distance references; and retaining ILS at current sites with installation of new ILSs by military where needed in lieu of LP and LPV.

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Issued in Washington, DC, on August 14, 2012.

Lansine Toure,

Acting Manager, Navigation Programs.

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COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 39

RIN 3038–AD47

Clearing Exemption for Swaps Between Certain Affiliated Entities

AGENCY: Commodity Futures Trading Commission.

ACTION: Proposed rule.

SUMMARY: The Commodity Futures Trading Commission (''CFTC'' or ''Commission'') is proposing a rule to exempt swaps between certain affiliated entities within a corporate group from the clearing requirement (the ''inter-affiliate clearing exemption'' or the ''proposed exemption'') under Section 2(h)(1)(A) of the Commodity Exchange Act (''CEA''). The Commission also is proposing rules that detail specific conditions counterparties must satisfy to elect the proposed inter-affiliate clearing exemption, as well as reporting requirements for affiliated entities that avail themselves of the proposed exemption. The Commission has finalized a rule that addresses swaps that are subject to the end-user exception. Counterparties to inter-affiliate swaps that qualify for the end-user exception would be able to elect to not clear swaps pursuant to the end-user exception or the proposed rule. The proposed rule does not address swaps that an affiliate enters into with a third party that are related to inter-affiliate swaps that are subject to the end-user exception. The Commission intends separately to propose a rule addressing swaps between an affiliate and a third party where the swaps are used to hedge or mitigate commercial risk arising from inter-affiliate swaps for which the end-user exception has been elected.

DATES: Comments must be received on or before September 20, 2012.

ADDRESSES: You may submit comments, identified by RIN number 3038–AD47, by any of the following methods:

- *The agency's Web site, at: http://comments.cftc.gov.* Follow the instructions for submitting comments through the Web site.
- *Mail:* David A. Stawick, Secretary of the Commission, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street NW., Washington, DC 20581.
- *Hand Delivery/Courier:* Same as mail above.
- *Federal eRulemaking Portal: http://www.regulations.gov.* Follow the instructions for submitting comments.

Please submit your comments using only one method.

All comments must be submitted in English, or if not, accompanied by an English translation. ''Inter-affiliate Clearing Exemption'' must be in the subject field of responses submitted via email, and clearly indicated on written submissions. Comments will be posted as received to *http://www.cftc.gov.* You should submit only information that you wish to make available publicly. If you wish the Commission to consider information that is exempt from disclosure under the Freedom of Information Act, a petition for confidential treatment of the exempt information may be submitted according to the established procedures in CFTC regulation 145.9.[1]

Throughout this proposed rulemaking, the Commission requests comment in response to specific questions. For convenience, the Commission has numbered each of these comment requests. The Commission asks that, in submitting responses to these requests, commenters identify the specific number of each request to which their comments are responsive.

The Commission reserves the right, but shall have no obligation, to review, pre-screen, filter, redact, refuse, or remove any or all of a submission from www.cftc.gov that it may deem to be inappropriate for publication, such as obscene language. All submissions that have been redacted or removed that contain comments on the merits of the rulemaking will be retained in the public comment file and will be considered as required under the Administrative Procedure Act and other applicable laws, and may be accessible under the Freedom of Information Act.

FOR FURTHER INFORMATION CONTACT: Gloria Clement, Assistant General Counsel, (202) 418–5122, *gclement@cftc.gov,* Office of General Counsel; Jonathan Lave, Associate Director, Exchange & Data Repository, (202) 418–5983, *jlave@cftc.gov,* and Alexis Hall-Bugg, Attorney-Advisor, (202) 418–6711, *ahallbugg@cftc.gov,* Division of Market Oversight; Warren Gorlick, Supervisory Attorney-Advisor, (202) 418–5195, *wgorlick@cftc.gov,* and Anuradha Banerjee, Attorney-Advisor, (202) 418–5661, *abanerjee@cftc.gov,* Office of International Affairs; Theodore Kneller, Attorney-Advisor, (202) 418–5727, *tkneller@cftc.gov,* Division of Enforcement; Elizabeth Miller, Attorney-Advisor, (202) 418–5985, *emiller@cftc.gov,* Division of Swap Dealer and Intermediary Oversight; Esen Onur, Research Economist, (202) 418–6146, *eonur@cftc.gov,* Office of the Chief Economist; and Jolanta Sterbenz, Counsel, (202) 418–6639, *jsterbenz@cftc.gov,* Office of General Counsel, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581.

I. Background

A. Clearing Requirement for Swaps

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (''Dodd-Frank Act'' or ''DFA'').[2] Title VII of the Dodd-Frank Act amended the CEA,[3] and established a new regulatory framework for swaps. The legislation was enacted to reduce systemic risk, increase transparency, and promote market integrity within the financial system by, among other things: (1) Imposing clearing and trade execution requirements on standardized derivative products; (2) creating rigorous recordkeeping and data reporting regimes with respect to swaps, including real-time public reporting; and (3) enhancing the Commission's rulemaking and enforcement authorities over all registered entities, intermediaries, and swap counterparties subject to the Commission's oversight.

Section 723 of the Dodd-Frank Act added section 2(h) to the CEA, which establishes a clearing requirement for swaps.[4] The new section makes it unlawful for any person to engage in a swap, if the Commission determines such swap is required to be cleared, unless the person submits the swap for clearing to a registered derivatives clearing organization (''DCO'') (or a DCO that is exempt from registration).[5] The

[1] 17 CFR 145.9. Commission regulations may be accessed through the Commission's Web site, *http://www.cftc.gov.*

[2] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (July 21, 2010).

[3] 7 U.S.C. 1 *et seq.* (2006).

[4] CEA section 2(h)(1)(A), 7 U.S.C. 2(h)(1)(A).

[5] *See* CEA section 2(h)(1)(A), 7 U.S.C. 2(h)(1)(A). The CEA's clearing requirement states that, ''[i]t shall be unlawful for any person to engage in a swap unless that person submits such swap for

Continued

CEA, however, permits exceptions and exemptions to the clearing requirement.

A person may elect not to clear certain swaps if such person qualifies for an exception under CEA section 2(h)(7) and the Commission regulations issued in connection therewith (the ''end-user exception'').[6] To summarize the principal components of the end-user exception, for a swap to qualify, a counterparty to the swap electing the exception must (i) not be a ''financial entity,'' as defined in CEA section 2(h)(7)(C)(i) or qualify for an exemption from that defined term under section 2(h)(7)(D),[7] or through a Commission-issued exemption under CEA sections 2(h)(7)(C)(ii)[8] or 4(c)[9] and (ii) be using the swap to hedge or mitigate commercial risk. The Commission has determined to exempt certain small banks, savings associations, farm credit institutions, and credit unions under section 2(h)(7)(C)(ii) of the CEA from the definition of ''financial entity.''[10]

Importantly, a counterparty to an inter-affiliate swap that qualifies for both the end-user exception and the inter-affiliate exemption may elect not to clear the inter-affiliate swap under either the end-user exception or the inter-affiliate exemption. As such, the Commission believes that the rule proposed in this rulemaking may not be necessary for the vast majority of inter-affiliate swaps involving a non-financial entity or a small financial institution because the end-user exception can be elected for those swaps. Accordingly, it is likely the proposed rule will be used for inter-affiliate swaps between two financial entities that do not qualify for the end-user exception or for swaps involving a non-financial entity that do not qualify for the end-user exception because the swaps do not hedge or mitigate commercial risk.

Finally, CEA section 4(c)(1), described in more detail below, grants the Commission general exemptive powers.[11] Pursuant to that authority, the Commission has proposed a rule that would allow cooperatives meeting certain conditions to elect not to submit for clearing certain swaps subject to a clearing requirement.[12]

B. Swaps Between Affiliated Entities

Except as provided with respect to certain financing affiliates as noted above, CEA section 2(h) does not provide any specific exception to swaps entered into by affiliates that are subject to a clearing requirement (''inter-affiliate swaps'').[13] Inter-affiliate swaps that are hedged by back-to-back or matching book swaps entered into with third parties may pose risks to the financial system if the inter-affiliate swaps are not properly risk managed thereby raising the likelihood of default on the outward facing swaps. Furthermore, there could be systemic risk implications if an affiliate used by the corporate group to trade outward facing swaps (commonly referred as centralized treasury or conduit affiliates) has large positions and defaulted on obligations arising from inter-affiliate swaps if such swaps are hedged with third-party swaps.[14] Such a default could harm third-party swap counterparties, and potentially, financial markets as a whole, if the treasury/conduit affiliate was unable to satisfy third-party obligations as a consequence of the default.

A number of commenters in a variety of Commission rulemakings have recommended that the Commission adopt an exemption to the clearing requirement for inter-affiliate swaps.[15] Some commenters claimed that inter-affiliate swaps offer significant benefits with substantially less risk than swaps between unaffiliated entities. They contended that inter-affiliate swaps enable a corporate group to aggregate its risks on a global basis in one entity through risk transfers between affiliates. Commenters also described varying structures through which corporate groups entered into inter-affiliate swaps and manage risks.

Prudential Financial, Inc. (''PFI''), stated that it employs a ''conduit'' structure where separate legal entities are commonly owned by PFI.[16] Under this structure, PFI uses one affiliate to directly face the market as a ''conduit'' to hedge the net commercial and financial risk of the various operating affiliates within PFI. PFI contended that the use of a conduit diminishes the demands on PFI's financial liquidity, operational assets, and management resources, because ''affiliates within PFI avoid having to establish independent relationships and unique infrastructure to face the market.'' Moreover, PFI explained that its conduit facilitates the netting of its affiliates' trades (*e.g.,* where one affiliate hedges floating rates while another hedges fixed rates). PFI stated that this conduit structure effectively reduces the overall risk of PFI and its affiliates, and it allows PFI to manage fewer outstanding positions with external market participants.[17]

In a letter to Congress, the Coalition for Derivatives End-Users (''CDEU'') asserted that inter-affiliate swaps do not create external counterparty exposure and, therefore, pose none of the systemic or other risks that the clearing requirement is designed to protect against.[18] Thus, in CDEU's view, the

clearing to a derivatives clearing organization that is registered under this Act or a derivatives clearing organization that is exempt from registration under this Act if the swap is required to be cleared.''

[6] CEA section 2(h)(7)(A), 7 U.S.C. 2(h)(7)(A). CEA section 2(h)(7)(A) provides an elective exception to the clearing requirement to any counterparty to a swap that is not a financial entity, is using the swap to hedge or mitigate commercial risk, and notifies the Commission how it generally meets the financial conditions associated with entering into non-cleared swaps. The Commission issued the end-user exception in a rulemaking entitled, ''End-User Exception to the Clearing Requirement for Swaps,'' 77 FR 42560, July 19, 2012 (final).

[7] CEA section 2(h)(7)(D), 7 U.S.C. 2(h)(7)(D).

[8] CEA section 2(h)(7)(C)(ii), 7 U.S.C. 2(h)(7)(C)(ii) (''The Commission shall consider whether to exempt small banks, savings associations, farm credit system institutions, and credit unions * * * '').

[9] CEA section 4(c), 7 U.S.C. 6(c).

[10] ''End-User Exception to the Clearing Requirement for Swaps,'' 77 FR 42560, July 19, 2012 (*see* § 39.6(d)).

[11] Section 4(c)(1) of the CEA empowers the Commission to exempt any transaction or class of transactions, including swaps, from certain CEA provisions, such as the clearing requirement.

[12] ''Clearing Exemption for Certain Swaps Entered into by Cooperatives,'' 77 FR 41940, July 17, 2012.

[13] For the purposes of this proposed rulemaking, ''inter-affiliate swaps'' refers to swaps between ''affiliates,'' as that term is defined in proposed § 39.6(g)(1): ''[c]ounterparties to a swap * * * may elect not to clear a swap with an affiliate if one party directly or indirectly holds a majority ownership interest in the other, or if a third party directly or indirectly holds a majority interest in both, based on holding 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.'' *See infra* pt. II.B.1 for further discussion.

[14] There does not appear to be a common definition of a ''treasury affiliate'' or a ''conduit affiliate.'' For purposes of this proposed rulemaking, a treasury/conduit affiliate (or structure) is an affiliate that enters into inter-affiliate swaps and enters into swaps with third parties that are related to such inter-affiliate swaps on a back-to-back or aggregate basis.

[15] The Commission notes that comment letters to other proposed rulemakings under Title VII of the Dodd-Frank Act are not part of the administrative record for this rulemaking unless specifically cited herein.

[16] Prudential Financial, Inc. comment letter to the proposed rulemaking, ''Further Definition of 'Swap Dealer,' 'Security-Based Swap Dealer,' 'Major Swap Participant,' 'Major Security-Based Swap Participant' and 'Eligible Contract Participant,' '' 75 FR 80147, Dec. 21, 2010.

[17] J.P. Morgan commented that the most efficient way to manage risk is often at one entity and on a portfolio level. This way all the risk for the corporate group resides in one entity. J.P. Morgan maintained that this reduces market risk at each legal entity and can reduce risk on a group level because offsetting positions held by different members of the group can be aggregated to mitigate the overall risk of the portfolio. J.P. Morgan asserted that portfolio risk management enables regulators to more easily assess the net risk position on a group level rather than piecing together data from separate affiliates to reconstruct the actual risk profile of the group. J.P. Morgan comment letter to the proposed rulemaking, ''Process for Review of Swaps for Mandatory Clearing,'' 75 FR 67277, Nov. 2, 2010.

[18] Coalition for Derivatives End-Users comment letter for H.R. 2682, H.R. 2779, and H.R. 2586 (Mar. 23, 2012).

imposition of required clearing on inter-affiliate swaps would not reduce systemic risk. CDEU also commented that a conduit or treasury structure is beneficial because it centralizes trade expertise and execution in a single or limited number of entities. Finally, CDEU claimed that a treasury or conduit structure benefits affiliates because they can enjoy their parents' corporate credit ratings and associated pricing benefits.

These comments suggest that swaps entered into between corporate affiliates, if properly risk-managed, may be beneficial to the operation of the corporate group as a whole. They indicate that inter-affiliate swaps may improve a corporate group's risk management internally and allow the corporate group to use the most efficient means to effectuate swaps with third parties. While the Commission recognizes these potential benefits of inter-affiliate swaps, the Commission is also taking into account the systemic risk repercussions of inter-affiliate swaps as it considers and proposes an exemption to the CEA's clearing requirement applicable to those inter-affiliate swaps.

II. Inter-Affiliate Clearing Exemption Under CEA Section 4(c)(1)

A. The Commission's Section 4(c)(1) Authority

Section 4(c)(1) of the CEA empowers the Commission to ''promote responsible economic or financial innovation and fair competition'' by exempting any transaction or class of transactions, including swaps, from any of the provisions of the CEA (subject to exceptions not relevant here).[19] In enacting CEA section 4(c)(1), Congress noted that the goal of the provision ''is to give the Commission a 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.'' [20] Observant of that objective, the Commission has determined preliminarily that it would be appropriate to exempt inter-affiliate swaps from the clearing requirement in CEA section 2(h) under certain terms and conditions. The proposed exemption, however, would not extend to swaps that affiliates entered into with third parties.

The primary benefit of clearing is the reduction of counterparty risk. The Commission notes commenters' assertions that there is less counterparty risk associated with inter-affiliate swaps than swaps with third parties to the extent that affiliated counterparties internalize each other's counterparty risk because they are members of the same corporate group. This internalization can be demonstrated by the example of a swap entered into between affiliates A and B that are majority owned by the same person.[21] If affiliate A fails to perform, then affiliate B would be harmed. However, affiliate A also may be harmed if (1) B's harm adversely impacts the profits of A and B's corporate group [22] or (2) A's failure to perform drives the group into bankruptcy, because, for instance, B has entered into a swap with a third party and B is unable to perform as a consequence of A's failure to perform. The potential harm to A for failing to perform is greater than the harm A would experience if B was not a majority-owned affiliate. Accordingly, A internalizes B's counterparty risk and A has a greater economic incentive to perform than if B were a third party.

The Commission does not believe there is significantly reduced counterparty risk with respect to swaps between affiliates that are not majority-owned by the same person because there is less economic feedback. If A is a majority-owned affiliate and B is a minority-owned affiliate, then any harm that B experiences as a consequence of A's failure to perform is likely to have a less adverse impact on the profits of A's corporate group than if B was a majority-owned affiliate. In addition, the Commission believes that B's failure to perform would be significantly less likely to drive A's corporate group into bankruptcy than if B were majority-owned.

On the basis of reduced counterparty risk, the Commission has determined preliminarily that inter-affiliate swap risk may not need to be mitigated through clearing, but can be reduced through other means. The Commission also believes at the proposal stage that exempting inter-affiliate swaps would enable corporations to structure their groups so that corporate risk is concentrated in one entity—whether it be at a treasury- or conduit-type affiliate, or at the parent company.[23] The Commission recognizes there may be advantages for the corporate group and regulators if risk is appropriately managed and controlled on a consolidated basis and at a single affiliate. Based upon the comments received, the Commission understands that some corporate groups use this type of structure.

The Commission, nevertheless, believes that uncleared inter-affiliate swaps could pose risk to corporate groups and market participants, generally. Uncleared inter-affiliate swaps also may pose risk to other market participants, and therefore the financial system, if the treasury/conduit affiliate enters into swaps with third parties that are related on a back-to-back or matched book basis with inter-affiliate swaps. To continue the above example, if A's failure to perform (for whatever reason) makes it impossible for B to meet its third-party swap obligations, then those third parties would be harmed and risk could spread into the marketplace. However, A's risk of nonperformance is less than it would be if B were a third party to the extent A internalizes B's counterparty risk.

To address these concerns, the Commission is proposing rules that would exempt inter-affiliate swaps from clearing if certain conditions are satisfied. First, the proposed exemption would be limited to swaps between majority-owned affiliates whose financial statements are reported on a consolidated basis. Second, the proposed rules would require the following: Centralized risk management, documentation of the swap agreement, variation margin payments (for financial entities), and satisfaction of reporting requirements. In addition, the exemption would be limited to swaps between U.S. affiliates, and swaps between a U.S. affiliate and a foreign affiliate located in a jurisdiction with a comparable and comprehensive clearing regime or the non-United States counterparty is otherwise required to clear the swaps it enters into with third

[19] Section 4(c)(1) of the CEA, 7 U.S.C. 6(c)(1), provides, in pertinent part, that:

In order to promote responsible economic or financial innovation and fair competition, the Commission by rule, regulation, or order, after notice and opportunity for hearing, may (on its own initiative or on application of any person * * *) exempt any agreement, contract, or transaction (or class thereof) that is otherwise subject to subsection (a) of this section * * * either unconditionally or on stated terms or conditions or for stated periods and either retroactively or prospectively, or both, from any of the requirements of subsection (a) of this section, or from any other provision of this Act.

By issuing a proposed exemptive rule, the Commission also is exercising its general rulemaking authority under CEA section 8a(5), 7 U.S.C. 12a(5).

[20] House Conf. Report No. 102–978, 1992 U.S.C.C.A.N. 3179, 3213 (''4(c) Conf. Report'').

[21] The meaning of ''majority-owned'' is set forth and discussed in part B1.

[22] A's corporate group is the group that contains the person with a majority ownership interest of A. Similarly, B's corporate group is the group that contains the person with a majority ownership interest of B.

[23] Treasury/conduit affiliates, for example, often enter into swaps with third parties that hedge aggregate inter-affiliate swap risk. The aggregation is based on risk correlations. If those correlations break down, then the treasury/conduit affiliate may no longer be able to satisfy its third-party swap obligations.

parties in compliance with United States law or does not enter into swaps with third parties. Additionally, the Commission notes that the proposed exemption does not limit the applicability of any CEA provision or Commission regulation to any person or transaction except as provided in the proposed rulemaking. These conditions will be discussed in further detail below.

Request for Comments

Q1. The Commission requests comment on whether it should exercise its authority under CEA section 4(c).

Q2. Do inter-affiliate swaps pose risk to the corporate group? If so, what risk is posed? In particular, do inter-affiliate swaps pose less risk to a corporate group than swaps with third parties? If so, why is that the case?

Q3. Do inter-affiliate swaps pose risk to the third parties that have entered into swaps that are related to the inter-affiliate swaps? If so, what risk is posed?

Q4. Would the proposed exemption promote responsible economic or financial innovation and fair competition?

Q5. Would the proposed exemption promote the public interest?

Q6. Inter-affiliate swaps that do not meet the conditions to the proposed exemption would be subject to the clearing requirement under CEA section 2(h)(1)(A) and, potentially, the trade execution requirement under CEA section 2(h)(8) as well. What would be the costs and benefits of imposing the trade execution requirement on these inter-affiliate swaps? Should the Commission exempt some or all inter-affiliate swaps from the trade execution requirement regardless of whether the conditions to the proposed inter-affiliate clearing exemption are met?

B. Proposed Regulations

1. Proposed § 39.6(g)(1): Definition of Affiliate Relationship

Under proposed § 39.6(g)(1), the inter-affiliate clearing exemption would only be available for swaps between majority-owned affiliates. As explained above, the Commission believes there is reduced counterparty risk with respect to such swaps. Under the proposed rule, affiliates would be majority-owned if one affiliate directly or indirectly holds a majority ownership interest in the other affiliate, or if a third party directly or indirectly holds a majority ownership interest in both affiliates and the financial statements of both affiliates are reported on a consolidated basis. A majority-ownership interest would be based on holding 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.[24]

The Commission is not proposing to extend the exemption to affiliates that are related on a minority-owned basis. As explained above, the Commission does not believe there is significantly reduced counterparty risk with respect to swaps between such affiliates. The Commission also believes it is important for the proposed 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.[25] For example, the European Parliament and Council of the European Union have adopted the European Market Infrastructure Regulation (''EMIR'').[26] Subject to the relevant provisions, technical standards, and regulations under EMIR, certain derivatives transactions between parent and subsidiary entities, could be exempt from its general clearing requirement.

Request for Comments

Q7. The Commission requests comments on all aspects of the Commission's proposed requirement that the inter-affiliate clearing exemption be available to majority-owned affiliates.

Q8a. Should the Commission consider requiring a percentage of ownership greater than majority ownership to qualify for the inter-affiliate clearing exemption?

Q8b. If so, what percentage should be used and what are the benefits and burdens of such ownership requirements?

Q8b. Should the Commission require a 100% ownership threshold for the inter-affiliate clearing exemption? Would a 100% ownership threshold reduce counterparty risk and protect minority owners better than the proposed threshold. Are there other means to lessen risk to minority owners, such as consent?

Q9. Should the Commission consider an 80% ownership threshold based on section 1504 of the Internal Revenue Code, which establishes an 80% voting and value test for an affiliate group.[27] In light of the potential benefits from centralized risk management in an affiliated group, would an 80% threshold sufficiently reduce overall risk to financial system

2. Proposed § 39.6(g)(2)(i): Both Counterparties Must Elect the Inter-Affiliate Clearing Exemption

The Commission believes that affiliates within a corporate group may make independent determinations on whether to submit an inter-affiliate swap for clearing. Ostensibly, each affiliate may reach different conclusions regarding the appropriateness of clearing. Given this possibility, proposed § 39.6(g)(2)(i) would require that both counterparties elect the proposed inter-affiliate clearing exemption (each, an ''electing counterparty'').

Request for Comments

Q10. Would this requirement create any operational issues?

3. Proposed § 39.6(g)(2)(ii): Swap Documentation

The Commission understands that affiliates may enter into swaps with

[24] The affiliate status required by proposed § 39.6(g)(1) to elect the proposed exemption is based on and functionally equivalent to the definition of majority-owned affiliates in recently adopted CFTC regulation 1.3(ggg)(6)(i).

[25] In 2009, the G20 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.'' G20 Leaders' Final Statement at Pittsburgh Summit: Framework for Strong, Sustainable and Balanced Growth (Sept. 29, 2009).

[26] *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) available at *http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF.*

[27] The Internal Revenue Service allows a business conglomerate to file consolidated tax returns if the parent company and its subsidiaries meet a relationship test that is outlined in 26 U.S.C. 1504(a)(2):

(a) Affiliated group defined for purposes of this subtitle—

(1) In general. The term ''affiliated group'' means—

(A) 1 or more chains of corporations connected through stock ownership with a common parent corporation which is a corporation, but only if—

(B) (i) the common parent owns directly stock meeting the requirements of paragraph (2) in at least 1 of the other corporations, and

(ii) stock meeting the requirements of paragraph (2) in each of the includible corporations (except the common parent) is owned directly by 1 or more of the other includible corporations.

(2) 80-percent voting and value test The ownership of stock of any corporation meets the requirements of this paragraph if it—

(A) possesses at least 80 percent of the total voting power of the stock of such corporation, and

(B) has a value equal to at least 80 percent of the total value of the stock of such corporation.

(3) Stock not to include certain preferred stock

For purposes of this subsection, the term ''stock'' does not include any stock which—(A) is not entitled to vote,

(B) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent,

(C) has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium), and

(D) is not convertible into another class of stock.

each other with little documentation about the terms and conditions of the swaps. The Commission is concerned that without proper documentation affiliates would be unable to effectively track and manage risks arising from inter-affiliate swaps or offer sufficient proof of claim in the event of bankruptcy. This could create challenges and uncertainty that could adversely affect affiliates, third party creditors, and potentially the financial system. The Commission also is concerned about transparency should there be a need for an audit or enforcement proceeding.

Proposed § 39.6(g)(2)(iii) would address these concerns by requiring affiliates to enter into swaps with a swap trading relationship document.[28] The proposed rule would require the document to be in writing and to include all terms governing the trading relationship between the affiliates, including, without limitation, terms addressing payment obligations, netting of payments, events of default or other termination events, calculation and netting of obligations upon termination, transfer of rights and obligations, governing law, valuation, and dispute resolution procedures.[29] The Commission believes this requirement would not be onerous because affiliates should be able to use a master agreement to document most of the terms of their inter-affiliate swaps.

Request for Comments

Q11. The Commission requests comment as to the burden or cost of the proposed rule requiring documentation of inter-affiliate swaps.

Q12. The Commission also requests comment as to whether its risk tracking and management and proof-of-claim concerns could be addressed by other means of documentation.

Q13. The Commission requests comment as to whether the Commission should create a specific document template. Should the industry do so?

4. Proposed § 39.6(g)(2)(iii): Centralized Risk Management

Proposed § 39.6(g)(2)(iii) would require inter-affiliate swaps to be subject to a centralized risk management program reasonably designed to monitor and manage the risks associated with the inter-affiliate swaps. As noted in Part I.B. above, inter-affiliate swaps may pose risk to third parties if risks are not properly managed. Accordingly, to encourage prudent risk management, the proposed inter-affiliate clearing exemption would be conditioned on a corporate group's evaluation, measurement and control of such risks. The Commission anticipates that the program would be implemented and run by the parent company or the treasury/conduit affiliate, but the rule provides flexibility to determine how best to satisfy this requirement.[30]

The Commission understands that some groups that use inter-affiliate swaps, particularly large financial entities, already have a centralized risk management program.[31] Indeed, several commenters—*e.g.,* SIFMA and ISDA—supported centralized risk management and claimed that centralized risk management for inter-affiliate swaps ''would be compromised'' by a clearing requirement.[32] CDEU also commented that inter-affiliate swaps are beneficial because they allow swaps with third parties to be traded at a treasury-type structure which contains risk management expertise.[33] Based on comments received, the Commission believes that the proposed rule is in line with industry practice. Proposed § 39.6(g)(2)(iii) also is in harmony with similar requirements under EMIR, which would require under certain circumstances for both counterparties to intra-group transactions to be ''subject to an appropriate centrali[z]ed risk evaluation, measurement and control procedures. * * *'' [34]

Request for Comments

Q14. The Commission requests comments that explain how current centralized risk management programs operate.

Q15. The Commission requests comment on whether it should promulgate additional regulations that set forth minimum standards for a centralized risk management program. If so, what should those standards be? Is there a consistent industry practice which could be observed?

Q16. Is the proposed rule in line with industry practice?

5. Proposed § 39.6(g)(2)(iv): Variation Margin

Proposed § 39.6(g)(2)(iv) would require that variation margin be collected for swaps between affiliates that are financial entities, as defined in CEA section 2(h)(7)(C), in compliance with the proposed variation margin requirements set forth in proposed § 39.6(g)(3).[35] Variation margin is an essential risk-management tool. A well-designed variation margin system protects both parties to a trade. It 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. 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.[36] This process prevents uncollateralized exposures from accumulating over time and thereby reduces the size of any loss resulting from a default should one occur. Required margining also might cause parties to more carefully consider the risks involved with swaps and manage those risks more closely over time. The Commission believes, at this stage, that inter-affiliate swap risk may be mitigated through variation margin and notes that requiring variation margin for inter-affiliate swaps is being discussed by international regulators working on harmonizing regulations governing swap clearing.

The Commission understands that a number of financial entities currently

[28] For swap dealers and major swap participants, these issues are addressed in the swap trading relationship documentation rules proposed by the Commission in § 23.504. *See* ''Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants,'' 76 FR 6715, Feb. 8, 2011. The proposed rule requires that if one or more of the parties to the swap for which the inter-affiliate exemption is elected is a swap dealer or major swap participant, then that party shall comply with § 23.504 for that swap. Swap dealers and major swap participants that comply with that provision would also satisfy the proposed requirements.

[29] The requirements of the swap trading relationship document are informed by proposed CFTC regulation 23.504(b)(1). *See* ''Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants,'' 76 FR 6715, Feb. 8, 2011.

[30] The Commission has adopted risk management rules for swap dealers and major swap participants in § 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 20128, 20173–75, April 3, 2012 (final rule). The rule requires that if one or more of the parties to the swap for which the inter-affiliate exemption is elected is a swap dealer or major swap participant, then that party shall comply with § 23.600 for that swap. Swap dealers and major swap participants that comply with that provision will also satisfy the proposed requirements.

[31] *See, e.g.,* Letter from SIFMA and ISDA submitted to the Commission on their own initiative (May 14, 2012).

[32] *Id.*

[33] *See* 3/23/23 Letter from CDEU.

[34] *See* EMIR Article 3, paragraphs 1 and 2. EMIR identifies factors necessary to establish a transaction as an intra-group transaction.

[35] Discussed in pt. II.B.8., below.

[36] Variation margin is distinguished from initial margin, which is intended to serve as a performance bond against potential future losses. If a party defaults, the other party may use initial margin to cover most or all of any loss that may result between the time the default occurs and when the non-defaulting party replaces the open position.

post variation margin for their inter-affiliate swaps. According to SIFMA and ISDA, ''[t]he posting of variation margin limiting the impact of market movements upon the respective positions of the affiliated parties now occurs routinely in financial groups and its imposition on affiliates who transact directly with affiliated swap dealers (SDs) or major swap participants (MSPs) should not be unduly disruptive.'' [37] The Commission has proposed rules requiring certain financial entities to pay and collect variation and initial margin for uncleared swaps entered into with other financial entities.[38]

The proposed requirement would not apply to 100% commonly-owned and commonly-guaranteed affiliates, provided that the common guarantor is also under 100% common ownership. As discussed above, the risk of an inter-affiliate swap may be mitigated through the posting of variation margin. The Commission believes that when the economic interests of two affiliates are both (i) fully aligned and (ii) a common guarantor bears the ultimate risk associated swaps entered into with a third party, non-affiliated counterparty, the posting of variation margin does not substantially mitigate the risk of an inter-affiliate swap. This exception is intended to apply to swaps between two wholly-owned subsidiaries of a common parent or in instances where one affiliate is wholly owned by the other.

The first of the conditions required to claim the exception to the requirement under proposed regulation 39.6(g)(2)(iv) to post variation margin relates to complete common ownership. When two affiliates are owned by the same owner or one is wholly owned by the other, the underlying owners are the same and the economic interests of the two affiliates are aligned.[39] In such circumstances, the two affiliates are subject to the control of a common owner or common set of owners.[40]

A person would not be able to claim 100 percent ownership for the purposes of this provision based on a contingent right or obligation, by contract or otherwise, to take ownership of the equity interest in the affiliate by purchase or otherwise.[41] Conversely, structures in which a person owns 100 percent of the equity but has an obligation or right, by contract or otherwise, to give up, by sale or otherwise, all or a portion of that equity interest would not meet the 100 percent ownership test. Such contingent or residual rights evidence a less than complete responsibility for the affiliate, including its swap obligations, that the 100 percent ownership and guaranty provision is intended to require. Under such circumstances, the interests of the owner and the affiliate are not fully aligned. The second condition requires the existence of a common guarantor. When two affiliates share a common guarantor that is under the same common ownership, the Commission believes that the risk created by a swap with a non-affiliated third party is ultimately borne by the enterprise (which is defined by an alignment of economic interests). To provide an example, assume that A and B are guaranteed wholly-owned subsidiaries of X. B enters into a swap with non-affiliated third party T. B then enters into a back-to-back swap (mirroring the risk created in the swap with T) with A (i.e., an inter-affiliate swap). In this scenario, the risk associated with the swap with T is effectively borne by X and therefore ultimately borne by the enterprise. In such circumstances therefore the inter-affiliate swap does not create new risks for the enterprise, rather, it allocates the risk from one wholly-owned subsidiary to another. The posting of variation margin here would not substantially mitigate the risk of the inter-affiliate swap because the inter-affiliate swap itself does not create new risks for the enterprise.

Request for Comments

Q17a. The Commission requests comment as to whether it should promulgate regulations that set forth minimum standards for variation margin. If so, what should those standards be?

Q17b. The Commission requests comment as to whether it should promulgate regulations that set forth minimum standards for initial margin. If so, what should those standards be?

Q17c. The Commission requests comment as to whether it should promulgate regulations that set forth minimum standards for both initial and variation margin for inter-affiliate swaps. If so, what should those standards be?

Q17d. The Commission's proposed rule ''Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants''—17 CFR Part 23—would require initial and variation margin for certain swaps that are not cleared by a registered designated clearing organization. Should inter-affiliate swaps that are not subject to the clearing requirement of CEA section 2(h)(1)(A) be subject to the margin requirements as set out in proposed Part 23 or otherwise?

Q18. The Commission requests comment on the costs and benefits of requiring variation margin for inter-affiliate swaps, both in general and specifically, regarding corporate groups that do not currently transfer variation margin in respect of inter-affiliate swaps.

Q19. The Commission requests comment on whether 100% commonly-owned affiliates sharing a common guarantor—that is, a guarantor that is also 100% commonly owned—should be exempt from the requirement to transfer variation margin. Please explain the impact on the corporate group, if any, if the described affiliates are required to transfer variation margin.

Q20a. Should any other categories of entities or corporate groups, such as non-swap dealers and non-major swap participants, be exempt from the variation margin requirement for their inter-affiliate swaps? If so, which categories and why?

Q20b. Should the Commission limit the variation margin requirements to those inter-affiliate swaps for which at least one counterparty is a swap dealer, major swap participant, or financial entity, as defined in paragraph (g)(6) of the proposed rule text, that is subject to prudential regulation?

Q21. The Commission requests comment as to whether it should eliminate the proposed exemption's variation margin condition for swaps between 100% owned affiliates.

Q22. The Commission requests comment as to whether it should eliminate the proposed exemption's

[37] *See, e.g.,* 5/14/12 Letter from SIFMA and ISDA.

[38] The Commission does not propose that variation margin posted in respect of inter-affiliate swaps be required to be held in a segregated account or be otherwise unavailable for use and rehypothecation by the counterparty holding such variation margin.

[39] In contrast, if two affiliates do not have the same owners, the potential exists that the two affiliates may have differing economic interests. *See* also *Copperweld* v. *Independence Tube*—467 U.S. 752 (1984) at 771 (''The coordinated activity of a parent and its wholly owned subsidiary must be viewed as that of a single enterprise for purposes of § 1 of the Sherman Act. A parent and its wholly owned subsidiary have a complete unity of interest. Their objectives are common, not disparate, and their general corporate objectives are guided or determined not by two separate corporate consciousnesses, but one.'').

[40] Under such circumstances, the two affiliates are subject to common control, in actuality or potentially—i.e., the common owner could assert full control when one or both affiliates cease to act in the common owner's best interest.

[41] For example, if a financial entity established a trust, partnership, corporation or other type of entity, and sells the equity interests therein to investors, but retains the right to call, repurchase, or otherwise take control of the equity interest, or has a contingent obligation to call, repurchase or otherwise take control of the equity interest, such right or obligation would not be sufficient to constitute ownership of the affiliate for purposes of this provision.

variation margin condition for swaps between 80% owned affiliates.

Q23. The Commission requests comment on whether all types of financial entities identified in CEA section 2(h)(7)(C) should be subject to the variation margin requirement. Should entities that are part of a commercial corporate group and are financial entities solely because of CEA section 2(h)(7)(C)(i)(VIII) be excluded from such requirement? Why?

6. Proposed § 39.6(g)(2)(v): Both Affiliates Must Be Located in the United States or in a Country With a Comparable and Comprehensive Clearing Regime or the Non-United States Counterparty Is Otherwise Required To Clear Swaps With Third Parties in Compliance With United States Law or Does Not Enter Into Swaps With Third Parties

The Commission is proposing to limit the inter-affiliate clearing exemption to inter-affiliate swaps between two U.S.-based affiliates or swaps where one affiliate is located abroad in a jurisdiction with a comparable and comprehensive clearing regime or the non-United States counterparty is otherwise required to clear swaps with third parties in compliance with United States law or does not enter into swaps with third parties. The limitation in § 39.6(g)(2)(v) is designed to address the Commission's concerns about risk and to deter evasion as directed by CEA section 2(h)(4)(A).

Under section 2(h)(4)(A), the Commission must prescribe rules necessary to prevent evasion of the clearing requirement.[42] The Commission is concerned that an inter-affiliate clearing exemption could enable entities to evade the clearing requirement through trades, for example, with affiliates that are located in foreign jurisdictions that do not have a comparable and comprehensive clearing regime. Informed in part by certain relevant intra-group transactions provisions under EMIR,[43] proposed § 39.6(g)(2)(v) would require that both affiliates be U.S. persons or one of the affiliates is a U.S. person and the other affiliate is domiciled in a non-U.S. jurisdiction with a comparable and comprehensive regulatory regime for swap clearing or the non-United States counterparty is otherwise required to clear swaps with third parties in compliance with United States Law or does not enter into swaps with third parties.[44]

The Commission recognizes that there may be a legitimate reason for an inter-affiliate swap where one affiliate is located in a country that does not have a comparable clearing regime. However, the Commission believes that financial markets may be at risk if the foreign affiliate enters into a related third-party swap that would be subject to clearing were it entered into in the United States, but is not cleared. On balance, the Commission believes that the risk of evasion and the systemic risk associated with uncleared swaps necessitates that the exemption be limited to swaps between affiliates located in the United States or in foreign countries with comparable clearing regimes or the non-United States counterparty is otherwise required to clear swaps with third parties in compliance with United States law or does not enter into swaps with third parties.

Request for Comments

Q24a. The Commission requests comment on proposed § 39.6(g)(2)(v). Is the proposed condition that both affiliates must be located in the United States or in a country with a comparable and comprehensive clearing jurisdiction or the non-United States counterparty is otherwise required to clear swaps with third parties or does not enter into swaps with third parties a necessary and appropriate means of reducing risk and evasion concerns related to inter-affiliate swaps? If not, how should these concerns be addressed?

Q24b. Should the Commission limit the inter-affiliate clearing exemption to foreign affiliates that only enter into inter-affiliate swaps if such foreign affiliates are not located in a jurisdiction with a comparable and comprehensive clearing requirement or are otherwise required to clear swaps with third parties in compliance with United States?

Q24c. Should the Commission limit the inter-affiliate clearing exemption to foreign affiliates that enter into swaps with third parties on an occasional basis if such foreign affiliates are not located in a jurisdiction with a comparable and comprehensive clearing requirement or are otherwise required to clear swaps with third parties in compliance with United States. What would constitute an occasional basis? For example, would once a year be an appropriate time frame?

Q25. The Commission requests comment on (1) the prevalence of cross-border inter-affiliate swaps and the mechanics of moving swap-related risks between U.S. and non-U.S. affiliates for risk management and other purposes (including an identification of such purposes); (2) the risk implications of cross-border inter-affiliate swaps for the U.S. markets; and (3) specific means to address the risk issues potentially presented by cross-border inter-affiliate swaps.

Q26. The Commission recently adopted anti-evasion provisions relating to cross-border swap activities in its new rule 1.6.[45] To what extent are the risk issues potentially presented by cross-border inter-affiliate swaps addressed by the anti-evasion provisions in rule 1.6?

Q27. The Commission also is considering an alternative condition to address evasion. That condition would require non-U.S. affiliates to clear all swap transactions with non-U.S. persons, provided that such transactions are related to inter-affiliate swaps which would be subject to a clearing requirement if entered into by two U.S. persons.[46] Should the Commission adopt such a condition? Would such a condition help enable the Commission to ensure that the proposed inter-affiliate clearing exemption is not abused or used to evade the clearing requirement? Are there any other means to prevent evasion of the clearing requirement or abuse of the proposed inter-affiliate clearing exemption that the Commission should adopt?

7. Proposed § 39.6(g)(2)(vi): Notification to the Commission

As explained in more detail below, the Commission has preliminarily determined that it must receive certain

[42] *See* CEA section 2(h)(4)(A), 7 U.S.C. 2(h)(4)(A). Additionally, CEA section 6(e)(4)–(5) states that any DCO, SD, or MSP may be subject to double civil monetary penalties should they evade the clearing requirement, among other things. The relevant CEA sections state, ''that knowingly or recklessly evades or participates in or facilitates an evasion of the requirements of section 2(h) shall be liable for a civil monetary penalty twice the amount otherwise available for a violation of section 2(h).'' *See* CEA section 6(e)(4)–(5), 7 U.S.C. 9a(4)–(5).

[43] *See, generally,* EMIR Articles 3, 4, 11, 13.

[44] For example, a counterparty located in a country that does not have a comparable clearing regime may be required to clear swaps with third parties in compliance with United States law if it meets the definition of a ''conduit'' as described in the Commission's proposed interpretive guidance and policy statement entitled, ''Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act,'' 77 FR 41214, July 12, 2012.

[45] Rule 1.6 was included in the Commission's ''Product Definitions'' rulemaking, which was adopted jointly with the SEC. *See* ''Further Definition of 'Swap,' 'Security-Based Swap,' and 'Security-Based Swap Agreement;' Mixed Swaps; Security-Based Swap Agreement Recordkeeping,'' 77 FR 39626 (July 23, 2012).

[46] The Commission has proposed separately interpretative guidance on certain entity-level and transaction-level requirements imposed by Title VII of Dodd-Frank for cross-border swaps. *See* Proposed Interpretive Guidance and Policy Statement entitled, ''Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act,'' 77 FR 41214 (July 12, 2012).

information to effectively regulate inter-affiliate swaps. Proposed § 39.6(g)(2)(vi) would require one of the counterparties to an inter-affiliate swap to comply with the reporting requirements set forth in § 39.6(g)(4.).

8. Proposed § 39.6(g)(3): Variation Margin Requirements

Proposed § 39.6(g)(3) would set forth the requirements for transferring variation margin. Proposed § 39.6(g)(3)(i) would require that if both counterparties to the swap are financial entities, each counterparty shall pay and collect variation margin for each inter-affiliate swap for which the proposed exemption is elected. Proposed § 39.6(g)(3)(ii) would require that the swap trading relationship document set forth and describe the methodology to be used to calculate variation margin with sufficient specificity to allow the counterparties, the Commission, and any appropriate prudential regulator to calculate the margin requirement independently. The Commission believes that the proposed rule would help ensure that affiliates have a written methodology. The proposed rule also would allow affiliates to manage their risks more effectively throughout the life of the swap and to avoid disputes regarding issues such as valuation.[47]

9. Proposed § 39.6(g)(4): Reporting Requirements

Pursuant to CEA section 4r,[48] uncleared swaps must be reported to a Swap Data Repository (''SDR''), or to the Commission if no repository will accept such information, by one of the counterparties (the ''reporting counterparty'').[49] In addition to any general reporting requirements applicable under other applicable rules to a particular type of entity that is an affiliate or to the inter-affiliate swap, proposed § 39.6(g)(4) would implement reporting requirements specifically for uncleared inter-affiliate swaps.[50] Proposed § 39.6(g)(4)(i) would require the reporting counterparty to affirm 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). Besides alerting the Commission of the election, the information would help ensure that each counterparty is aware of, and satisfies the definitions and conditions set forth in proposed § 39.6(g)(1)–(2).

Proposed § 39.6(g)(4)(ii)–(iii) would require the reporting counterparty to provide certain information, unless such information had been provided in a current annual filing pursuant to proposed § 39.6(g)(5). Proposed § 39.6(g)(4)(ii) would require the reporting counterparty to submit information regarding how the financial obligations of both counterparties are generally satisfied with respect to uncleared swaps. The information is valuable because it would provide the Commission a more complete view of the risk characteristics of uncleared swaps. The information also would enhance the Commission's efforts to identify and reduce potential systemic risk.

Proposed § 39.6(g)(4)(iii) would implement CEA section 2(j) for purposes of the inter-affiliate exemption.[51] That CEA section places a prerequisite on issuers of securities registered under section 12 of the Securities Exchange Act of 1934 (''Exchange Act'')[52] or required to file reports under Exchange Act section 15(g)[53] (''electing SEC Filer'') that elect exemptions from the CEA's clearing requirement under section 2(h)(1)(A). CEA section 2(j) requires that an appropriate committee of the electing SEC Filer's board or governing body review and approve its decision to enter into swaps subject to the clearing exemption.

Proposed § 39.6(g)(4)(iii)(A) would require an electing SEC Filer to notify the Commission of its SEC Filer status by submitting its SEC Central Index Key number. This information would enable the Commission to cross-reference materials filed with the relevant SDR with information in periodic reports and other materials filed by the electing SEC Filer with the U.S. Securities and Exchange Commission (''SEC''). In addition, proposed § 39.6(g)(4)(iii)(B) would require 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.[54] If both affiliates/counterparties are electing SEC Filers, both counterparties would have to report the additional information in proposed § 39.6(g)(4)(iii).

Finally, proposed § 39.16(g)(5) would permit counterparties to provide the information listed in proposed (g)(4)(ii)–(iii) on an annual basis in anticipation of electing the inter-affiliate clearing exemption for one or more swaps. Any such reporting under this paragraph would be effective for inter-affiliate swaps entered into within 365 days following the date of such reporting. During the 365-day period, the affiliate would be required to amend the information as necessary to reflect any material changes to the reported information. In addition, the Commission anticipates that for most corporate groups, affiliates would submit identical annual reports.

Request for Comments

Q28. The Commission requests comment on whether affiliates would submit identical annual reports for most corporate groups.

Q29a. The Commission requests comment as to whether reporting counterparties that would not report to an SDR should be subject to swap-by-swap reporting requirements? Should the Commission allow such entities to report all information on an annual basis? Please provide any information as to the number of reporting counterparties that would be affected by such a rule change.

Q29b. The Commission requests comment as to whether different sized entities should be subject to the proposed reporting requirements or the reporting requirements for affiliates that elect the end-user exception, as applicable. If different sized entities should not be subject to such reporting requirements, please explain why. Alternatively, should the Commission

[47] For further discussion on the concept of variation margin for uncleared swaps, *see* proposed rulemaking, ''Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants,'' 76 FR 27621, Feb. 12, 2011.

[48] CEA section 4r; 7 U.S.C. 6r.

[49] *See* CEA sections 2(a)(13) (reporting of swaps to SDRs) and 4r (reporting alternatives for uncleared swaps); 7 U.S.C. 2(a)(13) and 7 U.S.C. 6r.

[50] *See* ''Swap Data Recordkeeping and Reporting Requirements,'' 77 FR 2136, Jan. 13, 2012 (''Swap Data Recordkeeping and Reporting''). Regulation 45.11 contemplates that this information may be delivered to the Commission directly in limited circumstances when a SDR is not available. 77 FR at 2168. When permitted, such delivery would also meet the proposed inter-affiliate clearing exemption reporting requirement.

[51] 7 U.S.C. 2(j), in pertinent part:

Exemptions from the requirements of subsection (h)(1) to clear a swap and subsection (h)(8) to execute a swap through a board of trade or swap execution facility shall be available to a counterparty that is an issuer of securities that are registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l) or that is required to file reports pursuant to section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o) only if an appropriate committee of the issuer's board or governing body has reviewed and approved its decision to enter into swaps that are subject to such exemptions.

[52] 15 U.S.C. 78l.

[53] 15 U.S.C. 78o.

[54] For example, a board resolution or an amendment to a board committee's charter could expressly authorize such committee to review and approve decisions of the electing person not to clear the swap being reported. In turn, such board committee could adopt policies and procedures to review and approve decisions not to clear swaps, on a periodic basis or subject to other conditions determined to be satisfactory to the board committee.

allow phased compliance for different sized entities?

III. Consideration of Costs and Benefits

A. Introduction

Section 15(a) of the CEA [55] 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.[56] 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 such swaps could cause or exacerbate instability in the financial system.[57] 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.[58] For reasons explained above,[59] the Commission proposes to exercise its authority under CEA section 4(c)(1) to exempt inter-affiliate swaps—that is, swaps between majority-owned affiliates—from the Section 2(h)(1)(A) clearing requirement.

In the discussion that follows, the Commission considers the costs and benefits of the proposed 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 proposed exemption: (1) Swap trading relationship documentation, which would require affiliates to document in writing all terms governing the trading relationship; (2) centralized risk management and variation-margin requirements, which would require affiliates to subject the swap to centralized risk management and to post variation margin; and (3) 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 inter-affiliate clearing exemption would require one of the following four conditions be satisfied for each affiliate: The affiliate is located in the United States; the affiliate is located in a jurisdiction with a comparable and comprehensive clearing requirement; the affiliate is required to clear all swaps it enters into with non-affiliated counterparties; or the affiliate does not enter into swaps with non-affiliated counterparties.

B. Proposed Baseline

The Commission's proposed baseline for consideration of the costs and benefits of this proposed exemption are the costs and benefits that the public and market participants (including potentially eligible affiliates) would experience in the absence of this regulatory action. In other words, the proposed baseline is an alternative situation in which the Commission takes no action, meaning that potentially eligible affiliates would be required to comply with the clearing requirement. More specifically, under the CEA, as amended by the Dodd-Frank Act, and Commission regulations (finalized or future) inter-affiliate swaps will be subject to a clearing requirement and, depending on whether the affiliate is an SD, MSP, or eligible contract participant, a variety of record-keeping and reporting requirements. In such a scenario, the public and market participants, including corporate affiliates transacting swaps with each other, would experience the costs and benefits related to clearing and complying with Commission regulations under parts 23, 45, and 46.[60] The proposed exemption would alter these costs and benefits. For example, among other things, the public and market participants would not experience the full benefits related to clearing or satisfying all the requirements under parts 23, 45, and 46. At the same time, affiliates electing the exemption would likely incur lower costs for two reasons. First, the cost of variation margin is significantly less than the cost of clearing.[61] Second, the costs of satisfying the reporting requirements under the proposed exemption would be less than the costs associated with satisfying all of the requirements under parts 23, 45, and 46.

The Commission also considers the regulatory landscape as it existed before the Dodd-Frank Act's enactment. Entities that transacted inter-affiliate swaps within a corporate group were neither subject to a clearing requirement nor compelled to comply with regulatory requirements, including requirements to record and report inter-affiliate swaps. Thus, measured against a pre-Dodd-Frank Act reference point, affiliates that avail themselves of the proposed exemption would experience incremental costs and benefits occasioned by compliance with the conditions for exercising the proposed exemption.

[55] 7 U.S.C. 19(a).

[56] *See* Section 2(h)(1) of the CEA, 7 U.S.C. 2(h)(1).

[57] 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.

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

[59] *See* pt.II.A.

[60] *See, e.g.,* costs and benefits discussion in the following rulemakings: ''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 20128, 20194, Apr. 3, 2012; ''Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties,'' 77 FR 9803, 9804, Feb. 17, 2012; ''Swap Data Record Keeping and Reporting Requirements,'' 77 FR 2136, 2171, Jan. 13, 2012; ''Opting Out of Segregation,'' 66 FR 20740, 20743, Apr. 25, 2001; ''Swap Data Recordingkeeping and Reporting Requirements: Pre-Enactment and Transition Swaps,'' 77 FR 35200, Jun. 12, 2012.

[61] The cost of clearing includes posting initial and variation margin.

In the discussion that follows, where reasonably feasible, the Commission endeavors to estimate quantifiable dollar costs. The benefits of the proposed exemption, as well as certain costs, however, are not presently susceptible to meaningful quantification. Where it is unable to quantify, the Commission discusses proposed costs and benefits in qualitative terms.

C. Costs

1. To Market Participants and the Public

As discussed above, inter-affiliate swaps—though possessing a lesser degree of counterparty risk than swaps transacted between non-affiliated counterparties—are not risk-free. As evidenced in the 2008 financial crisis, counterparty swap risk, transmitted systemically, can exact a heavy cost on market participants as well as the public. Thus, unconditionally exempting inter-affiliate swaps from the clearing requirement would come with a cost of increased risk that clearing is intended to contain. This includes the risk that the failure of one party to perform under the terms of a swap transaction would cause the counterparty to be unable to perform under the terms of swaps it had entered into with other counterparties, thereby causing a cascading series of non-performance throughout the financial system. Clearing both reduces this risk of non-performance and promotes confidence throughout the financial system that the failure of one firm will not lead to a systemic crisis, thereby lessening the chance of such a crisis or the need for the federal government to intervene to prevent any such failures. Accordingly, the Commission does not propose an unconditional, blanket exemption. Rather, the Commission proposes an exemption with conditions carefully tailored to offset the narrower, counterparty-risk profile that inter-affiliate swaps present relative to all swaps generally. Based on the expectation that for the subset of inter-affiliate swaps covered by this proposed exemption these conditions are capable of closely approximating the risk protections that clearing provides to swaps more generally, the Commission foresees no significant additional risk cost from the proposed exemption.

2. To Potentially Eligible Entities

The proposed rule is exemptive and would provide potentially eligible affiliates with relief from the clearing requirement and attendant Commission regulations. As with any exemptive rule or order, the proposed rule is permissive, meaning that potentially eligible affiliates are not required to elect it. Accordingly, the Commission assumes that an entity would rely on the proposed exemption only if the anticipated benefits warrant the costs. Here, the proposed inter-affiliate clearing exemption identifies three categories of conditions that an eligible affiliate must satisfy to elect the proposed exemption: documentation, risk management, and reporting. The Commission believes that a person would have to incur costs to satisfy these conditions. The Commission also believes that an affiliate would elect the exemption only if these costs are less than the costs that an affiliate would incur should it decide not to elect the exemption.

Regarding the documentation condition, the Commission believes that affiliates electing the exemption (other than SDs/MSPs satisfying the swap documentation condition and risk-management conditions by satisfying the requirements of regulations 23.504 and 23.600, respectively) would likely incur costs to develop a standardized document to comply with the proposed § 39.6(g)(2)(ii) requirement that all terms governing the trading relationship be in writing.[62] The Commission estimates 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. Unless otherwise stated, the remaining wage calculations used in this proposed rule also are derived from this source and modified in the same manner. The Commission, however, is unable to estimate such costs with greater specificity because it is unable to estimate the frequency of, and costs associated with modifying a swap agreement.

Affiliates also would incur costs related to signing swap documents and retaining copies. The Commission believes that affiliates would incur less than $1,000 per year for such activities. The Commission notes, however, that these estimates may overstate the actual costs because it expects that affiliates within a corporate group would be able to share legal-drafting and record-retention costs, as well as labor costs.

The second category of conditions concerns risk management. Affiliates electing the proposed exemption would have to subject inter-affiliate swaps to centralized risk management, which would include variation margin.[63] To meet the centralized-risk-management condition under § 39.16(g)(2)(iii), some affiliates may have to create a risk management system.[64] To do so, affiliates would have to purchase equipment and software to adequately evaluate and measure inter-affiliate swap risk. The Commission believes that such costs could be possibly as high as $150,000. For example, these costs might include 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. The total would amount to $75,000. There also might be installation and unexpected costs that could increase up-front costs to approximately $150,000. In addition to these start-up costs, there could be ongoing costs. The Commission estimates that centralized risk management could require up to ten full-time staff at an average salary of $150,000 per year.[65] Finally, a data subscription for price and other market data may have to be purchased at cost of up to $100,000 per year.

Proposed § 39.6(g)(2)(iv) would require counterparties to post variation margin in compliance with proposed § 39.6(g)(3)'s documentation and other

[62] For a discussion of the costs and benefits incurred by swap dealers and major swap participants that must satisfy requirements under § 23.504, see ''Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants,'' 76 FR 6715, 6724–25, Feb. 8, 2011 (proposed rule).

[63] 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 20128, 20173–75, April 3, 2012 (final rule).

[64] 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.

[65] 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.

requirements. The Commission believes that companies may have to hire attorneys and financial analysts to develop and document the variation margin methodology to comply with this rule, resulting in a one-time cost of $29,000 per entity electing the proposed exemption. This estimate assumes up to 100 hours of financial analyst time at an average cost of $208 per hour, and up to 20 hours of compliance attorney time at an average cost of $390 per hour.

The Commission also believes that affiliates would incur certain costs to comply with the proposed § 39.16(g)(2)(iv) condition to post variation margin. The Commission anticipates that affiliates would have to hire up to three people at an average salary of $150,000 per year to estimate the price of inter-affiliate swaps and to manage variation margin payments between affiliates. In addition, the Commission expects that companies would have to purchase equipment and software to estimate the price of inter-affiliate swaps and to subscribe to a data service. However, the Commission anticipates that such costs also would be incurred to satisfy the centralized risk management condition in proposed § 39.6(g)(2)(iii). Finally, affiliates would have to incur the opportunity costs associated with posting collateral to cover variation margin.[66]

The third category of conditions involves reporting requirements. Proposed § 39.6(g)(4) would require affiliates to report specific information to an SDR or to the Commission if no SDR would accept such information. Proposed § 39.16(g)(4)(i) would require notice reporting on a swap-by-swap basis that two affiliates are electing the exemption and that they both meet the requirements in proposed § 39.6(g)(1)–(2). The Commission believes 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.

Affiliates would incur costs to satisfy the conditions that the reporting party (1) identify how the affiliates expect to meet the financial obligations associated with their uncleared swap as required under proposed § 39.6(g)(4)(ii), and (2) provide the information required under proposed § 39.6(g)(4)(iii) if either electing affiliate is an SEC Filer. Affiliates may decide to report this information on either a swap-by-swap or annual basis, and the costs would vary depending on the reporting frequency. Regarding the financial information in proposed § 39.6(g)(4)(ii)-(iii), the Commission believes 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 complying with proposed § 39.6(g)(4)(ii)–(iii) for the first inter-affiliate swap, and a cost range of $6.50–$32.50 for complying with proposed § 39.6(g)(4)(ii)–(iii) for subsequent inter-affiliate swaps.

The Commission anticipates that companies electing not to clear would have established reporting systems to comply with other Commission rules regarding swap reporting. However, all reporting counterparties likely would need to modify their reporting systems to accommodate the additional data fields required by this rule. The Commission estimates that those modifications would create a one-time programming expense of approximately one to ten burden hours per affiliate. The Commission estimates that the hourly wage for a senior programmer is $341, which means that the one-time, per entity cost for modifying reporting systems would likely be between $341 and $3,410.

An affiliate that does not function as the reporting counterparty may need to communicate information to the reporting counterparty after the swap is entered. That information could include, among other things, whether the affiliate has filed an annual report pursuant to proposed § 39.6(g)(5) and information to facilitate any due diligence that the reporting counterparty may conduct. These 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. The Commission estimates 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. The hourly wage for a compliance attorney is $390, translating to an aggregate annual cost for communicating information to the reporting counterparty of between $33 to $3,900.

The Commission expects a proportion of affiliates would choose to file an annual report pursuant to proposed § 39.6(g)(5). The annual filing option may be less costly than swap-by-swap reporting. The Commission estimates that it would take an average of 30 to 90 minutes to complete and submit this filing. The average hourly wage for a compliance attorney is $390, translating to an aggregate annual cost for submitting the annual report of between $195 to $585.

The Commission anticipates that SDRs and the Commission also would bear costs associated with the proposed reporting conditions. SDRs would be required to add or edit reporting data fields to accommodate information reported by affiliates electing the inter-affiliate clearing exemption.[67] Similarly, the Commission would need to create a reporting system for affiliates electing the exemption should there be no available SDR.

Finally, the rule would impose a limitation on those affiliates electing the inter-affiliate clearing exemption. Namely, the inter-affiliate clearing exemption would require one of the following four conditions be satisfied for each affiliate: the affiliate is located in the United States; the affiliate is located in a jurisdiction with a comparable and comprehensive clearing requirement; the affiliate is required to clear all swaps it enters into with non-affiliated counterparties; or the affiliate does not enter into swaps with non-affiliated counterparties. This limitation would impose no additional cost over not providing the exemption. However, as compared to the state of regulation that existed pre-Dodd-Frank Act, this condition would impose the costs of clearing for those inter-affiliate swaps that occur in countries without a clearing regime comparable to the United States.

D. Benefits

The CEA does not require the Commission to issue an exemption to the clearing requirement for inter-affiliate swaps. Section 4(c)(1) of the CEA, however, provides the Commission with authority to exempt certain entities and types of transactions from CEA obligations. The statutory section requires that the Commission consider two objectives when it decides to issue an exemption: (1) The promotion of responsible economic or financial innovation, and (2) the promotion of fair competition.

The Commission believes there are benefits to exempting swaps between certain affiliated entities. For example,

[66] The opportunity cost of posting collateral is the highest return an affiliate would have earned by investing that collateral instead of using it to cover variation margin under similar conditions.

[67] *See generally,* ''Swap Data Recordkeeping and Reporting Requirements,'' 77 FR 2137 at 2176–2193, Jan. 13, 2012 (for costs and benefits incurred by SDRs).

as explained above,[68] a number of commenters stated that clearing swaps through treasury or conduit affiliates enables entities to more efficiently and effectively manage corporate risk.

The Commission also is considering the previously-discussed comments that an exemption is appropriate because inter-affiliate swaps pose reduced counterparty risk relative to swaps with third parties.[69] The Commission remarks that this proposition is more likely to hold true provided that the terms and conditions of the swaps are the same. The Commission believes that inter-affiliate swap risk may be appropriately managed, in lieu of clearing, through the proposed conditions that affiliates would be required to satisfy to elect the proposed exemption. It has considered the benefits of each of these conditions. The Commission believes that the first category—documentation of the swap trading relationship between affiliates—would benefit affiliates and the overall financial system. Specifically, the Commission believes that requiring documentation of inter-affiliate swaps in a swap confirmation would help 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. Also, though not a documentation condition, the proposed exemption would require that the affiliates would be able to elect this exemption for their inter-affiliate swaps if one of the following four conditions is satisfied for each affiliate: The affiliate is located in the United States; the affiliate is located in a jurisdiction with a comparable and comprehensive clearing requirement; the affiliate is required to clear all swaps it enters into with non-affiliate counterparties; or the affiliate does not enter into swaps with non-affiliate counterparties. This limitation should help mitigate systemic risk attributable to affiliates who, subsequent to conducting inter-affiliate swaps, transact uncleared, market-facing (*i.e.,* not inter-affiliate) swaps in a jurisdiction without a clearing regime comparable to the United States.

The Commission recognizes that there may be a legitimate reason for inter-affiliate swaps where one affiliate is located in a country that does not have a comparable clearing regime or the non-United States counterparty is otherwise required to clear swaps with third parties. However, the Commission believes that the corporate group and financial markets may be at risk if the foreign affiliate is free to enter into a related, uncleared swap with a third party that would be subject to clearing were it entered into in the United States. On balance, the Commission believes that the risk associated with uncleared swaps necessitates that the proposed exemption be limited to swaps between affiliates located in the United States or in foreign countries with comparable clearing regimes or the non-United States counterparty is otherwise required to clear swaps with third parties or the affiliates do not enter into swaps with third parties.

Centralized-risk management and variation margin are also beneficial conditions. The requirement that an inter-affiliate swap be subject to centralized-risk management is beneficial because it is intimately connected to the variation-margin condition. Centralized-risk management establishes appropriate measurements and procedures so that affiliates can mitigate the amount being concentrated in a single treasury or conduit-type affiliate. Moreover, the Commission believes that proper risk management benefits the public by reducing risk and the losses related to defaults.

The requirement that affiliates post variation margin should protect both parties to a trade by ensuring that each party to the swap has the financial wherewithal to meet the obligations of the swap. Variation margin also would serve as a resource that could reduce losses to a counterparty when there is a default. Overall, the variation-margin condition would benefit each affiliate and the financial system, at large, by increasing the security of affiliate positions.

The final category of conditions, reporting certain information about inter-affiliate swaps, should enhance the level of transparency associated with inter-affiliate swaps activity, afford the Commission new insights into the practices of affiliates that engage in inter-affiliate swaps, and help the Commission and other appropriate regulators identify emerging or potential 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.

E. Costs and Benefits as Compared to Alternatives

The Commission considered several alternatives to the proposed rulemaking. For instance, the Commission could have: (1) Chosen not to propose an inter-affiliate clearing exemption; (2) proposed an alternative definition of affiliate; or (3) decided not to place certain conditions on those electing the inter-affiliate clearing exemption. The Commission, however, has proposed what it considers a measured approach—in terms of the implicated costs and benefits of the exemption—given its current understanding of inter-affiliate swaps.

First, the Commission considered not exempting inter-affiliate swaps from the clearing requirement. Without an exemption, inter-affiliate swaps subject to a clearing requirement would have to be cleared. This alternative was not favored by the Commission because the Commission believes that there are considerable benefits of exempting inter-affiliate swaps from clearing to the market, as discussed in detail above. In addition, while the Commission does not believe inter-affiliate swaps are riskless, the Commission is considering comments that inter-affiliate swaps pose less risk than swaps with third parties because of reduced counterparty risk and therefore risk-reducing conditions may be a satisfactory alternative to clearing for these swaps. Commenters in other rulemakings as discussed above recognized implicitly risk concerns by sharing that some corporate groups manage inter-affiliate risk via centralized risk management programs that include variation-margin calculations. Consequently, it would not be prudent to exempt inter-affiliate swaps categorically from the CEA's clearing requirement without conditions that address inter-affiliate swap risk.

Second, the Commission also considered ownership requirements of greater than, and lesser than majority ownership.[70] Increasing the ownership requirement would reduce the number of affiliates that could benefit from the exemption.[71] At the same time, a higher ownership threshold for affiliates could help protect minority owners and reduce counterparty risk and risk to third parties who have entered into swaps that are related to inter-affiliate swaps.

Nevertheless, the Commission believes that any benefit from an ownership requirement of greater than majority ownership, in the form of reduced counterparty risk, would not be

[68] See pt. I.B. for in-depth discussion of relevant comments regarding inter-affiliate swaps and the advantages of such treasury or conduit structures.

[69] See pt. II.A.

[70] See pt. II.B.1 for further discussion and other requests for comment on this issue.

[71] In the Paperwork Reduction Act, the Commission points out that it does not possess sufficient information to estimate the number of affiliates, even majority-owned, that might avail themselves of the proposed inter-affiliate clearing exemption.

substantial due to the risk mitigation conditions such as centralized risk management programs that are being proposed with majority ownership. The Commission welcomes comments as to the costs and benefits of an increased ownership requirement.

Similarly, the Commission considered an ownership requirement of less than majority ownership. While a reduction in the ownership requirement would allow more affiliates to benefit from the exemption, it would also considerably increase the counterparty risk in the market. The Commission welcomes comments as to the costs and benefits of a decreased ownership requirement.

Finally, the Commission considered not requiring each condition—*i.e.,* swap trading relationship documentation; centralized risk management that includes variation margin; or reporting. In other words, the Commission could have proposed an inter-affiliate clearing exemption with fewer or no conditions. Because there is no indication at this stage that inter-affiliate swaps are riskless, the Commission proposed conditions. The Commission's views on the costs and benefits of each condition are discussed above. The Commission invites comments as to the costs and benefit of each condition.

F. Consideration of CEA Section 15(a) Factors

1. Protection of Market Participants and the Public

In deciding to propose the inter-affiliate clearing exemption, the Commission assessed how to protect affiliated entities, third parties in the swaps market, and the public. The Commission sought to ensure that in the absence of a clearing requirement the risks presented by uncleared inter-affiliate swaps would be minimized should there be significant losses to one affiliate counterparty or a default of one of the affiliate counterparties. Toward that end, the Commission proposed that affiliates eligible to elect the proposed exemption must execute swap trading relationship documentation; post variation margin as part of a centralized-risk management process; and report specific information to an SDR, or to the Commission if no SDR would accept the information. 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 would 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 would be less contractual ambiguity should disagreements between affiliates arise. The proposed condition that an inter-affiliate swap be subject to a centralized risk management program reasonably designed to monitor and manage risk would help mitigate the risks associated with inter-affiliate swaps. As noted throughout this proposed rulemaking, inter-affiliate swap risk could adversely impact third parties who enter into swaps that are related to an inter-affiliate swap. In addition, if inter-affiliate swap risk is not carefully monitored, there could be greater probability that an adverse financial event could lead to bankruptcy, which could harm market participants and the public overall. Similarly, the proposed condition that affiliated counterparties post variation margin should help to prevent unrealized losses from accumulating over time and thereby reduce both the chance of default and the size of any default should one occur. In turn, this should lessen the likelihood and extent of harm to third parties that enter into swaps that are related to inter-affiliate swaps.

The proposed reporting obligations would help the Commission monitor compliance with the proposed 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 informed.

2. Efficiency, Competitiveness, and Financial Integrity of Futures Markets

Exempting swaps between majority-owned affiliates within a corporate group from the clearing requirement would promote efficiency by reducing overall clearing costs for eligible counterparties. The Commission is also considering comments that the proposed exemption would increase the efficiency and financial integrity of markets because it would enable corporate groups to clear swaps through their treasury or conduit affiliates. As explained above,[72] commenters in other rulemakings have stated that clearing swaps through treasury or conduit 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, that affiliates post variation margin, and that certain information be reported, also would discourage abuse of the exemption. Together, these conditions would 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.'' [73] The Commission does not consider non-arms-length swaps as contributing to price discovery in the markets.[74] Given that inter-affiliate swaps as defined in this proposed rulemaking are generally not arm's length transactions, the Commission does not anticipate the proposed inter-affiliate clearing exemption would have any effect on price discovery.[75]

4. Sound Risk Management Practices

As a general rule, the Commission believes that clearing swaps is a sound risk management practice. But, in proposing the inter-affiliate clearing exemption, the Commission has assessed the risks of inter-affiliate swaps, and proposes that it can impose alternative, sound risk-management practices for these particular swaps in the form of conditions. In other words, a prudent use of the Commission's exemptive authority would include proposing an exemption that requires affiliates to manage risks appropriately.[76] In this case, the specific

[72] See pt. I.B. for in-depth discussion of relevant comments regarding inter-affiliate swaps and the advantages of such treasury or conduit structures.

[73] 17 CFR 43.2. *See also* ''Real-Time Public Reporting of Swap Transaction Data,'' 77 FR 1182, Jan. 9, 2012 (Real-Time Reporting).

[74] Transactions that fall outside the definition of ''publicly reportable swap transaction''—that is, they are not arms-length—''do not serve the price discovery objective of CEA section 2(a)(13)(B).'' Real-Time Reporting, 77 FR at 1195. *See also Id.* at 1187 (discussion entitled ''Swaps Between Affiliates and Portfolio Compression Exercises'').

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

[76] Furthermore, CEA section 8a(5) states that ''in the judgment of the Commission,'' it is authorized to make and promulgate rules ''necessary to

Continued

risk-management conditions include: documentation of swap terms; establishment of centralized risk management, and the posting of variation margin. The Commission also believes that SEC Filer reporting is a prudent practice. As detailed in this preamble and the proposed rule text,[77] 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 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

The Commission believes that the proposed exemptive rulemaking would reduce the costs of transacting swaps between majority-owned affiliates. At the same time, the proposed rulemaking would foster the financial integrity of swap markets by mandating that certain conditions be satisfied by affiliates electing the inter-affiliate clearing exemption. The Commission believes that the financial savings by affiliates, and, ultimately, corporate groups would serve public-interest considerations. For example, affiliates and corporate groups could use the cost-savings to provide new services or products for the public. They could also pass-on some or all of the cost-savings through prices they charge the public for their services and products.

G. Request for Public Comment on Costs and Benefits

Q30. The Commission invites public comment on its cost-benefit considerations, including the consideration of reasonable alternatives.

Q31. If the Commission were to propose a clearing exemption limited to 100% owned affiliates, what costs and benefits would affect market participants and the public?

Q32. If the Commission were to propose a clearing exemption with an ownership requirement of greater or less than majority ownership what costs and benefits would affect market participants and the public?

Q33. If the Commission were to issue a proposed clearing exemption limited to those affiliates that file consolidated tax returns, what costs and benefits would affect market participants and the public?

Q34. Do inter-affiliate swaps affect price discovery? To what extent would the inter-affiliate clearing exemption affect price discovery?

Q35. Besides variation margin, is there a less costly risk-management tool that would serve the same risk-management objectives as variation margin?

Q36. Besides affiliates, SDRs, and the Commission, are there any other entities that might bear a direct cost as a result of the proposed inter-affiliate clearing exemption? If so, who and to what extent?

Q37. Commenters are invited to submit any data or other information that they may have quantifying or qualifying the costs and benefits of the proposal with their comment letters.

Q38. Commenters are invited to submit any data or other information that they may have quantifying or qualifying start-up and on-going costs and benefits associated with establishing a centralized risk management program.

IV. Administrative Compliance

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (''RFA'') requires that agencies consider whether the proposed rules will have a significant economic impact on a substantial number of small entities and, if so, provide a regulatory flexibility analysis respecting the impact.

Consistent with other Commission rulemakings, the proposed rules will not have a significant economic impact on a substantial number of small entities. The proposed rules would affect the electing and reporting parties, which could be SDs, MSPs, and Eligible Contract Participants (''ECPs''). The Commission has certified previously that neither category involves small entities for purposes of the RFA in other Commission rulemakings, including those implementing requirements of the Dodd-Frank Act.[78] The Commission is making a similar determination for purposes of this proposal. Accordingly, the Chairman, on behalf of the Commission, hereby certifies, pursuant to 5 U.S.C. 605(b), that the proposed rules will not have a significant economic impact on a substantial number of small entities with respect to SDs, MSPs, and ECPs.

The proposed rules also would affect SDRs, which the Commission has similarly determined not to be small entities for purposes of the RFA.[79] The Commission is making the same determination with respect to the proposed rules. Accordingly, the Chairman, on behalf of the Commission, hereby certifies, pursuant to 5 U.S.C. 605(b), that the proposed regulation would not have a significant economic impact on a substantial number of small entities with respect to SDRs.

Request for Comments

Q39. The Commission invites comments on the impact of this proposed regulation on small entities.

B. Paperwork Reduction Act

1. Overview

The Paperwork Reduction Act (''PRA'')[80] 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 displays a currently valid control number issued by the Office of Management and Budget (''OMB''). Certain provisions of proposed § 39.6(g) would result in new collection of information requirements within the meaning of the PRA. These new reporting requirements are not currently covered by any existing OMB control number and OMB has not yet assigned a control number for this new collection. The Commission therefore is submitting this proposal to the OMB for review in accordance with 44 U.S.C. 3507(g) and 5 CFR 1320.11.

effectuate any'' CEA provisions or to accomplish any CEA purpose. 7 U.S.C. 12a(5).

[77] See pt. II.B.9 and proposed § 39.6(g)(4)(iii).

[78] For SDs and MSPs, *see, e.g.,* ''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 20128, 20194, Apr. 3, 2012 (SDs and MSPs); ''Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties,'' 77 FR 9803, 9804, Feb. 17, 2012 (SDs and MSPs); ''Policy Statement and Establishment of Definitions of 'Small Entities' for Purposes of the Regulatory Flexibility Act,'' 47 FR 18618, Apr. 30, 1982 (MSPs). For ECPs, *see, e.g.,* ''Commodity Options,'' 77 FR 25320, 25334, Apr. 27, 2012; ''Swap Data Record Keeping and Reporting Requirements,'' 77 FR 2136, 2171, Jan. 13, 2012; ''Opting Out of Segregation,'' 66 FR 20740, 20743, Apr. 25, 2001.

[79] *See* Swap Data Repositories, 75 FR 80898, 80926, Dec. 23, 2010; Registration of Swap Dealers and Major Swap Participants, 75 FR 71379, 71385, Nov. 23, 2010.

[80] 44 U.S.C. 3501 *et seq.*

The title for this collection of information is ''Rule 39.6(g) Affiliate Transaction Uncleared Swap Notification.'' If adopted, responses to this collection of information would be mandatory. The Commission will protect proprietary information according to the Freedom of Information Act and 17 CFR part 145, ''Commission Records and Information.'' In addition, section 8(a)(1) of the CEA strictly prohibits the Commission, unless specifically authorized by the CEA, 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.'' The Commission is also required to protect certain information contained in a government system of records according to the Privacy Act of 1974, 5 U.S.C. 552a.

2. Information Provided by Reporting Entities

Proposed § 39.6(g) would set forth certain reporting conditions that must be satisfied for affiliates to elect the inter-affiliate clearing exemption. As described above, these conditions are designed to address Commission concerns regarding inter-affiliate swap risk and to provide the Commission with information necessary to regulate swaps markets. In particular, the reporting conditions in proposed § 39.6(g)(4) and the optional annual report set forth in proposed § 39.6(g)(5) would establish new collection of information requirements within the meaning of the PRA. Additionally, affiliates may be required to update their reporting systems for purposes of complying with the proposed reporting requirement, and non-reporting affiliates electing the proposed exemption may incur costs in transmitting information to their reporting counterparties.

The Commission has estimated the time burden required for entities to comply with the proposed requirements.[81] The Commission has estimated quantifiable costs, including one-time and annual costs per affiliate and costs that are incurred on a swap-by-swap basis. The dollar estimates are offered as ranges with upper and lower bounds, which is necessary to accommodate uncertainty regarding the estimates. The Commission notes that the most likely outcome with respect to each estimate is the average cost. With that in mind, the Commission has included tables that provide the average burden hour and average cost for each of the PRA requirements in the proposed exemption.

The total cost of the inter-affiliate clearing exemption would depend on the number of affiliates electing the proposed exemption, as well as the number of inter-affiliate swaps for which affiliates would elect to use the proposed exemption. To identify the number of affiliates that could elect the proposed exemption, the Commission is relying upon the most recent data collected by the U.S. Bureau of Economic Analysis (''BEA'').[82] The BEA has determined that there are 2,347 U.S. multinational parent companies (''MNCs''),[83] and 25,424 foreign subsidiaries that are majority-owned by such MNCs.[84] Because the BEA does not provide the number of majority-owned U.S. subsidiaries, the Commission has decided to double BEA's foreign-subsidiary total to identify the number of potential U.S. subsidiaries that might elect the proposed inter-affiliate clearing exemption. The result is that there are an estimated 50,848 U.S. and foreign subsidiaries [25,424 × 2], or approximately 22 subsidiaries per MNC [50,848 ÷ 2,347], that is, 11 U.S. subsidiaries and 11 foreign subsidiaries. This total number of U.S. and foreign subsidiaries combined with the total U.S. parent companies equals 53,195 [2,347 + 50,848] affiliates that might elect the inter-affiliate clearing exemption.

To obtain information on the average number of inter-affiliate swaps, the Commission surveyed five corporations.[85] Two corporations were large financial companies and the other three were manufacturing companies. Recognizing that most MNCs are manufacturers as opposed to financial companies, the Commission decided to take a weighted average of the sample and assumed that 95% of MNCs are manufacturers and 5% are financial companies. Based on this weighted average, the Commission estimates that affiliates enter into 2,230 inter-affiliate swaps annually on average.[86]

Using the figures above, namely 2,347 MNCs with 22 subsidiaries each and each affiliate transacting an average of 2,230 swaps, the Commission has estimated that there are approximately 64,768,399 inter-affiliate swaps entered into annually. To make this calculation, the Commission assumed that all U.S. inter-affiliate swaps and most foreign inter-affiliate swaps are with a single U.S. treasury/conduit affiliate. The Commission also assumed that 75% of treasury/conduit affiliates would be subsidiaries and would therefore be subject to this rulemaking. The remaining 25% of treasury/conduit affiliates would be the parent MNC and would not be the subject of this rulemaking because in general such swaps would qualify for the end-user exception.[87] Finally, the Commission assumed that 50% of the inter-affiliate swaps entered into by foreign affiliates would be entered into with a U.S. treasury/conduit affiliate while the remaining swaps would be entered into with foreign affiliates and would not be

[81] *See* 5 CFR 1320.3(b) for the definition of the term ''burden.''

[82] The BEA's Web site is located at *http://www.bea.gov/*. BEA's most recent data on the number of U.S. parent companies of multinational corporations and their affiliates is listed in the ''U.S. Direct Investment Abroad: Preliminary Results from the 2009 Benchmark Survey,'' located at *http://www.bea.gov/international/usdia2009p.htm*.

[83] *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 an 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, located at *http://www.bea.gov/scb/pdf/internat/usinvest/1995/0395iid.pdf*.

[84] *See* Table II.A 1., ''Selected Data for Foreign Affiliates in All Countries in Which Investment Was Reported,'' located at *http://www.bea.gov/international/pdf/usdia_2009p/Group%20II%20tables.pdf*. The BEA limited foreign affiliates to those with total assets, sales, or net income of more than $25 million.

[85] The Commission is unable to provide additional information regarding the survey because information was submitted on a confidential basis.

[86] Due to the small sample size and data inconsistencies, this estimate may not provide a complete representation of the affiliate corporate structure or inter-affiliate swaps. For instance, responses were not consistent in format (quarterly figures versus six-month or annual figures) and also provided data for different time periods in 2010 or 2011. To generate its estimates, the Commission had to extrapolate this data by assuming that the amount of inter-affiliate swaps transacted during one quarter would be the same for the remaining three quarters of the year, or that inter-affiliate swap data from 2010 and 2011 are comparable and can be combined for averaging purposes. The Commission also notes that responses regarding the number of inter-affiliate swap transactions varied widely and a much larger sample size would be required to generate a more accurate estimate. The Commission requests comment on the typical annual inter-affiliate swap activity within corporate groups and the total number of affiliates that would potentially elect the proposed inter-affiliate clearing exemption.

[87] As noted above, the Commission assumes that 95% of MNCs are commercial entities and 5% are financial companies. Based on these numbers, the Commission believes that most of the swaps between affiliates are likely to qualify for the end-user exception because in most cases one of the affiliates will be a manufacturer and the inter-affiliate swap will hedge or mitigate the commercial risk of that affiliate. The Commission, however, does not have information as to how many inter-affiliate swaps would qualify for the end-user exception. Accordingly, the Commission has taken a conservative approach and assumed that none of the inter-affiliate swaps would qualify for the end-user exception.

subject to this rulemaking. Table A summarizes the Commission's estimates of the number of MNCs, subsidiaries, affiliates, and annual inter-affiliate swaps.

TABLE A—MNC, AFFILIATE, AND INTER-AFFILIATE SWAP ESTIMATES

Number of MNCs	2,347
Number of Subsidiaries per MNC	22 [88]
Total Number of Subsidiaries	50,848
Total Number of Affiliates Potentially Electing the Proposed Exemption	53,195 [50,848 + 2,347]
Estimated Number of MNCs Subject to Proposed Reporting Requirements	1,760 [2,347 × 75%]
Estimated Number of Reporting MNCs that Would File Annual Reports [89]	1,584 [1,760 × 90%]
Average Annual Number of Inter-Affiliate Swaps per Affiliate	2,230
Total Annual Number of Inter-Affiliate Swaps [90]	64,768,399

Request for Comments

Q40. As discussed above, the Commission does not have information as to how many inter-affiliate swaps would qualify for the end-user exception. The Commission invites comments on whether most inter-affiliate swaps would qualify for the end-user exception because one of the affiliates is a commercial entity and the swap hedges or mitigates the commercial risk of that affiliate. The Commission also requests any information that would help to quantify the number of inter-affiliate swaps or the share of inter-affiliate swaps that would qualify for the end-user exception.

a. Proposed § 39.6(g)(4) Reporting Requirements

Proposed § 39.6(g)(4) would require electing entities that are reporting counterparties to notify the Commission each time the inter-affiliate clearing exemption is elected by delivering specified information to a registered SDR or, if no registered SDR is available, the Commission. Except as noted below, the notification would occur only once at the beginning of the swap life cycle.

The reporting counterparty would have to report the information required in proposed § 39.6(g)(4)(i) for each swap. It would also have to report the information required in proposed §§ 39.6(g)(4)(ii)–(iii) for each swap if no annual report had been filed. To comply with proposed § 39.6(g)(4)(i), each reporting counterparty would be required to check one box indicating that both counterparties to the swap are electing not to clear the swap. The Commission expects that each reporting counterparty would likely spend 15 seconds to two minutes per transaction entering this information into the reporting system. Regarding the proposed §§ 39.6(g)(4)(ii)–(iii) information, the Commission expects that it would 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 Commission expects a compliance attorney may be responsible for the collection at $390 per hour, resulting in the following per transaction costs to reporting counterparties: A range of $1.63–$13.00 for proposed § 39.6(g)(4)(i); a cost of $65.00 for complying with proposed §§ 39.6(g)(4)(ii)–(iii) for the first inter-affiliate swap; and range of $6.50–$32.50 for complying with proposed §§ 39.6(g)(4)(ii)–(iii) for subsequent inter-affiliate swaps with the same counterparty. Table B summarizes the estimated average burden hours and costs per reporting entity under proposed § 39.6(g)(4), as follows:

TABLE B—BURDEN AND COST ESTIMATES OF PROPOSED § 39.6(g)(4)

Proposed regulation/requirement description	Average burden hours per transaction	Average cost per transaction	Total average annual burden hours	Total average annual cost
§ 39.6(g)(4)(i)	0.019 hours (1.14 minutes)	$7.41	1,230,600 [64,768,399 × .019]	$479,933,837 [64,768,399 × $7.41] [91]
§§ 39.6(g)(4)(ii)–(iii) (costs incurred if no annual report filed under § 39.6(g)(5) [92]).	First Transaction: 0.17 hours (10 minutes).	65.00	648 [(50,848 × 75% × 10% × 0.17]	$247,884 [(50,848 × 75%) × 10% × $65] [93]
	Subsequent Transactions: 0.05 hours (3 minutes).	19.50	323,651 [(64,768,399 − 50,848 × 75%) × 10% × .05]	$126,224,013 [(64,768,399 − 50,848 × 75%) × 10% × $19.50] [94]

[88] Eleven of the 22 affiliates are assumed to be U.S. affiliates.

[89] The Commission assumed that at least 90% of MNCs would elect to file annual reports, see further discussion below.

[90] The Total Annual Number of Inter-Affiliate Swaps is the total number of inter-affiliate swaps that MNCs, U.S. subsidiaries, and foreign subsidiaries entered into that would be subject to this rule. The total number of inter-affiliate swaps that MNC's entered into that would be subject to this rule is the number of MNCs (2,347) times the number of swaps per MNC (2,230) times 75%, or 0.75 × 2,347 × 2,230. The total number of inter-affiliate swaps that U.S. subsidiaries entered into that would be subject to this rule is 10 × (0.75 × 2,230 × 2,347). There are 11 U.S. subsidiaries per MNC and each subsidiary enters into as many as swaps as each MNC, on average. However, 1 of the U.S. subsidiaries is the treasury/conduit affiliate and it enters into swaps with every other affiliate, including foreign affiliates. To avoid double counting, that subsidiary is removed from the equation and the number of U.S. subsidiaries is 10. Finally, the total number of inter-affiliate swaps that foreign subsidiaries entered into that would be subject to this rule is 0.5 × (11 × 0.75 × 2,230 × 2,347). Each foreign subsidiary enters into as many swaps as each U.S. subsidiary, but only 50% of foreign subsidiary swaps would be subject to this rule.

b. Other Costs

i. Updating Reporting Procedures

The Commission believes that companies subject to this rule would have established reporting systems to comply with other Commission rules regarding swap reporting. However, reporting counterparties may need to modify their reporting systems in order to accommodate the additional data fields required by this rule. The Commission estimates that those modifications would create a one-time expense of approximately one to ten burden hours per reporting counterparty. The Commission estimates that the hourly wage for a senior programmer is $341, which means that the one-time, per entity cost for modifying reporting systems to comply with proposed § 39.6(g)(4) would likely be between $341 and $3,410.

ii. Burden on Non-Reporting Affiliates

An affiliate who does not function as the reporting counterparty may need to communicate information to the reporting counterparty after the swap is entered. That information could include, among other things, information to facilitate any due diligence that the reporting counterparty may conduct. These costs would likely vary substantially depending on how frequently the affiliate enters into swaps and the due diligence that the reporting counterparty chooses to conduct. The Commission estimates that a non-reporting affiliate would incur a burden of between five minutes and ten hours annually. The hourly wage for a compliance attorney is $390, which means that the aggregate annual cost for an electing counterparty communicating information to the reporting counterparty would likely be between $33 and $3,900.

iii. Annual Reporting Under Proposed § 39.6(g)(5)

The Commission expects at least 90% of MNCs would choose to file an annual report pursuant to proposed § 39.6(g)(5). This assumption is based on feedback in comment letters submitted in response to other proposed rulemakings, in which commenters proposed an annual reporting requirement in lieu of swap-by-swap reporting. Additionally, the Commission believes that there is an economic incentive for corporate groups to file an annual report because filing annually is less costly and operationally simpler than swap-by-swap reporting. The Commission estimates that it would take an average of 30 minutes to 90 minutes to complete and submit this filing, resulting in 0.5 to 1.5 burden hours per MNC that elects to file the annual report. The average hourly wage for a compliance attorney is $390, which means that the aggregate annual cost for submitting the annual report would likely be approximately $195 to $585. Table C summarizes the estimated average burden hours and costs for modifying the reporting system, for non-reporting affiliates to communicate information to the reporting counterparty after the swap is entered into, and for providing the annual report under proposed § 39.6(g)(5), as follows:

TABLE C—OTHER BURDENS AND COSTS TO REPORTING AND NON-REPORTING AFFILIATES

Proposed regulation/requirement description	Average burden hours per affiliate	Average cost per affiliate	Total average annual burden hours	Total average annual cost
Modifying Reporting System (One-time cost).[95]	5.5 hours	$1,875.50	9,680 [5.5 × 1,760]	$3,300,880 [$1,875.50 × 1,760] [96]
Burden on Non-Reporting Affiliates.	5.04 hours	1,966.25	192,205 [5.04 × 38,136]	$74,984,910 [$1,966.25 × 38,136] [97]
§ 39.6(g)(5) Annual Report	1 hour	390.00	1,584 [(1,760 × 90%) × 1] [98]	$617,760 [$390 × 1,760 * 90%]

c. Total Burden Hours

The Commission estimates that the proposed exemption could result in an average total annual burden of 1,758,369 hours and average total annual costs of $685,309,281.[99] The burden and cost estimates are approximately 1.8 minutes and $10.48 per inter-affiliate swap. Table D provides the total burden hours and costs of the proposed exemption and breaks down the totals into burden hours and costs per MNC, per affiliate, and per inter-affiliate swap.

TABLE D—AVERAGE ANNUAL BURDEN AND COST ESTIMATES OF THE PROPOSED EXEMPTION

	Burden hours	Cost of proposed exemption
Total	1,758,369	685,309,281
Total Average Annual per MNC [100]	999	389,380

[91] To derive the annual burden hours and cost for this row, the Commission calculated the following: the average burden hours or cost per transaction times total number of inter-affiliate swaps annually.

[92] The Commission assumes that at least 90% of corporations would elect to file an annual report to supply the information required by proposed § 39.6(g)(4)(ii)–(iii) rather than report the information on a swap-by-swap basis; 10% of affiliates would report the required information on a swap-by-swap basis.

[93] To derive the annual burden hours and cost for this row, the Commission calculated the following: (A) The total number of subsidiaries (see Table A) times 75% to determine the number of affiliates involved in a first transaction subject to reporting; (B) then multiplied that number—38,136—with 10% to determine the number of affiliates that would report swap-by-swap, *i.e.,* 3,813.6, and (C) then multiplied that number by 0.16667, to obtain the average burden hours to report, or $65, to obtain the average cost to report.

[94] To derive the annual burden hours and cost for this row, the Commission calculated following: (A) The total number of subsequent transactions, which is the total number of transactions (64,768,399) minus the total number of first time transactions (0.75 × 50,848); (B) then multiplied that number—64,730,263—by 10% to determine the number of affiliates that would report swap-by-swap, *i.e.,* 6,473,26.3, and (C) then multiplied that number by 0.05, to obtain the average burden hours to report, or $19.50, to obtain the average cost to report.

[95] The Commission assumes that there is only one reporting counterparty at each MNC.

[96] 1,760 represents the 75% of 2,347 MNCs that the Commission estimates would be reporting parties.

[97] 38,136 represents 75% of 50,848, the total number of affiliates potentially electing the proposed exemption.

[98] This calculation represents the total burden hours for the estimated 90% of MNCs—1,584.2—that would file annual reports.

[99] These numbers are obtained by adding all of the burden hours or costs in Tables B and C.

TABLE D—AVERAGE ANNUAL BURDEN AND COST ESTIMATES OF THE PROPOSED EXEMPTION—Continued

	Burden hours	Cost of proposed exemption
Total Average Annual per Affiliate [101]	46	17,970
Total Average per Inter-Affiliate Swap [102]	* 0.03	[103] 10.58

* (1.8 minutes).

3. Information Collection Comments

The Commission invites public comment on any aspect of the reporting burdens discussed above. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments in order to: (i) Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collection of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) minimize the burden of the collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Comments may be submitted directly to the Office of Information and Regulatory Affairs (''OIRA'') in OMB, by fax at (202) 395–6566, or by email at *OIRAsubmissions@omb.eop.gov.* Please provide the Commission with a copy of submitted comments so that they can be considered in connection with a final rule. Refer to the **ADDRESSES** section of this release for comment submission instructions to the Commission. A copy of the supporting statements for the collections of information discussed above may be obtained by visiting *www.RegInfo.gov.* OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this release in the **Federal Register**. Consequently, a comment to OMB is most assured of being fully effective if received by OMB (and the Commission) within 30 days after publication.

V. Text of Proposed Rules

List of Subjects in 17 CFR Part 39

Business and industry, Clearing, Cooperatives, Reporting requirements, Swaps.

For the reasons stated in the preamble, the Commission proposes to amend 17 CFR part 39 as follows:

PART 39—DERIVATIVES CLEARING ORGANIZATIONS

1. The authority citation for part 39 is revised to read as follows:

Authority: 7 U.S.C. 2, 6, 12a, and 24a, 7a–1 as amended by Pub. L. 111–203, 124 Stat. 1376 (2010).

2. In § 39.6, add paragraph (g) to read as follows:

§ 39.6 Exceptions to the clearing requirement.

* * * * *

(g) Exemption for swaps between affiliates.

(1) *Affiliate Status.* 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 if one counterparty directly or indirectly holds a majority ownership interest in the other, or if a third party directly or indirectly holds a majority ownership interest in both counterparties, and the financial statements of both counterparties are reported on a consolidated basis (''eligible affiliate counterparties''). 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.

(2) *Conditions.* Eligible affiliate counterparties to a swap may elect the exemption described in paragraph (g)(1) of this section if:

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

(ii)(A) A swap dealer or major swap participant that is an eligible affiliate counterparty to the swap satisfies the requirements of § 23.504; or (B) the swap is, if neither eligible affiliate counterparty is a swap dealer or major swap participant, documented in a swap trading relationship document that shall be in writing and shall include all terms governing the trading relationship between the affiliates, including, without limitation, payment obligations, netting of payments, events of default or other termination events, calculation and netting of obligations upon termination, transfer of rights and obligations, governing law, valuation, and dispute resolution procedures;

(iii) 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;

(iv) With the exception of 100% commonly-owned and commonly-guaranteed affiliates where the common guarantor is also 100% commonly-owned, for a swap for which both counterparties are financial entities, as defined in paragraph (g)(6), both parties shall pay and collect variation margin and comply with paragraph (g)(3) of this section;

(v) Each counterparty either:

(A) Is located in the United States;

(B) Is located in a jurisdiction that has a clearing requirement that is comparable and comprehensive to the clearing requirement in the United States;

(C) Is required to clear swaps with non-affiliated parties in compliance with United States law; or

(D) Does not enter into swaps with non-affiliated parties; and

(vi) The reporting counterparty for the swap, as determined in accordance with § 45.8 of this chapter, complies with paragraph (g)(4) of this section with respect to each of the counterparties.

(3) *Variation Margin.* When both counterparties are financial entities each counterparty shall pay and collect any variation margin as calculated pursuant to paragraph (g)(3)(i) for each uncleared swap for which the exemption described in paragraph (1) is elected.

(i) The swap trading relationship documentation required in paragraph (g)(2)(ii) of this section must set forth the methodology to be used to calculate variation margin and describe it with sufficient specificity to allow the counterparties, the Commission, and any appropriate prudential regulator to calculate the margin requirement independently.

(ii) Variation margin calculations and payments shall start on the business day after the swap is executed and continue

[100] Total Hours or Costs divided by 1,760 MNCs, which is equal to 75% × 2,347.

[101] Total Hours or Costs divided by 38,136 affiliates, which is equal to 75% × 50,848.

[102] Total Hours or Costs per Affiliate divided by 64,768,399 inter-affiliate swaps.

[103] The ''Total Average per Inter-Affiliate Swap'' of $10.58 is less than the average transaction costs listed in Table B (i.e., $65 and $19.50) for two reasons. First, $10.58 is the average cost for over 64 million inter-affiliate swaps. Second, the ''average total transaction costs'' in Table B apply only to the assumed ten percent (10%) of reporting counterparties that might choose to report swap-by-swap under §§ 39.6(g)(4)(ii)–(iii).

each business day until the swap is terminated.

(iii) Each counterparty shall pay the entire variation margin amount as calculated pursuant to paragraph (g)(3)(i) when due.

(iv) The swap trading relationship documentation required in paragraph (g)(2)(ii) of this section shall specify for each counterparty where margin assets will be held and under what terms.

(4) *Reporting Requirements.* When the exemption described in paragraph (g)(1) of this section is elected, the reporting counterparty 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:

(i) Confirmation that both counterparties to the swap are electing not to clear the swap and that each of the counterparties satisfies the requirements in paragraphs (g)(1) and (2) of this section applicable to it;

(ii) For each 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:

(A) A written credit support agreement;

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

(C) A written guarantee from another party;

(D) The counterparty's available financial resources; or

(E) Means other than those described in subparagraphs (A), (B), (C) or (D); and

(iii) If a 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:

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

(B) Acknowledgment that an appropriate committee of the board of directors (or equivalent body) of the counterparty has reviewed and approved the decision not to clear the swap.

(5) *Annual Reporting.* An affiliate that qualifies for the exemption described in paragraph (g)(1) of this section may report the information listed in paragraphs (g)(4)(ii) and (iii) of this section annually in anticipation of electing the exemption for one or more swaps. Any such reporting under this paragraph will be effective for purposes of paragraphs (g)(4)(ii) and (iii) of this section for 365 days following the date of such reporting. During the 365-day period, the affiliate 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 § 39.6(g).

(6) *Financial Entity.* For purposes of this § 39.6(g), the term ''financial entity'' shall have the meaning given such term in section 2(h)(7)(C) of the Act.

Issued in Washington, DC, on August 15, 2012, by the Commission.

Sauntia Warfield,

Assistant Secretary of the Commission.

Appendices to Clearing Exemption for Swaps Between Certain Affiliated Entities—Commission Voting Summary and Statements of Commissioners

Note: The following appendices will not appear in the Code of Federal Regulations.

Appendix 1—Commission Voting Summary

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

Appendix 2—Statement of Chairman Gary Gensler

I support the proposed rules to exempt swaps between certain affiliated entities within a corporate group, known as inter-affiliates, from the clearing requirement in the Dodd-Frank Wall Street Reform and Consumer Protection Act.

One of the primary benefits of swaps market reform is that standard swaps between financial firms will move into central clearing, which will significantly lower the risks of the highly interconnected financial system.

Transactions between affiliates, however, pose less risk to the financial system because the risks are internalized within the financial institution.

The proposed rule would allow for an exemption from clearing for swaps between affiliates under the following limitations.

First, the proposed exemption would be limited to swaps between majority-owned affiliates whose financial statements are reported on a consolidated basis.

Second, the proposed rules would require centralized risk management, documentation of the swap agreement, payment of variation margin and completion of reporting requirements.

Third, the exemption would be limited to swaps between U.S. affiliates and swaps between a U.S. affiliate and a foreign affiliate located in a jurisdiction with a comparable and comprehensive clearing regime.

This approach largely aligns with the Europeans' approach to an exemption for inter-affiliate clearing.

I look forward to the public's comments on this proposal.

Appendix 2—Joint Statement of Commissioners Jill Sommers and Scott O'Malia

We respectfully dissent from the notice of proposed rulemaking to exempt swaps between certain affiliated entities from the clearing requirement. While we wholly support a clearing exemption for swaps between affiliated entities within a corporate group, we cannot support the proposal before the Commission today because in certain instances it imposes an unnecessary requirement for variation margin on corporate entities that engage in inter-affiliate trades.

Inter-affiliate swaps enable a corporate group to aggregate risk on a global basis in one entity through risk transfers between affiliates. Once aggregated, commercial risk of various affiliates is netted, thereby reducing overall commercial and financial risk. This practice allows for more comprehensive risk management within a single corporate structure.

Another benefit to this practice is that it allows one affiliate to face the market and hedge the risk of various operating affiliates within the group. Notably, inter-affiliate swaps between majority owned affiliates do not create external counterparty exposure and therefore do not pose the systemic risks that the clearing requirement is designed to protect against. The practice actually reduces risk and simply allows for more efficient business management of the entire group.

We believe it is entirely appropriate that the Commission exempt inter-affiliate swaps from the clearing mandate. Unfortunately, this proposal inserts a requirement that most financial entities engaging in inter-affiliate swaps post variation margin to one another. It is not clear that this requirement will do anything other than create administrative burdens and operational risk while unnecessarily tying up capital that could otherwise be used for investment.

The variation margin requirement is also largely inconsistent with the requirements included in the European Market Infrastructure Regulation. As we have both made clear during the implementation process, we believe coordination with our global counterparts is critical to the success of this new framework.

Finally, the legislative history on this issue is clear. During the passage of the Dodd-Frank Act many Members' statements directly addressed the concerns regarding inter-affiliate swaps. Additionally, Members of the U.S. House of Representatives passed, by an overwhelming bi-partisan majority, an inter-affiliate swap exemption that does not include a variation margin requirement.

We believe this proposal may have the unintended consequence of imposing substantial costs on the economy and consumers. With this in mind, we welcome comments from the public as to the costs and benefits of the variation margin requirement and hope that we incorporate those views in adopting the final rule.

[FR Doc. 2012–20508 Filed 8–20–12; 8:45 am]

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