to variation margin requirements under a DCO's rules. Exempting inter-affiliate swaps from required clearing's variation margin requirements may help affiliates and corporate entities as a whole manage their liquidity needs because the entities would not have to routinely collateralize losses at the DCO. It is also likely to reduce the operational costs that the affiliates would otherwise bear in order to manage margin calls and associated variation margin payments.

3. Risk management benefits of inter-affiliate swaps.

A number of commenters stated that executing swaps with the market through one affiliate enables entities to more efficiently and effectively manage corporate risk.[114] In this arrangement, the one affiliate engages in inter-affiliate swaps with other affiliated entities in order to hedge the risks of those affiliates. The one, central affiliate then engages in market-facing swaps to offset the risk that it has taken on. Executing swaps through one affiliate may enable corporate entities to concentrate their swap and hedging expertise and activity within a single affiliate, which reduces personnel costs. It also allows the corporation to net various positions before facing the market, thus reducing the number of market facing swaps, and the attendant fees.

Moreover, these affiliate structures may not only reduce costs, but certain types of risk for the corporation as well. By concentrating personnel with swap and hedging expertise in one affiliate, and running inter-affiliate and market facing swap activities

[114] See, e.g., letters from The Working Group, EEI, and ISDA & SIFMA.

through a single entity, corporations may reduce the risk of operational errors. Such errors can create considerable risk when engaging in large hedging transactions. Moreover, the corporation's operational risk may be further mitigated by reducing the total number of market facing swaps into which the affiliated entities enter.[115]

Additionally, as stated above and as noted in the NPRM, affiliates that are commonly owned internalize a portion of one another's risk.[116] To the extent that affiliated entities internalize one another's risk, those entities have an economic incentive to perform on their obligations with respect to one another, thus reducing the counterparty risk that they bear as a consequence of their swaps with one another. However, the qualification "to the extent that affiliated entities internalize one other's risk" is significant. Two important factors limit the degree to which affiliates internalize one another's risk. First, if either of the affiliated entities has a portion of ownership that is not held in common, then a corresponding portion of the risks transferred to that entity will not be borne by the common owners, and thus will not be internalized. In other words, a smaller common ownership stake will cause less counterparty risk to be internalized, and will lessen the incentive affiliates will have to perform on their obligations toward one another. Second, as described above, there are circumstances in bankruptcy where affiliates do not internalize each other's risks, which may also reduce,

[115] Commenters also asserted that inter-affiliate swaps are used in order to assist in tax management and compliance with international laws, stating that the exemption would help to preserve those benefits. Commenters did not provide sufficient information regarding their operations, tax management strategies, and international compliance requirements for the Commission to evaluate these stated benefits.

[116] See NPRM at 50426 and Section II.A.

or eliminate, the affiliates' incentives to perform with respect to their obligations they have toward one another.[117]

Reduced internalization of risk among affiliates may create incentives for certain affiliates to use inter-affiliate swaps to shift risk to other affiliates in ways that are not necessarily in the best interests of minority stakeholders or counterparties to certain affiliates. In order to address this concern, the Commission has conditioned election of the exemption on several requirements that are intended to mitigate the costs created by reduced internalization of risk among affiliates, as well as the foregone benefits of required clearing.

C. Costs and Benefits of Exemption's Conditions.

The inter-affiliate exemption from required clearing sets forth five conditions that must be satisfied in order to elect the exemption: (1) both affiliates must be majority-owned and their financial statements must be reported on a consolidated basis; (2) the swap must be documented in a written swap trading relationship document; (3) the swap must be subject to a centralized risk management program; (4) certain information regarding the swap must be reported to an SDR; and (5) both affiliates must meet certain conditions with regard to their outward-facing swaps. The Commission believes that entities will have to incur costs to satisfy these conditions. Those costs may offset some of the benefits that would otherwise result from the exemption. However, the exemption is permissive, and therefore the Commission also believes that an affiliate will elect the exemption only if these costs are less than the costs that an affiliate will incur should it decide not to elect the exemption. Moreover, as described below, the conditions provide

[117] See Section II.A.

certain benefits to the affiliates' counterparties and to the public that the Commission believes are essential in order to mitigate counterparty credit risk in situations where affiliates do not completely internalize each other's risks. Lastly, the Commission believes that in some cases entities are already meeting some or all of the requirements for electing the exemption, in which cases the affiliates would bear less new costs, or no new costs at all, due to the conditions.[118]

1. Eligible affiliate counterparty status.

In order to qualify as an eligible affiliate counterparty under the terms of the exemption, two factors must be met. First, one affiliate must directly or indirectly hold a majority ownership interest in the other, or a third party must hold a majority ownership interest in both. Second, the financial statements of both affiliates are reported on a consolidated basis under Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS).

The Commission anticipates that in a relatively small number of cases entities may alter their ownership structures in order to qualify for the inter-affiliate exemption's majority-ownership condition. In these cases, entities may bear certain legal costs, and in some cases, costs associated with negotiations with other owners in the entity. These costs could vary significantly, depending on the complexity of the entity's existing ownership structure, including the number of owners and the alignment or misalignment of their interests. The Commission does not have adequate information to determine which entities or how many entities may consider altering their ownership structure in

[118] See e.g., letters from MetLife and Prudential (explaining that it is current business practice to document inter-affiliate swaps); letter from EEI (explaining that inter-affiliate swaps are subject to risk management).

order to become eligible for the inter-affiliate exemption, but notes again that entities would only do this if they anticipate that the benefits of the exemption are greater than the costs of meeting the qualifying criteria.

Four commenters supported proposed majority-ownership requirement. CDEU commented that the majority-ownership test strikes an appropriate balance between ensuring that the rule is not overly broad and providing companies with the flexibility to account for differences in corporate structures. EEI noted that majority-owned affiliates will have strong incentives to internalize one another's risks because the failure of one affiliate impacts all affiliates within the corporate group. The Working Group generally supported the Commission's definition, but stated that inter-affiliate swaps should be unconditionally exempt from mandatory clearing when the affiliates are consolidated for accounting purposes. MetLife stated that it would likely limit inter-affiliate trading to "commonly-owned" affiliates, but agreed with the flexibility of including majority-owned affiliates.

Two commenters objected to the proposal and requested the Commission require 100% ownership of affiliates. AFR stated that permitting such a low level of joint ownership would lead to evasion of the clearing requirement through the creation of joint ventures set up to enable swap trading between banks without the need to clear the swaps. Similarly, Better Markets agreed that only 100% owned affiliates should be eligible for the exemption because allowing the exemption for the majority owner permits that owner to disregard the views of its minority partners and creates an incentive to evade the clearing requirement by structuring subsidiary partnerships. Finally, Better Markets stated that the majority-ownership standard will result in corporate groups transferring

price risk and credit risk to different locations facilitating interconnectedness and potentially giving rise to systemic risk during times of market stress.

As discussed above, the degree to which one affiliate's risks are internalized by another affiliate depends significantly on the percentage of common ownership between them. For example, two affiliates that are 100% commonly owned are likely to internalize much of one another's risk. This creates a strong incentive for affiliates to perform on their obligations to one another. Therefore, if the Commission were to increase the common ownership requirement above a majority stake, it would likely result in affiliate counterparties internalizing more of one another's risk with respect to inter-affiliate swaps in order to qualify for the exemption. This, in turn, would provide additional incentives for affiliates to perform on their inter-affiliate swap obligations. However, if the Commission were to increase the common ownership percentage requirement, it also would reduce the number of affiliates that could qualify for, and benefit from, the exemption.

On the other hand, if the Commission lowered the percentage of common ownership that is required to be eligible for the exemption (i.e., made it 50% or less), it would increase the number of affiliates that are eligible for the exception. This lower standard would allow affiliates that internalize less of each other's risks and therefore have weaker incentives to perform on their obligations to one another to qualify for the exemption. Moreover, the absence of a majority common ownership requirement could create opportunities for otherwise unrelated entities to form joint ventures and transact swaps with one another in order to claim the inter-affiliate exemption from clearing, which would undermine the effectiveness of the clearing requirement.

The Commission considered each of these factors and concluded that the majority stake requirement is sufficient to internalize costs and incentivize affiliates to perform on their obligations to one another. The Commission also believes that the potential for evasion is mitigated through the conditions to the final rule, which have been carefully crafted in order to narrow the exemption. For example, two unrelated entities cannot each hold a majority stake in the same affiliate. Consequently, such unrelated entities cannot use an inter-affiliate swap as an indirect means of trading without being subject to the clearing requirement under section 2(h) of the CEA and part 50 of the Commission's regulations.

As an additional consideration, as noted above, the majority requirement also harmonizes with Commission's understanding of the EMIR requirements. Harmonizing with EMIR is likely to reduce compliance monitoring costs for entities electing the affiliated entity exemption. In terms of potential costs in the form of disregarding the interests of minority shareholders, the Commission recognizes that a 100% ownership requirement would eliminate the risk of minority shareholders' interests not being aligned with decisions to elect the exemption. However, the Commission is also cognizant that such a requirement would reduce the number of affiliates that are able to claim the exemption. The Commission believes that the majority-ownership requirement appropriately considers the risk of the former and the benefits of the latter.

With regard to the consolidation of financial statements, FSR requested that the Commission clarify that alternative accounting standards can be used for purposes of meeting the requirement that the financial statements of both affiliates be reported on a consolidated basis. The Commission considered this comment and is adopting the

alternative suggested by FSR. As modified the rule requires that the financial statements of both counterparties be reported on a consolidated basis under GAAP or IFRS. This change recognizes the fact that some entities claiming the exemption may report their financial statements under different accounting standards, and makes it possible for those entities to elect the exemption as long as they would be required to report their financial statements on a consolidated basis under GAAP or IFRS. This likely increases the number of entities that may elect the exemption relative to the form of the rule proposed in the NPRM while maintaining the protections that were intended with the requirement for consolidated financial statements. The Commission also modified the rule to clarify which entities are subject to the consolidated financial statement requirement.

2. Inter-affiliate swap documentation.

As proposed, the inter-affiliate exemption required that eligible affiliate counterparties that elect the inter-affiliate exemption must enter into swaps with a swap trading relationship document that is in writing and includes all the terms governing the relationship between the affiliates. These terms included, but were not limited to, payment obligations, netting of payments, transfer of rights and obligations, governing law, valuation, and dispute resolution. This requirement would be satisfied if an eligible affiliate counterparty is an SD or MSP that complies with the swap trading relationship documentation requirements of § 23.504.[119]

[119] For a discussion of the costs and benefits incurred by swap dealers and major swap participants that must satisfy requirements under § 23.504, see Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 77 FR 55904, 55906 (Sept. 11, 2012) (final rule) and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 76 FR 6715, 6724-25 (Feb. 8, 2011) (proposed rule).

The Commission received a number of comments both supporting and opposing the swap documentation requirement. Better Markets, MetLife, and Prudential all supported the proposed documentation requirement. Specifically, MetLife and Prudential did not believe that the documentation requirement would be any more "burdensome or costly" for them because they already document all of their swaps.

Cravath, EEI, CDEU, and DLA Piper opposed the proposed documentation requirement. Cravath stated that the costs associated with the imposition of documentation requirements outweigh any benefits to the financial system, and that the Commission should leave the determination as to the appropriate level of documentation to boards of directors and management of companies, to determine based on the "reasonable exercise of their fiduciary responsibilities." DLA Piper commented that the documentation requirements are burdensome and questioned the benefits of imposing documentation requirements on transactions between two parties.

CDEU expressed concern that proposed documentation condition would require that full ISDA Master Agreements be used to document inter-affiliate swaps. CDEU explained that while many market participants use master agreements, some end users many not have full master agreements because inter-affiliate swaps are purely internal and do not increase systemic risk. CDEU recommended that the proposed rule be revised to require that the swap documentation "include all terms necessary for compliance with its centralized risk management program" and eliminate the list of required terms. CDEU also requested that the Commission clarify that (1) market participants can continue to use documentation required by their risk management

programs and (2) the rule does not require market participants use ISDA Master Agreements.

EEI recommended that the Commission eliminate the documentation requirement because the requirement is duplicative of corporate accounting records that affiliates currently maintain. EEI commented that a documentation requirement imposes "an additional, costly layer of ministerial process and documentation that is unnecessary to achieve the Commission's stated objectives." EEI commented on the NPRM's consideration of costs and benefits and stated that the costs of the proposed documentation requirement are unjustified. The NPRM included an estimate that there would be a one-time cost of $15,000 to develop appropriate documentation for use by an entity's affiliates. EEI objected to this estimate because, in its view, the legal costs associated with individually negotiating and amending standard agreements between individual affiliates would exceed the NPRM's estimates. In addition, EEI objected to the NPRM's estimate of 22 affiliated counterparties for each corporate group as "far too low" for U.S. energy companies.[120] However, EEI did not provide specific, quantitative information in terms of either the legal costs of complying with the proposed documentation requirement or number of affiliates for a corporate group subject to this rule. Accordingly, the Commission is unable to verify whether the legal costs or average number of affiliates estimates are too low.

ISDA & SIFMA stated that the documentation requirements were overly prescriptive and would impose unnecessary costs on affiliates. ISDA & SIFMA

[120] This estimate appeared in the NPRM section regarding the Paperwork Reduction Act not in the consideration of costs and benefits section.

recommended a more flexible approach that would require adequate documentation of "all transaction terms under applicable law."

In response to commenters' requests for a more flexible standard, the Commission modified the proposal for swaps between affiliates that are not SDs or MSPs. The Commission adopted ISDA & SIFMA's recommendation that the focus of the documentation requirement be on documenting all of an inter-affiliate transaction's terms.[121]

Under this modification, the Commission is eliminating the non-exclusive list of terms, which included payment obligations, netting of payments, transfer of rights and obligations, governing law, valuation, and dispute resolution. The change responds to commenters' requests for a more flexible approach that reflects current market best practices, and signals that market participants retain the ability to craft appropriate documentation for their affiliated entities so long as such documentation includes the terms of the swap and "all terms governing the trading relationship between the eligible affiliate counterparties."[122] This modification also serves to address concerns that the intent of the proposed rule was to require formal master agreements, such as the ISDA Master Agreement.[123] The proposed rule was not intended to require affiliates to enter

[121] The Commission is modifying the documentation condition to require that "the terms of the swap are documented in a swap trading relationship document that shall be in writing and shall include all terms governing the trading relationship between the affiliates."

[122] See § 50.52(b)(2)(ii).

[123] In the NPRM, the Commission estimated that affiliates could pay a law firm for up to 30 hours of work at $495 per hour to modify an ISDA Master Agreement, resulting in a one-time cost of $15,000, and there may be additional costs related to revising documentation to address a particular swap. All salaries in these calculations are taken from the 2011 SIFMA Report on Management and Professional Earnings in the Securities Industry. Annual wages were converted to hourly wages assuming 1,800 work hours per year and then multiplying by 5.35 to account for bonuses, firm size, employee benefits and overhead. The

into formal master agreements. Rather, the Commission observed that parties that already use master agreements (of any sort) to document their inter-affiliate swaps would likely meet the requirements of the proposed rule without additional costs. This observation was supported by commenters such as MetLife and Prudential. The Commission believes that these modifications to the proposal and clarifications respond to commenters' concerns and will serve to reduce documentation costs for those electing the inter-affiliate exemption.[124]

Entities that have already established systems for documenting the terms of their inter-affiliate swaps and all the terms of the trading relationship between eligible affiliates will not bear any costs as a consequence of this requirement.[125] However, as noted in the NPRM, the Commission understands that some affiliates may enter into inter-affiliate swaps with little documentation regarding the terms of the swaps.[126] Such entities may not have systems to document the terms of their inter-affiliate swaps or all the terms of the trading relationship between eligible affiliates. They will bear some initial costs and ongoing costs in order to comply with this requirement. In the NPRM, the Commission estimated that the initial costs of up to $15,000 to create such the

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Commission also estimated that affiliates would incur costs of less than $1,000 per year related to signing swap documents and retaining copies.

[124] In response to comments from Better Markets and AFR that the proposed regulations should be retained and not weakened, the Commission does not believe that eliminating the non-exclusive list of terms and replacing it with a simple requirement that all terms of the swap transaction and the relationship between the affiliates be documented will weaken the rule. Rather, while affiliates will have discretion to select the appropriate terms to document their swap, they will still have an obligation to ensure that their documentation contains an accurate and thorough written record of their swaps. In most instances, this will necessarily include all of the previously enumerated terms.

[125] See comments letters from MetLife and Prudential.

[126] See NPRM at 50428-50429.

necessary documentation, and less than $1,000 per year on an ongoing basis to sign and retain appropriate documentation.[127]

In response to EEI's comment regarding duplicative requirements, to the extent that the documentation requirement is duplicative of an affiliate's existing recordkeeping practices, it will not introduce new costs. However, the Commission notes that if existing records do not contain the terms of each inter-affiliate swap or all the terms of the trading relationship between affiliates, affiliates will be required to implement new documentation that creates incremental costs, as noted above.

Regarding benefits, documentation of inter-affiliate swaps is essential to effective risk management. In the absence of such documentation, affiliates cannot track or value their swaps effectively. Documentation also helps ensure that affiliates have proof of claim in the event of bankruptcy. As explained earlier, insufficient proof of claim could create challenges and uncertainty at bankruptcy that could adversely affect affiliates and third party creditors. The documentation requirement, to the extent that it requires entities to document all the terms that are necessary in order to value inter-affiliate swaps and to provide legal certainty in the event of bankruptcy, will promote effective risk management and resolution of claims in the event of insolvency.[128]

3. Centralized risk management.

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[127] See id. at 50434.

[128] As discussed in Section II.D above, the Commission expects that, in most instances, documentation between affiliates will include all of the previously enumerated terms, several of which are essential to effective valuation of swaps and resolution in bankruptcy. However, the Commission notes that a more flexible approach makes it possible that some entities could document the terms of their inter-affiliate swaps and all the terms of their trading relationship without covering all of the terms that are necessary for effective valuation or resolution in bankruptcy. If this occurs, it would reduce the risk management and bankruptcy benefits created by the documentation requirement.

Another condition of the inter-affiliate exemption requires that the swap be subject to a centralized risk management program that is "reasonably designed to monitor and manage the risks associated with the swap." If at least one of the eligible affiliate counterparties is an SD or MSP, the centralized risk management requirement is satisfied by complying with the requirements of § 23.600.[129]

Four commenters objected to the proposed requirement, suggested alternatives, and/or requested clarification. FSR stated that the condition should be eliminated because integrated risk management systems "are generally not established across international boundaries" and are not consistent with general risk practices in large, multinational organizations. FSR suggested that the requirement be dropped in favor of each entity making "its own evaluations of the risk associated with an inter-affiliate position."

Cravath stated that in many cases, for companies outside of the financial sector, the proposed rule will require a substantial change in the processes and procedures currently maintained by such companies, and the cost of complying with the risk management program requirements outweigh any benefits to the financial system. Cravath commented that rather than subject companies to a risk management rule, "[c]ompanies should have the flexibility to engage in prudent risk management for their corporate group in a manner consistent with the overall level of risks to their business."

[129] For a discussion of the costs and benefits incurred by swap dealers and major swap participants that must satisfy requirements under § 23.600, see Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants, 77 FR at 20173-75.

EEI suggested that the Commission eliminate the centralized risk management program requirement on the grounds that it would be duplicative for corporate groups that already have risk management programs in place. According to EEI, it is standard industry practice for both private and public companies to have a risk management program. EEI accordingly does not see a "need to impose a separate, discrete regulatory requirement to document with an SDR or the Commission the existence of a centralized risk management program." If the Commission decides to retain the requirement, EEI requested that the Commission require a program be "reasonably designed to monitor and manage the risks associated with the swap" and provide the flexibility to design risk management programs that address the unique risks of an entity's business.

The Working Group requested that the Commission clarify whether non-SDs and non-MSPs would be subject to the same enterprise-level risk management program as required for SDs and MSPs under § 23.600. The Working Group proposed that the Commission require "a robust risk management program" rather than "a centralized risk management program."

In response to comments asking that the Commission clarify the level of risk management required for non-SDs and non-MSPs, the Commission confirms that the risk management condition is intended to be flexible and does not require the same level of policies and procedures as required under § 23.600 for SDs and MSPs. Under the rule, a company would be free to structure its centralized risk management program according to its unique needs, provided that the program reasonably monitors and manages the risks associated with its uncleared inter-affiliate swaps. In all likelihood, if a corporate group has a centralized risk management program in place that reasonably monitors and

manages the risk associated with its inter-affiliate swaps as part of current industry practice, it is likely that the program would fulfill the requirements of exemption and therefore the exemption would not create new costs in such cases.

Given that a number of commenters stated that it is common practice for market participants, including end users, to have risk management programs in place, [130] expects that the majority of companies with eligible affiliates will not have to create centralized risk management programs from scratch in order to meet the eligibility requirements for the exemption. Those with existing systems may need to make some changes in order to centralize them, but the Commission has provided significant flexibility to companies in determining the specific contours of the centralized risk management system. Given this flexibility, and the fact that it is common practice for market participants to have risk management programs in place, the Commission is not persuaded by Cravath's comment that the rule will require a substantial change in the processes and procedures currently maintained by companies to manage risk. Accordingly, costs will be limited where an entity only needs to make modifications to existing risk management programs. Moreover, a corporate group may not have to incur any costs if it already has in place a risk management system that meets the requirements of the inter-affiliate exemption.

The Commission also declined to modify the requirement to state "a robust risk management program" rather than "a centralized risk management program." While change proposed by the Working Group may prevent certain entities from having to reorganize their risk management program in order to meet the requirements of the inter-affiliate exemption, it could also significantly reduce the ability of the risk management

[130] See, e.g., letters from Prudential, MetLife, and CDEU.

program to mitigate counterparty risk among affiliates. In the absence of variation margin, or clearing to mitigate counterparty credit risk among affiliates, risk management committees must have a clear line of sight into the financial health and obligations of each affiliate involved in inter-affiliate swaps.

In the NPRM, the Commission explained that some affiliates may have to create a risk management system to meet the risk management condition.[131] The Commission itemized a number of specific costs, including the purchase of equipment and software to adequately evaluate and measure inter-affiliate swap risk.[132] In addition, in the NPRM, the Commission estimated that centralized risk management could require up to ten full-time staff at an average salary of $150,000 per year.[133] The Commission received no comments in response to its risk management condition cost estimates.

There are benefits that derive from the centralized-risk management condition. The Commission expects that centralized risk management programs will establish appropriate measurements and procedures to monitor the amount of risk that each individual affiliate bears, and to monitor the condition of each entity's affiliate counterparties. Because a centralized risk management program is more likely to have a

[131] As pointed out above, industry commenters underscored the fact that many corporate groups that currently use inter-affiliate swaps have centralized-risk-management procedures in place.

[132] See NPRM at 50434 (estimating such costs to be as high as $150,000 for purchasing a computer network at approximately $20,000; purchasing personal computers and monitors for 15 staff members at approximately $30,000; purchasing software at approximately $20,000; purchasing other office equipment, such as printers, at approximately $5,000; and installation and unexpected costs that could increase up-front costs).

[133] This average annual salary is based on 15 senior credit risk analysts only. The Commission appreciates that an affiliate would likely choose to employ different positions as well, such as risk management specialists at $130,000 per year, and computer supervisors at $140,000. But for the purposes of this estimate, the Commission has assumed salaries at the high end for risk management professionals. The Commission also estimated a data subscription for price and other market data may have to be purchased at cost of up to $100,000 per year.

clear line of sight into the financial condition of all affiliated entities, it is better positioned to manage each affiliate's exposure to the counterparty risk of other affiliates than a risk management program situated inside any single affiliate. As a consequence, centralized risk management programs may reduce the likelihood that individual affiliates could become insolvent because of their exposure to other affiliates, which not only benefits the affiliates, but their third party counterparties as well.

4. Reporting to an SDR.

Another condition of electing the inter-affiliate exemption is that certain information about the swap and the election of the exemption be reported to an SDR. The reporting condition requires affiliates to report specific information to an SDR, or to the Commission if no SDR is available. Such information includes a notice that both affiliates are electing the exemption and that they both meet the other conditions of exemption, as well as information regarding how the financial obligations of both affiliates are generally satisfied with respect to uncleared swaps. The final rule also requires reporting certain information if the affiliate is an SEC filer.

The Commission received several comments in response to the reporting obligations of affiliates. Prudential and MetLife both commented that the Commission should clarify that only one counterparty is required to report the swap to an SDR. EEI stated that the Commission should eliminate the transaction-by-transaction reporting requirement for the election of the exemption and confirmation that the conditions have the exemption have been met. Instead, EEI recommended that one of the affiliates be permitted to file an annual notice on behalf of both affiliates to exempt all of their swaps from clearing for an entire year. EEI contended that it will increase costs if both affiliates

have to communicate that they elect not to clear the swap and meet the conditions of the exemption for each swap.[134] CDEU also objected to reporting any information to an SDR on a trade-by-trade basis for inter-affiliate swaps as such reporting would be costly and onerous for parties. Instead, CDEU recommended that all reporting be done on an annual basis through a board resolution.

In response to commenters' requests, the Commission clarified that the reporting condition can be fulfilled by one of the affiliate counterparties on behalf of both counterparties. As noted in the NPRM, the Commission believes that affiliates within a corporate group may make independent determinations on whether to submit an inter-affiliate swap for clearing. Given the possibility that each affiliate may reach different conclusions regarding clearing the swap, the final rule requires that both counterparties elect the proposed inter-affiliate clearing exemption.

DLA Piper commented that corporate groups do not maintain back-office systems necessary to keep the level of detail required under parts 45 and 46 with respect to their inter-company swaps. DLA Piper further commented that many corporate groups will need to develop costly systems and procedures, which will increase their hedging costs, in order to comply with the reporting rules. The Commission observes that the costs of

[134] EEI also commented that the Commission should state that part 45 does not apply to inter-affiliate swaps because the Commission will be able to obtain information regarding an inter-affiliate transaction based on reporting of a corresponding market-facing swap. EEI cited to a statement in the NPRM's consideration of costs and benefits as support for an argument that the Commission did not intend for part 45 reporting to apply to inter-affiliate swaps. See NPRM at 50433. As explained above, the statement in the cost-benefit consideration of the NPRM merely drew a comparison between the reporting requirements under the proposed exemption and the general reporting requirements under parts 45 and 46, and those reporting requirements applicable to SDs and MSPs under part 23. The statement should not be read as calling into question the applicability of part 45 to inter-affiliate swaps.

parts 45 and 46 reporting have been addressed in prior rulemakings and are beyond the scope of this rule.

With regard to comments recommending that all reporting be done on an annual basis rather than a swap-by-swap basis, the Commission declines to modify the rule. The Commission believes it is appropriate to provide for annual reporting of certain information, including how affiliates generally meet their financial obligations and information related to its status as an electing SEC Filer. However, it would not be sufficient to allow one annual report to cover both affiliate counterparties' election of the exemption from clearing and the confirmation that both affiliates meet the conditions of the exemption.

Eligible affiliates may choose to elect or not elect the exemption on a swap-by-swap basis. As noted above, whether a swap is cleared or not has a significant impact on its ability to transfer credit risk from one entity to another. Regulators must know which swaps are cleared and which swaps are not cleared in order to monitor potential accumulations and transfers of risk within the financial system. In addition, they must know which exemption is being used to exempt certain swaps in order to monitor the use of each exemption and its possible effect on systemic risk. Consequently, the election of the exemption and the confirmation that the exemption's conditions are met must be made for each swap.

The Commission does not believe that this reporting requirement will impose a significant burden on affiliate counterparties because, as discussed above, other detailed information for every swap must be reported under sections 2(a)(13) and 4r of the CEA

and Commission regulations. This approach comports with the approach adopted for market participants claiming the end-user exception under section 2(h)(7) of the CEA.[135]

In the NPRM, the Commission estimated specific costs for the reporting condition, including entering a notice of election into the reporting system.[136] Cost estimates in the NPRM also included costs of identifying how the affiliates expect to meet the financial obligations associated with their uncleared swap and providing information if either electing affiliate is an SEC Filer.[137] The Commission also estimated costs for entities to modify their reporting systems to accommodate the additional data fields required by this rule.[138] The Commission also estimated costs for non-reporting affiliates.[139] Finally, in the NPRM, the Commission explained that SDRs would bear costs associated with the reporting conditions insofar as SDRs would be required to add

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[135] See End-User Exception to the Clearing Requirement for Swaps, 77 FR at 42565-66.

[136] The NPRM at 50435, included an estimate that each counterparty may spend 15 seconds to two minutes per swap entering a notice of election of the exemption into the reporting system. The hourly wage for a compliance attorney is $390, resulting in a per transaction cost of $1.63-$13.00.

[137] See NPRM at 50435. Affiliates may decide to report financial obligation information and SEC Filer information on either a swap-by-swap or annual basis, and the costs would vary depending on the reporting frequency. Regarding the financial obligation information, the Commission estimated in the NPRM that it may take the reporting counterparty up to 10 minutes to collect and submit the information for the first transaction, and one to five minutes to collect and submit the information for subsequent transactions with that same counterparty. The hourly wage for a compliance attorney is $390 resulting in a cost of $65.00 for reporting the first inter-affiliate swap, and a cost range of $6.50-$32.50 for reporting subsequent inter-affiliate swaps.

[138] See id. (estimating that such modifications would create a one-time programming expense of approximately one to ten burden hours per affiliate, which means a one-time, per entity cost ranging from $341 and $3,410).

[139] See id. (noting that costs would likely vary substantially depending on how frequently the affiliate enters into swaps, whether the affiliate undertakes an annual filing, and the due diligence that the reporting counterparty chooses to conduct, but estimating that a non-reporting affiliate would incur annually between five minutes and ten hours of compliance attorney time to communicate information to the reporting counterparty, translating to an aggregate annual cost for communicating information to the reporting counterparty of between $33 to $3,900). See also, id. (noting that an annual filing option may be less costly than swap-by-swap reporting and estimating that such an option would take an average of 30 to 90 minutes, translating to an aggregate annual cost for submitting the annual report of between $195 to $585).

or edit reporting data fields to accommodate information reported by affiliates electing the inter-affiliate clearing exemption.[140] The Commission received no comments in response to its cost estimates for the reporting condition.

The benefits of the reporting condition include enhancing the level of transparency associated with inter-affiliate swaps activity, thereby affording the Commission new insights into the practices of affiliates that engage in inter-affiliate swaps, and helping the Commission and other appropriate regulators identify emerging or potential risks. As noted above, regulators must know whether swaps are cleared or uncleared in order to use swap data to monitor emerging risks. In short, the overall benefit of reporting would be a greater body of information for the Commission to analyze with the goal of identifying and reducing systemic risk.[141]

5. Treatment of outward-facing swaps.

The final condition imposed on the inter-affiliate exemption from required clearing relates to the treatment of outward-facing swaps entered into by the two eligible affiliate counterparties to the inter-affiliate swap. As proposed, the condition required that each affiliate counterparty either: (i) is located in the United States; (ii) is located in a jurisdiction with a clearing requirement that is comparable and comprehensive to the clearing requirement in the United States; (iii) is required to clear swaps with non-affiliated parties in compliance with U.S. law; or (iv) does not enter into swaps with non-affiliated parties.

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[140] See generally, Swap Data Recordkeeping and Reporting Requirements, 77 FR at 2176-2193 (for costs and benefits incurred by SDRs). To the extent that no SDR is available to accept this data, the costs would fall to the Commission.

[141] The Commission received no comments in response to its cost estimates for the reporting condition.

The Commission received a number of comments in support of and opposed to this proposed condition, but did not receive any comments quantifying the costs or benefits of the proposed condition. AFR supported the proposal and stated that inter-affiliate swaps could, without appropriate restrictions, bring risk back to the U.S. from foreign affiliates. AFR commented that an inter-affiliate swap might be used to move parts of the U.S. swaps market outside of U.S. regulatory oversight by transferring risk to jurisdictions with little or no regulatory oversight, whereby a non-U.S. affiliate of a U.S. entity could enter into an outward-facing swap. AFR stated that an inter-affiliate swap could contribute to financial contagion across different groups within a complex financial institution, making it more difficult to "ring-fence" risks in one part of an organization. AFR further commented that laws and regulations of a foreign country might prevent U.S. counterparties to swaps from having access to the financial resources of an affiliate in the event of a bankruptcy or insolvency. Better Markets also supported the proposed treatment of outward-facing swaps condition.

In opposition to the proposed condition, CDEU commented that the proposed "comparable and comprehensive" condition is not necessary or appropriate to reduce risk and prevent evasion because, according to CDEU, transactions between affiliates do not increase systemic risk, regardless of the location of the affiliate. ISDA & SIFMA stated that the concern that foreign inter-affiliate swaps pose risk to the U.S. financial system is unfounded because internal swaps have no conclusive effect on systemic risk.[142]

The Commission considered each of these comments and decided to adopt the treatment of outward-facing swaps condition, with certain important modifications,

[142] Other commenters, including The Working Group and FSR also opposed the condition regarding treatment of outward-facing swaps. See Section II.G above.

because the Commission believes that the risk of evasion of the U.S. clearing requirement and the potential systemic risk associated with uncleared inter-affiliate swaps involving foreign affiliates and non-affiliated counterparties necessitates that the inter-affiliate exemption include such a condition. As modified, the final rule requires that each eligible affiliate counterparty must clear all swaps that it enters into with third parties to the extent that the swap is subject to the Commission's clearing requirement. In order to satisfy this requirement, eligible affiliates may clear their third-party swaps pursuant to the Commission's clearing requirement or comply with the requirements for clearing the swap under a foreign jurisdiction's clearing mandate that is comparable to, and as comprehensive as, the clearing requirement of section 2(h) of the Act and part 50 of the Commission's regulations, as determined by the Commission. In addition, the Commission modified the condition to allow for recognition of clearing exemptions and exceptions under the CEA and an exception or exemption under a comparable foreign jurisdiction's clearing mandate that is comparable to an exception or exemption under section 2(h)(7) of the CEA or part 50. For entities that are not in a jurisdiction with a clearing requirement that is comparable to, and as comprehensive as, the clearing mandate in 2(h) of the Act, they may comply by clearing swaps with unaffiliated counterparties through a registered DCO or clearing organization that is subject to supervision by appropriate government authorities in the home country of the clearing organization and has been assessed to be in compliance with the PFMIs.

The Commission believes that this modification will provide greater clarity and transparency by more clearly establishing the conditions to the exemption and alternative methods by which eligible affiliates may satisfy the requirements. In addition, the

Commission considered the approach adopted in EMIR.[143] To the extent there is consistency with the international authorities, including the European Union, the likelihood of regulatory arbitrage is reduced. Regulatory arbitrage can impose high costs in terms of market efficiency.

As AFR noted, without appropriate restrictions, inter-affiliate swaps could transfer risk back to the United States from foreign affiliates. The final rule takes steps to mitigate this risk insofar as the intent of the condition on outward-facing swaps is to narrow the exemption such that the risk of a cascading series of defaults among unrelated entities is reduced.

For companies whose inter-affiliate swap activities are conducted exclusively through entities in the United States and jurisdictions with clearing mandates that are comparable to, and as comprehensive as, the clearing requirement of section 2(h) of the CEA, all outward-facing swaps that fall under a § 50.4 class will be subject to required clearing,[144] which will serve as a buffer to the spread of credit risk from one corporation to another through those swaps, thus reducing the risk of financial contagion. Affiliates that meet the conditions of the inter-affiliate exemption will be able to transfer risk from one affiliate to the other without clearing those swaps, but third parties that enter into swaps that are required to be cleared with either of those affiliates will continue to be protected by clearing requirement.

For companies whose inter-affiliate swap activities extend to countries without clearing mandates that are comparable to, and as comprehensive as, the clearing

[143] See Section II.G above.

[144] In these jurisdictions, outward-facing swaps that are not subject to required clearing may be subject to margin requirements, which can serve to mitigate counterparty credit risk.

requirement of section 2(h) of the CEA, the requirements of the rule mitigate counterparty risk associated with swaps that are required to be cleared under § 50.4 by requiring those swaps to be cleared at a DCO or a clearing organization that is subject to supervision by appropriate government authorities and that is in compliance with the PFMIs. In this manner, swaps that the Commission has determined must be cleared cannot be used as a means of transferring financial risk among unaffiliated entities where one of the counterparties is also claiming an exemption from required clearing under this inter-affiliate exemption. However, the Commission observes that outward-facing swaps that are not required to be cleared under § 50.4 and that are entered into between unrelated entities in a jurisdiction without comparable margin requirements, may be a means through which financial risk could be passed between unaffiliated entities without the protection of required clearing, creating the possibility of financial contagion.[145] It is possible that such contagion could then be transferred back to the United States or other jurisdictions through inter-affiliate swaps, creating potential costs for the public.[146] The Commission notes, however, that this is only a concern to the extent that affiliates in such jurisdictions enter into outward-facing swaps that are not required to be cleared under § 50.4 in order to meet their needs.

The Commission does not agree with CDEU's assertion that transactions between affiliates do not increase systemic risk, regardless of the location of the affiliate, or with ISDA & SIFMA's comment that the concern that foreign inter-affiliate swaps pose risk to the U.S. financial system is unfounded. As noted above, in the absence of any

[145] This risk may be mitigated if such swaps were subject to bilateral margining.

[146] Not only is there the possibility of risk transfer but also a potential inability for regulators to monitor the risks that are capable of being transferred.

restrictions on outward-facing swaps, inter-affiliate swaps could be used to transfer risk to jurisdictions without clearing requirements or margin requirements for uncleared swaps. Risk could then be transferred between unrelated entities without the protection of clearing or margin requirements to mitigate the risk of financial contagion spreading from one to the other.

In addition to the modifications to the treatment of outward-facing swaps condition described above, the Commission also accepted commenter's suggestions and is providing a transition period with two alternative compliance frameworks for eligible affiliates domiciled in certain foreign jurisdictions that have the legal authority to implement mandatory clearing regimes. As noted above, ISDA & SIFMA and CDEU stated that questions of timing and criteria for comparability render the proposed treatment of outward-facing swaps condition problematic, and that unless the condition is satisfactorily resolved, the condition could hamper the ability of U.S.-based groups to compete in foreign markets. ISDA & SIFMA further commented that if the Commission retains the cross-border requirements, the Commission should provide an appropriate transition period in order to allow foreign jurisdictions to implement their own G-20 mandates. The Commission is adopting two alternative compliance frameworks in response to concerns raised by commenters pertaining to the timing and sequencing of the implementation of the inter-affiliate exemption.

The Commission is adopting a time-limited alternative compliance framework, available until March 11, 2014, for certain eligible affiliates transacting swaps with affiliated counterparties located in the European Union, Japan, or Singapore. The alternative compliance framework will allow affiliated counterparties, or a third party that

directly or indirectly holds a majority interest in both eligible affiliate counterparties, to pay and collect full variation margin daily on all swaps entered into between affiliates or between an affiliate and its unaffiliated counterparties, rather than submitting such swaps for clearing. In addition, the Commission has determined to provide time-limited relief for certain eligible affiliated counterparties located in the European Union, Japan, or Singapore from complying with the requirements of § 50.52(b)(4)(i) as a condition of electing the inter-affiliate exemption. In particular, § 50.52(b)(4)(ii)(B) provides that if one of the eligible affiliate counterparties is located in the European Union, Japan, or Singapore, the requirements of paragraph (b)(4)(i) will not apply to such eligible affiliate counterparty until March 11, 2014, provided that: (1) the one counterparty that directly or indirectly holds a majority ownership interest in the other counterparty or the third party that directly or indirectly holds a majority ownership interest in both counterparties is not a "financial entity" as defined in section 2(h)(7)(C)(i) of the Act, and (2) neither eligible affiliate counterparty is affiliated with an entity that is a swap dealer or major swap participant, as defined in § 1.3.

Another time-limited alternative compliance framework also will be available for eligible affiliates transacting swaps with affiliated counterparties located outside the European Union, Japan, and Singapore, as long as the aggregate notional value of such swaps, which are included in a class of swaps identified in §50.4, does not exceed five percent of the aggregate notional value of all swaps, which are included in a class of swaps identified in §50.4, in each instance the notional value as measured in U.S. dollar equivalents and calculated for each calendar quarter, entered into by the eligible affiliate counterparty located in the United States.

These alternative compliance frameworks will mitigate the competitive effects that ISDA & SIFMA and CDEU noted by allowing certain entities to collect variation margin rather than clearing such swaps until March 11, 2014. The Commission expects that collecting full variation margin is likely to be less costly than clearing because the latter includes initial margin in addition to variation margin, as well as clearing fees. To the extent that the alternative compliance approach is less costly, it will reduce the competitive effects that foreign affiliates experience during the period of time when comparable clearing requirements do not yet exist for competitors operating in foreign jurisdictions.

The time-limited alternative compliance frameworks may, nevertheless, have some temporary competitive effects in the market. Companies with foreign affiliates that are required to pay and collect variation margin daily on all swaps entered into between affiliates or between an affiliate and its unaffiliated counterparties will bear some costs that competing firms based entirely in foreign jurisdictions may not bear because comparable clearing mandates have not yet been implemented. In the European Union, Japan, and Singapore, these effects are likely to largely disappear once comparable regimes are established and companies with entities in those jurisdictions are required to clear. In jurisdictions where comparable regimes are never implemented, the competitive effects will be longer-standing.

The Commission, however, believes that such costs are warranted in light of the benefits provided by mitigating the likelihood of transferring risk back to the United States through inter-affiliate swaps that are not cleared or margined. Requiring the payment and collection of full variation margin will address the possibility of foreign

affiliates developing significant counterparty credit risk exposures and then passing that risk back to affiliates in the United States through non-cleared swaps. Variation margin is one of the tools used by clearinghouses to mitigate counterparty credit risk. As an independent risk management tool, it reduces counterparty credit risk by requiring counterparties to make daily payments reflecting gains or losses based on each swap's value. However, it is not a complete replacement for the panoply of risk management tools that are used by clearinghouses to manage counterparty credit risk. As a consequence, this time-limited alternative compliance framework will mitigate counterparty credit risk, but not to the extent that clearing would. The Commission, however, believes that this measure will enable affiliates in the European Union, Japan, or Singapore to take advantage of the exemption while comparable clearing regimes are being established in those jurisdictions, while simultaneously mitigating the risk of financial risk being transferred back to the United States through uncleared inter-affiliate swaps. In this way it provides benefits to companies with affiliates in these jurisdictions, and also to the American public.

Moreover, the Commission believes that providing additional time-limited relief for certain affiliates located in the European Union, Japan, or Singapore from the requirements of § 50.52(b)(4)(i) to clear their outward-facing swaps until March 11, 2014 under § 50.52(b)(4)(ii)(B) also will mitigate the competitive effects noted commenters by allowing such entities to continue to enter into inter-affiliate swaps without requiring those swaps to be submitted to clearing or variation margin, and is likely to be less costly than requiring such entities to either clear or exchange variation margin on their inter-affiliate or outward-facing swaps.

Lastly, the Commission received several comments regarding the criteria for issuing comparability determinations, and expressing concern that unless such issues are satisfactorily resolved, the condition could hamper the ability of U.S.-based groups to compete in foreign markets. In response, the Commission has provided in this final release a significant amount of additional information regarding how and when those determinations will be made.

In the NPRM, the Commission stated that the condition for the treatment of outward-facing swaps would not impose additional costs.[147] Commenters stated that the proposed condition would increase the costs of inter-affiliate swaps.[148] In terms of the revised rule, there may be some additional costs for entities that must clear their outward-facing swaps. Such costs, as discussed above, would include the cost of initial and variation margin, contributions to a guaranty fund, and clearing fees. However, in light of the comments discussed above, the Commission observes that, as modified, and with the transition period provided for under the rule, costs have been mitigated to the extent possible while preserving the goal of preventing evasion.

In terms of benefits, the Commission stated in the NPRM that the corporate group and U.S. financial markets may bear additional risk if the foreign affiliate is free to enter into an uncleared swap with a third-party that would be subject to clearing were it entered into in the United States. The Commission believes that the requirements for outward-facing swaps will prevent foreign affiliates from taking on significant risk through

[147] See NPRM at 50435.

[148] See e.g., letter from CDEU.

outward-facing swaps that fall under a § 50.4 class, which reduces the risk that could then be transferred back to the United States through exempt inter-affiliate swaps.

D. Costs and Benefits to Market Participants and the Public

Many commenters asserted that inter-affiliate swaps do not create any additional risk for third parties facing those affiliates.[149] In addition, some commenters state that third parties may benefit from an inter-affiliate exemption because it will allow corporate entities to hedge their swaps more efficiently.[150]

The Commission recognizes that these claims may be true to the extent that each affiliate, or a common parent, completely internalizes the risks facing the other affiliate. Majority ownership facilitates such internalization of costs among affiliated entities, and the threat of reputational risk is another factor that may cause related entities to act in the best interests of affiliate counterparties. However, as discussed above, two other factors reduce the degree to which affiliated entities may internalize each other's costs. Ownership stakes that are less than 100% reduce the percentage of costs that one affiliate internalizes from another, and bankruptcy laws providing protection for the assets of one affiliate from the creditors of another affiliate may create incentives to permit one affiliate to fail. These factors reduce the internalization of costs among affiliates.

As a consequence, the counterparty risk that creditors to a given entity face may be increased by the inter-affiliate swaps into which that the entity enters. This risk may not be "new" in the sense that it is risk that was previously borne by another affiliate.

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[149] See, e.g., letters from EEI, The Working Group, and DLA Piper.

[150] See, e.g., letters from EEI, The Working Group, and ISDA & SIFMA.

But from the perspective of counterparties to the entity that now bears the risk, it is new. It increases the credit risk that the entity they face bears.

The Commission, however, has established conditions on the inter-affiliate exemption that are intended to mitigate any increase in counterparty risk that third parties might bear as the result of the exemption. As described above, the documentation and centralized risk management requirements help to ensure that each group of affiliates engaging in inter-affiliate swaps has a centralized risk management program with adequate information to value and risk manage swap positions effectively. Moreover, the reporting requirements will help to ensure that regulators have information that is necessary to understand the use of inter-affiliate swaps under this exemption.

In terms of costs, some commenters assert that this exception creates risk of contagion and systemic risk that could threaten the U.S. financial system.[151] As explained above, this concern is substantiated to the extent that the inter-affiliate exemption prevents affiliates from protecting themselves from counterparty risk they bear with respect to one another, and to the extent that it prevents third parties from protecting themselves from affiliates' counterparty risk. The Commission believes that internalization of risk among affiliated entities mitigates this concern, and that the application of required clearing to swaps between affiliates and third parties further reduces the probability of risk cascading through the financial system via inter-affiliate swaps.

AFR stated that the exemption may deprive DCOs of swaps volume and liquidity that is necessary for risk management. In effect, the exemption will reduce the number of

[151] See letters from AFR and Better Markets.

swaps being cleared. All other things being equal, this may cause DCOs to increase the margin requirements for those swaps to compensate for having less volume, which may increase the cost of using cleared swaps. AFR also stated that the inter-affiliate exception will enable banks to set up joint ventures to trade swaps without clearing them. The Commission believes that its conditions with regard to treatment of outward-facing swaps address AFR's concerns about evasion of the clearing requirement.

E. Costs and Benefits Compared to Alternatives

The Commission considered several alternatives to the final rulemaking, including: (1) alternative definitions of eligible affiliate counterparty; (2) more prescriptive documentation requirements; (3) alternative risk management requirements; (4) different requirements for treatment of outward-facing swaps; and (5) requiring variation margin for swaps between affiliated financial entities. The first four alternatives are discussed at length above. The fifth alternative, the imposition of variation margin on swaps between affiliates that are financial entities, was considered by the Commission and ultimately rejected based on comments.

As proposed, the inter-affiliate exemption would have required affiliated financial entities to pay and collect variation margin associated with their swaps unless the affiliates were 100% commonly owned and commonly guaranteed by a 100% commonly owned guarantor. In the final rule, the Commission has eliminated the variation margin requirement. This change is likely to create significant savings for eligible affiliates. Reduced margin requirements will reduce the capital costs that entities bear when transacting inter-affiliate swaps, and may reduce the capital requirements for financial entities under prudential regulation. In addition, it may help entities avoid liquidity

crunches when their positions move significantly out of the money in a short period of time.

However, eliminating the variation margin requirement also significantly reduces the protective value of the eligibility requirements that the Commission established in order to reduce the likelihood of cascading defaults among affiliated entities, and the associated risk to third parties transacting with those entities. Without the variation margin requirements, affiliated entities may develop large outstanding exposures toward one another, and to the degree that affiliated entities do not internalize one another's costs, an affiliate that is out of the money will have incentives not to perform on its obligations. In addition if the obligations of one entity are sufficiently large, its default may jeopardize the health of other affiliated entities, which would also increase counterparty risk for third parties that have uncleared outstanding positions with those entities.

F. Consideration of CEA section 15(a) Factors

1. Protection of market participants and the public.

In deciding to finalize the inter-affiliate clearing exemption, the Commission assessed how to protect affiliated entities, third parties in the swaps market, and the public. The Commission has sought to ensure that in the absence of a clearing requirement the risks presented by uncleared inter-affiliate swaps would be mitigated so that significant losses to one affiliate counterparty or a default of one of the affiliate counterparties is less likely to create significant repercussions for third-parties or the American public. Toward that end, the Commission has required that affiliates to execute swap trading relationship documentation, maintain a centralized-risk

management process, and report specific information to an SDR, and meet certain requirements related to outward-facing swaps in order to be eligible for the exception. As explained in this cost-benefit section, these conditions serve multiple objectives that ultimately protect market participants and the public.

For instance, the documentation requirement will reduce uncertainties where affiliates incur significant swaps-related losses or where there is a defaulting affiliate. Because the documentation would be in writing, the Commission expects that there will be less contractual ambiguity should disagreements between affiliates arise. The condition that an inter-affiliate swap be subject to a centralized risk management program reasonably designed to monitor and manage risk will also help mitigate the risks associated with inter-affiliate swaps. As noted throughout this final rulemaking, inter-affiliate swap risk could adversely impact third parties that enter into uncleared swaps or other contracts with affiliates engaging in inter-affiliate swaps.

The reporting condition would help the Commission and the affiliate's leadership monitor compliance with the inter-affiliate clearing exemption. For example, an affiliate that also is an SEC Filer must receive a governing board's approval for electing the proposed exemption. It cannot act independently. In the Commission's opinion, the reporting conditions promote accountability and transparency, offering another public safeguard by keeping the Commission and each entity's board of directors informed.

On the other hand, the rule also creates certain costs that will be borne by eligible entities, the counterparties to those entities, and the public. Regarding costs for eligible entities, the qualification requirements will create some new costs for those that do not already have recordkeeping and risk management systems that are in compliance with the

rule. However, as noted above, the Commission believes that some entities may already have systems in place that meet most or all of the requirements. Moreover, entities will elect the exemption only if they project the benefit of doing so is greater than the costs associated with the qualifying requirements. Therefore, these costs may decrease the value of the exemption, but they will not create new costs for entities that choose not to elect the exemption.

2. Efficiency, competitiveness, and financial integrity of futures markets.

Exempting swaps between majority-owned affiliates within a corporate group from the clearing requirement will promote allocational efficiency by reducing overall clearing costs for eligible affiliate counterparties. The Commission also anticipates that the exemption will increase allocational efficiency and the financial integrity of markets because it will make it less costly for corporate groups to centralize their hedging and market facing swap activities within a single affiliate. As explained above, commenters stated that clearing swaps through single affiliates enables affiliates and corporate groups to more efficiently and effectively manage corporate risk.

Certain provisions of the proposed rule, such as the requirements that inter-affiliate swaps be subject to centralized risk management and that certain information be reported, also would discourage abuse of the exemption. Together, these conditions promote the financial integrity of swap markets and financial markets as a whole.

3. Price discovery.

Under Commission regulation 43.2, a "publicly reportable swap transaction," means, among other things, "any executed swap that is an arm's length transaction between two parties that results in a corresponding change in the market risk position

between the two parties."[152] The Commission does not consider non-arms-length swaps as contributing to price discovery in the markets.[153] Given that inter-affiliate swaps as defined in this rulemaking are generally not arm's length transactions, the Commission does not anticipate the inter-affiliate clearing exemption to have any significant effect on price discovery.[154]

4. Sound risk management practices.

As a general rule, the Commission believes that clearing swaps is a sound risk management practice. Exempting certain inter-affiliate swaps from the clearing requirement creates additional counterparty exposure for affiliates that do not completely internalize each other's risk, and for third parties that enter into uncleared swaps or other transactions with those affiliated entities. This increased counterparty risk among affiliates may increase the likelihood that a default within one affiliate could cause significant losses in other affiliated entities. If the default causes other affiliated entities to default, then third parties that have entered into uncleared swaps or other agreements with those entities also could be affected. But, in finalizing the inter-affiliate clearing exemption, the Commission has assessed the risks of inter-affiliate swaps, and believes that the partial internalization of costs among affiliated entities, combined with the

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[152] 17 CFR 43.2. See also Real-Time Public Reporting of Swap Transaction Data, 77 FR 1182 (Jan. 9, 2012).

[153] Transactions that fall outside the definition of "publicly reportable swap transaction"—that is, transactions that are not arms-length—"do not serve the price discovery objective of CEA section 2(a)(13)(B)." Real-Time Public Reporting of Swap Transaction Data, 77 FR at 1195. See also id. at 1187 (discussing "Swaps Between Affiliates and Portfolio Compression Exercises").

[154] The definition of "publicly reportable swap transaction" identifies two examples of transactions that fall outside the definition, including "internal swaps between one-hundred percent owned subsidiaries of the same parent entity." 17 CFR 43.2 (adopted by Real-Time Public Reporting of Swap Transaction Data, 77 FR at 1244). The Commission notes that the list of examples is not exhaustive.

documentation, risk management, reporting, and treatment of outward-facing swaps requirements for electing the exception, will mitigate some of the risks associated with uncleared inter-affiliate swaps. However, they are not a complete substitute for the protections that would be provided by required clearing, or by a requirement to use some of the same risk management tools that a clearinghouse would use to mitigate counterparty credit risk (i.e., initial and variation margin).

Also, as noted above, without clearing to mitigate transmission of risk among affiliates, the risk that any one affiliate takes on, and any contagion that may be caused by that risk, may be transferred more easily to other affiliates. This makes the risk mitigation requirements for outward-facing swaps more important. The Commission's requirements for outward-facing swaps mitigate the risk that swaps that the Commission has determined are required to be cleared could transfer risk that would then be spread among the affiliates, but does not eliminate the possibility that swaps that are not required to be cleared and are transacted in a regime without mandatory clearing (or bilateral margin requirements) for uncleared swaps could result in financial risk that impacts its affiliates and counterparties of those affiliates.[155]

The Commission also believes that SEC Filer reporting is a prudent practice. As detailed in this preamble and the rule text, SEC Filers are affiliates that meet certain SEC-related qualifications, and their governing boards or equivalent bodies are directly responsible to shareholders for the financial condition and performance of the affiliate. The boards also have access to information that would give them a comprehensive

[155] The Commission notes that even in the absence of required clearing or margin requirements for swaps between certain affiliated entities, such entities may choose to use initial and variation margin to manage risks that could otherwise be transferred from one affiliate to another. Similarly, third parties that have entered into swaps with affiliates may also include variation margin requirements in their swap agreements.

picture of the company's financial condition and risk management strategies. Therefore, any oversight they provide to the affiliate's risk management strategies would likely encourage sound risk management practices. In addition, the condition that affiliates electing the inter-affiliate clearing exemption must report their boards' knowledge of the election is a sound risk management practice.

5. Other public interest considerations.

Aside from those discussed in Section II.A above, the Commission has identified no other public interest considerations.

IV. RELATED MATTERS

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) requires that agencies consider whether the rules they propose will have a significant economic impact on a substantial number of small entities and, if so, provide a regulatory flexibility analysis respecting the impact.[156] As stated in the NPRM, the clearing requirement determinations and rules proposed by the Commission will affect only eligible contract participants (ECPs) because all persons that are not ECPs are required to execute their swaps on a designated contract market (DCM), and all contracts executed on a DCM must be cleared by a DCO, as required by statute and regulation; not by operation of any clearing requirement.[157] Accordingly, the Chairman, on behalf of the Commission, certified pursuant to 5 U.S.C. 605(b) that the proposed rules would not have a significant economic impact on a substantial number of

[156] See 5 U.S.C. 601 et seq.

[157] To the extent that this rulemaking affects DCMs, DCOs, or FCMs, the Commission has previously determined that DCMs, DCOs, and FCMs are not small entities for purposes of the RFA. See, respectively and as indicated, 47 FR 18618, 18619 (Apr. 30, 1982) (DCMs and FCMs); and 66 FR 45604, 45609 (Aug. 29, 2001) (DCOs).

small entities. The Commission then invited public comment on this determination. The Commission received no comments.

The Commission has previously determined that ECPs are not small entities for purposes of the RFA.[158] However, in its proposed rulemaking to establish a schedule to phase in compliance with certain provisions of the Dodd-Frank Act, including the clearing requirement under section 2(h)(1)(A) of the CEA, the Commission received a joint comment (Electric Associations Letter) from the Edison Electric Institute (EEI), the National Rural Electric Cooperative Association (NRECA) and the Electric Power Supply Association (EPSA) asserting that certain members of NRECA may both be ECPs under the CEA and small businesses under the RFA.[159] These members of NRECA, as the Commission understands, have been determined to be small entities by the Small Business Administration (SBA) because they are "primarily engaged in the generation, transmission, and/or distribution of electric energy for sale and [their] total electric output for the preceding fiscal year did not exceed 4 million megawatt hours."[160] Although the Electric Associations Letter does not provide details on whether or how the NRECA members that have been determined to be small entities use the interest rate swaps and CDS that are the subject of this rulemaking, the Electric Associations Letter does state that the EEI, NRECA, and EPSA members "engage in swaps to hedge commercial

[158] See 66 FR 20740, 20743 (Apr. 25, 2001).

[159] See joint letter from EEI, NRECA, and ESPA, dated Nov. 4, 2011, (Electric Associations Letter), commenting on Swap Transaction Compliance and Implementation Schedule: Clearing and Trade Execution Requirements under Section 2(h) of the CEA, 76 FR 58186 (Sept. 20, 2011).

[160] Small Business Administration, Table of Small Business Size Standards, Nov. 5, 2010.

risk."[161] Because the NRECA members that have been determined to be small entities would be using swaps to hedge commercial risk, the Commission expects that they would be able to use the end-user exception from the clearing requirement and therefore would not be affected to any significant extent by this rulemaking.

Thus, because nearly all of the ECPs that may be subject to the proposed clearing requirement are not small entities, and because the few ECPs that have been determined by the SBA to be small entities are unlikely to be subject to the clearing requirement, the Chairman, on behalf of the CFTC, hereby certifies pursuant to 5 U.S.C. 605(b) that the rules herein will not have a significant economic impact on a substantial number of small entities.

B. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (PRA)[162] imposes certain requirements on Federal agencies in connection with their conducting or sponsoring any collection of information as defined by the PRA. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it has been approved by the Office of Management and Budget (OMB) and displays a currently valid control number.[163]

Certain provisions of this final rulemaking impose new information collection requirements within the meaning of the PRA, for which the Commission must obtain a

[161] See Electric Associations Letter, at 2. The letter also suggests that EEI, NRECA, and EPSA members are not financial entities. See id., at note 5, and at 5 (the associations' members "are not financial companies").

[162] 44 U.S.C. 3501 et seq.

[163] Id.

valid control number. Accordingly, the Commission requested, and OMB has assigned control number 3038-0104 for the new collection of information. The Commission also has submitted this final rule release, the proposed rulemaking, and all required supporting documentation to OMB for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The title for this new collection of information is "Rule 50.52 (proposed as rule 39.6(g)) Affiliate Transaction Uncleared Swap Notification." Responses to this collection of information will be mandatory.

The Commission will protect proprietary information in accordance with the Freedom of Information Act and 17 CFR part 145, entitled "Commission Records and Information." In addition, section 8(a)(1) of the CEA strictly prohibits the Commission, unless specifically authorized by the Act, from making public "data and information that would separately disclose the business transactions or market positions of any person and trade secrets or names of customers."[164] The Commission also is required to protect certain information contained in a government system of records according to the Privacy Act of 1974, 5 U.S.C. 552a.

1. Information provided by reporting entities.

The regulations being adopted in this final rule release impose certain reporting requirements on eligible affiliates that enter into inter-affiliate swaps and elect the inter-affiliate exemption from clearing such swaps. As described in the NPRM and in this final release, the reporting requirements are designed to address Commission concerns regarding inter-affiliate swap risk and to provide the Commission with information necessary to regulate the swaps market. In particular, regulation 50.52(c) (proposed as §

[164] 7 U.S.C. 12(a)(1).

39.6(g)) will require an electing counterparty to provide, or cause to be provided, certain information to a registered SDR or, if no registered SDR is available to receive the information, to the Commission, in the form and manner specified by the Commission. As further described in this final rule release, § 50.52(c)(1) requires reporting counterparties to notify the Commission each time they elect the inter-affiliate clearing exemption for each swap, by reporting certain information to a registered SDR, or to the Commission, if no registered SDR is available to receive the information. Reporting counterparties also must report the information required by § 50.52(c)(2) and (3), and have the option to report such information each time that the eligible counterparties elect the inter-affiliate exemption for each swap, or on an annual basis in anticipation of electing the exemption.

To determine the total time burden and cost associated with the proposed rules for PRA purposes, the Commission estimated the number of affiliates that likely would seek to claim the exemption and the average number of inter-affiliate swaps for which the affiliates would elect to use the proposed exemption. The Commission also estimated the time burden required for entities to comply with the reporting requirements.

In estimating the number of affiliates and the average number of inter-affiliate swaps that likely would claim the inter-affiliate exemption, the Commission used data from the U.S. Bureau of Economic Analysis (BEA) to estimate that there are approximately 22 subsidiaries per U.S. multinational parent company (MNC), resulting in a total of 53,195 affiliates that might elect the inter-affiliate exemption.[165] As more fully described in the NPRM, the Commission surveyed five corporations to obtain

[165] NPRM at 50439-40.

information that allowed it to estimate that affiliates enter into an average of 2,230 inter-affiliate swaps annually.[166]

In estimating the time burden associated with complying with the reporting requirements of the rules, the Commission stated in the NPRM that it expected each reporting counterparty would likely spend between 15 seconds to two minutes per transaction entering information required by § 50.52(c)(1) (proposed § 39.6(g)(4)(i)) into the reporting system.[167] The Commission further estimated that it would take the reporting counterparty up to 10 minutes to collect and submit the information required under § 50.52(c)(2)-(3) (proposed § 39.6(g)(4)(ii)-(iii)), for the first transaction and one to five minutes to collect and submit the information for subsequent transactions with that same counterparty. The Commission estimated that together these requirements would cost a reporting counterparty between $1.63 and $13.00 to comply with § 50.52(c)(2)-(3) (proposed § 39.6(g)(4)(i)), $65.00 to comply with § 50.52(c)(2)-(3) (proposed § 39.6(g)(4)(ii)-(iii)) for the first inter-affiliate swap, and between $6.50 and $32.50 to comply with § 50.52(c)(2)-(3) (proposed § 39.6(g)(4)(ii)-(iii)) for subsequent inter-affiliate swaps with the same counterparty.[168]

With respect to the annual reporting option described in § 50.52(d), the Commission stated in the NPRM that it anticipated that at least 90% of MNCs would choose to file an annual report in lieu of reporting each swap separately. The

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[166] Id.

[167] The NPRM noted that to comply with proposed § 39.6(g)(4)(i) (now § 50.52(c)(1)), each reporting counterparty would be required to check a box indicating that both counterparties to the swap are electing not to clear the swap.

[168] NPRM at 50440.

Commission estimated in the NPRM that it would take an average of 30 to 90 minutes to complete and submit the filing, resulting in an annual aggregate cost for submitting the annual report of approximately $195 to $585.[169]

In addition to the specific reporting obligations described in the rules, the NPRM also noted that reporting counterparties may need to update established reporting systems to comply with the reporting requirement, and non-reporting affiliate counterparties may need to transmit information to reporting counterparties after entering into a swap subject to the rules. In the NPRM, the Commission stated that it anticipated that reporting counterparties may have to modify their established reporting systems in order to accommodate the additional data fields required by § 50.52(c) (proposed § 39.6(g)(4)), and estimated that the modifications would create a one-time cost of between $341 and $3,410 per entity.[170] The Commission further stated in the NPRM that it anticipated that an affiliate who is not the reporting counterparty may need to communicate information to the reporting counterparty after executing an inter-affiliate swap, and estimated the cost of, among other things, providing information to facilitate any due diligence that the reporting counterparty may conduct, to be between $33 and $3,900.[171]

Using these figures, the Commission estimated that the inter-affiliate exemption could result in an average total annual burden of 1,758,369 hours and average total annual costs of $685,309,281, or approximately 1.8 minutes and $10.48 per inter-affiliate swap.

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[169] NPRM at 50441.

[170] Id.

[171] Id.

2. Information collection comments.

The Commission invited public comment on the proposed PRA analysis and estimates and on any aspect of the reporting burdens resulting from proposed § 39.6(g) (now §50.52(c)). One commenter submitted comments in relation to the Commission's estimate of the number of eligible affiliates seeking to claim the exemption. No commenters submitted comments to OMB, and OMB itself did not submit any comments to the Commission pertaining to the proposed rule.[172]

In the context of its comments pertaining to the costs and benefits of the reporting requirements of the proposed rule, EEI claimed that the Commission's estimation of 22 eligible affiliates per MNC was "far too low" for many U.S. energy companies. Although EEI commented that the Commission's estimate of the number of affiliates per MNC was too low in the context of U.S. energy companies, EEI did not provide an alternative estimate or point to any other sources of information that might provide an alternative source for estimating the average number of subsidiaries per MNC.

The Commission has considered EEI's comment and declines to revise its estimate of the number of affiliates of an MNC.[173] As described in the NPRM, the Commission estimated that a total of 53,195 affiliates might elect the inter-affiliate clearing exemption. The Commission's estimation of the number of affiliates of an MNC was based on the most recent data collected by the BEA, which indicated that there are 2,347 MNCs in the U.S. and 25,424 foreign subsidiaries that are majority owned by such

[172] See 5 CFR 1320.11(f).

[173] The Commission further notes that EEI's comments were made exclusively with respect to U.S. energy companies and not the broader spectrum of potential MNCs that are included within the estimation.

MNCs.[174] To account for the number of majority-owned U.S. subsidiaries of MNCs, the Commission doubled the BEA's foreign subsidiaries, and determined that there are an estimated 50,848 U.S. and foreign subsidiaries, or approximately 22 subsidiaries per MNC.

The Commission further notes that the estimate of the number of affiliates per MNC proposed in the NPRM and adopted in this release for purposes of the PRA, is an averaged approximation based on publically available information collected by the BEA, and acknowledges that the number of affiliates of an MNC may be higher or lower than 22. However, there is no basis for concluding that the use of a different source for estimating the average number of affiliates per MNC would result in a higher number estimate, nor did the Commission receive comments to that effect. Accordingly, the Commission believes that its estimation is reasonable in light of the information that is publicly available at this time, and that its original proposed estimates remain appropriate for purposes of the PRA.

List of Subjects

17 CFR Part 50

Business and industry, Clearing, Swaps.

For the reasons stated in the preamble, amend 17 CFR part 50 as follows:

1. Revise part 50 to read as follows:

[174] See Table I.A 2., "Selected Data for Foreign Affiliates and U.S. Parents in All Industries," located at http://www.bea.gov/international/pdf/usdia_2009p/Group%20I%20tables.pdf. The BEA defines a U.S. Parent of a MNC as a person that is a resident in the United States and owns or controls 10 percent or more of the voting securities, or the equivalent, of a foreign business enterprise. A Guide to BEA Statistics on U.S. Multinational Companies, available at http://www.bea.gov/scb/pdf/internat/usinvest/1995/0395iid.pdf.

PART 50 – CLEARING REQUIREMENT AND RELATED RULES

Sec.

Authority: 7 U.S.C. 2(h) and 7a-1 as amended by Pub. L. 111-203, 124 Stat. 1376.

2. Add § 50.52 to read as follows:

§ 50.52 Exemption for swaps between affiliates.

(a) Eligible affiliate counterparty status. Subject to the conditions in paragraph (b), (1) Counterparties to a swap may elect not to clear a swap subject to the clearing requirement of section 2(h)(1)(A) of the Act and this part if:

(i) One counterparty, directly or indirectly, holds a majority ownership interest in the other counterparty, and the counterparty that holds the majority interest in the other counterparty reports its financial statements on a consolidated basis under Generally Accepted Accounting Principles or International Financial Reporting Standards, and such

consolidated financial statements include the financial results of the majority-owned counterparty; or

(ii) A third party, directly or indirectly, holds a majority ownership interest in both counterparties, and the third party reports its financial statements on a consolidated basis under Generally Accepted Accounting Principles or International Financial Reporting Standards, and such consolidated financial statements include the financial results of both of the swap counterparties.

(2) For purposes of this section, (i) a counterparty or third party directly or indirectly holds a majority ownership interest if it directly or indirectly holds a majority of the equity securities of an entity, or the right to receive upon dissolution, or the contribution of, a majority of the capital of a partnership; and (ii) the term "eligible affiliate counterparty" means an entity that meets the requirements of this paragraph.

(b) Additional conditions. Eligible affiliate counterparties to a swap may elect the exemption described in paragraph (a) of this section if:

(1) Both counterparties elect not to clear the swap;

(2) (i) A swap dealer or major swap participant that is an eligible affiliate counterparty to the swap satisfies the requirements of § 23.504; or (ii) if neither eligible affiliate counterparty is a swap dealer or major swap participant, the terms of the swap are documented in a swap trading relationship document that shall be in writing and shall include all terms governing the trading relationship between the eligible affiliate counterparties;

(3) The swap is subject to a centralized risk management program that is reasonably designed to monitor and manage the risks associated with the swap. If at least one of the

eligible affiliate counterparties is a swap dealer or major swap participant, this centralized risk management requirement shall be satisfied by complying with the requirements of § 23.600; and

(4) (i) Each eligible affiliate counterparty that enters into a swap, which is included in a class of swaps identified in § 50.4, with an unaffiliated counterparty shall: (A) comply with the requirements for clearing the swap in section 2(h) of the Act and this part; (B) comply with the requirements for clearing the swap under a foreign jurisdiction's clearing mandate that is comparable, and comprehensive but not necessarily identical, to the clearing requirement of section 2(h) of the Act and this part, as determined by the Commission; (C) comply with an exception or exemption under section 2(h)(7) of the Act or this part; (D) comply with an exception or exemption under a foreign jurisdiction's clearing mandate, provided that (1) the foreign jurisdiction's clearing mandate is comparable, and comprehensive but not necessarily identical, to the clearing requirement of section 2(h) of the Act and this part, as determined by the Commission; and (2) the foreign jurisdiction's exception or exemption is comparable to an exception or exemption under section 2(h)(7) of the Act or this part, as determined by the Commission; or (E) clear such swap through a registered derivatives clearing organization or a clearing organization that is subject to supervision by appropriate government authorities in the home country of the clearing organization and has been assessed to be in compliance with the Principles for Financial Market Infrastructures.

(ii)(A) Except as provided in subparagraph (B), if one of the eligible affiliate counterparties is located in the European Union, Japan, or Singapore, the following may satisfy the requirements of paragraph (b)(4)(i) of this section until March 11, 2014: (1)

each eligible affiliate counterparty, or a third party that directly or indirectly holds a majority interest in both eligible affiliate counterparties, pays and collects full variation margin daily on all swaps entered into between the eligible affiliate counterparty located in the European Union, Japan, or Singapore and an unaffiliated counterparty; or (2) each eligible affiliate counterparty, or a third party that directly or indirectly holds a majority interest in both eligible affiliate counterparties, pays and collects full variation margin daily on all of the eligible affiliate counterparties' swaps with other eligible affiliate counterparties. (B) If one of the eligible affiliate counterparties is located in the European Union, Japan, or Singapore, the requirements of paragraph (b)(4)(i) of this section shall not apply to the eligible affiliate counterparty located in the European Union, Japan, or Singapore until March 11, 2014, provided that: (1) the one counterparty that directly or indirectly holds a majority ownership interest in the other counterparty or the third party that directly or indirectly holds a majority ownership interest in both counterparties is not a "financial entity" as defined in section 2(h)(7)(C)(i) of the Act; and (2) neither eligible affiliate counterparty is affiliated with an entity that is a swap dealer or major swap participant, as defined in § 1.3.

(iii) If an eligible affiliate counterparty located in the United States enters into swaps, which are included in a class of swaps identified in § 50.4, with eligible affiliate counterparties located in jurisdictions other than the United States, the European Union, Japan, and Singapore, and the aggregate notional value of such swaps, which are included in a class of swaps identified in § 50.4, does not exceed five percent of the aggregate notional value of all swaps, which are included in a class of swaps identified in § 50.4, in each instance the notional value as measured in U.S. dollar equivalents and calculated for

each calendar quarter, entered into by the eligible affiliate counterparty located in the United States, then such swaps shall be deemed to satisfy the requirements of paragraph (b)(4)(i) of this section until March 11, 2014, provided that: (A) each eligible affiliate counterparty, or a third party that directly or indirectly holds a majority interest in both eligible affiliate counterparties, pays and collects full variation margin daily on all swaps entered into between the eligible affiliate counterparties located in jurisdictions other than the United States, the European Union, Japan, and Singapore and an unaffiliated counterparty; or (B) each eligible affiliate counterparty, or a third party that directly or indirectly holds a majority interest in both eligible affiliate counterparties, pays and collects full variation margin daily on all of the eligible affiliate counterparties' swaps with other eligible affiliate counterparties.

(c) Reporting Requirements. When the exemption described in paragraph (a) of this section is elected, the reporting counterparty, as determined in accordance with § 45.8 of this chapter, shall provide or cause to be provided the following information to a registered swap data repository or, if no registered swap data repository is available to receive the information from the reporting counterparty, to the Commission, in the form and manner specified by the Commission:

(1) Confirmation that both eligible affiliate counterparties to the swap are electing not to clear the swap and that each of the electing eligible affiliate counterparties satisfies the requirements in paragraph (b) of this section applicable to it;

(2) For each electing eligible affiliate counterparty, how the counterparty generally meets its financial obligations associated with entering into non-cleared swaps by identifying one or more of the following categories, as applicable:

(i) A written credit support agreement;

(ii) Pledged or segregated assets (including posting or receiving margin pursuant to a credit support agreement or otherwise);

(iii) A written guarantee from another party;

(iv) The electing counterparty's available financial resources; or

(v) Means other than those described in paragraphs (i), (ii), (iii) or (iv); and

(3) If an electing eligible affiliate counterparty is an entity that is an issuer of securities registered under section 12 of, or is required to file reports under section 15(d) of, the Securities Exchange Act of 1934:

(i) The relevant SEC Central Index Key number for that counterparty; and

(ii) Acknowledgment that an appropriate committee of the board of directors (or equivalent body) of the eligible affiliate counterparty has reviewed and approved the decision to enter into swaps that are exempt from the requirements of section 2(h)(1) and 2(h)(8) of the Act.

(d) Annual Reporting. An eligible affiliate counterparty that qualifies for the exemption described in paragraph (a) of this section may report the information listed in paragraphs (c)(2) and (3) of this section annually in anticipation of electing the exemption for one or more swaps. Any such reporting by a reporting counterparty under this paragraph will be effective for purposes of paragraphs (c)(2) and (3) of this section for 365 days following the date of such reporting. During the 365-day period, the reporting counterparty shall amend the report as necessary to reflect any material changes to the information reported.

Each reporting counterparty shall have a reasonable basis to believe that the eligible affiliate counterparties meet the requirements for the exemption under this § 50.52.

Issued in Washington, DC, on April 1, 2013, by the Commission.

Melissa Jurgens,

Secretary of the Commission.

Appendix to Clearing Exemption for Swaps Between Certain Affiliated Entities—Commission Voting Summary

NOTE: The following appendix will not appear in the Code of Federal Regulations.

Appendix 1—Commission Voting Summary

On this matter, Chairman Gensler and Commissioners Chilton, O'Malia, and Wetjen voted in the affirmative; Commissioner Sommers voted in the negative.