

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

Release No. 34-63556; File No. S7-43-10

RIN 3235-AK88

End-User Exception to Mandatory Clearing of Security-Based Swaps

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: In accordance with Section 763(a) of Title VII (“Title VII”) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”), the Securities and Exchange Commission (“Commission”) is proposing new Rule 3Cg-1 under the Securities Exchange Act of 1934 (“Exchange Act”) governing the exception to mandatory clearing of security-based swaps available for counterparties meeting certain conditions. The Commission is requesting comments on the proposed rule and related matters.

DATES: Comments must be received on or before [insert date 45 days after publication in the Federal Register].

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File No. S7-43-10 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

Paper Comments

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File No. S7-43-10. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549 on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Peter Curley, Attorney Fellow, at (202) 551-5696, or Andrew Blake, Special Counsel, at (202) 551-5846, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-7010.

SUPPLEMENTARY INFORMATION: The Commission is proposing Rule 3Cg-1 under the Exchange Act to govern the exception to mandatory clearing of security-based swaps available to counterparties to security-based swaps meeting certain conditions. The Commission is soliciting comments on all aspects of the proposed rule and alternative rule language and will carefully consider any comments received.

I. Introduction

On July 21, 2010, the President signed the Dodd-Frank Act into law.¹ The Dodd-Frank Act was enacted to, among other purposes, promote the financial stability of the United States by improving accountability and transparency in the financial system.² Title VII of the Dodd-Frank Act provides the Commission and the Commodity Futures Trading

¹ The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

² See Pub. L. No. 111-203, Preamble.

Commission (“CFTC”) with the authority to regulate over-the-counter (“OTC”) derivatives in light of the recent financial crisis, which demonstrated the need for enhanced regulation in the OTC derivatives market.

The Dodd-Frank Act provides that the CFTC will regulate “swaps,” the Commission will regulate “security-based swaps,” and the CFTC and the Commission will jointly regulate “mixed swaps.”³ The Dodd-Frank Act amends the Exchange Act⁴ to require, among other things, the following: (1) transactions in security-based swaps must be cleared through a clearing agency if they are of a type that the Commission determines must be cleared, unless an exemption from mandatory clearing applies;⁵ (2) transactions in security-based swaps must be reported to a registered security-based swap data repository (“SDR”) or the Commission;⁶ and (3) if a security-based swap is subject to a clearing requirement, it must be traded on a registered exchange or a registered or exempt security-based swap execution facility, unless no facility makes such security-based swap available for trading.⁷

³ Section 712(d) of the Dodd-Frank Act provides that the Commission and the CFTC, in consultation with the Board of Governors of the Federal Reserve System (“Federal Reserve”), shall jointly further define the terms “swap,” “security-based swap,” “swap dealer,” “security-based swap dealer,” “major swap participant,” “major security-based swap participant,” “eligible contract participant,” and “security-based swap agreement.” These terms are defined in Sections 721 and 761 of the Dodd-Frank Act and, with respect to the term “eligible contract participant,” in Section 1a(18) of the Commodity Exchange Act (“CEA”), 7 U.S.C. 1a(18), as re-designated and amended by Section 721 of the Dodd-Frank Act. See Exchange Act Release Nos. 62717 (Aug. 13, 2010), 75 FR 51429 (Aug. 20, 2010) (File No. S7-16-10) (advance joint notice of proposed rulemaking regarding definitions contained in Title VII of the Dodd-Frank Act) (“Definitions Release”); 63452 (Dec. 7, 2010) (“Definitions Proposing Release”).

⁴ All references to the Exchange Act contained in this release refer to the Securities Exchange Act of 1934, as amended by the Dodd-Frank Act.

⁵ See Pub. L. No. 111-203, § 763(a) (adding Exchange Act Section 3C).

⁶ See Pub. L. No. 111-203, §§ 763(i) and 766(a) (adding Exchange Act Sections 13(m)(1)(G) and 13A(A)(1), respectively).

⁷ See Pub. L. No. 111-203, § 763(a) (adding Exchange Act Section 3C). See also Pub. L. No. 111-203, § 761 (adding Exchange Act Section 3(a)(77) (defining the term “security-based swap execution facility”).

The Dodd-Frank Act seeks to ensure that, wherever possible and appropriate, derivatives contracts formerly traded exclusively in the OTC market be cleared.⁸ One key way in which the Dodd-Frank Act promotes clearing of such contracts is by setting forth a process by which the Commission would determine whether a security-based swap is required to be cleared; if the Commission makes a determination that a security-based swap is required to be cleared, then parties may not engage in such security-based swap without submitting it for clearing unless an exception applies.

Standards for mandatory clearing of security-based swaps are established by Exchange Act Section 3C(a)(1).⁹ The purpose of mandatory clearing of security-based swap products is to centralize individual counterparty risks through a clearing agency acting as a central counterparty that distributes risk among the clearing agency's participants. Exchange Act Section 3C(g) provides that a security-based swap otherwise subject to mandatory clearing is not required to be cleared if one party to the security-based swap is not a financial entity, is using security-based swaps to hedge or mitigate commercial risk, and notifies the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations associated with entering into non-cleared security-based swaps (the "end-user clearing exception").¹⁰ Though beneficial for reasons such as those described above, mandatory

⁸ See, e.g., Report of the Senate Committee on Banking, Housing, and Urban Affairs regarding The Restoring American Financial Stability Act of 2010, S. Rep. No. 111-176 at 34 (stating that "[s]ome parts of the OTC market may not be suitable for clearing and exchange trading due to individual business needs of certain users. Those users should retain the ability to engage in customized, uncleared contracts while bringing in as much of the OTC market under the centrally cleared and exchange-traded framework as possible.").

⁹ See Exchange Act Release No. 63557 (Dec. 15, 2010) ("Mandatory Clearing Release").

¹⁰ See Pub. L. No. 111-203, § 763(a) (adding Exchange Act Section 3C(g)). This clearing exception is elective. When trading with a security-based swap dealer and a major security-based swap participant, counterparties that are not swap dealers, security-based swap dealers, major swap participants or major security-based swap participants have the right to forgo the end-user clearing exception and require clearing

clearing of security-based swaps may also alter the burdens on non-financial end-users of derivatives relative to bilateral transactions, and thereby possibly affect their risk management practices.¹¹ Exchange Act Section 3C(g) is designed to permit non-financial end-users that meet the specified conditions to elect not to centrally clear security-based swaps and retain flexibility to use both cleared and non-cleared security-based swaps in their risk management activities.

The Dodd-Frank Act provides the Commission with authority to adopt rules governing the end-user clearing exception and to prescribe rules, issue interpretations or request information from persons claiming the end-user clearing exception necessary to prevent abuse of the exception.¹² The Commission is also required to consider whether to exempt small banks, savings associations, farm credit system institutions and credit unions from the definition of “financial entity” contained in Exchange Act Section 3C(g)(3)(A). The Commission is proposing Rule 3Cg-1 under the Exchange Act to specify requirements for using the exception to mandatory clearing of security-based swaps established by Exchange

for a security-based swap that is subject to a Commission clearing mandate. These counterparties are granted a similar right when a security-based swap has been listed for clearing, but is not the subject of a Commission clearing mandate. See Pub. L. No. 111-203, § 763(a) (adding Exchange Act Section 3C(g)(5)). The choice to require or forgo clearing is solely at the non-financial counterparty’s discretion. See Pub. L. No. 111-203, § 763(a) (adding Exchange Act Section 3C(g)(2)).

¹¹ Burdens that may rest upon non-financial end-users arising from central clearing could include clearing fees and the requirement to post initial and variation margin. The net cost of these burdens to non-financial end-users is expected to vary. In particular, the final net cost to non-financial end-users would also need to account for the fees and charges of dealers and other counterparties to security-based swaps with non-financial end-users and for any bilateral margin or other collateral requirements established in connection with such transactions. As a result, it is possible that the costs for an end-user to engage in a centrally cleared transaction may be less than for comparable bilateral transactions in some circumstances. The Commission is requesting comments on the costs experienced by non-financial end-users in connection with both cleared and non-cleared security-based swaps.

¹² See Pub. L. No. 111-203, § 712(f). See also Pub. L. No. 111-203, § 763(a) (adding Exchange Act Section 3C(g)(6)).

Act Section 3C(g), together with proposed alternative language to provide an exemption for small banks, savings associations, farm credit system institutions and credit unions.

II. Description of Proposed Rule

A. Notification to the Commission

In order to qualify for the end-user clearing exception, a non-financial entity¹³ that uses security-based swaps to hedge or mitigate commercial risk must notify the Commission how it generally meets its financial obligations associated with non-cleared security-based swaps.¹⁴ The Exchange Act authorizes the Commission to establish rules regarding such notification as well as to prescribe rules as may be necessary to prevent abuse of the end-user clearing exception.¹⁵ The Commission is proposing Rule 3Cg-1 to require non-financial entities to notify the Commission each time the end-user clearing exception is used by delivering certain information to an SDR in the manner required by proposed Exchange Act Regulation SBSR.¹⁶

¹³ Exchange Act Section 3C(g)(1)(A) limits availability of the end-user clearing exception to circumstances when one of the counterparties to the security-based swap is not a financial entity. The term financial entity is defined in Section 3C(g)(3)(A) of the Exchange Act, and includes the following eight entities: (i) a swap dealer; (ii) a security-based swap dealer; (iii) a major swap participant; (iv) a major security-based swap participant; (v) a commodity pool as defined in section 1a(10) of the Commodity Exchange Act; (vi) a private fund as defined in section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80-b-2(a)); (vii) an employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002); or (viii) a person predominantly engaged in activities that are in the business of banking or financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956. Four of these terms, “swap dealer”, “major swap participant”, “security-based swap dealer” and “major security-based swap participant” are themselves the subject of current proposed joint rulemaking by the Commission and the CFTC. Definitions Proposing Release, supra note 3.

¹⁴ See Pub. L. No. 111-203, § 763(a) (adding Exchange Act Section 3C(g)(1)(C)).

¹⁵ See Pub. L. No. 111-203, §§ 712(f) and 763(a) (adding Exchange Act Sections 3C(g)(1)(C) and 3C(g)(6)).

¹⁶ See Exchange Act Release No. 63346 (Nov. 18, 2010), 75 FR 75208 (Dec. 2, 2010) (“Regulation SBSR Proposing Release”). Regulation SBSR contemplates that information may be delivered to the Commission directly in limited circumstances when an SDR is not available. When permitted by Regulation SBSR, such delivery would also meet the end-user clearing exception notice requirement. Persons wishing

The Commission believes that receiving a notification for each transaction may provide for a more complete picture regarding how end-users meet their financial obligations based on the transactions in which they engage. The specified additional information would be delivered to the SDR by the reporting party defined in proposed Regulation SBSR (the “Reporting Party”)¹⁷ together with other information regarding the security-based swap separately required by proposed Regulation SBSR. Under the applicable requirements of proposed Regulation SBSR, the additional information required by proposed Rule 3Cg-1 would be delivered to the SDR in the same electronic format established by the SDR for purposes of proposed Regulation SBSR,¹⁸ promptly after the security-based swap transaction is executed, which for information of this kind would be no later than:

- 15 minutes after the time of execution for a security-based swap that is executed and confirmed electronically;
- 30 minutes after the time of execution for a security-based swap that is confirmed electronically but not executed electronically; or
- 24 hours after execution for a security-based swap that is not executed or confirmed electronically.¹⁹

The information delivered to the SDR pursuant to Rule 3Cg-1 would need to be accurate as of the date and time the information is delivered to the SDR.²⁰ The Commission believes that

to comment on the requirements of proposed Regulation SBSR should submit comments pursuant to the Regulation SBSR Proposing Release.

¹⁷ Proposed Exchange Act Rule 901(a) under Regulation SBSR defines which of the parties to a security-based swap will be designated the Reporting Party for these purposes. See id.

¹⁸ See id. (proposed Rules 901(h) and 907(a)(2) of proposed Regulation SBSR).

¹⁹ See id. (proposed Rule 901(d)(2) of proposed Regulation SBSR).

²⁰ See id. (for each security-based swap transaction made in reliance on the end-user clearing exception, proposed Rule 901(d)(1)(ix) under Regulation SBSR requires parties to a security-based swap to indicate whether or not the end-user clearing

this requirement should improve transaction efficiency by allowing notification to be made in a manner consistent with other transaction reporting requirements being developed pursuant to the Dodd-Frank Act. The timing requirements should also ensure the Commission has up to date information as of the time of submission.

1. Meeting Financial Obligations

A non-financial entity invoking the end-user clearing exception must notify the Commission of “how it generally meets its financial obligations associated with non-cleared security-based swaps” (“Financial Obligation Notice”).²¹ Under existing market practices, counterparties to security-based swaps regularly use forms of collateral support both to create incentives for obligors to meet their financial obligations under the agreements and to provide themselves with access to some asset of value that can be sold or the value of which can be applied in the event of default.²² Though not required by Exchange Act Section 3C(g), such individualized credit arrangements between counterparties in bilateral security-based swap transactions can be important components of risk management consistent with the policy rationale of ensuring that the end-user clearing exception is reasonably available to non-financial entities hedging or mitigating commercial risks.²³

However, a principal feature distinguishing cleared security-based swaps from

exception is being invoked when reporting transaction information to an SDR as required by Exchange Act Section 13(m)(1)(F). The information required under proposed Exchange Act Rule 3Cg-1 is separate from these requirements but would be delivered to the SDR by the Reporting Party in the same manner as required by proposed Regulation SBSR).

²¹ See Pub. L. No. 111-203, § 763(a) (adding Exchange Act Section 3C(g)(1)(C)).

²² See ISDA Collateral Steering Committee, Market Review of OTC Derivative Bilateral Collateralization Practices (2.0), (March 1, 2010) (available at http://www.isda.org/c_and_a/pdf/Collateral-Market-Review.pdf) (“ISDA Collateralization Practices”) (explaining credit risk, methods of risk mitigation and the context for collateralization as a risk reduction technique).

²³ See 156 Cong. Rec. S6192 (daily ed. July 22, 2010) (letter from Sen. Dodd and Sen. Lincoln to Rep. Frank and Rep. Peterson (the "Dodd-Lincoln Letter")).

non-cleared security-based swaps is that non-cleared security-based swaps do not provide a uniform method of mitigating such counterparty credit risk.²⁴ Given this lack of uniformity, proposed Rule 3Cg-1(a)(5) would require a counterparty relying on the end-user clearing exception to provide certain information as part of its notification to the Commission regarding the methods used to mitigate credit risk in connection with non-cleared security-based swaps. If more than one method is used then information must be provided regarding each applicable method. Notification of all methods, as proposed in proposed Rule 3Cg-1(a)(5), would provide the Commission with more complete information regarding the risk characteristics of non-cleared security-based swaps used by non-financial entities to hedge or mitigate commercial risk.

Proposed Rule 3Cg-1(a)(5)(i) requires notification to the Commission regarding whether a credit support agreement is being used in connection with the non-cleared security-based swap. For these purposes, the term credit support agreement refers to any agreement, or annex, amendment or supplement to another agreement, which contemplates the periodic transfer of specified collateral to or from another party to support payment obligations associated with the security-based swap. Agreements of this kind are frequently used to mitigate the counterparty credit risk of security-based swaps and other derivatives that are not centrally cleared, but the use of such arrangements may be more or less common among certain types of counterparties and for certain types of security-based swaps.²⁵ The proposed notification would provide the Commission with information regarding the extent to which

²⁴ See ISDA Collateralization Practices, supra note 22 (describing methods of risk mitigation used in connection with OTC Derivatives and key legal foundations supporting collateralization).

²⁵ See ISDA Collateralization Practices, supra note 22. See also ISDA, ISDA Margin Survey 2010 (available at http://www.isda.org/c_and_a/pdf/ISDA-Margin-Survey-2010.pdf) (“ISDA Margin Survey 2010”) (describing collateralization levels for derivatives transactions by counterparty type, product type and types of collateral received).

credit support agreements are used by non-financial entities to support their financial obligations associated with non-cleared security-based swaps.

Proposed Rule 3Cg-1(a)(5)(ii) requires notification to the Commission regarding whether the financial obligations associated with the non-cleared security-based swap are secured by collateral pledged under a written security arrangement not requiring the transfer of possession of collateral to either of the security-based swap counterparties. Examples of this type of arrangement include, but are not limited to, (i) agreements granting security interests over property of the reporting person, whether or not such security interests are perfected by the filing of a mortgage, financing statements or similar documents, and (ii) agreements to transfer assets to collateral agents or escrow agents acting pursuant to instructions agreed by both parties to a security-based swap. While such arrangements may be somewhat less commonly used to mitigate credit risk associated with non-cleared security-based swaps, the Commission preliminarily believes these methods may have particular importance for certain categories of non-financial entities, such as enterprises with high levels of fixed assets relative to cash flows.²⁶ Accordingly, the Commission preliminarily considers it appropriate to separately categorize this information in the data proposed to be collected.

Proposed Rule 3Cg-1(a)(5)(iii) requires notification to the Commission regarding whether the financial obligations associated with the non-cleared security-based swap are guaranteed by a person or entity other than the counterparty invoking the end-user clearing exception. The proposed notification would provide the Commission with information regarding the manner in which financial obligations are met by providing information regarding the use of guarantees by third parties (such as parent companies, affiliated parties or

²⁶ See ISDA Margin Survey 2010, *supra* note 25, at 9 (noting types of non-ISDA collateral agreements used and frequency of use).

others) in meeting financial obligations associated with non-cleared security-based swaps.²⁷

Proposed Rule 3Cg-1(a)(5)(iv) requires notification to the Commission regarding whether the counterparty invoking the end-user clearing exception intends to meet its obligations associated with the security-based swap solely by utilizing available financial resources (*i.e.*, its general creditworthiness).²⁸ Financial resources that might be available to meet obligations associated with non-cleared security-based swaps may include any number of sources, including existing assets, investments and cash balances, cash flow from operations, short-term and long-term lines of credit and capital market sources of funding.

Proposed Rule 3Cg-1(a)(5)(v) requires notification to the Commission regarding whether the counterparty invoking the end-user clearing exception intends to employ means other than those described in proposed Rules 3Cg-1(a)(5)(i), (ii), (iii), or (iv) to meet its financial obligations associated with a security-based swap. This item is intended to separately categorize all other methods that may be used in the markets today or that may develop in the future for meeting obligations associated with non-cleared security-based swaps relying on the end-user clearing exception to provide a clearer picture of the manner in which an end-user is meeting its financial obligations. The Commission anticipates many entities would meet their financial obligations through one of the specific methods listed in Rule

²⁷ See ISDA Collateralization Practices, *supra* note 22, at 20 (identifying master cross-netting and cross-guarantee structures as common credit risk mitigation practices); see also ISDA 2002 Master Agreement, Multicurrency – Cross Border Schedule, Part 4(f) (contemplating bank letters of credit and third party guarantees as credit support documents).

²⁸ For a variety of reasons one or both of the counterparties to some non-cleared security-based swaps may choose not to mitigate credit risk and instead rely on the general creditworthiness of their opposite counterparty, given the circumstances and financial terms of the transaction. See, *e.g.*, Office of the Comptroller of Currency, Risk Management of Financial Derivatives, Comptroller's Handbook, at 50 (Jan. 1997) (available at <http://www.occ.gov/static/publications/handbook/deriv.pdf>) (contemplating that evaluations of individual counterparty credit limits should aggregate limits for derivatives with credit limits established for other activities, including commercial lending).

3Cg-1(a)(5)(i), (ii), (iii), or (iv). The information collected pursuant to proposed Rule 3Cg-1(a)(5)(v), however, may allow the Commission to gain greater insight regarding the potential existence of other means for meeting financial obligations, as well as whether there is a significant number of transactions that would justify more granular rules concerning the manner in which end-users are meeting their financial obligations in the future with respect to whether and how end-users are using other credit risk mitigating methodologies to support meeting their financial obligations associated with non-cleared security-based swaps.

2. Preventing Abuse of the End-User Clearing Exception

The remaining items of information required by proposed Rule 3Cg-1, specifically proposed Rules 3Cg-1(a)(1), (2), (3), (4) and (6), are designed to affirm compliance with particular requirements of Exchange Act Section 3C(g) or otherwise produce information necessary to aid the Commission in its efforts to prevent abuse of the end-user clearing exception as contemplated by Exchange Act Section 3C(g)(6).²⁹

Proposed Rule 3Cg-1(a)(1) requires identifying which of the counterparties to the security-based swap is invoking the end-user clearing exception. At least one counterparty must be identified for each security-based swap that will rely on the end-user clearing exception. When both counterparties to a security-based swap are non-financial entities and meet the other requirements of the end-user clearing exception, both parties may choose to use the exception and provide the required information to the SDR.

Proposed Rule 3Cg-1(a)(2) requires information to be provided regarding the status of the counterparty invoking the end-user clearing exception as a non-financial entity under Section 3C(g)(3) of the Act.³⁰ This information is being solicited because the exception to

²⁹ See Pub. L. No. 111-203, § 763(a) (adding Exchange Act Section 3C(g)(6)). See also Pub. L. No. 111-203, § 764 (adding Exchange Act Section 15F of the Exchange Act creating new business conduct standards applicable to interactions of security-based swap dealers and major security-based swap participants with other counterparties).

³⁰ See Pub. L. No. 111-203, § 763(a) (adding Exchange Act Section 3C(g)(3)).

mandatory clearing of security-based swaps under Exchange Act Section 3C(g) is only available to persons that are not financial entities, or are affiliates of non-financial entities satisfying the requirements of Exchange Act Section 3C(g)(4).

Proposed Rule 3Cg-1(a)(3) requires information to be provided regarding whether the counterparty invoking the end-user clearing exception is an affiliate of another person qualifying for the exception under Exchange Act Section 3C(g), and satisfies the additional requirements of Exchange Act Section 3C(g)(4).³¹ Section 3C(g)(4) of the Exchange Act contains a number of provisions specially designed for finance affiliates of persons qualifying for the end-user clearing exception, and among other things does not permit finance affiliates that are themselves swap dealers, security-based swap dealers, major swap participants, major security-based swap participants or certain other defined categories of entities to use the end-user clearing exception as an agent for another entity in any circumstances.³² Given these additional features, the Commission preliminarily believes it is appropriate to separately

³¹ See Pub. L. No. 111-203, § 763(a) (adding Exchange Act Section 3C(g)(4)).

³² Exchange Act Section 3C(g)(4)(A) provides that affiliates of persons qualifying for the end-user clearing exception will also qualify for the end-user clearing exception if the affiliate (1) acts on behalf of the person and as agent, (2) uses the security-based swap to hedge or mitigate commercial risk of that person or another affiliate of that person that is not a financial entity as defined in Exchange Act Section 3C(g)(3), and (3) is not itself one of seven entities defined in Exchange Act Section 3C(g)(4)(B). See Pub. L. No. 111-203, § 763(a) (adding Exchange Act Section 3C(g)(4)(A)). The seven entities are: (i) a swap dealer; (ii) a security-based swap dealer; (iii) a major swap participant; (iv) a major security-based swap participant; (v) an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3), but for paragraph (1) or (7) of subsection c of that Act (15 U.S.C. 80a-3(c)); (vi) a commodity pool; or (vii) a bank holding company with over \$50,000,000,000 in consolidated assets. See Pub. L. No. 111-203, § 763(a) (adding Exchange Act Section 3C(g)(4)(B)). In addition, an affiliate, subsidiary, or wholly owned entity of a person that qualifies for an exception under Exchange Act Section 3C(g)(4)(A) and which is predominantly engaged in providing financing for the purchase or lease of merchandise or manufactured goods of the person shall be exempt from both the margin requirements described in Exchange Act Section 15F(e) and the clearing requirement in Exchange Act Section 3C(a), provided that the security-based swaps in question are entered into to mitigate the risk of the financing activities. See Pub. L. No. 111-203, § 763(a) (adding Exchange Act Section 3C(g)(4)(C)).

categorize security-based swaps transacted by finance affiliates in particular in order to aid the Commission in its efforts to prevent abuse of the end-user clearing exception by being able to readily identify entities that qualify as financial entities and are participating in the use of the exception.

Proposed Rule 3Cg-1(a)(4) requires information to be provided regarding whether the counterparty invoking the end-user clearing exception uses the security-based swap being reported to hedge or mitigate commercial risk. The exception to mandatory clearing of security-based swaps pursuant to Section 3C(g) of the Exchange Act is only available to persons that use security-based swaps to hedge or mitigate commercial risk. The Commission has proposed to adopt Exchange Act Rule 3a67-4 to define the meaning of hedging or mitigating commercial risk for these purposes.³³

Proposed Rule 3Cg-1(a)(6) requires all counterparties invoking the end-user clearing exception to indicate whether they are an issuer of securities registered under Exchange Act Section 12 or required to file reports pursuant to Exchange Act Section 15(d) (“SEC Filer”).³⁴ Under Exchange Act Section 3C(i), the exception to mandatory clearing of security-based swaps pursuant to Exchange Act Section 3C(g) is available to SEC Filers only if an appropriate committee of the issuer’s board of directors or governing body has reviewed and approved the issuer’s decision to enter into security-based swaps that are subject to the exception.³⁵ When

³³ See infra notes 49-51 and accompanying text.

³⁴ For these purposes, a counterparty invoking the end-user clearing exception is considered by the Commission to be an issuer of securities registered under Exchange Act Section 12 or required to file reports pursuant to Exchange Act Section 15(d) if it is controlled by a person that is an issuer of securities registered under Exchange Act Section 12 or required to file reports pursuant to Exchange Act Section 15(d). See Rule 1-02(x) of Regulation S-X, 17 CFR 210.1-02(x) (defining subsidiary for purposes of the financial statements required to be filed as part of registration statements under Section 12, and annual and other reports under Exchange Act Sections 13 and 15(d)).

³⁵ See Pub. L. No. 111-203, § 763(a) (adding Exchange Act Section 3C(i)). For these purposes, the Commission considers a committee to be appropriate if it is specifically

the counterparty invoking the end-user clearing exception is an SEC Filer, two additional items of information must be provided:

- Proposed Rule 3Cg-1(a)(6)(i) requires an SEC Filer invoking the end-user clearing exception to specify its SEC Central Index Key number. Collection of this information will allow the Commission to cross reference materials filed with the relevant SDR with information in periodic reports and other materials filed by the SEC Filer with the Commission.³⁶
- Proposed Rule 3Cg-1(a)(6)(ii) requires confirmation that an appropriately authorized committee of the board of directors or equivalent governing body of the SEC Filer invoking the clearing exception has reviewed and approved the decision to enter the security-based swap subject to the end-user clearing exception.³⁷ The Commission preliminarily believes collection of this information is appropriate to promote compliance with the requirements of the end-user clearing exception.

Request for Comment:

The Commission generally requests comments on all aspects of proposed Rule 3Cg-1.

Additionally, the Commission requests comments on the following specific issues:

authorized to review and approve the issuer's decisions to enter into security-based swaps).

³⁶ Exchange Act Section 3C(i) contemplates board review and approval of the decision to enter into the swap that is subject to the exemption. See Item 305 of Regulation S-K, 17 CFR 229.305.

³⁷ 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 reporting person not to clear the security-based swap being reported. In turn, such board committee also could adopt policies and procedures regarding the review and approval required by Exchange Act Section 3C(i), which may include periodic consideration of the relative costs, risk management characteristics and other features of cleared and non-cleared security-based swaps.

- Is it sufficiently clear what information the Commission is requiring to be reported under proposed Rule 3Cg-1? If not, why not? Are there clarifications or instructions the Commission could adopt that would be useful for parties seeking to invoke the end-user clearing exception? If so, what are they and what would be the benefits of adopting them?
- Would it be difficult or prohibitively expensive for counterparties to report the information required under the proposed Rule 3Cg-1? If so, why?
- Should the Commission require more or less frequent notifications to the Commission than are currently contemplated by proposed Rule 3Cg-1? What other types of notifications should the Commission consider and what would be the potential frequency associated with such notifications? Are the requirements that the information provided under the proposal be accurate as of the date and time the information is provided to the SDR appropriate? Should the Commission consider any other time frame for accuracy of information? If so, what time frame should the Commission consider and what would be the advantages or disadvantages of such time frame?
- Should the Commission consider collecting more or less information than it has proposed to collect in connection with the Financial Obligation Notice? Is other information needed to achieve the purposes of the Dodd-Frank Act with respect to how an end-user meets its financial obligations or in order to prevent evasion of the end-user clearing exception? For example, is it necessary or appropriate for the Commission to collect:
 - Additional information from that proposed regarding the credit support agreement and the collateral practices under the agreement, such as the level of margin collateral outstanding (e.g., less than or equal to a specified dollar

amount, or greater than a series of progressively higher dollar amounts) or the frequency of portfolio reconciliation?

- Additional information from that proposed regarding the types of collateral provided (e.g., cash, government securities, other securities, other collateral) by an end-user and the effect of the liquidity of such collateral on the ability of the end-user to meet its financial obligations?
- Additional information from that proposed regarding specific terms of the credit support agreement, such as whether the collateral requirements are unilateral or bilateral provisions and whether there are contractual terms triggered by changes in the credit rating or other financial circumstances of one or both of the counterparties?
- Additional information from that proposed about the guarantor, such as whether or not the guarantor is a parent or affiliate of the person invoking the end-user clearing exception?
- Additional information from that proposed regarding the assets pledged, such as the type of security interest or the type of property being used as collateral?
- Additional information from that proposed regarding the segregation arrangements, such as the identity of the collateral agent or other third party involved in the arrangement, and information regarding whether the arrangement involves a custodial, tri-party or different type of relationship?
- Additional information from that proposed regarding the adequacy of other means being used, or the adequacy of the financial resources available, to meet the financial obligations associated with the non-cleared security-based swap?
- Additional information from that proposed regarding the review and approval by the appropriate committee of the SEC Filer's board or governing body of the

issuer's decision to enter into the security-based swap subject to the end-user clearing exception, such as information provided to the committee and/or a summary of the policies and procedures used by the committee in practice?

- Are each of the terms used in Exchange Act Section 3C(g)(4) sufficiently clear to permit compliance with proposed Rule 3Cg-1 by affiliates invoking the end-user clearing exception? Should the Commission adopt more specific requirements to implement the provisions of Exchange Act 3C(g)(4)? Should the Commission provide further guidance on terms used in Exchange Act Section 3C(g)(4), such as the meaning of the term “predominantly engaged”? If so, what specific rules or guidance should the Commission consider and what would be the benefits of adopting them?
- Are the requirements of Exchange Act Section 3C(i) sufficiently clear to permit compliance with proposed Rule 3Cg-1 by parties invoking the end-user clearing exception? Should the Commission adopt more specific requirements to implement the provisions of Exchange Act 3C(i)? For example, should the Commission adopt provisions to specify the membership or other characteristics of the board committee, such as that a majority of the committee, or the entire committee, consist of independent directors? Should the Commission adopt provisions to clarify the steps that should be taken by board committees reviewing and approving an SEC Filer's decision to enter into security-based swaps subject to the end-user clearing exception? If so, what specific rules should the Commission consider and what would be the benefits or disadvantages of adopting them? Should the review and approval contemplated by Exchange Act Section 3C(i) include a review and approval of the SEC Filer's decisions by a board committee (1) composed of a majority of independent directors, (2) that has adopted procedures pursuant to which security-based swap transactions that are subject to the end-user clearing exception may be entered into by

the company, which are reasonably designed to facilitate a risk management policy that has been approved by the board or an appropriate committee, (3) that makes and approves such changes to the policy as the committee deems necessary, and (4) determines no less frequently than quarterly that all security-based swap transactions entered into during the preceding quarter subject to the end-user clearing exception were effected in compliance with such procedures?³⁸ Are there other Commission rules concerning board approvals that may be useful models for the review and approval contemplated by Exchange Act Section 3C(i)?

- Is the meaning of the term “issuer of securities” as used in Exchange Act Section 3C(i) sufficiently clear? Is there a better alternative that the Commission should consider?
- Should the Commission consider requiring parties invoking the end-user clearing exception to report additional types of information, to limit the possibility for the exception to be abused or for other reasons? If so, what other information should be reported and what would be the benefit of requiring such information to be reported? What categories of information, if any, should not be required to be reported and why?
- Will some types of security-based swaps be more susceptible to abuse than others?

For example:

- Are persons more or less likely to abuse the end-user clearing exception in connection with credit default swaps or equity swaps or when the underlying reference credit or security has certain characteristics?
- Are large or small companies or other identifiable sub-categories of counterparties to security-based swaps more or less likely to abuse the end-user clearing exception than other persons?

³⁸ Cf., 17 CFR 270.17a-7(e) (Rule 17a-7(e) under the Investment Company Act of 1940).

- Are there certain security-based swap products or counterparties that the Commission should monitor for abuse more closely than others?

If so, why?

- Are there different considerations for small companies or other identifiable categories of persons who may wish to invoke the end-user clearing exception? If so, what are they and how should the Commission take these considerations into account?
- Should the Commission consider requiring that a narrative statement be provided when an end-user employs means other than those described in proposed Rules 3Cg-1(a)(5)(i), (ii), (iii), or (iv) to meet its financial obligations?

3. Form of Notice to the Commission

Proposed Rule 3Cg-1(a) provides that a counterparty to a security-based swap that invokes the end-user clearing exception shall satisfy the notice requirements of Exchange Act Section 3C(g)(1)(C) by delivering or causing to be delivered the additional information specified in proposed Rule 3Cg-1(a) to a registered SDR or the Commission in the form and manner required for delivery of the information separately specified under proposed Rule 901(d) of Regulation SBSR.³⁹ Delivery of such information would also allow the information submitted pursuant to proposed Rule 3Cg-1(a) by the counterparty invoking the end-user clearing exception to be made available to the public by the SDR, to the extent required by

³⁹ See Regulation SBSR Proposing Release, *supra* note 16. For each security-based swap transaction made in reliance on the end-user clearing exception, proposed Rule 901(d)(1)(ix) under Regulation SBSR requires parties to a security-based swap to indicate whether or not the end-user clearing exception is being invoked when reporting transaction information to an SDR as required by Exchange Act Section 13(m)(1)(F). Proposed Exchange Act Rule 901(a) under Regulation SBSR defines which of the parties to a security-based swap will be designated the Reporting Party for these purposes. The information required under proposed Exchange Act Rule 3Cg-1 would be in addition to these requirements but would be delivered to the SDR by the Reporting Party in the same manner as required by proposed Regulation SBSR. Regulation SBSR contemplates that information may be delivered to the Commission directly in limited circumstances when an SDR is not available. When permitted by Regulation SBSR, such delivery would also meet the end-user clearing exception notice requirement.

proposed Regulation SBSR.⁴⁰ Under this approach, rather than collecting information through a separate process established by the Commission for these purposes, the information delivered in compliance with the requirements of proposed Rule 3Cg-1(a) and proposed Regulation SBSR would serve as the official notice of a security-based swap transaction made in reliance on the end-user clearing exception.

The Dodd-Frank Act requires all transactions in security-based swaps (whether cleared or non-cleared) to be reported to a registered SDR or the Commission.⁴¹ As centralized recordkeeping facilities of OTC derivatives transactions, SDRs are intended to play a critical role in enhancing transparency in the security-based swap markets. SDRs will enhance transparency by having complete records of security-based swap transactions, maintaining the integrity of those records, and providing effective access to those records to relevant authorities and the public in line with their respective information needs.⁴² The Commission recently

⁴⁰ See Regulation SBSR Proposing Release, at Section V., supra note 16, discussing public dissemination of security-based swap transaction information generally, including Exchange Act Section 13(m)(1)(B) (authorizing the Commission to make security-based swap transaction data available to the public to enhance price discovery) and Exchange Act Section 13(m)(1)(E)(iv) (requiring the Commission to consider whether public disclosure of security-based swap transaction data will materially reduce market liquidity). The Commission preliminarily believes information collected pursuant to proposed Rule 3Cg-1 would not be required to be publicly disseminated, but is requesting comments on this point. See infra note 47 and accompanying text.

⁴¹ See Pub. L. No. 111-203, §§ 763(i) and 766(a) (adding Exchange Act Sections 13(m)(1)(G) and 13A(A)(1), respectively).

⁴² In the case of non-cleared security-based swaps, each SDR is required to confirm with both parties to the security-based swap the accuracy of the data submitted to the SDR pursuant to Exchange Act Section 13(n)(5)(B), and both the parties to the security-based swap and the SDR have duties to correct errors in the data that may be identified under proposed Rules 905(a) (parties to the security-based swap) and 905(b) (SDRs) of Regulation SBSR. See Pub. L. No. 111-203, § 763(i) (adding Exchange Act Section 13(n)(5)(B); Regulation SBSR Proposing Release, supra note 16. SDRs are required by Exchange Act Section 13(n)(5) (15 U.S.C. 78m(n)(5)) to have policies and procedures reasonably designed to protect the privacy of all transaction information received by the SDR, and the Commission recently proposed Rule 13n-9 to implement this requirement. See Exchange Act Release No. 63347 (Nov. 19, 2010), 75 FR 77306

proposed a series of new rules relating to the SDR registration process, duties, and core principles to ensure that SDRs operate in the manner contemplated by the Dodd-Frank Act.⁴³

The Commission also recently proposed Regulation SBSR to establish the standards that would apply when information is submitted to an SDR.⁴⁴

The Commission preliminarily believes collecting notice information for the end-user clearing exception through SDRs will support the development of straight through trade processing, help to reduce the administrative burdens of the notice requirement and assure the accuracy of the information collected.⁴⁵ Using the centralized facilities of SDRs should also make it easier for the Commission to analyze how the end-user clearing exception is being used, monitor for potentially abusive practices, and take timely action to address abusive practices if they were to develop.⁴⁶

(Dec. 10, 2010) (“Regulation SDR Release”). Exchange Act Section 13A(c) requires each party to a non-cleared security-based swap to maintain records of the security-based swaps held by such party in the form required by the Commission, and Exchange Act Section 13A(d) mandates that these records must be in a form not less comprehensive than required to be collected by SDRs. See Pub. L. No. 111-203, § 766(a) (adding Exchange Act Sections 13A(c)-(d)). These records are available for inspection by the Commission and other specified authorities pursuant to Exchange Act Section 13A(c)(2) (Pub. L. No. 111-203, § 766(a) (adding Exchange Act Section 13A(c)(2))).

⁴³ See Regulation SDR Release, supra note 42.

⁴⁴ See id.

⁴⁵ See id. Exchange Act Sections 13(n) and 13A require parties to report transaction information to SDRs, confirm its accuracy and correct inaccuracies. See Pub. L. No. 111-203, § 763(i) (adding Exchange Act Section 13(n)); Pub. L. No. 111-203, § 766(a) (adding Exchange Act Section 13A). The Commission preliminarily believes these requirements create sufficient assurance to consider the transaction records collected by SDRs reliable for use in connection with regulatory decisions, and therefore the Commission preliminarily believes the records should also be considered reliable for purposes of the notice requirement under Exchange Act Section 3C(g). Pub. L. No. 111-203, § 763(a) (adding Exchange Act Section 3C(g)).

⁴⁶ The proposed notification method is supported by the recordkeeping requirements under Exchange Act Section 13A, which will permit the Commission to review transaction information and take such action as may be necessary to prevent abuses of the end-user clearing exception. See Pub. L. No. 111-203, § 766(a) (adding Exchange

Under proposed Regulation SBSR, and in particular proposed Rule 901(d), the information required to be reported to an SDR includes, if the security-based swap is not cleared, “whether the exception in Section 3C(g) of the Exchange Act was invoked.” This information would then be included in the transaction report disseminated to the public under proposed Rule 902. Pursuant to proposed Rule 3Cg-1(a), however, the information required to be reported to an SDR would include more detailed information than simply whether Section 3C(g) was invoked – for example, under Rule 3Cg-1(a) the reportable information would include the identity of the counterparty relying on the clearing exception, and information regarding how that counterparty expects to meet its financial obligations. The Commission preliminarily believes that this additional information would either fall under the exception to public dissemination contained in proposed Rule 902(c)(2),⁴⁷ or otherwise should be excluded from the publicly-disseminated transaction report. Thus, the only information collected pursuant to Rule 3Cg-1 that would be disseminated publicly is “whether the exception to Section 3C(g) of the Exchange Act was invoked.”

Request for Comment:

The Commission generally requests comments on all aspects of proposed Rule 3Cg-1. Additionally, the Commission requests comments on the following specific issues:

- Is it appropriate for the Commission to require notification regarding use of the end-user clearing exception to be made through SDRs? Should notifying the Commission necessarily involve direct conveyance of the information to the

Act Section 13A). Such Commission action would be taken in a manner consistent with our review practices for other transaction information submitted to SDRs, rather than through a separate process developed for these purposes, thereby helping to maintain consistency of regulatory action in comparable areas.

⁴⁷ Proposed Rule 902(c)(2) of Regulation SBSR would prohibit disclosure of any information disclosing the business transactions and market positions of any person with respect to a security-based swap that is not cleared. See supra note 16 (citing Regulation SBSR Proposing Release).

Commission rather than delivery through an SDR? What are the advantages or disadvantages of the Commission's proposal?

- Does collecting Financial Obligation Notice information through SDRs interfere with the ability of non-financial entities to use the end-user clearing exception in any way? Are SDRs reliable enough to be used for these purposes? Are the services provided by SDRs reasonably available to non-financial entities?
- Is Financial Obligation Notice information different from other information proposed to be collected by SDRs in some respect that makes use of SDRs for these purposes inappropriate? If so, how is the notice information different and why is it inappropriate to use SDRs to collect the information?
- Would it be preferable to require notice of use of the end-user clearing exception to be given through the Commission's EDGAR system on a newly developed EDGAR form?⁴⁸ What would be the advantages or disadvantages of using the EDGAR system? For example:
 - Do parties intending to invoke the end-user clearing exception anticipate any benefits or burdens of filing an EDGAR form electronically that should be considered?
 - Is the EDGAR system likely to be familiar to all entities invoking the end-user clearing exception? Will small companies or other identifiable categories of persons face different burdens or advantages than others when using the EDGAR system?

⁴⁸ See EDGAR Filer Manual, Volume I: "General Information" Version 8 (Sept. 2009), incorporated by reference into the Code of Federal Regulations (Release Nos. 33-9058, 34-60390, 39-2466, IC-28838, July 28, 2009); EDGAR Filer Manual, Volume II: "EDGAR Filing," Version 15 (Aug. 2010), incorporated by reference into the Code of Federal Regulations (Release Nos. 33-9140; 34-62873; 39-2471; IC-29413, Sept. 9, 2010).

- Should the Commission require persons invoking the end-user clearing exception to submit notice to the Commission on an EDGAR form in addition to the information collected through SDRs? Would collecting information in both ways significantly aid the Commission's efforts to prevent abuse of the end-user clearing exception or have other benefits that should be considered by the Commission? Would doing so create significant additional burdens for persons invoking the end-user clearing exception?
- Other than the alternative of using the Commission's EDGAR system, are there other methods that the Commission should consider for receiving notification regarding the use of the end-user clearing exception? For example, could the information submitted to an SDR also be dually submitted to Commission in some form? If so, what are the possible alternatives and what advantages or disadvantages would they have?
- Do the Exchange Act and the associated rules and proposed rules regulating SDRs and parties to security-based swaps create sufficient assurance that notice information collected through SDRs will be accurate? Are there additional protections the Commission should establish to create greater assurance that the notice information collected will be accurate? If so, what are they and how will they improve the information collection process?
- Would the person reporting information to the SDR be in a position to know, in all cases, the information the Commission is requiring to be reported under proposed Rule 3Cg-1(a)? If not, why not? Are representations and warranties and similar established market practices associated with documenting security-based swap transactions adequate to ensure the person reporting information to the SDR can obtain the information required to be reported under proposed Rule 3Cg-1?

- Should the Commission consider more or less frequent reporting of the information required by Rule 3Cg-1(a)? How frequently will the information required to be reported be expected to change? Would alternatives to proposed Rule 3Cg-1 such as the collection of periodic reports or updates of general notifications to the Commission be sufficient to achieve the purposes of Exchange Act Section 3C(g)? If so, what are the possible alternatives and what advantages or disadvantages would they have?
- How long would it be expected to take for the person reporting information to the SDR to gather the information required under proposed Rule 3Cg-1(a)? Will the time needed to gather the required information disrupt the transaction process for security-based swaps to any material extent?
- Should the Commission require persons invoking the end-user clearing exception to follow additional compliance practices in some circumstances? For example:
 - Should the Commission require persons invoking the end-user clearing exception swap to create additional records of the means being used to mitigate the credit risk of the security-based swap as contemplated by proposed Rule 3Cg-1(a)(5) and maintain such record in the manner required by Exchange Act Section 13A(d)?
 - Should the Commission require persons invoking the end-user clearing exception to file materials referred to in proposed Rule 3Cg-1(a)(5) with the Commission? Why or why not?
 - Should the Commission require persons invoking the end-user clearing exception to establish any other additional compliance practices? If not, why not? If so, what should those practices be and what would be the advantages and disadvantages of adopting such a requirement?

- Will collecting notice information together with other transaction information have the advantages expected by the Commission? For example, will analyzing information regarding use of the end-user clearing exception by product type and other transaction characteristics help to promote market efficiency or inform future Commission rulemaking? Are there other advantages or disadvantages related to collecting notice information through SDRs that the Commission should consider? If so, what are they?
- Does collecting notice information regarding use of the end-user clearing exception through SDRs create significantly greater burdens or advantages for some parties to security-based swaps compared to others? For example, will parties who frequently transact security-based swaps face higher or lower burdens or advantages compared to parties that enter into security-based swap transactions less frequently? Will parties who enter into both cleared and non-cleared security-based swaps face different burdens or advantages in comparison to parties who enter into only cleared security-based swaps or only non-cleared security-based swaps? Will small companies face different burdens than large companies? If so, what steps should the Commission consider taking to account for these differences? Given that certain efficiencies may arise from conducting frequent transactions in security-based swaps, are the additional burdens that may be faced by small companies or non-financial entities that enter into security-based swaps infrequently unique to the proposed rule or do they principally reflect the nature of the security-based swaps market and the nature of the transacting party? Are there benefits from collecting notice information that should also be considered?
- Should any or all of the information required to be reported to an SDR pursuant to proposed Rule 3Cg-1(a) be publicly disseminated? Should public dissemination be limited only to the fact that Exchange Act Section 3C(g) was invoked? Are there any

changes to the proposed rules the Commission should consider regarding public dissemination? If publicly disclosed, how would market participants, academics and other members of the public expect to use such information and what are the potential benefits or costs of such uses? Would additional information be useful? What information, if any, included in proposed Rule 3Cg-1(a) would raise concerns for end-users if made public after the end-user elected to use the exception? How would the public interest be better served by keeping information relating to the end-user clearing exception in or out of the public domain?

- If restrictions on public dissemination of the information are in place, should the Commission consider permitting such dissemination after the lapse of a certain period of time? If so, should all or only a subset of the information be disseminated? What would be an appropriate time period for a delay in dissemination? How would the analysis of whether the public interest would be better served by keeping information relating to the end-user clearing exception in or out of the public domain change based on whether there is a delay in such dissemination?
- Should information regarding whether the end-user clearing exception was invoked that is collected pursuant to proposed Rule 3Cg-1(a) be made available to the public through the SDR or through new processes established by the Commission? What would be the advantages and disadvantages of either approach?

B. Hedging or Mitigating Commercial Risk

To apply the end-user clearing exception, Exchange Act Section 3C(g)(1)(B) requires a non-financial entity to determine whether it uses security-based swaps to hedge or mitigate commercial risk.⁴⁹ The phrase “hedging or mitigating commercial risk” is itself the subject of current joint rulemaking by the Commission and the CFTC. The Commission and the CFTC

⁴⁹ See Pub. L. No. 111-203, § 763(a) (adding Exchange Act Section 3C(g)(1)(B)).

recently proposed a definition of “hedging or mitigating commercial risk” under proposed Exchange Act Rule 3a67-4 that the Commission preliminarily believes should also govern the meaning of “hedging or mitigating commercial risk” for purposes of Exchange Act Section 3C(g)(1)(B).⁵⁰ The Commission preliminarily believes this approach should ensure consistency of interpretation across the Exchange Act provisions for which this concept is

⁵⁰ See Definitions Proposing Release, *supra* note 3. Persons wishing to comment on the definition of “hedging or mitigating commercial risk” should submit comments pursuant to the Definitions Proposing Release. For reference, proposed Exchange Act Rule 3a67-4(a) reads as follows:

“Hedging or mitigating commercial risk

For purposes of section 3(a)(67) of the Act, 15 U.S.C. 78c(a)(67) and §240.3a67-1 of this chapter, a security-based swap position shall be deemed to be held for the purpose of hedging or mitigating commercial risk when:

- (a) Such position is economically appropriate to the reduction of risks that are associated with the present conduct and management of a commercial enterprise, or are reasonably expected to arise in the future conduct and management of the commercial enterprise, where such risks arise from:
- (1) The potential change in the value of assets that a person owns, produces, manufactures, processes, or merchandises or reasonably anticipates owning, producing, manufacturing, processing, or merchandising in the ordinary course of business of the enterprise;
 - (2) The potential change in the value of liabilities that a person has incurred or reasonably anticipates incurring in the ordinary course of business of the enterprise; or
 - (3) The potential change in the value of services that a person provides, purchases, or reasonably anticipates providing or purchasing in the ordinary course of business of the enterprise;
- (b) Such position is:
- (1) Not held for a purpose that is in the nature of speculation or trading;
 - (2) Not held to hedge or mitigate the risk of another security-based swap position or swap position, unless that other position itself is held for the purpose of hedging or mitigating commercial risk as defined by this section or 17 CFR § 1.3(tt); and
- (c) The person holding the position satisfies the following additional conditions:
- (1) The person identifies and documents the risks that are being reduced by the security-based swap position;
 - (2) The person establishes and documents a method of assessing the effectiveness of the security-based swap as a hedge; and
 - (3) The person regularly assesses the effectiveness of the security-based swap as a hedge.”

relevant and provide assurance of fair and equivalent treatment for similarly situated parties in a wide variety of circumstances.⁵¹

Request for Comment:

The Commission generally requests comments on all aspects of proposed Rule 3Cg-1. Additionally, the Commission requests comments on the following specific issues:

- Are there reasons to believe that the proposed joint rulemaking by the Commission and the CFTC to define the meaning of certain terms used in the Exchange Act may affect the availability of the end-user clearing exception? If so, what specifically are the affects expected and what concerns do they raise?
- Are there further distinctions or clarifications that should be made by the Commission for purposes of the end-user clearing exception that are different from those being made in connection with the proposed joint rulemaking by the Commission and the CFTC? If so, what are they and what would be the benefits of adopting them?
- Are there technical requirements or details associated with terms used in the definition of “financial entity” in Exchange Act Section 3C(g)(3) that may have unexpected consequences when used in connection with the end-user clearing exception? Are there aspects of the CEA, the Investment Advisers Act of 1940 (15

⁵¹ The Commission notes that certain portions of proposed Rule 3a67-4 would be either inapplicable to, or would need to be interpreted in light of, the circumstances surrounding the end-user clearing exception. For example, subparagraph 3a67-4(c)(3) of the proposed Rule requires that a person regularly assess the effectiveness of the security-based swap as a hedge. Given that persons must determine whether the end-user clearing exception is available at the time the security-based swap is first confirmed, this portion of proposed Rule 3a67-4 is inapplicable for purposes of Exchange Act Section 3C(g)(1)(B). In addition, proposed Rule 3a67-4 does not contemplate applying the definition of hedging or mitigating commercial risk to affiliates. Exchange Act Section 3C(g)(4) creates certain additional requirements for affiliates of non-financial entities seeking to invoke the end-user clearing exception, and these requirements must also be satisfied for the end-user clearing exception to be available.

U.S.C. 80), the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002), or the Bank Holding Company Act of 1956 (12 U.S.C. 184) that are incorporated in the definition that may need to be taken into consideration by the Commission to ensure the end-user clearing exception is available in appropriate circumstances? If so, what specific changes should the Commission consider and what would be the benefits of adopting them?

- Should the Commission consider adopting a separate definition of “hedging or mitigating commercial risk” specifically designed to address the circumstances of the end-user clearing exception? If so, what are the specific considerations associated with the end-user clearing exception that make a separate rule desirable? What features would such a rule need in order to be effective and what would be the benefits of adopting them?
- Should the Commission consider limiting or broadening the definition of “hedging or mitigating commercial risk” as it applies to the end-user clearing exception? For example, should security-based swaps subject to the end-user clearing exception be required to hedge or mitigate commercial risk on a single risk or an aggregate risk basis, and/or on a single entity or a consolidated basis? Are more specific industry-specific rules on hedging or rules that apply only to certain categories of asset classes appropriate at this time? Should security-based swaps facilitating asset optimization or dynamic hedging be included? Why or why not? Commenters are requested to discuss both the policy and legal bases underlying such comments.
- If an entity is designated as a swap dealer, security-based swap dealer, major swap participant or major security-based swap participant only for some of its swaps or security-based swaps, should it be treated as a financial entity under Exchange Act

Section 3C(g)(3) and thereby be disqualified from invoking the end-user clearing exception for all of its security-based swaps? If so, why? If not, should the Commission require security-based swap dealers and major security-based swap participants in that position to separate or otherwise keep distinct those security-based swap activities for which they are designated as a security-based swap dealer or major security-based swap participant from their other security-based swap activities? If so, how? If not, why not?

III. Required Consideration of a Clearing Exemption for Small Banks, Savings Associations, Farm Credit System Institutions and Credit Unions

Mandatory clearing of security-based swaps is a central part of the reforms enacted by the Dodd-Frank Act and generally applies to financial entities without regard to size. However, Section 3C(g)(3)(B) of the Exchange Act requires the Commission to consider whether to exempt small banks, savings associations, farm credit systems institutions and credit unions from the Exchange Act's definition of "financial entity", including specifically those with total assets of \$10,000,000,000 or less ("Identified Financial Institutions").⁵² The advantages and disadvantages associated with mandatory clearing may be different with respect to certain types of financial entities and the Commission is required to consider whether such differences warrant granting an exemption for Identified Financial Institutions.⁵³

The Identified Financial Institutions may use security-based swaps, and other derivatives to hedge or mitigate their business risks in ways that may be directly related to the business of banking. Under the definition of "financial entity" in the Dodd-Frank Act, however, these institutions would not qualify to use the end-user clearing exception unless further action is taken by the Commission. Depending on the extent to which an Identified Financial Institution relies on security-based swaps to manage its risk, the lack of an end-user

⁵² See Pub. L. No. 111-203, § 763(a) (adding Exchange Act Section 3C(g)(3)(B)).

⁵³ See Dodd-Lincoln Letter, *supra* note 23.

exception could limit the availability, or raise associated initial costs, of security-based swaps for that institution.

Alternatively, providing a blanket carve-out from the clearing requirement, albeit in connection with hedging transactions, for a class of financial entities could undercut the statutory goal of greater centralized clearing and the related benefits of efficiency and transparency. The Commission preliminarily does not believe that Identified Financial Institutions transact in securities-based swaps for hedging purposes in significant volume, but is requesting comments on this point. The Commission would also be interested in commenters' views on the practical impact of either permitting or prohibiting Identified Financial Institutions from using the end-user exception to effect securities-based swaps transactions, and how narrowly or broadly any exemption should be structured.⁵⁴

In accordance with Section 3C(g)(3)(B) of the Exchange Act and taking the above considerations into account, the Commission is proposing alternative additional rule text under consideration in proposed Rules 3Cg-1(b) and (c) to exclude from the definition of "financial entity" those banks, savings associations, farm credit systems institutions and credit unions with total assets of \$10 billion or less falling within the definition of "financial entity" solely because of Section 3C(g)(3)(A)(viii) of the Exchange Act. The Commission preliminarily believes it would be appropriate to consider an alternative that contains an exemption for such

⁵⁴ See S. Rep. No. 111-176, at 34 (2010) (Report of the Senate Committee on Banking, Housing, and Urban Affairs regarding The Restoring American Financial Stability Act of 2010 discussing the end-user clearing exception and exceptions from bilateral reporting, capital and margin requirements, and stating that "Some parts of the OTC market may not be suitable for clearing and exchange trading due to individual business needs of certain users. Those users should retain the ability to engage in customized, uncleared contracts while bringing in as much of the OTC market under the centrally cleared and exchange-traded framework as possible. Also, OTC (contracts not cleared centrally) should still be subject to reporting, capital, and margin requirements so that regulators have the tools to monitor and discourage potentially risky activities, except in very narrow circumstances. These exceptions should be crafted very narrowly with an understanding that every company, regardless of the type of business they are engaged in, has a strong commercial incentive to evade regulatory requirements.")

entities at the \$10 billion total assets threshold because it would be consistent with the consideration contemplated in Section 3C(g)(3)(B) of the Exchange Act and because it may include financial institutions in the relevant categories that may face difficulties in meeting the burdens associated with a mandatory clearing requirement due to their limited operations or infrequent use of security-based swaps.

Specifically, the alternative language would apply to a bank, as defined in Section 3(a)(6) of the Exchange Act, the deposits of which are insured by the Federal Deposit Insurance Corporation; a savings association, as defined in section 3(b) of the Federal Deposit Insurance Act (12 U.S.C. 1831), the deposits of which are insured by the Federal Deposit Insurance Corporation; a farm credit system institution chartered under the Farm Credit Act of 1971 (12 U.S.C. 2001); or an insured Federal credit union, State credit union or State-chartered credit union under the Federal Credit Union Act (12 U.S.C. 1752) falling within the definition of “financial entity” solely because of Section 3C(g)(3)(A)(viii) of the Exchange Act. The exemption would not be available to any institution that falls into any of the other seven categories specified in Exchange Act Section 3C(g)(3) for any reason. The \$10 billion total asset threshold for these entities would be measured by reference to the total assets of the institution on the last day of the most recent fiscal year. The Commission believes it would be appropriate to consider such time frame for measurement of the \$10 billion threshold in order to balance the need to maintain an updated assessment of the total asset threshold and the need to avoid frequently monitoring the ability to make use of the exemption.

Request for Comment:

The Commission generally requests comments on all aspects of proposed Rule 3Cg-1. In addition, to inform our consideration of whether it would be appropriate for the Commission to provide an exemption for Identified Financial Institutions, the Commission requests comments on the following specific issues:

- Should the Commission grant an exemption from mandatory clearing requirements for Identified Financial Institutions? Would it be better for the Commission to simply require Identified Financial Institutions to follow the same clearing requirements as other financial entities? Why or why not?
- Is the proposed alternative language in proposed Rules 3Cg-1(b) and (c) sufficiently clear to allow Identified Financial Institutions to assess whether or not they would qualify to use the alternative proposed end-user clearing exception? Why or why not? If not, what steps could the Commission take to make the standards more clear and what would be the advantages or disadvantages of the alternative approach?
- How significant are the aggregated activities of Identified Financial Institutions to the security-based swap market currently? Do the activities of such institutions have a material effect on the pricing of swaps, or contribute to an understanding of the security-based swap market? What is the aggregate gross exposure of security-based swaps held by Identified Financial Institutions? How would these activities and exposures change if such institutions were excluded from the mandatory clearing requirement? Is it possible that the activities of such institutions could change in a way such that they could have an effect on the pricing of security-based swaps if they are excluded from the mandatory clearing requirement? If so, what would be the effect on pricing of security-based swaps?
- What types of security-based swap transactions do Identified Financial Institutions enter into and why? Are any risks presented by these types of transactions adequately addressed through the regulatory controls and business practices of Identified Financial Institutions? Should the Commission consider treating different types of security-based swaps differently when considering whether the

end-user clearing exception is available for Identified Financial Institutions? If so, what specific distinctions should be considered by the Commission and what would be the advantages and disadvantages of adopting them?

- Would there be any benefit for Identified Financial Institutions in receiving an exemption taking into account their anticipated activity in the security-based swap market? What would be the potential effects of granting an exemption for Identified Financial Institutions? What would be the effect on the security-based swap market? What would be the effect on the goals of promoting central clearing and reducing systemic risk?
- If an exemption permitting Identified Financial Institutions to use the end-user clearing exception were to be adopted, should the Commission consider limiting the availability of the end-user clearing exception to only some of the financial institutions identified in Exchange Act Section 3C(g)(3)(B)? Are there differences in the supervisory regimes applicable to banks, savings associations, farm credit institutions and credit unions that create material substantive differences between such institutions that are relevant for these purposes? If so, what specific distinctions should be considered by the Commission and what would be the benefits of adopting them?
- Do Identified Financial Institutions commonly enter into security-based swaps? Would such institutions' behavior in respect of security-based swaps change if the end-user exception was extended or not extended to include them?
- What would be the possible consequences of not proposing an exemption on the banking activities and operational practices of Identified Financial Institutions? Would the absence of an exemption prevent Identified Financial Institutions from providing or increase the costs of providing certain types of financial services to

their customers or require them to make additional investments? If so, how?

What types of services and what types of customers might be impacted? What types of investments might be required? Would the expected impact be justified by the systemic or other benefits of requiring mandatory clearing?

- Is the \$10,000,000,000 total asset threshold an appropriate point for the Commission to use when defining the availability of a clearing exception for Identified Financial Institutions? Should the threshold be lower? Should the threshold be higher? Is there a measure other than total assets, or a more precise definition of total assets, that should be used for these purposes, and if so, what would be the benefit of adopting the alternative measure?
- What would be an appropriate frequency for measuring compliance with the \$10,000,000,000 total asset threshold for entities? Is the proposed time frame too long or too short? If so, why? Are there any difficulties in measuring or monitoring such threshold? Would Identified Financial Institutions generally measure and monitor such thresholds as part of their normal business practices?

IV. General Request for Comments

The Commission is requesting comments from all members of the public. The Commission will carefully consider the comments that it receives. The Commission seeks comment generally on all aspects of the proposed rule. In addition, the Commission seeks comment on the following:

1. Should the Commission clarify or modify any of the definitions included in the proposed rules? If so, which definitions and what specific modifications are appropriate or necessary?
2. Are the obligations in the proposed rule sufficiently clear? Is additional guidance from the Commission necessary?

3. What are the technological or administrative burdens of complying with the rule proposed by the Commission? Does the method of collecting information contained in the proposed rule offer any technological or administrative advantages in comparison to other possible methods?
4. Should the Commission implement substantive requirements in addition to, or in place of, the requirements in the proposed rule?

In addition, the Commission seeks commenters' views regarding any potential impact of the proposal on non-financial entities expecting to invoke the end-user clearing exception, SDRs, other market participants, and the public generally. The Commission seeks comments on the proposal as a whole, including its interaction with the other provisions of the Dodd-Frank Act. The Commission seeks comments on whether the proposals would help achieve the broader goals of increasing transparency and accountability in the OTC derivatives market.

The Commission requests comment generally on whether its proposed actions today to govern the exception to mandatory clearing of security-based swaps available under Exchange Act Section 3C(g) are necessary or appropriate for those purposes. If commenters do not believe the provisions of the proposed rule are necessary and appropriate, why not? What would be the preferred action?

Title VII requires that the SEC consult and coordinate to the extent possible with the CFTC for the purposes of assuring regulatory consistency and comparability, to the extent possible, and states that in adopting rules, the CFTC and SEC shall treat functionally or economically similar products or entities in a similar manner.

The CFTC is proposing rules related to an exception to mandatory clearing of swaps as required under Section 723(a) of the Dodd-Frank Act. Understanding that the Commission and the CFTC regulate different products and markets, and as such, appropriately may be

proposing alternative regulatory requirements, we request comments on the impact of any differences between the Commission and CFTC approaches to the regulation of swap data repositories and SDRs, respectively. Specifically, do the regulatory approaches under the Commission's proposed rulemaking pursuant to Section 763(a) of the Dodd-Frank Act and the CFTC's proposed rulemaking pursuant to Section 723(a) of the Dodd-Frank Act result in duplicative or inconsistent efforts on the part of market participants subject to both regulatory regimes or result in gaps between those regimes? If so, in what ways do commenters believe that such duplication, inconsistencies, or gaps should be minimized? Do commenters believe the approaches proposed by the Commission and the CFTC to govern the end-user clearing exception to mandatory clearing of security-based swaps and swaps are comparable? If not, why? Do commenters believe there are approaches that would make the end-user clearing exceptions for security-based swaps and swaps more comparable? If so, what are they and what would be the benefits of adopting such approaches? Do commenters believe that it would be appropriate for us to adopt an approach proposed by the CFTC that differs from our proposal? If so, which one?

Commenters should, when possible, provide the Commission with empirical data to support their views. Commenters suggesting alternative approaches should provide comprehensive proposals, including any conditions or limitations that they believe should apply, the reasons for their suggested approaches, and their analysis regarding why their suggested approaches would satisfy the statutory mandate contained in Section 763(a) of the Dodd-Frank Act governing the exception to mandatory clearing of security-based swaps.

V. Paperwork Reduction Act Analysis

Proposed Rule 3Cg-1

Proposed Rule 3Cg-1 Notice to the Commission [and Financial Entity Exemption] contains "collection of information" requirements within the meaning of the Paperwork

reduction Act of 1995 (44 U.S.C. §3501 et seq.). The Commission has submitted it to the Office of Management and Budget (“OMB”) for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The title of the new collection of information under proposed Rule 3Cg-1 under the Exchange Act is "Rule 3Cg-1 Notice to the Commission [and Financial Entity Exemption]." OMB has not yet assigned a control number for the new collection of information contained in proposed Rule 3Cg-1 under the Exchange Act. 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.

A. Summary of Collection of Information

Proposed Rule 3Cg-1(a) under the Exchange Act would require a counterparty to a security-based swap transaction to meet the requirements of Exchange Act Section 3C(g)(1)(C) by delivering certain specified items of information to an SDR in the manner required by proposed Regulation SBSR.⁵⁵ Whenever the end-user clearing exception is invoked, ten additional items of information would be required to be produced. If the counterparty invoking the end-user clearing exception is also an issuer of securities under Exchange Act Section 12 or required to file periodic reports with the Commission pursuant to Exchange Act Section 15(d) then two additional items of information would also be required for a total of twelve items of information required to be produced. In either case, this additional information collected in the form and manner required by Regulation SBSR would

⁵⁵ See *supra*, notes 21-37 and accompanying text. Proposed Regulation SBSR would specify who reports security-based swap transactions, where such transactions are to be reported, what information is to be reported, and in what format. The information required under proposed Exchange Act Rule 3Cg-1 would be in addition to these requirements but would be delivered to the SDR by the Reporting Party in the same manner as required by proposed Regulation SBSR. Regulation SBSR contemplates that information may be delivered to the Commission directly in limited circumstances when an SDR is not available. When permitted by Regulation SBSR, such delivery would also meet the end-user clearing exception notice requirement.

serve as the official notice to the Commission of a security-based swap transaction that is made in reliance on the end-user clearing exception.⁵⁶

B. Proposed Use of Information

The collection of information in proposed Rule 3Cg-1(a) serves two purposes contemplated by the Dodd-Frank Act. First, the proposed Rule identifies what a party to a security-based swap transaction must do to satisfy the statutory requirement in Exchange Act 3C(g)(1)(C) to provide notice to the Commission if it invokes the end-user clearing exception.⁵⁷ Second, the Commission expects the empirical data collected under Rule 3Cg-1(a) will aid efforts to prevent abuse of the end-user clearing exception by allowing it to evaluate how the end-user clearing exception is being used, identify areas of potential concern and take prompt action to limit abuses in appropriate circumstances.⁵⁸

C. Respondents

The proposed collection of information in proposed Rule 3Cg-1(a) would apply to transactions that qualify for the end-user clearing exception under Exchange Act Section 3C(g)(1) where at least one of the parties to the security-based swap is not included in the definition of financial entity and is using the security-based swap to hedge or mitigate commercial risk. For an entity to determine whether it is not a financial entity and whether it is using the security-based swap transaction to hedge or mitigate commercial risk, the party must first make an assessment under the applicable definition of financial entity in Exchange Act Section 3C(g)(3)⁵⁹ and then consider whether the definition of hedging or mitigating

⁵⁶ See Pub. L. No. 111-203, § 763(a) (adding Exchange Act Section 3C(g)(1)(C)).

⁵⁷ Id.

⁵⁸ See Pub. L. No. 111-203, § 763(a) (adding Exchange Act Section 3C(g)(6)).

⁵⁹ See Pub. L. No. 111-203, § 763(a) (adding Exchange Act Section 3C(g)(3)(A)(i)-(viii)).

commercial risk in proposed Rule 3a67-4 applies to the security-based swap in question.⁶⁰ In addition, those entities that may be considered Identified Financial Institutions and therefore fall within the exemption under the proposed alternative language in Rule 3Cg-1(b) and (c) would be required to conduct an assessment under the proposed alternative language to determine whether they are entitled to elect to use the end-user clearing exception.

Based on the information currently available to the Commission, the Commission preliminarily estimates there are roughly 5,000 entities in the credit default swaps marketplace.⁶¹ The Commission preliminarily estimates that 1,000 of these entities regularly participate in the market for credit default swaps and other security-based swaps to an extent that may lead them to be reporting persons for purposes of proposed Regulation SBSR. In addition, the Commission estimates that there may be up to another 4,000 security-based swap counterparties⁶² that transact security-based swaps much less frequently.⁶³ The Commission preliminarily believes the 1,000 regular participants in the security-based swaps market are likely to be entities that are financial entities for purposes of the Dodd-Frank Act and would therefore not qualify for the end-user clearing exception, while the 4,000 less frequent counterparties to security-based swaps could, for purposes of the end-user clearing exception, be non-financial entities using security-based swaps to hedge or mitigate commercial risk. These 4,000 counterparties are also preliminarily believed by the Commission to include Identified Financial Institutions using security-based swaps.⁶⁴ Accordingly, with respect to

⁶⁰ See Definitions Proposing Release, supra note 3.

⁶¹ See Regulation SBSR Proposing Release, supra note 16.

⁶² Id.

⁶³ This figure is based on the 5,000 total participants in the security-based swap market minus the 1,000 of those participants that qualify as financial entities.

⁶⁴ For purposes of the discussion that follows, the term “non-financial entities” includes Identified Financial Institutions that would be excluded from the definition of

burdens applicable to all security-based swap counterparties that qualify for the end-user clearing exception, the Commission preliminarily believes that it is reasonable to use the figure of 4,000 respondents for purposes of estimating collection of information burdens under the PRA.

D. Total Initial and Annual Reporting and Recordkeeping Burdens

The Commission preliminarily believes the notification required by proposed Rule 3Cg-1⁶⁵ imposes a limited reporting or record keeping burden, because it references commonly used market practices when defining whether a security-based swap hedges or mitigates commercial risk⁶⁶ and utilizes the proposed reporting and recordkeeping mechanism under Rule 901 of Regulation SBSR to meet the notice requirement contemplated by Exchange Act Section 3C(g)(1)(C).⁶⁷ Under proposed Rule 3Cg-1 the additional reporting burden on the party invoking the end-user clearing exception would be to identify and document the commercial risk being hedged and the effectiveness of the proposed security-based swap as a hedge, and then complete ten or, at the most, twelve additional data points in a larger set of transaction information that would be required to be submitted to an SDR or the Commission under proposed Regulation SBSR. In addition, those entities that may be considered Identified Financial Institutions and therefore fall within the exemption under the proposed alternative language in Rule 3Cg-1(b) and (c) would be required to conduct an assessment under the proposed alternative language to determine whether they are entitled to elect to use the end-user clearing exception. The recordkeeping burden on the SDR would also be limited

“financial entity” in Exchange Act Section 3C(g)(3) in the event the proposed alternative language in Rules 3Cg-1(b) and (c) is adopted by the Commission.

⁶⁵ For purposes of the discussion that follows, references to proposed Rule 3Cg-1 are to proposed Rule 3Cg-1 including the alternative proposed rule text, unless otherwise noted.

⁶⁶ See Definitions Proposing Release, supra note 3.

⁶⁷ See Regulation SBSR Proposing Release, supra note 16.

to storing the additional ten or twelve data points in the larger set of transaction information separately required to be delivered pursuant to proposed Regulation SBSR.

1. Estimated Number of Security-Based Swap Transactions

According to publicly available data from the Depository Trust Clearing Corporation (“DTCC”) recently, there have been an average of approximately 20,000 new transactions in single-name credit default swap (“CDS”) transactions per day,⁶⁸ corresponding to a total number of CDS transactions of approximately 5,200,000 per year.⁶⁹ The Commission preliminarily believes that CDS represent 85% of all security-based swap transactions.⁷⁰

Accordingly, and to the extent that historical market activity is a reasonable predictor of future activity,⁷¹ the Commission preliminarily estimates that the total number of security-based swap transactions that would be subject to proposed Rule 3Cg-1 on an annual basis would be approximately 6,200,000.⁷²

⁶⁸ See, e.g., “Table 17: Summary of Weekly Transaction Activity,” http://www.dtcc.com/products/derivserv/data_table_iii.php (weekly data as updated by DTCC).

⁶⁹ Cf., Regulation SBSR Proposing Release, *supra* note 16, which used an estimate of 36,000 transactions in single name CDS transactions per day, referencing the same DTCC data. The difference is accounted for by differences in the scope of proposed Rule 3Cg-1 compared to proposed Regulation SBSR. Proposed Regulation SBSR encompasses both new transactions in security-based swaps and certain transactions occurring during the lifecycle of security-based swaps and therefore both of these elements are taken into account for purposes of its discussion of estimated burdens to be experienced by respondents as a result of the proposed regulation. Proposed Rule 3Cg-1 would only affect new transactions and therefore the estimated number of transactions used for purposes of the burden calculations is limited to new transactions.

⁷⁰ The Commission’s estimate is based on internal analysis of available security-based swap market data. The Commission is seeking comment about the overall size of the security-based swap market.

⁷¹ The Commission notes that regulation of the security-based swap markets, including by means of proposed Regulation SBSR and proposed Rule 3Cg-1, could impact market participant behavior.

⁷² This figure is based on the following: $(5,200,000 / 0.85) = 6,117,647$.

Based on publicly available information and consultation with industry sources, the Commission preliminarily believes that even the most active non-financial entity participants in the security-based swap market enter a relatively small number of new security-based swaps during any given period.⁷³ There are approximately 4,000 participants in the security-based swap marketplace that the Commission preliminarily believes could qualify for the end-user clearing exception and they represent approximately 80% of the total number of participants in the security-based swap market.⁷⁴ However, based on all information reviewed the Commission preliminarily estimates that non-financial entities account for 1% of all security-based swap transactions.⁷⁵

2. Reporting and Recordkeeping Burdens

To qualify for the end-user clearing exception proposed Rule 3Cg-1(a)(4) would require a non-financial entity to determine whether the terms of the proposed security-based swap and the manner in which it will be used satisfy the definition of hedging or mitigating commercial risk established by proposed Exchange Act Rule 3a67-4. To meet the

⁷³ Information from ISDA surveys relating to collateralized swap transactions indicate that the average number of outstanding OTC derivative trades for non-bank firms generally average just 1% of all transactions in the marketplace, and this figure includes transactions associated with certain parties not entitled to invoke the end-user clearing exception, such as certain major swap participants, commodity pools as defined in section 1a(10) of the Commodity Exchange Act and private funds as defined in section 202(a) of the Investment Advisers Act of 1940. See ISDA Collateral Committee, ISDA Feasibility Study: Extending Collateralized Portfolio Reconciliations (Dec. 18, 2009) (available at www.isda.org/c_and_a/pdf/ISDA-Portfolio-Reconciliation-Feasibility-Study.pdf). The Commission is seeking comment about the overall size of the security-based swap market.

⁷⁴ This 80% figure is based on the quotient of dividing the 4,000 participants that could qualify for the end-user clearing exception by the estimated 5,000 participants in the security-based swaps marketplace.

⁷⁵ See *supra* note 73. An estimate that non-financial entities account for 1% of security-based swap transactions will be used for purposes of the calculations that follow below.

requirements of the definition, subsection 3a67-4(a)(3) of proposed Rule 3a67-4 specifies that the counterparty to the security-based swap must identify and document one or more risks associated with the present or future conduct and management of the enterprise that are being reduced by the security-based swap and establish and document a method of assessing the effectiveness of the security-based swap as a hedge for such identified risks. In complying with proposed Rule 3a67-4, non-financial entities seeking to invoke the end-user clearing exception would need to establish and maintain an appropriate compliance mechanism including the necessary professional, legal, technical and administrative support to make and document the required assessment of hedging effectiveness.⁷⁶

The Commission preliminarily believes that counterparties transacting in security-based swaps to hedge commercial risks ordinarily will have established risk management or financial control systems in place for other reasons which will likely be adjusted to accommodate the requirements of proposed Rule 3a67-4(a)(3).⁷⁷ Accordingly, the Commission preliminarily estimates that designing and implementing an appropriate compliance and support program to estimate the hedging effectiveness of security-based swaps would impose an initial one time aggregate burden of approximately 44,000 hours,

⁷⁶ See Definitions Proposing Release, supra note 3.

⁷⁷ The Commission preliminarily believes some entities establish and follow these types of procedures so that their hedging transactions will qualify for hedge accounting treatment under generally accepted accounting principles, which require procedures similar to those contained in this proposed rule, or to meet other statutory requirements. While hedging relationships involving security-based swaps that qualify for the hedging or mitigating commercial risk exception within the proposed rule are not limited to those recognized as hedges for accounting purposes, we believe that entities that are not seeking hedge accounting treatment for their hedging transactions commonly identify and document their risk management activities as well as assess the effectiveness of those activities as a matter of good business practice. See also Item 305 of Regulation S-K, 17 CFR 229.305 (requiring SEC Filers to provide identified risk based disclosures relating to their activities in financial derivatives); Internal revenue Code Section 1259 (26 U.S.C. 1259) (recognizing hedging transactions as “constructive sales” of certain appreciated financial positions in specified circumstances).

corresponding to 11 burden hours for each reporting party, to adjust these established risk management or financial control systems to accommodate the requirements of proposed Rule 3a67-4.⁷⁸

The Commission preliminarily estimates that to gather the information required to notify the Commission that a security-based swap is being used to hedge or mitigate commercial risk purposes of proposed Rule 3Cg-1(a)(4) would impose an ongoing aggregate annual burden of approximately 62,000 burden hours for all respondents, which corresponds to an ongoing annual aggregate burden of approximately 16 burden hours for each respondent.⁷⁹ The Commission further preliminarily estimates that for a party to make an assessment required under proposed Rules 3Cg-1(b) and (c) of the proposed alternative rule text, if applicable, gather the remaining information required by proposed Rule 3Cg-1(a) and include the information in the security-based swap information delivered to an SDR as contemplated by proposed Regulation SBSR would impose an ongoing aggregate annual burden of approximately 31,000 burden hours for all respondents, which corresponds to an ongoing aggregate annual burden of approximately eight (8) burden hours for each respondent,⁸⁰ as

⁷⁸ This figure is based on the following: (Senior Business Analyst at 4 hours) + (Compliance Manager at 4 hours) + (Director of Compliance at 2 hours) + (Compliance Attorney at 1 hour) x (4000 respondents) = 44,000 burden hours; (44,000 burden hours per year) / (4000 respondents) = 11 burden hours per year per respondent.

⁷⁹ These figures are based on the following: (((Senior Business Analyst at 30 minutes) + (Compliance Manager at 30 minutes)) x (6,200,000 security-based swap transactions) x (1% transactions by parties eligible to invoke end-user clearing exception))) / 60 minutes = 62,000 burden hours per year; (62,000 burden hours per year) / 4,000 respondents = 15.5 burden hours per year per respondent.

⁸⁰ These figures are based on the following: ((Compliance Manager at 30 minutes) x (6,200,000 security-based swap transactions) x (1% transactions by parties eligible to invoke end-user clearing exception)) / 60 minutes = 31,000 burden hours per year; (31,000 burden hours per year) / 4,000 respondents = 7.75 burden hours per year per respondent.

each item of additional information is factual information known to the party invoking the end-user clearing exception and unlikely to vary from transaction to transaction.⁸¹

The Commission preliminarily believes that proposed Rule 3Cg-1 would impose minimal additional burdens on either Reporting Parties not using the end-user clearing exception themselves or on SDRs. Reporting Parties would be required by proposed Regulation SBSR to report transaction information relating to security-based swaps in a specified manner, and the Commission therefore preliminarily believes reporting a limited number of additional data elements to the SDR in an equivalent manner will have a de minimis effect on the burdens they experience. Similarly, the Commission preliminarily believes that for an SDR to receive and retain these additional data fields would effectively impose minimal additional burdens, as the information would be transmitted and received electronically and would then be stored as part of the existing transaction data already required under proposed Regulation SBSR.

For the reasons described above, the Commission preliminarily estimates that the initial one-time aggregate burden associated with proposed Rule 3Cg-1 would be 44,000 hours,

⁸¹ For example, the Commission preliminarily expects that a counterparty's status as a non-financial entity, a finance affiliate or an SEC Filer would change infrequently. The Commission understands the time required to collect this information is likely to vary depending on whether the particular security-based swap is documented using electronic or manual processes. Electronic processes allow for fields of required information to be populated automatically, substantially reducing the time required for transaction processing and compliance confirmation. A high percentage of electronically eligible security-based swaps are currently transacted using electronic processes. See ISDA, 2010 ISDA Operations Benchmarking Survey (available at http://www.isda.org/c_and_a/pdf/ISDA-Operations-Survey-2010.pdf) (showing that for credit derivatives 99% of transactions are eligible to be confirmed electronically and 98% of eligible transactions are confirmed electronically, while for equity derivatives 36% of transactions are eligible to be confirmed electronically and 81% of eligible transactions are confirmed electronically). The Commission preliminarily believes CDS transactions represent 85% of all security-based swap transactions. See supra note 69. The 30 minutes of time estimated to be required to produce the information to comply with proposed Rule 3Cg-1 (other than the hedging or mitigating commercial risk requirement) is intended to account for both manually and electronically processed transactions.

corresponding to 11 burden hours for each respondent,⁸² and the recurring aggregate annualized burden associated with proposed Rule 3Cg-1 would be 93,000 burden hours, which corresponds to 23 annual burden hours per respondent.⁸³

E. Collection of Information Is Mandatory

The collection of information under proposed Rule 3Cg-1 would be mandatory when a security-based swap counterparty chooses to invoke the end-user clearing exception.

F. Record Retention Period

Information collected pursuant to proposed Rule 3Cg-1 would be required to be retained for not less than five years. The Commission recently proposed to adopt rules to regulate the operation of SDRs, which include recordkeeping requirements for security-based swap transaction data reported to a registered SDR pursuant to proposed Regulation SBSR. Specifically, proposed Rule 13n-5(b)(5) would require registered SDRs to maintain the transaction data for not less than five years after the applicable security-based swap expires and historical positions and historical market values for not less than five years.⁸⁴ Exchange Act Section 13A(c)⁸⁵ requires each party to a non-cleared security-based swap to maintain records of the security-based swaps held by such party in the form required by the Commission, and Exchange Act Section 13A(d)⁸⁶ mandates that these records must be in a form not less comprehensive than required to be collected by SDRs. These records are available for inspection by the Commission and other specified authorities pursuant to Exchange Act

⁸² See supra note 78 and accompanying text.

⁸³ This figure is the sum of the calculations presented in notes 79 and 80 above. Summation differences between the final figures in the body of the text are due to the effects of rounding.

⁸⁴ See Regulation SDR Release, supra note 42. See also Pub. L. No. 111-203, § 763(i) (adding Exchange Act Section 13(n)(5)).

⁸⁵ See Pub. L. No. 111-203, § 766(a) (adding Exchange Act Section 13A(c)).

⁸⁶ See Pub. L. No. 111-203, § 766(a) (adding Exchange Act Section 13A(d)).

Section 13A(c)(2).⁸⁷ Accordingly, security-based swap transaction reports received by a registered SDR pursuant to proposed Rule 3Cg-1 and proposed Rule 901 of Regulation SBSR would be required to be retained for not less than five years.

G. Responses to Collection of Information Will Be Kept Confidential

A registered SDR would be under a general obligation to maintain the confidentiality of all information collected pursuant to proposed Rule 3Cg-1 and proposed Rule 901 of Regulation SBSR, subject to limited exceptions under proposed Regulation SDR.⁸⁸ The Commission also preliminarily believes that the additional information collected pursuant to proposed Rule 3Cg-1 would either fall under the exception to public dissemination contained in proposed Rule 902(c)(2), or otherwise should be excluded from the publicly-disseminated transaction report.⁸⁹ Accordingly, the Commission preliminarily believes the collection of information pursuant to proposed Rule 3Cg-1 would be confidential and would not be publicly available.

To the extent that the Commission receives confidential information pursuant this collection of information, such information would be kept confidential, subject to the provisions of the Freedom of Information Act (“FOIA”). Exemption 4 of FOIA provides an exemption for “trade secrets and commercial or financial information obtained from a person and privileged or confidential”⁹⁰ The information required to be submitted to the Commission under proposed Rule 3Cg-1 may contain proprietary financial information regarding security-based swap transactions and therefore be subject to protection from disclosure under Exemption 4 of the FOIA.

⁸⁷ See Pub. L. No. 111-203, § 766(a) (adding Exchange Act Section 13A(c)(2)).

⁸⁸ See Regulation SDR Release, supra note 42.

⁸⁹ See supra note 47 and accompanying text.

⁹⁰ 5 U.S.C. 552(b)(4).

H. Request for Comment

Pursuant to 44 U.S.C. 3505(c)(2)(B), the Commission solicits comment to:

1. Evaluate whether the proposed collection of information is necessary for the performance of the functions of the agency, including whether the information shall have practical utility;
2. Evaluate the accuracy of the agency's estimate of the burden of the proposed collection of information;
3. Enhance the quality, utility and clarity of the information to be collected;
and
4. Minimize the burden of collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements should direct them to the following persons: (1) Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, OMB, Room 3208, New Executive Office Building, Washington, DC 20503; and (2) Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090 with reference to File No. S7-43-10. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication, so a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication. The Commission has submitted the proposed collection of information to OMB for approval. Requests for the materials submitted to OMB by the Commission with regard to this collection of information should be in writing, refer to File No. S7-43-10, and be submitted to the Securities and Exchange Commission, Office of Investor Education and Advocacy, 100 F Street, NE, Washington, DC 20549-0213.

VI. Analysis of Costs and Benefits of the Proposed Rule

Proposed Rule 3Cg-1 implements the requirements of Exchange Act Section 3C(g) which provides an exception to the general requirement that a security-based swap must be cleared provided that one party to the security-based swap (1) is not a financial entity, (2) is using security-based swaps to hedge or mitigate commercial risk, and (3) notifies the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations associated with entering into non-cleared security-based swaps. The application of the end-user clearing exception is solely at the discretion of the counterparty to the security-based swap that meets the conditions of Exchange Act Section 3C(g)(1). Section 3C(g) specifically preserves the ability of counterparties qualifying for the end-user clearing exception to elect to clear a security-based swap when a clearing agency is available and to select the clearing agency at which the security-based swap will be cleared.

The purpose of mandatory clearing of security-based swap products is to centralize individual counterparty risks through a clearing agency acting as a central counterparty that distributes risk among the clearing agency's participants. When effective, centralization of counterparty risks through clearing reduces the likelihood that defaults propagate between counterparties by establishing and enforcing margin requirements based on risk-based models and parameters designed to limit the possibility that participants will be exposed to losses they cannot anticipate or control. Effective central clearing can also lessen the risk of capital flight from a dealer that becomes economically distressed. In particular, without central clearing, a solvency concern at a major dealer could be made worse by its counterparties quickly moving to other dealers.⁹¹

⁹¹ Darrell Duffie and Haoxiang Zhu, "Does a Central Clearing Counterparty Reduce Counterparty Risk?," (Stanford University, Working Paper, 2010) (available at <http://www.stanford.edu/~duffie/DuffieZhu.pdf>).

However, mandatory clearing of security-based swap products may also alter the burdens on non-financial end-users of derivatives relative to bilateral transactions, including direct costs associated with clearing fees and additional margin requirements and indirect costs associated with using derivatives less tailored to their individual business needs and thereby possibly affect their risk management practices.⁹² Exchange Act Section 3C(g) is designed to permit non-financial end-users that meet the specified conditions to elect not to centrally clear security-based swaps and retain flexibility to use both cleared and non-cleared security-based swaps in their risk management activities.

A. Notification to the Commission

Exchange Act Section 3C(g)(1)(C) requires a non-financial entity that uses security-based swaps to hedge or mitigate commercial risk to notify the Commission how it generally meets its financial obligations associated with non-cleared security-based swaps in order for the end-user clearing exception to be available.⁹³ Section 3C(g)(1)(C) contemplates that the Commission may establish the manner of notification and Exchange Act Section 3C(g)(6) provides that the Commission may prescribe such rules as may be necessary to prevent abuse of the end-user clearing exception. In accordance with Exchange Act Sections 3C(g)(1)(C) and 3C(g)(6), proposed Rule 3Cg-1(a) requires that notification be given to the Commission by delivering specified information to a registered SDR or the Commission with each security-based swap transaction that invokes the end-user clearing exception in the manner required by proposed new Regulation SBSR under the Exchange Act.⁹⁴

⁹² See supra note 11 and accompanying text.

⁹³ See Pub. L. No. 111-203, § 763(a) (adding Exchange Act Section 3C(g)(1)(c)).

⁹⁴ See Regulation SBSR Proposing Release, supra note 16.

1. Meeting Financial Obligations

Proposed Rule 3Cg-1(a)(5) requires the reporting of five specified items of information to satisfy the requirement under the Exchange Act Section 3C(g)(1)(C) for a non-financial entity invoking the end-user clearing exception to notify the Commission of “how it generally meets its financial obligations associated with non-cleared security-based swaps.” Because non-cleared security-based swaps are not subject to uniform margin and collateral requirements such as those established by clearing agencies, providing this information will be useful in monitoring the extent to which non-financial entities that invoke the end-user exception are taking steps to mitigate credit risks associated with security-based swaps.

In order to understand these potential risks, proposed Rule 3Cg-1(a)(5) requires a counterparty invoking the end-user clearing exception to provide notification regarding how they expect to meet their financial obligations associated with the security-based swap by reporting specified information to a registered security-based swap depository. In particular, an entity invoking the end-user clearing exception must indicate in the materials provided to the SDR whether it provides security for the performance of its financial obligations by (i) transferring assets directly to the security-based swap counterparty pursuant to a written credit support agreement; (ii) pledging collateral pursuant to a security arrangement not requiring the transfer of collateral to the security-based swap counterparty; (iii) receiving credit support from a third-party pursuant to a written guarantee; (iv) solely relying on its available financial resources; or (v) using other means.

a. Benefits

Requiring end-users to provide the Commission with general information regarding their arrangements to meet financial obligations associated with non-cleared security-based swaps may confer benefits by reducing concerns about the potential risks that these market

participants introduce into the financial markets in the absence of central clearing. The notification will also allow the Commission to understand how margining and other credit support practices may affect the prices and liquidity of security-based swaps, including by comparing and contrasting the trading costs of non-cleared security-based swaps with different credit support characteristics to each other and to security-based swaps that are cleared. Proposed Rule 3Cg-1(a)(5) also establishes a reporting option for “other means” that may be used to meet financial obligations associated with non-cleared security-based swaps providing the Commission with insight on the possible emergence of new and currently less common methods of mitigating financial risks associated with non-cleared security-based swaps that may arise as the market develops.

b. Costs

The Commission preliminarily estimates the costs associated with the notification required by Rule 3Cg-1(a)(5) will be limited, as the methods used to meet financial obligations associated with non-cleared security-based swaps are expected to be readily known to counterparties invoking the end-user clearing exception and unlikely to vary from transaction to transaction. The Commission preliminarily estimates there are 6,200,000 transactions in security-based swaps annually,⁹⁵ and that parties eligible to invoke the end-user clearing exception are counterparties in approximately 1% of all security-based swap transactions.⁹⁶ The Commission preliminarily estimates that to gather the information required for purposes of complying with proposed Rule 3Cg-1(a)(5) would impose an ongoing aggregate annual burden of approximately 15,500 burden hours for all respondents, which corresponds to a burden of

⁹⁵ See supra note 72 and accompanying text.

⁹⁶ Based on the information presented in note 73 above and the accompanying text, the Commission preliminarily estimates entities qualifying for the end-user exception are involved in roughly 1% of the estimated 6,200,000 annual security-based swap transactions, or 62,000 such transactions ((6,200,000 x 1%) = 62,000).

four (4) burden hours for each respondent.⁹⁷ Accordingly, applying an estimated hourly cost of \$316 for a compliance attorney to gather information about how the counterparty is meeting its Financial Notice Obligation,⁹⁸ the Commission preliminarily estimates proposed Rule 3Cg-1(a)(5) would result in an ongoing aggregate annual cost of \$4,900,000 to the entire end-user community, which corresponds to an average ongoing aggregate annual cost of \$1,225 per end-user.⁹⁹

2. Preventing Abuse of the End-User Clearing Exception

To aid the Commission's efforts to prevent abuse of the end-user clearing exception, proposed Rule 3Cg-1(a) requires notification of which of the counterparties to the security-based swap is invoking the end-user clearing exception, whether the counterparty invoking the exception is or is not a financial entity, whether the counterparty invoking the exception is a finance affiliate meeting the requirements of Exchange Act 3C(g)(4), whether the counterparty invoking the exception uses the security-based swap to hedge or mitigate commercial risk, and whether the counterparty invoking the exception is an SEC Filer. SEC Filers invoking the end-user clearing exception must provide their SEC Central Index Key number and confirm that an appropriate committee of the SEC Filer's board of directors or

⁹⁷ See supra note 80 and accompanying text. The estimates that follow are based on an assumption that the burden of complying with proposed Rule 3Cg-1(a)(5) is equivalent to the burden of complying with the other requirements of proposed Rule 3Cg-1, not including proposed Rule 3Cg-1(a)(4).

⁹⁸ The hourly rate for the compliance attorney is from SIFMA's Management & Professional Earnings in the Securities Industry 2009, modified by the Commission's staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. The remaining hourly rates for professionals used in this cost benefit analysis section are also derived from this source and modified in the same manner.

⁹⁹ These monetized costs are calculated as follows: (15 minutes/60 minutes per hour) x (\$316 dollars per hour) x (62,000 security-based swap transactions annually) = \$4,898,000 annually; (\$4,898,000 annually) / 4,000 respondents = \$1,225 average annually per respondent.

equivalent body has reviewed and approved the decision to enter into the security-based swap that is subject to the end-user clearing exception.

a. Benefits

Requiring notification of the above-listed information would provide regulators with information about the end-user that could help verify that the end-user clearing exception is being invoked by market participants appropriately. The requirement to identify which counterparty is invoking the end-user clearing exception is critical in making this determination. Similarly, since Exchange Act Section 3C(g) limits the availability of the end-user clearing exception to non-financial entities and counterparties hedging or the mitigating commercial risk, an affirmative notification to the Commission that these two factors are satisfied will help verify eligibility of the counterparty to invoke the exception. Given the nature of the specific provisions in the Exchange Act governing use of the end-user clearing exception by finance affiliates,¹⁰⁰ separately identifying transactions involving finance affiliates will also help to ensure these requirements are complied with over time.

The Commission preliminarily expects counterparties to security-based swaps invoking the end-user clearing exception would frequently be entities that have raised capital in public financial markets and are therefore regulated by the Commission.¹⁰¹ Entities registered under the Exchange Act Section 12 or required to file reports pursuant to the Exchange Act Section 15(d) are generally required to include a discussion of qualitative and quantitative elements of market risk in annual reports filed with the Commission, including a discussion of

¹⁰⁰ See Pub. L. No. 111-203, § 763(a) (adding Exchange Act Section 3C(g)(4)).

¹⁰¹ See Coalition for Derivatives End-Users comment (September 20, 2010), pursuant to Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act, Exchange Act Rel. No. 34-62,717, 75 Fed. Reg. 51,429 (Aug. 20, 2010).

how derivatives are used to manage risk.¹⁰² Notification by an end-user that it is subject to this requirement would allow regulators to review how frequently SEC Filers use the end-user clearing exception and better understand how security-based swaps are used by SEC Filers to hedge or mitigate commercial risk. The proposed requirement that SEC Filers invoking the end-user clearing exception provide the relevant Commission file number will allow the Commission to cross reference information received in connection with the end-user clearing exception with other Commission documents more easily. The additional proposed requirement that SEC Filers indicate whether a committee of the board of directors (or equivalent body) reviewed and approved the decision to enter into the security-based swap that is the subject of the end-user clearing exception would serve as confirmation that the requirements of Exchange Act Section 3C(i) applicable to SEC Filers were completed.

b. Costs

To qualify for the end-user clearing exception a non-financial entity would be required to determine whether the terms of the proposed security-based swap and the manner in which it will be used satisfy the definition of hedging or mitigating commercial risk established by proposed Exchange Act Rule 3a67-4. To meet the requirements of the definition, subsection 3a67-4(a)(3) of proposed Rule 3a67-4 specifies that the counterparty to the security-based swap must identify and document one or more risks associated with the present or future conduct and management of the enterprise and establish and document a method of assessing the effectiveness of the security-based swap as a hedge for such identified risks.

¹⁰² See Item 305 of Regulation S-K, 17 CFR 229.305. The Commission does not require companies with a public common equity float of less than \$75 million, or, if a company is unable to calculate public equity float, less than \$50 million in revenue in the last fiscal year to provide quantitative and qualitative disclosure about market risk as required of larger companies under Regulation S-K. See Smaller Reporting Company Regulatory Relief and Simplification, Securities Act Release No. 8876, Exchange Act Release No. 56994, Trust Indenture Act No. 2451 (Dec. 19, 2007), 73 FR 934 (Jan. 4, 2008).

The Commission preliminarily believes that non-financial entities seeking to invoke the end-user clearing exception would need to establish and maintain an appropriate compliance mechanism to meet the hedge or mitigate standard in proposed Rule 3a67-4 including the necessary professional, legal, technical and administrative support to make and document the required assessment of hedging effectiveness.¹⁰³ The Commission also preliminarily believes that counterparties transacting in security-based swaps to hedge commercial risks ordinarily will have established risk management systems in place for other reasons that can be adjusted to accommodate the requirements of proposed Rule 3Cg-1(a)(4) and proposed Rule 3a67-4.¹⁰⁴ Accordingly, the Commission preliminarily estimates that designing and implementing an appropriate compliance and support program to identify the risks being reduced and document the hedging effectiveness of security-based swaps would impose an initial one time initial aggregate cost of \$13,200,000 to all end-users, which corresponds to and an average initial cost of \$3300 per end-user.¹⁰⁵

The Commission expects there would also be ongoing costs associated with determining whether the hedging or mitigating commercial risk standard is met for each security-based swap transaction for which the end-user clearing exception is invoked. The Commission preliminarily estimates that to gather the information required for purposes of complying with proposed Rule 3a67-4 and proposed Rule 3Cg-1(a)(4) would impose an ongoing aggregate annual burden of approximately 62,000 burden hours for all respondents,

¹⁰³ See supra note 76 and accompanying text.

¹⁰⁴ See supra note 77 and accompanying text.

¹⁰⁵ This figure is based on the following: (Senior Business Analyst at 4 hours x \$234 per hour) + (Compliance Manager at 4 hours x \$294 per hour) + (Director of Compliance at 2 hours x \$426 per hour) + (Compliance Attorney at 1 hour x \$316 per hour) x (4000 respondents) = \$13,120,000; (\$13,120,000 initial aggregate cost) / (4000 respondents) = \$3,280 initial aggregate cost per respondent. See also supra note 78.

which corresponds to a burden of 16 burden hours for each respondent.¹⁰⁶ Assuming an hourly cost of \$234 per hour for a senior business analyst and \$294 per hour for a compliance manager to meet this requirement, proposed Rule 3Cg-1 would impose an annual cost of \$16,400,000 to all end-users and an average annual cost of \$4,100 dollars per end-user.¹⁰⁷

It was estimated that to make an assessment required under proposed Rules 3Cg-1(b) and (c) of the alternative proposed rule text, if applicable, gather the information required by Rule 3Cg-1(a) besides the information with respect to hedging or mitigating commercial risk, would require the additional work of a compliance manager.¹⁰⁸ That information is factual information a party is likely to have as a result of its existing compliance process and the information is unlikely to vary between transactions.¹⁰⁹ Costs associated with collecting requisite Financial Obligation Notice information required by proposed Rule 3Cg-1(a)(5) have already been discussed.¹¹⁰ Therefore, the information collection and reporting costs that remain to be accounted for are those not associated with either proposed Rules 3Cg-1(a)(4) or

¹⁰⁶ See supra note 79 and accompanying text. The estimates that follow are based on an assumption that the burden of complying with proposed Rule 3Cg-1(a)(5) is equivalent to the burden of complying with the requirements of proposed Rule 3Cg-1, not including proposed Rules 3Cg-1(a)(4), given the comparable nature of the information required.

¹⁰⁷ This figure is based on the following: ((Senior Business Analyst at 30 minutes x \$234 per hour) + (Compliance Manager at 30 minutes x \$294 per hour)) x ((6,200,000 security-based swap transactions) x (1% transactions by parties eligible to invoke end-user clearing exception)) = \$16,368,000 aggregate ongoing costs per year; (\$16,368,000 aggregate ongoing costs per year) / (4,000 respondents) = \$4,092 in aggregate ongoing costs per year per respondent. These figures do not include the costs associated with complying with proposed Rule 3Cg-1(a)(5), which are separately accounted for in note 99 above and the accompanying text, or costs associated with proposed Rule 3Cg-1 other than proposed Rules 3Cg-1(a)(4) and (5), which are separately accounted for in note 112 below and the accompanying text. See also supra note 79.

¹⁰⁸ See supra note 80 and accompanying text.

¹⁰⁹ See supra note 81.

¹¹⁰ See supra note 99 and accompanying text.

(5). The Commission preliminarily estimates that to gather the information required for purposes of complying with proposed Rule 3Cg-1 other than proposed Rules 3Cg-1(a)(4) and (5) would impose an ongoing aggregate annual burden of approximately 15,500 burden hours for all respondents, which corresponds to a burden of four (4) burden hours for each respondent.¹¹¹ These remaining costs are estimated to impose an annual cost of approximately \$4,600,000 on all respondents and an average annual cost of approximately \$1,200 per respondent.¹¹²

3. Form of Notice to the Commission

Exchange Act Section 3C(g)(1)(C) requires that a non-financial entity invoking the end-user clearing exception notify the Commission how it generally meets its financial obligations and gives the Commission discretion to establish how to collect this information. To satisfy this requirement, proposed Rule 3Cg-1(a) requires entities invoking the end-user clearing exception to deliver specified information to a registered SDR in the form and manner required for delivery of information specified under proposed Rule 901(d) of Regulation SBSR.¹¹³ Under this approach, rather than collecting information through a separate process established by the Commission for these purposes, the information delivered in compliance

¹¹¹ See supra note 80 and accompanying text. The estimates that follow are based on an assumption that the burden of complying with proposed Rule 3Cg-1(a)(5) is equivalent to the burden of complying with the requirements of proposed Rule 3Cg-1, not including proposed Rule 3Cg-1(a)(4), given the comparable nature of the information required.

¹¹² These monetized costs are calculated as follows: (15 minutes/60 minutes per hour) x (Compliance Manager at \$294 dollars per hour) x (62,000 security-based swap transactions annually) = \$4,557,000 annually; (\$4,557,000 dollars annually) / (4,000 respondents) = \$1,139 average annually per respondent. These figures do not include the costs associated with complying with proposed Rule 3Cg-1(a)(5), which are separately accounted for in note 99 above and the accompanying text, and the costs associated with complying with proposed Rule 3Cg-1(a)(4), which are separately accounted for in note 107 above and the accompanying text.

¹¹³ See supra notes 16-20 and accompanying text.

with the requirements of proposed Rule 3Cg-1(a) and proposed Regulation SBSR would serve as the notice to the Commission necessary to invoke the end-user clearing exception.

a. Benefits

Since all market participants must already report security-based swap transactions to a registered SDR, the Commission preliminarily believes that requiring participants invoking the end-user clearing exception to report the information required by proposed Rule 3Cg-1(a) as part of the transaction record should be a reliable and cost-effective method of collecting the information. Standardized reporting through a registered SDR also should increase transparency of the market to regulators by providing a full account of all transactions, which benefits market participants through increased confidence in the reliability and integrity of market transactions and activity. Furthermore, standardized reports should allow periodic auditing, which should be less costly to regulators than examining on a case-by-case basis possibly unstructured financial data submitted by entities invoking the exception to perform their regulatory duties.

b. Costs

Because the form of notice required by proposed Rule 3Cg-1(a) would use the existing reporting and recordkeeping mechanism for security-based swap transactions that is required by proposed Rule 901 of Regulation SBSR, the Commission preliminarily believes the form of notice required by proposed Rule 3Cg-1(a) would impose no additional burden on persons invoking the end-user clearing exception or SDRs other than those described above. The information required to be provided to the Commission pursuant to proposed Rule 3Cg-1(a) would be transmitted and received electronically and would be stored as part of the existing transaction materials that would be required to be prepared by proposed Regulation SBSR. The Commission preliminarily believes that information collected under proposed Rule 3Cg-1 will not be required to be publicly disseminated by the SDR, therefore the Commission

preliminarily believes there will be no costs associated with organizing and posting such information under the requirements for public dissemination of information proposed to be met by SDRs.¹¹⁴

4. Total Costs

In total, the Commission preliminarily estimates that proposed Rule 3Cg-1 would result in a one-time initial aggregate annualized cost of \$13,200,000, or \$3400 per covered entity¹¹⁵ and an ongoing aggregate annualized cost of \$25,900,000 for all covered entities, or approximately \$6,500 per covered entity.¹¹⁶

B. Request for Comments

The Commission requests comment on the costs and benefits of proposed Rule 3Cg-1 discussed above, as well as any costs and benefits not already described that could result. The Commission also requests data to quantify any potential costs and benefits. In addition, the Commission requests comment on the following:

- What other factors, if any, should the Commission consider to estimate the costs and benefits of proposed Rule 3Cg-1?
- Is there additional data the Commission should use to estimate the costs and benefits of proposed Rule 3Cg-1?
- Would proposed Rule 3Cg-1 create additional costs and benefits not discussed here?

¹¹⁴ See Regulation SBSR Proposing Release, supra note 16, proposed Rule 902; Regulation SDR Release, supra note 42, proposed Rule 13n-4(b)(6).

¹¹⁵ See supra note 105 and accompanying text.

¹¹⁶ These figures are based on the following: (\$4,900,000 associated with proposed Rule 3Cg-1(a)(5)) + (\$16,400,000 to comply with proposed Rule 3Cg-1(a)(4)) + (\$4,600,000 to comply with other notification requirements established by Rule 3Cg-1) = \$25,900,000; (\$25,900,000 aggregate annual ongoing costs) / (4000 covered entities) = \$6,475 per covered entity.

VII. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation. In addition to the protection of investors, Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider the impact of such rules on competition.¹¹⁷ Section 23(a)(2) also prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The Commission preliminarily believes that the Rule 3Cg-1 would impose limited competitive burdens on counterparties to security-based swaps qualifying for the end-user clearing exception and the financial markets generally because the overall costs associated with invoking the end-user clearing exception are limited. Using the proposed reporting structure of Regulation SBSR to satisfy the notice requirement necessary to invoke the end-user clearing exception would promote efficiency by allowing participants in the security-based swap market to use an existing process to accomplish an additional legislative requirement. Satisfaction of the notice requirement in this way is preliminarily believed by the Commission to promote efficiency by allowing participants to fully utilize the capabilities of SDRs being established to serve the security-based swaps market specifically rather than requiring them to use a separate filing process and data repository created for other purposes, such as the Commission's EDGAR system, or to establish new infrastructure or business processes to meet the statutory notice obligation.

¹¹⁷ See 15 U.S.C. 78w(a)(2).

The end-user clearing exception would be available to non-financial entities¹¹⁸ that use security-based swaps to hedge or mitigate commercial risk, but do not necessarily compete with each other. Such counterparties by definition would not transact in security-based swaps as their primary business, but rather as part of a risk management program related to their other commercial operations. Therefore, the Commission preliminarily expects the end-user clearing exception to have a neutral effect on competition. In addition, proposed Rule 3Cg-1 contains elements noted above intended to limit the potential for the end-user clearing exception to be abused, as contemplated by Exchange Act Section 3C(g)(6). Features of this kind are preliminarily expected by the Commission to limit the potential for counterparties that make use of the exception to avoid the mandatory clearing requirements to gain an unfair competitive advantage over their competitors.

Proposed Rule 3Cg-1 allows certain non-financial entities who use security-based swaps to hedge or mitigate commercial risk to bypass mandatory clearing, and instead engage in non-cleared security-based swap transactions even when equivalent products are available for clearing by a central counterparty. To the extent that proposed Rule 3Cg-1 is successful in separating appropriate uses of the end-user clearing exception from abusive ones, the proposed rule should help economic efficiency and capital formation by not imposing additional costs on end-users using security-based swaps to hedge or mitigate commercial risk and therefore not contributing to systemic risk in the financial system.

The Commission requests comment on the possible effects of proposed Rule 3Cg-1 on efficiency, competition, and capital formation. The Commission requests that commenters provide views and supporting information regarding any such effects. The Commission notes that such effects are difficult to quantify. The Commission seeks comment on possible

¹¹⁸ For purposes of the discussion that follows, the term “non-financial entities” includes Identified Financial Institutions that would be excluded from the definition of “financial entity” in Exchange Act Section 3C(g)(3) in the event the proposed alternative language in Rules 3Cg-1(b) and (c) is adopted by the Commission.

anti-competitive effects of the proposed Rule not already identified. The Commission also requests comment regarding the competitive effects of pursuing alternative regulatory approaches such as requiring notice to be provided through the Commission's EDGAR system. In addition, the Commission requests comment on how the other provisions of the Dodd-Frank Act, for which Commission rulemaking is required, will interact with and influence the competitive effects of the proposed Rule.

VIII. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 ("SBREFA") the Commission must advise the OMB whether the proposed regulation constitutes a "major" rule.¹¹⁹ Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in: (1) an annual effect on the economy of \$100 million or more (either in the form of an increase or a decrease); (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effect on competition, investment or innovation. If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review.

The Commission requests comment on the potential impact of proposed Rule 3Cg-1, on the economy on an annual basis, on the costs or prices for consumers or individual industries, and on competition, investment, or innovation. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

IX. Initial Regulatory Flexibility Act Certification

Section 603(a) of the Regulatory Flexibility Act¹²⁰ ("RFA") requires federal agencies, in promulgating rules, to make available for public comment an initial regulatory flexibility

¹¹⁹ See Pub. L. No. 104-121 (March 29, 1996), as amended by Pub. L. No. 110-28 (May 25, 2007).

¹²⁰ See Pub. L. No. 96-354, 94 Stat. 1164 (1980), as amended by SBREFA.

analysis that describes the impact of the proposed rule on small entities. Alternatively, section 605(b) of the RFA provides that this analysis shall not apply to any proposed rule or proposed rule amendment, if the head of the agency certifies that the rule if promulgated will not have a significant economic impact on a substantial number of small entities.

For purposes of Commission rulemaking in connection with the RFA, a small business includes an issuer or person, other than an investment company, that on the last day of its most recent fiscal year had total assets of \$5 million or less.¹²¹ Based on input from security-based swap market participants and its own information, the Commission preliminarily believes that currently there is very little use of security-based swaps by non-financial entities that would be eligible to use the end-user clearing exception¹²², and that the non-financial entities eligible to invoke the end-user clearing exception and transacting in security-based swaps would be corporations, partnerships and trusts with assets in excess of \$10 million.¹²³ On this basis, the Commission preliminarily believes that the number of security-based swap transactions involving a small entity as that term is defined for purposes of the RFA would be de minimis. Moreover, the Commission does not believe that any aspect of proposed Rule 3Cg-1 would be likely to alter the type of counterparties presently engaging in security-based transactions.

¹²¹ 17 CFR 230.157. See also 17 CFR 240.0-10(a).

¹²² See supra note 73 and accompanying text.

¹²³ The Commodity Futures Modernization Act of 2000 introduced the concept of “eligible contract participant” that the Commission preliminarily believes is a standard frequently referenced by market participants and which may act to limit the ability of non-financial entities with assets less than \$10 million to transact in security-based swaps. See Pub. L. No. 106-554, 114 Stat. 2763 (Dec. 21, 2000). See also Section 1(a)(18) of the Commodity Exchange Act (“CEA”), 7 U.S.C. 1a(18) as re-designated and amended by Section 721 of the Dodd-Frank Act (defining “eligible contract participant”). The Dodd-Frank Act added a definition of eligible contract participant to the Exchange Act which references the equivalent definition in the CEA, and created new standards to limit the ability of persons who are not eligible contract participants to transact in security-based swaps. See Pub. L. No. 111-203, § 761(a) (adding Exchange Act Section 3(a)(65)). See also Pub. L. No. 111-203, § 761(e) (adding Exchange Act Section 6(l)) (making it unlawful for any person to effect a transaction in a security-based swap for a person that is not an eligible contract participant, unless such transaction is conducted on a registered national securities exchange).

Therefore, the Commission preliminarily believes that proposed Rule 3Cg-1 would have a de minimis impact on small entities.

For the foregoing reasons, the Commission certifies that Rule 3Cg-1 would not have a significant economic impact on a substantial number of small entities for purposes of the RFA. The Commission encourages written comments regarding this certification. The Commission requests that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of the impact.

X. Statutory Basis and Text of Proposed Rule

Pursuant to the Exchange Act and particularly Section 3C thereof, the Commission proposes new Rule 3Cg-1, as set forth below, governing the exception to mandatory clearing of security-based swaps established by Exchange Act Section 3C(g).

List of Subjects in 17 CFR Part 240

Reporting and Recordkeeping Requirements, Securities.

Text of the Proposed Rule

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations, is proposed to be amended as follows.

PART 240 – GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for Part 240 is amended by adding the following citation in numerical order to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78o-4, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et. seq.; 18 U.S.C. 1350; and 12 U.S.C. 5221(e)(3), unless otherwise noted.

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Section 240.3Cg-1 is also issued under Pub. L. 111-203, §763, 124 Stat. 1841 (2010).

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2. Add §240.3Cg-1 to read as follows:

§ 240.3Cg-1 Notice to the Commission [and Financial Entity Exemption].

(a) A counterparty to a security-based swap that invokes the clearing exception under Section 3C(g)(1) of the Act (15 U.S.C. 78c-3(g)(1)) shall satisfy the requirements of Section 3C(g)(1)(C) of the Act (15 U.S.C. 78c-3(g)(1)(C)) by delivering or causing to be delivered the following additional information to a registered security-based swap data repository (or, if none is available, to the Commission) in the form and manner required for delivery of the information separately specified under §242.901(d) of Regulation SBSR of this chapter:

- (1) The identity of the counterparty relying on the clearing exception;
- (2) Whether the counterparty invoking the clearing exception is a “financial entity” as defined in Section 3C(g)(3) of the Act (15 U.S.C. 78c-3(g)(3));
- (3) Whether the counterparty invoking the clearing exception is a finance affiliate meeting the requirements described in Section 3C(g)(4) of the Act (15 U.S.C. 78c-3(g)(4));
- (4) Whether the security-based swap is used by the counterparty invoking the clearing exception to hedge or mitigate commercial risk as defined in §240.3a67-4 of this chapter;
- (5) Whether the counterparty invoking the clearing exception generally expects to meet its financial obligations associated with the security-based swap by using any of the following:
 - (i) A written credit support agreement;
 - (ii) A written agreement to pledge or segregate assets;
 - (iii) A written third-party guarantee;

(iv) Solely the counterparty's available financial resources; or

(v) Means other than those described in paragraphs (a)(5)(i), (ii), (iii) and (iv) of this section;

(6) Whether the counterparty invoking the clearing exception is an issuer of securities registered under Section 12 (15 U.S.C. 78l) or subject to reporting requirements pursuant to Section 15(d) (15 U.S.C. 78o(d)) of the Act, and if so:

(i) The relevant Commission Central Index Key number for the counterparty invoking the clearing exception; and

(ii) Whether an appropriate committee of the board of directors (or equivalent body) of the counterparty invoking the clearing exception has reviewed and approved the decision to enter into a security-based swap subject to the clearing exception.

Additional Rule Text under Consideration by the Commission

(b) For purposes of Section 3C(g)(1)(A) of the Act (15 U.S.C. 78c-3(g)(1)(A)), any person specified in paragraph (c) of this section that would be a financial entity within the meaning of the term in Section 3C(g)(3)(A) of the Act (15 U.S.C. 78c-3(g)(3)(A)) solely because of Section 3C(g)(3)(A)(viii) of the Act (15 U.S.C. 78c-3(g)(3)(A)(viii)) shall be exempt from the definition of financial entity.

(c) A person shall be eligible for the exemption in paragraph (b) of this section if such person:

(1) Is organized as a bank, as defined in Section 3(a)(6) of the Act (15 U.S.C. 78c), the deposits of which are insured by the Federal Deposit Insurance Corporation, a savings association, as defined in section 3(b) of the Federal Deposit Insurance Act (12 U.S.C. 1831), the deposits of which are insured by the Federal Deposit Insurance Corporation, a farm credit system institution chartered under the Farm Credit Act of 1971 (12 U.S.C. 2001), or an insured

Federal credit union or State-chartered credit union under the Federal Credit Union Act (12 U.S.C. 1752); and

(2) Has total assets of \$10,000,000,000 or less on the last day of the most recent fiscal year.

By the Commission.

Elizabeth M. Murphy
Secretary

Dated: December 15, 2010