Dodd-Frank Act v. EMIR

Exemptions for inter-affiliate and intragroup transactions

January 2014

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Contents

Introduction

The U.S. Dodd-Frank Act and the EU regulation on OTC derivatives, central counterparties and trade repositories (EMIR) both impose obligations requiring the clearing and reporting of certain derivative transactions and the margining of uncleared trades. However, there are differences as to how the U.S. and the EU regimes apply to inter-affiliate or intragroup transactions.

This paper summarises and compares:

- **CFTC rules:**
  - Regulation 50.52 adopted by the U.S. Commodity Futures Trading Commission (CFTC) providing an exemption from the clearing obligation for certain inter-affiliate swaps;
  - CFTC No-Action Letter no. 13-09 providing relief from the reporting obligation for certain inter-affiliate swaps.
- **EU rules:** the provisions of Articles 3, 4(2) and 11(5) to (11) EMIR providing exemptions from the clearing and margining obligation for certain intragroup transactions.

This paper is not intended to be comprehensive or to provide legal advice.

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Overview

There are similarities between the approaches to inter-affiliate and intragroup transactions, but some notable differences including:

Availability of exemptions for inter-affiliate or intragroup transactions:

	U.S.: CFTC rules	EMIR
Clearing obligation	✓	✓
Reporting obligation	✓	×
Margining obligation	TBD	✓
Other business conduct/ risk mitigation rules	×	×

- Both the CFTC rules and EMIR grant exemptions from their respective clearing obligations for inter-affiliate or intragroup transactions.
- The CFTC no-action letter provides limited relief from the CFTC reporting obligation for certain inter-affiliate transactions while EMIR does not provide any exemptions from reporting for intragroup transactions.
- EMIR already includes provisions exempting certain intragroup transactions from the margining obligation for uncleared OTC transactions. It is expected that the CFTC rules on margin for uncleared trades, which are to be developed during 2014, will also address the treatment of inter-affiliate swaps.
- The CFTC rules do not provide any specific relief for SDs dealing with affiliates from the business conduct rules that apply to the SD. Similarly, EMIR does not provide relief from its other risk mitigation obligations for intragroup transactions.

Cross-border application of clearing exemptions:

- The EMIR exemption from the clearing obligation is only available for transactions between a counterparty established in the EU and a counterparty established in a non-EU jurisdiction if the European Commission has made a determination that the non-EU jurisdiction has an equivalent regime regulating clearing, reporting, non-financial counterparties and risk mitigation for uncleared swaps (and is not available where both counterparties are established outside the EU, even though the clearing obligation can apply to such counterparties).
- The CFTC rules do not impose corresponding restrictions on the exemption from the clearing obligation where one or both affiliated counterparties are located outside the U.S. However, where an affiliated entity relies on the exemption, the CFTC rules impose strict conditions on swaps between the affiliate and a non-affiliate ("outward-facing swaps"). Where the affiliates relying on the exemption are located in the U.S. or a jurisdiction determined by the CFTC to have a comprehensive and comparable clearing requirement, it should be sufficient if they comply with the clearing requirements (or an exception or exemption) under their local regime. However, an affiliate located in other jurisdictions may still be able to rely on the exemption at least if it clears its outward-facing swaps with a CFTC-registered DCO (or other non-U.S. clearing organisations meeting certain requirements).
- While the CFTC has not yet made any determinations as to whether non-U.S. jurisdictions have comprehensive and comparable clearing mandates, the CFTC regime does provide certain transitional relief for cross-border transactions until 11 March 2014. The European Commission has yet to make any determinations as to the equivalence of non-EU regimes (but the EMIR clearing obligation is not yet in effect)

Overview (continued)

EMIR clearing exemption more restrictive:

- The EMIR exemption from clearing for intragroup transactions is also more restrictive than the corresponding CFTC exemption for inter-affiliate transactions in some other ways, including the following:
  - While EMIR and the CFTC rules both make it a condition of the exemption that both counterparties' financial statements are included in the same consolidated financial statements, the EMIR regime also imposes restrictions as to the consolidation regimes that qualify for these purposes (but both IFRS and US GAAP qualify for this purpose and the EU regime also allows certain regulatory consolidations to qualify for this purpose).
  - Under EMIR, where one of the counterparties is an FC, the exemption is only available for transactions with a counterparty if that counterparty is an FC, a financial holding company, a financial institution or an ancillary services company subject to appropriate prudential supervision (or an NFC, including an NFC established outside the EU). There is no corresponding requirement under the CFTC rules.
  - Counterparties established in the EU must notify their regulator in advance (and either the regulator must have approved the proposal or not objected within a set time) before they can use the EMIR exemption. There is no corresponding requirement under the CFTC rules.

CFTC clearing exemption subject to some additional requirements:

- However, the CFTC rules also impose some requirements not reflected in the EMIR rules, including the following:
  - As already noted, the CFTC rules impose strict requirements on the clearing of outward-facing swaps of affiliates which rely on the exemption. There is no corresponding EMIR requirement but the EMIR exemption should ensure that both affiliates relying on the exemption are subject to the EU or an equivalent regime which regulates the clearing of transactions with unaffiliated counterparties.
  - The CFTC rules require an inter-affiliate swap to be subject to swap trading documentation. EMIR does not impose a similar documentation requirement.
  - Under the CFTC rules, reporting counterparties must report additional information about the swap to a CFTC-registered SDR. The EMIR rules just require a report to identify whether the derivative is eligible for the exemption from clearing.

Exemption from clearing obligation

Exemption from clearing obligation

	U.S.: CFTC rules	EU: EMIR	Comment
Source	CFTC Regulation 50.52.	Articles 3 and 4(2) EMIR.	
Scope – transactions	All swaps (other than security based swaps – these are subject to SEC jurisdiction).	All OTC derivatives subject to EMIR.	The SEC has not yet adopted its clearing regime for security based swaps.
Scope – entities	■ One counterparty must hold a majority interest in the other or a third party must hold a majority ownership interest in both counterparties; and ■ The financial statements of the counterparties must be included in the same consolidated financial statements.	■ Counterparties must be members of the same group (in summary, one entity controls the other or the two entities are in common control by a third entity); ■ Counterparties must included on a full basis in a qualifying accounting or regulatory consolidation; and ■ If one counterparty is an FC, the other counterparty must be an FC, financial holding company, financial institution or ancillary services undertaking subject to appropriate prudential requirements or an NFC (including an NFC established in a non-EU country).	For the purposes of EMIR, qualifying accounting consolidations include EU Accounting Directive, IFRS and US, Japanese, PRC, Canadian, Korean and (until 2015) Indian GAAP and qualifying regulatory consolidations are consolidation under the EU Capital Requirements Regulation and non-EU regimes verified as equivalent under the EU Capital Requirements Directive. EMIR also provides an exemption for transactions between members of an institutional protection scheme covered by Article 10(1) CRR or credit institutions permanently affiliated to a central body covered by Article 113(7) CRR.

Exemption from clearing obligation (continued)

	U.S.: CFTC rules	EU: EMIR	Comment
Scope – territorial	No restriction (but see below relating to treatment of outward-facing swaps).	Counterparties must be established in the EU or, if one is established outside the EU, it must be established in a jurisdiction determined to be "equivalent" by the European Commission.*	The EMIR exemption does not apply to transactions between two non-EU counterparties even where the EMIR clearing obligation applies to those transactions. The CFTC exemption can apply to transactions between two non-U.S. counterparties if they are subject to the clearing obligation under CFTC rules.
Other requirements	Both counterparties must elect for the exemption. The swap terms must be documented in a swap trading document (or, if one of the counterparties is an SD or MSP it must comply with the CFTC's swap trading relationship documentation regulation). The swap must be subject to a centralised risk management program designed to monitor and manage risks associated with the swap (or, if a counterparty is an SD or MSP, it must comply with the CFTC's risk management program regulation).	Both counterparties must be subject to an appropriate centralised risk evaluation, measurement and control procedure.	

* Under Article 13(2) EMIR, the Commission can adopt implementing acts declaring that the legal, supervisory and enforcement arrangements of a third country are equivalent to the EMIR requirements on clearing, reporting, non-financial counterparties and risk mitigation; ensure protection of professional secrecy equivalent to EMIR; and are being effectively applied and enforced in "an equitable and non-distortive manner" to ensure effective supervision and enforcement in the third country.

Exemption from clearing obligation (continued)

	U.S.: CFTC rules	EU: EMIR	Comment
Requirements regarding transactions with non-affiliates	Each counterparty relying on the exemption that enters into a swap subject to the CFTC clearing obligation with a non-affiliate (regardless of where both parties are located) shall: ▪ Comply with CEA/CFTC regulations or an exception or exemption; or ▪ Subject to the CFTC making an appropriate determination, comply with the clearing requirement or an exception or exemption under a non-U.S. jurisdiction's clearing mandate (if the mandate is comparable to and as comprehensive as the U.S.'s mandate and the exception or exemption is comparable to a U.S. exception or exemption); or ▪ Subject to the CFTC making an appropriate determination, clear the swap through a registered DCO or a non-U.S. clearing organisation authorised in its home country and assessed as compliant with the Principles for Financial Market Infrastructures.	None (but see requirement that any non-EU counterparty is located in a jurisdiction which has been determined to be "equivalent" by the European Commission).	The EU exemption assumes that both counterparties are required to clear OTC derivatives with non-affiliates because they are established in the EU or a jurisdiction subject to an "equivalent" regime regulating clearing (as well as reporting, NFCs and risk mitigation). The European Commission has not yet adopted any decision determining that any jurisdiction should be considered "equivalent" for the purposes of the clearing obligation. However, ESMA has advised the Commission to consider the U.S. "equivalent" for the purposes of the exemption under EMIR for intragroup transactions even though its advice was that the U.S. regime is only partially equivalent to the EU rules on clearing, reporting, NFCs and risk mitigation). The CFTC has not yet made any determinations as to whether any non-U.S. jurisdiction has a clearing mandate which is comparable to and as comprehensive as the U.S.'s mandate (or as to the compliance by non-U.S. clearing organisations with the Principles for Financial Market Infrastructures).

Exemption from clearing obligation (continued)

	U.S.: CFTC rules	EU: EMIR	Comment
Transitional relief regarding transactions with non-affiliates	Until 11 March 2014 counterparties that enter into a swap subject to the CFTC clearing obligation with a non-affiliate need not comply with the above conditions in order to rely on the exemption if: ■ Where one of the eligible affiliate counterparties is located in the EU, Japan or Singapore, variation margin is posted for all outward-facing swaps or swaps between affiliates (but no action is required if the relevant parent of the affiliates is not a financial entity and neither affiliate is affiliated with a swap dealer or major swap participant); or ■ Where an affiliate counterparty located in the United States enters into swaps, which must be cleared under U.S. law, with affiliate counterparties located in jurisdictions other than the United States, the EU, Japan and Singapore, and the aggregate notional value of such swaps, which must be cleared under U.S. law, does not exceed five percent of the aggregate notional value of all swaps that must be cleared under U.S. law (in each instance the notional value as measured in U.S. dollar equivalents and calculated for each calendar quarter, entered into by the affiliate counterparty located in the U.S.): (see next page)		It is possible that ESMA and the European Commission could address any delay in making equivalence determinations for non-EU jurisdictions by phasing in the clearing obligation where counterparties are established in those jurisdictions.

Exemption from clearing obligation (continued)

	U.S.: CFTC rules	EU: EMIR	Comment
Transitional relief regarding transactions with non-affiliates (cont.)	(A) full variation margin is posted daily on all outward-facing swaps entered into between the affiliate counterparties located in jurisdictions other than the U.S., the EU, Japan or Singapore; or (B) Each affiliate counterparty, or a third party that directly or indirectly holds a majority interest in both eligible affiliate counterparties, posts full variation margin daily on all of the affiliate counterparties' swaps with other affiliate counterparties		
Regulatory clearance requirement	None.	Counterparties established in the EU must notify their relevant competent authorities not less than 30 calendar days before using the exemption (and the regulator may object to the use of the exemption). Prior authorisation from the EU counterparty's competent authority is required if one counterparty established outside the EU.	

Exemption from clearing obligation (continued)

	U.S.: CFTC rules	EU: EMIR	Comment
Reporting obligation	Reporting counterparty must report the following to an SDR registered with CFTC: ▪ Confirmation that counterparties have elected for the exemption and comply with the eligibility requirements; ▪ How each counterparty meets its financial obligations for non-cleared swaps (e.g. credit support agreement, pledge, guarantee, available financial resources); ▪ If a counterparty is an issuer of securities its SEC Central Index Key number and acknowledgement of board of directors review and approval of decision not to clear swap.	Reports to a trade repository registered or recognised by ESMA must identify whether or not the transaction qualifies as an intergroup transaction eligible for the exemption (even if the parties elect to clear the transaction).	
Effective date	Exemption effective 10 June 2013.	Will be effective when clearing obligation takes effect (expected H2 2014).	

Exemption from reporting obligation

Exemption from reporting obligation

	U.S.: CFTC rules	EU: EMIR	Comment
Source	CFTC Letter No. 13-09.	N/A	EMIR does not provide an exemption from reporting for intragroup transactions (and reports must identify if they are intragroup transactions potentially eligible for clearing exemption).
Scope – transactions	All swaps (other than security based swaps).	N/A	The SEC has not yet adopted rules granting an exemption from reporting.
Scope – end user requirement	The exemption is only available for uncleared swaps. It is not available to those entities using the inter-affiliate exemption from clearing.	N/A	
Scope – wholly-owned affiliates	■ One counterparty must hold a 100% ownership interest in the other counterparty, or a third party must hold a 100% ownership interest in both counterparties; and ■ The financial statements of these counterparties must be included in the same consolidated financial statements.	N/A	Swaps between wholly-owned affiliates meeting these conditions and the general conditions below are completely exempted from the requirement to report to an SDR registered with the CFTC where the conditions of the exemption are met.
Scope – majority-owned affiliates	■ One counterparty must hold a majority ownership interest in the other counterparty, or a third party must hold a majority ownership interest in both counterparties;* ■ The financial statements of these counterparties must be included in the same consolidated financial statements; * and ■ the swap must not be subject to real time reporting pursuant to Part 43 of the CFTC rules	N/A	For swaps between majority-owned affiliates meeting these conditions and the general conditions below, the CFTC letter permits quarterly reporting of swap data to an SDR (no later than 30 days after the end of each fiscal quarter) and provides relief from the reporting requirements of Regulations 45.3(d)(1), 45.3(d)(3), 45.4(c)(1)(ii), 45.4(c)(2)(ii) and 50.50(b) of the CFTC's regulations. Swaps are not subject to real time reporting where not at arm's length.

Exemption from reporting obligation (continued)

	U.S.: CFTC rules	EU: EMIR	Comment
Scope – general conditions	In addition, all the following conditions must be met: ■ Neither of the counterparties is an SD or MSP, is affiliated with an SD or MSP or is affiliated with a financial company that has been designated as systemically important under DFA;* ■ The swap is not executed on or pursuant to the rules of any trading platform where the orders of the affiliated companies may be exposed to potential execution against unaffiliated parties (including a designated contract market, a swap execution facility, a foreign board of trade that is registered with the CFTC);* ■ The swap is not submitted for clearing to a DCO;* ■ All swaps between either of the counterparties with any unaffiliated counterparty (regardless of location) are reported to an SDR registered with the CFTC; and ■ A reporting counterparty relying on the exemption maintains records of the swaps as required by Part 45 of the CFTC's regulations, including internally generated swap identifiers for each swap that is not reported in reliance on the exemption, and must make such records available to the CFTC promptly upon request.*	N/A	The requirement to report all swaps with unaffiliated counterparties to a CFTC-registered SDR is an obstacle to reliance on the exemptions where one of the affiliated parties is located outside the U.S. (as these swaps might not otherwise be reportable to such an SDR).

Exemption from reporting obligation (continued)

	U.S.: CFTC rules	EU: EMIR	Comment
Majority-owned affiliate swaps – timing of reports	The first quarterly reports of data on swaps between majority-owned affiliates under the CFTC letter were due within 30 days after the end of the first fiscal quarter ending on or after 30 June 2013, and such report were required to nclude all swap transaction data required to be reported under Part 45 for the period between 10 April 2013 and the end of such fiscal quarter. Subsequent quarterly reports would be due no later than 30 days following the end of each fiscal quarter, and such reports must include all Part 45 swap transaction data for the most recently completed fiscal quarter.	N/A	
Reporting pre-enactment or transition swap data	The CFTC letter also provides relief from obligations to report pre-enactment or transition swap data for inter-affiliate swaps pursuant to Regulations 46.3(a) or 46.3(b) of the CFTC's regulations if all the conditions marked * above are met.	N/A	

Exemption from margining obligation

Exemption from margining obligation

	U.S.: CFTC rules	EU: EMIR	Comment
Source	TBD	Articles 3 and 11(5) to (10) EMIR.	It is expected that the CFTC rules on margin for uncleared trades, which are to be developed during 2014, will also address the treatment of inter-affiliate swaps.
Scope – transactions	TBD	All OTC derivatives subject to EMIR not cleared by a central counterparty.	The SEC has not yet adopted rules granting an exemption from margining.
Scope – availability of clearing exemption	TBD	The transaction must meet the conditions for eligibility for the clearing exemption (see above).	
Other conditions	TBD	■ There must be no current or foreseen practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between the counterparties. ■ Unless both counterparties are established in the same Member State, the risk management procedures of the counterparties must be adequately sound, robust and consistent with the complexity of the derivative transaction.	

Exemption from margining obligation (continued)

	U.S.: CFTC rules	EU: EMIR	Comment
Regulatory clearance requirement	TBD	Unless both counterparties are established in the same Member State, counterparties established in the EU must notify/apply to their competent authority which may object to the use of the exemption but FCs (and financial holding companies, financial institutions facing an FC) always require a positive decision of their competent authorities to use the exemption.	
Disclosure requirement	TBD	Counterparties making use of the exemption must publicly disclose: the counterparties to the transaction (including their LEIs), the relationship between them, whether the exemption is full or partial and the notional aggregate amount of the derivatives covered by the exemption.	Article 20 of Commission Delegated Regulation (EU) No. 149/2013.
Timing	TBD	The margining obligation is expected to become effective on 1 December 2015 in line with the BCBS-IOSCO final framework.	

Glossary

U.S. glossary

- **CEA:** U.S. Commodity Exchange Act
- **CFTC:** U.S. Commodity Futures Trading Commission
- **DCM:** designated contract market under the CEA
- **DCO:** derivatives clearing organisation under the CEA
- **DFA:** U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act
- **End user:** this term is not expressly defined under the CEA, but based on Section 2(h)(7) of the CEA would be an entity that is not a financial entity and is using swaps to hedge or mitigate commercial risk.
- **MSP:** major swap participant as defined under the DFA, which covers a person, other than an SD, that maintains a substantial position in swaps (excluding positions held for hedging or mitigating commercial risk), has substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets, or is highly leveraged relative to the amount of capital it holds
- **SD:** swap dealer as defined under the DFA
- **SEC:** U.S. Securities Exchange Commission
- **Swap:** the DFA defines a swap broadly to include interest rate, equity, currency, fixed income, commodity, agricultural, energy and broad-based security index swaps, forwards and options, and total return swaps referencing broad-based security indices

EU glossary

- **Clearing threshold:** the threshold size of derivatives positions specified for the purposes of determining whether a non-financial counterparty is subject to the clearing requirement under EMIR
- **Commission:** the European Commission
- **Derivative:** as defined in EMIR, i.e. a financial instrument as set out in points (4) to (10) Section C, Annex 1, MiFID, as implemented by the MiFID implementing regulation
- **EMIR:** the EU regulation on OTC derivatives, central counterparties and trade repositories
- **ESMA:** European Securities and Markets Authority
- **EU:** European Union
- **FC:** financial counterparty as defined in EMIR, i.e. an investment firm, credit institution, insurance/reinsurance undertaking, UCITS, pension scheme and alternative investment fund managed by an alternative investment manager, in each case where authorised or registered in accordance with the relevant EU directive
- **Member State:** member state of the EU
- **MiFID:** the EU Markets in Financial Instruments Directive
- **NFC:** non-financial counterparty as defined in EMIR, i.e. an undertaking established in the EU which is not a financial counterparty
- **NFC+:** a non-financial counterparty whose positions in OTC derivatives (excluding positions reducing risks directly relating to commercial or treasury financing activity) exceed the clearing threshold
- **OTC derivative:** over-the-counter derivative as defined in EMIR, i.e. a derivative executed outside a regulated market (as defined in MiFID) or equivalent non-EU market